# 7

# CHINA'S ECONOMIC SUCCESS AND ASIA'S FUTURE

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For two generations we have thought of China as a socialist system continually threatening to destabilize Asia and of Japan as a capitalist system whose dynamism and positive example stabilized Asia. That image was once accurate, and the reality behind it served U.S. strategic interests. Indeed, the Asian economic miracle, led by Japan, was the key to strategic victory in the Asian theater of the Cold War.

So important was the economic stabilization of Asia that is fair to say that the role of our military and of our military alliances in Asia was to provide a shield behind which superior economic growth consolidated the free world's position. Economic growth was the key to stabilization; democracy came later, facilitated by the emergence of secure, middle class societies. Behind our military shield, this consolidation occurred, and the economic and strategic successes of that consolidation proved so attractive that China effectively changed sides. Initially a devotee of "Politics in command" [over economics], a devotee of local economic self-reliance, an eloquent opponent of the market, and an advocate of regional political chaos, China later embraced economic growth as the key national strategy and acknowledged the market economy, globalization, and regional political stability as prerequisites of economic success.

## THE COMMITMENT TO STABILITY AND TO THE MARKET-ORIENTED SYSTEM

The importance of this commitment to stability must not be underestimated. In the 1960s, China was in the throes of cultural despair and impotent rage very similar to that of today's radical Islamic fundamentalists in the Middle East. As in the Middle East, a proud, ancient culture had found itself impoverished and humiliated. Its leaders and people raged against their fate. Much more than the Arab and Persian countries, China had tried many strategies to restore prosperity and national strength. In the Tung Ch'ih Restoration, it tried looking back to the glory days, as Islamic fundamentalists do today. In the Taiping Rebellion and the communist revolution, it tried looking abroad to Christianity and Marxism respectively. It tried right and left, warlordism and national unification. It tried

various ways of combining Eastern Culture and Western Technology. All these efforts failed. The response was a wild convulsion of effort and rage which, through the Great Leap Forward and the Cultural Revolution, killed tens of millions of Chinese and sponsored trouble all over the world. It is particularly poignant to reflect, in the aftermath of September 11, 2001, what the world would be like if China had persisted in this mode or even worsened; it would be Afghanistan times a thousand.

Instead, China serves as an ally in promoting a stable, market-oriented, globalized economic system. Its desire to join the World Trade Organization (WTO), the ultimate institution of the global capitalist order, is just one of many steps in the transformation of the former revolutionary power into a fundamentally conservative one. It is the same desire for order as a prerequisite of pursuing economic development that finds China functioning also as a political ally in the most crucial Asian situations. Notably, it helps to combat Afghan terror and, much more importantly, it has served since 1976 as an informal but fully committed ally in combating instability on the Korean peninsula and elsewhere. During much of the intervening period, China privately but emphatically supported the presence of U.S. bases in Asia as a guarantor of stability. (This has begun to change only recently, in the wake of Lee Teng-hui's assertions of Taiwan sovereignty and apparent U.S. support for them.)

Chinese support for the market-oriented system is crucial. With China in the WTO, and fully committed to its principles, the economic system promoted by the U.S. includes Europe, the U.S., Japan, China, and the smaller countries of Pacific Asia as firm allies; this coalition comprises the bulk of global production and virtually all of the really successful economies. Were China alienated from the system, the economic world would look quite different. The opposition, and potential opposition, to the pain of globalization's constant change and restructuring include: a combination of the anti-globalization movement in the West; an alienated Middle East; a hapless Russia that could go either way; a Japan that circumvents much of the intent of WTO rules through intricate forms of protectionism; and potentially India and other emerging countries that are grandfathered members of WTO but by no means really

committed to its principles.[1] If China were firmly a member of the opposition, the prospects of the globalizers would be shaky. With a (so far) extraordinarily successful China firmly committed to our side, we face primarily a ramshackle coalition of Naderites who haven't studied economics, backward unions, French farmers, and the like. The potential opposition has no large state to crystallize around, and we have in our favor a vitally important example of how an impoverished third world country with seemingly insuperable problems can succeed by accepting our rules.

## ASIAN FREE TRADE

In the developing world, the crucial support coalition for U.S. efforts to promote free trade has been the Asian miracle economies, especially the Association of Southeast Asian Nations (ASEAN) group of Southeast Asia. Without their unified support, much of the world's increased trade and prosperity might not have happened. But since the Asian crisis ASEAN has faltered. Indonesia, the principal leader, has been preoccupied with domestic economic crisis. The leader of Malaysia, Prime Minister Mahathir Mohammad, often speaks out for protectionist positions. The Philippine government generally drags its feet. More broadly, the whole organization is in disarray and an agreement to move toward an ASEAN free trade zone has therefore been in jeopardy. However, at the Asia-Pacific Economic Cooperation (APEC) meeting in November 2001, China stepped in and agreed on a free trade zone encompassing itself and ASEAN within this decade. Since China does not subsidize its agriculture, is the low-cost producer in many areas, and has agreed to a stricter WTO accession agreement than any other poor country, it now has a demonstrable interest in free trade. In fact, China has offered to lead by reducing its trade barriers prior to others doing so. The Chinese free trade proposal so far seems roughly parallel to the North American Free Trade Agreement (NAFTA) and could in principle some day merge with NAFTA, whereas Japan's "free trade" efforts are in principle contradictory to U.S. goals and NAFTA-like structures.

1 Countries that joined GATT automatically became members of WTO and were not subject to the new WTO disciplines.

Unlike China, Japan opposes movement toward free trade in agriculture and fiercely maintains a system that restricts its imports in other key areas as well. While China does not subsidize farmers, Japan subsidizes them to the tune of $4500 per farm acre per year. In advance of the November 2001 Doha WTO meeting, United States Trade Representative (USTR) Zoellick singled out Japan's stance on agriculture as uniquely obstinate. Japan's strategy is to sign a series of bilateral "free trade" agreements that exclude agriculture and preempt the movement toward real free trade. The first of these has already been negotiated with Singapore, which was chosen by Tokyo because Singapore has no agricultural sector. The negotiations were marked by serious and prolonged disagreement over country of origin rules because Japan is anxious that there be no loopholes that would allow agricultural products from Southeast Asia to compete with its farmers. Japan hopes to negotiate next with Hong Kong, which also has no agricultural sector, and gradually to create a series of bilateral agreements that will entrench agricultural protectionism in the name of free trade.[2] Negotiations with Mexico for a "free trade agreement" have bogged down because Japan refuses to accept Mexican agricultural exports. One of the great ideological ironies of the present day is that nominally socialist China has become an ally of the movement toward free trade while nominally capitalist Japan has remained, as it always has been, the biggest obstacle to real free trade among the wealthy economies. In fact, Japanese officials have been providing advice to ASEAN countries on how to increase protectionism in the process of reducing their tariffs. As we shall note below, this difference is not just in stated policy; there are now spectacular differences between the openness of China's economy and the relative protectionism of Japan's.

2 In April 2001 Japan started a minor trade war with China by imposing prohibitive tariffs on imports of mushrooms, leeks, and straw (for mats) from China. The imports in question were entirely by Japanese trading companies who had persuaded a group of particularly poor farmers in Shandong Province to change their crops to satisfy Japanese tastes in these items. The imports in question were small in scale and obviously of no strategic importance to the Japanese economy. The Japanese farmers received most of their income not from farming but from apartment buildings erected on subsidized agricultural land. (China retaliated with barriers on Japanese cars, air conditioners and mobile phones, but delayed implementation to give Tokyo time to back down.) This shows the extraordinary extent to which Japanese trade policy is vulnerable to tiny interest groups leveraging the agricultural cooperative movement.

## INTELLECTUAL PROPERTY: AN AREA OF CHARACTERISTICALLY RAPID CHANGES OF VIEW

The depth of Chinese commitment to the market system is frequently not apparent from outside. In the discussion below of what we shall call Phase Two, there will be a great deal more detail. But here it is worth taking one surprising example, namely intellectual property. Everyone who has bought copy software near the U.S. Embassy in Beijing, or who has observed the loud disputes of early 1990s over knock-off CDs, knows that we have a serious problem with China over intellectual property. That problem is common to most Pacific Asian countries, and it will persist for decades with most of them, including China, because of the practicalities of enforcement.[3] What is not clear from outside is that the Chinese have bought into the concept of intellectual property, as we in the West understand it, to a degree that is unusual in Asia. The reason is very straightforward. The Chinese authorities have discovered that their country has a vast amount of intellectual property that is worth protecting: famous mountain mineral waters, special drinks, ointments that purport to cure everything from hangnail to impotence to cancer, a huge variety of herbal medicines many of which actually work, and, increasingly, gizmos and software invented by Chinese scientists and entrepreneurs.

So long as markets were local, intellectual property issues did not really arise. A decade ago, the typical market for a Chinese beer was a circle marked by the distance a bicycle could go in the morning to deliver the beer and in the evening to return the empties. The village took care of its intellectual property without even knowing that there was such a thing. Now a national market is emerging, and the beer or the famous mountain spring water finds that the country is being covered by bottles of tap water with their famous label attached. This has led the government to take intellectual property seriously. As I

3 On the enduring nature of these intellectual property issues, it is worth noting that Taiwan has long been one of the largest problems. As this was being written, Philips initiated a patent infringement suit against three of Taiwan's largest electronics companies. Throughout this writer's professional life, Taiwan has been the world's largest producer of illegally copied books. Today, many, perhaps the majority, of the illegal knock-off factories in China are local subsidiaries of Hong Kong and Taiwan companies. While China is coming around proportionately faster than Taiwan did, one must expect decades of conflicts with Chinese companies over copying issues.

was writing this, a Chinese photographer named Ding Changlu sued the State Postal Bureau and the municipal government of Zhangjiakou for using one of his photographs without his permission and the Beijing First Intermediate Court awarded him damages.[4]

Suddenly intellectual property is an important subject locally, rather than an arrogant foreign imposition. Foreigners benefit from this; the government has closed over 100,00 shops in 2001 for selling pirated disks, but more importantly for the future the Chinese software industry itself expects to become profitable soon because the government is cracking down on piracy. The shift of the Beijing government itself away from pirated products is expected to give the Chinese software industry an additional RMB 100 million of revenue, and the broader shift of the Chinese government could multiply the market by three to five times.[5]

What is important is that, despite practical problems that will persist for decades, the Chinese authorities have accepted the concept wholeheartedly whereas in Thailand and India the authorities, and the center of gravity of national policy, remain largely committed to the view that technology is the common heritage of mankind. This reversal of the Chinese position, and of the relationship between their views and those of many traditional "capitalist" allies of the West, is historically sudden, so sudden that Western observers have largely missed it. However, it is very important not to miss it, because this Chinese buy-in is the key to one of the most remarkable role reversals of modern history, a role reversal we shall discuss further in the section on Phase Two below.

## PHASE ONE OF THE ASIAN MIRACLE: JAPAN LEADS, CHINA LAGS

From 1980 to 1995 China joined what I will call Phase One of the Asian economic miracle. This phase was led by Japan, and followed successively by the four tigers (South Korea, Taiwan, Hong Kong

4 Lehman Lee & Xu. China Lawyers. *China Intellectual Property Newsletter,* Volume 2, No. 13 (October 10, 2001), p. 1. Note also the phenomenon of an individual successfully suing the government, now a commonplace but unthinkable in communist China before about 1990.

5 Lehman Lee & Xu. China Lawyers. *China Intellectual Property Newsletter*, Volume 2, No 14 (October 15, 2001) , p. 2

and Singapore), then by the rest of ASEAN, and belatedly by China as the laggard. The rest of Asia is mostly intellectually converted but half-hearted (India) or less (Vietnam) in implementation.

The Phase One economic miracle had many variants, but they shared two kinds of common characteristics, one of which has been widely studied and one which has been neglected. The first set comprised what one might call the basic International Monetary Fund (IMF) package: getting market prices, employing positive real interest rates, permitting competition, allowing low-tariff imports of raw materials and intermediate goods, encouraging exports, using an exchange rate that would facilitate exports, and the like.

The second set comprised institutions designed for mobilization, initially for a specifically military-related mobilization of resources, subsequently for mobilization of economic resources in their own right. Most foreign analysts have forgotten that the Japanese economic system of today is just an evolutionary version of what Japanese economists call the 1940 System (a group of institutions created between 1937 and 1945 to mobilize and focus resources for war: lifetime employment; principal reliance on banks rather than capital markets to raise funds; limitations on shareholder rights; carefully coordinated government-business planning; government control over large portions of national capital flows; the channeling of those flows toward favored sectors and conglomerates; and the like). Many aspects of these institutions were specifically copied from similar institutions employed by Hitler and Stalin for the same purpose.[6]

Some of these institutions bore a resemblance to what the U.S. did under Roosevelt to ensure that resources needed for the war were available for that purpose. But Japan went much further and, whereas the Western democracies substantially dismantled their institutions of wartime mobilization, post-World War II Japan strengthened the mobilization system. The Japanese government called for more state controls in 1946, MacArthur for a replacement of entrepreneurial institutions with a more command-driven economy in 1947, and Joseph Dodge for wide-ranging state management of the market

6 Tetsuji Okazaki and Masahiro Okuno-Fujiwara, editors, *The Japanese Economic System and Its Historical Origins*, translated by Susan Herbert (New York: Oxford University Press, 1993), p. 3

together with powerful capital and trade controls in 1948. Dodge was responsible for the establishment of the Ministry of International Trade and Industry (MITI) and of the system whereby the Ministry of Finance today controls about half of government resources off-budget and largely free from political accountability.

The wartime mobilization system became the basic template for Northeast Asia. China, South Korea, Japan, and (partially) Taiwan shared the fundamental institutions: state control of the banks, state direction of capital toward favored firms and favored sectors, lifetime employment (not used in Taiwan), joint government-business planning, formal or informal state guarantees of the banks and of politically favored corporations against bankruptcy, protection of many sectors against imports, and the use of domestic monopolies and cartels to make key industries huge in record time.

The ideological lenses of the Cold War have obscured the common features of these systems. Japan created its system to build the industries of war (steel, ships, transport, construction...heavy industry in general) and, after the war, to rebuild them. Much of the fabulous success of postwar reconstruction was due to rebuilding existing companies with familiar technologies in the context of Korean War demand for precisely the products of those industries. What those very capital-intensive industries lacked was capital, and the institutions of mobilization shoveled vast amounts of capital to them. After the Korean War, the momentum of this capital-driven buildup carried on until 1975.

South Korea built up similar industries for similar reasons, and with similar institutions. A dozen (later 5 huge chaebol plus 25 very big ones) great state-sponsored companies worked closely with the government to plan every year's production and export targets. In the crucial early days, the government approved the details of every plan, licensed every import, directed the amount and interest rate of every major loan, and grudgingly provided every dollop of foreign exchange. The goal was to build, as quickly as possible, the sinews of a war economy that could defeat North Korea. China and Taiwan were focused on building the same industries with similar methods.

The economies of Japan and South Korea were nominally capitalist (at least after Park Chung Hee was partially disabused of

some of his very socialist predispositions). China and Taiwan were nominally socialist, with virtually identical political and economic structures, prior to the influence of U.S. economic advisors on Taiwan's economic policy. But they all shared an approach to banking, construction, steel, and the other core heavy industries that left them with more in common with each other than with the fragmented, entrepreneurial, relatively unmanaged U.S. economy. When I made research trips to Taiwan in the 1970s and early 1980s, I would carefully review the one-year plan, the three-year plan, the five-year plan, the ten-year plan, and the thirty-year plan. The demands of wartime mobilization and the demands of socialist ideology coincided almost perfectly in the way banking systems related to heavy industry and other favored sectors. This is why the countries of Northeast Asia face virtually identical problems today.

The trick of Phase One was to combine the basic features of socialist-style, wartime-style mobilization with the market reforms necessary to create an export-led takeoff. Having positive real interest rates encouraged savings and investment. Having market prices and competition encouraged efficient use of inputs. Reducing tariffs on inputs made it possible to produce exports at competitive prices. Abandoning overvalued currencies helped one's exports to be cheap, as did controlling labor union demands. Having a tough government that could impose order and reform in a time of ideological division, poverty, and low education limited instability and inflation. Encouraging competition in export industries, and gradually reducing tariffs, forced industry to become more and more competitive. Concentrating resources in export processing zones created extremely attractive areas for both foreign and domestic investors in countries that could not assure adequate power, water, transport, or for that matter labor and political stability throughout the entire national territories. The result was a win-win-win combination. The fastest growth rates in world history dispelled poverty, created the sinews of national strength, and stabilized politics both within countries and regionally. Eventually, rising education, economic openness, and social pluralism created freer societies and more democratic politics.

China was a latecomer to all this, and it benefited from the experiences of its predecessors. It started off worse than its

predecessors in almost every dimension, but, after 1980, implemented most of the Asian miracle package faster and more enthusiastically than its predecessors. It freed the farmers faster, freed prices faster, opened to foreign investors faster, and liberalized currency controls faster. The takeoff of local entrepreneurship outside the core socialist institutions was far faster in China than in Japan and Korea and probably at least as fast as Taiwan 40 years earlier. We often fail to see the greater speed of China's reforms because China started 30 years later and has been digging itself out of a much deeper hole.

One example will illustrate this Chinese enthusiasm for reform once they got started. The earlier Asian mobilization systems had often created dual economies. Korea and Taiwan created special export processing zones where things worked differently from the more backward parts of the economy. Japan liberalized the car and consumer electronics industries and a few others, creating a sub-economy quite different from the rest of a broader economy enmeshed in a web of protectionism and cartels. China went much, much further. It created many special economic zones in China proper. It created a "one-country-two systems" model to get full advantage of Hong Kong's and Macao's greater modernization. It created window companies to bridge between the capitalists outside and the socialists inside. It divided its best companies into unlisted dinosaur state enterprises and publicly listed more modern companies. It started dividing each big bank into good bank and bad bank. Recently China has even had two distinct labor markets within many of its larger companies. The result was two decades as the fastest growing economy in the world—just as Japan had earlier experienced two decades as the fastest growing economy in the world

There is one final aspect of Phase One worth noting here. While Japan led, others lagged far behind, often dangerously far. Korea and Taiwan were very reluctant to undertake many of the needed market opening and currency liberalization reforms. Thailand and Indonesia often lagged dangerously far behind, with elite political pressures for protectionism so great that Thailand often teetered on the brink of failure to grow adequately to overcome its domestic and international communist problems. Indeed, the reformers succeeded only to the extent that they were abetted by widespread fear of national takeover

by the communists. Where fear was limited by adequate international protection, most notably in the Philippines, reform basically didn't happen. This pattern of reluctance to reform, and reform only at the brink, recurs in Phase Two under different leadership.

## THE ASIAN CRISIS

In the 1990s, the financial mobilization systems of Pacific Asia ran aground. In retrospect, we now understand that the problems began to emerge when Japan's growth started to wind down after 1975. The problem with the wartime mobilization structure is that it only works for a limited time, with limited industries, under limited conditions.[7] When Japan was rebuilding its postwar steel industry, having the government squeeze personal consumption, grab control of much of the society's capital, and give it to a proven company like Nippon Steel, using proven organization and (modernized but mostly) proven technology, worked beautifully; all they lacked was capital, and the government was making up the shortfall. When such firms had fully recovered, having the government throw ever-larger amounts of money at them led to unbelievable misuse of funds. The money went to support projects that were not viable, to sustain divisions that were obsolete, and to create history's greatest financial bubbles. At the peak of the bubbles, Japan's stock market was 49% of all world stock markets, the land under the Emperor's Palace was worth all the land in California, and Tokyo real estate was worth as much as all the real estate in the United States.

The Japanese bubble collapsed in 1990, and so did a Taiwan stock market and real estate bubble. Other bubbles elsewhere in Asia popped intermittently—for instance Hong Kong real estate in 1994. By the mid-1990s, the whole region was experiencing bubbles—property in Japan, Hong Kong and Thailand; conglomerate overcapacity in South Korea, Indonesia, China and Japan. The nature of the bubbles varied, but they had a common provenance: government channeling of capital into favored sectors.

7 I have developed these themes more fully in William H. Overholt, "Japan: An Economy At War With Itself,:" *Foreign Affairs*, forthcoming, January-February 2002, and William H. Overholt, forthcoming "The Changing Face of Asia (tentative title)," *Survival*, Spring 2002

In retrospect, the signs were clear. For instance, Thai property companies were building numbers of apartments so vast that there was no prospect that the market could absorb them, and average earnings growth of listed Thai companies approached zero for three successive years after many years of double-digit growth. Such indicators show that capital was simply being wasted.

After Japan's bubble burst in 1990, it did none of the things that were necessary to remedy its problems. When the stock and property bubbles burst, whole sectors were effectively bankrupt. Aside from lost stock market profits, many companies that had prospered during the bubble years were shown to be incapable of survival in normal times. Their difficulties translated into potentially fatal problems for the banks, which had lent these companies money that now could not be repaid. The only way to resolve these problems is to do what the U.S. did in the 1980s: let stock market and property prices fall to their market level; let insolvent companies go bust; restructure the banks at great cost to their shareholders and top management; and, having absorbed the pain, enjoy the fruits of a now much more efficient economy. The U.S. experienced the pain in the 1980s and the gain in the 1990s.

Japan did the opposite of all these things. It propped up the stock market, propped up the property market, propped up the busted banks, and instructed the banks to coddle the insolvent companies. (Taiwan emulated these Japanese policies.) The consequence was a decade of Japanese economic stagnation and worsening problems. Taiwan was able to ride the electronics bubble until early 2000, but then went into a milder version of the same kind of economic funk as Japan.

Japan had another problem. The dual economy of Phase One, with cars and consumer electronics in the internationally competitive part and almost everything else protected by trade barriers and domestic cartels, turned out to be unsustainable. The inefficiency of construction and property and retail sales and banking and almost everything else, raised the costs for the few internationally competitive sectors and threatened to sink them. Therefore, the limited number of efficient companies began to flee overseas at a

startling rate. Quite aside from the bubbles of the financial sector, the real economy now faced a spiral of inefficiency.

By 1997, the problems of the Japanese banks were going critical. Banks must maintain a certain ratio of capital to assets (loans). As hundreds of billions of dollars of loans at home went sour, the capital of Japanese banks was being destroyed, so they had to contract their assets too. They didn't want to stop lending to Japanese companies, so they drastically reduced their overseas loans. As they withdrew money from one Asian country after another, the bubbles in those other countries popped. These mobilization economies had always been prone to bubbles, but for the first time all of the bubbles popped simultaneously. This became known as the Asian Crisis. Japanese banks' assets in Hong Kong dropped US$226 billion in 1997 and 1998.[8] They withdrew proportionate amounts from Singapore and large amounts from other Asian countries. These Japanese banks' assets were loans to countries in the region, and their precipitate withdrawal created crises in several Asian countries. Japanese economic mismanagement at home had become radically destabilizing for much of Asia.

This destabilization promises to get worse, possibly much worse, before it gets better. Although Japan has huge foreign exchange reserves, its government has now run up domestic liabilities that are rapidly becoming unsustainable. These are variously estimated at 350 to 450% of Gross Domestic Product (GDP), a level that is simply off the scale of experience in modern industrial democracies. The consensus of stock market analysts is that Japanese banks have 150 to 240 trillion yen ($1.2 to $2 trillion) of non-performing loans[9] and that the top 15 commercial banks would all be insolvent under a proper accounting (they are supposed to provide their first proper accounting by March 2002—banking D-Day). Unless Japan reforms drastically and quickly, the Asian crisis of 1997-'98 will be seen by historians as simply a preliminary angina attack foreshadowing the massive coronary thrombosis of sometime between 2002 and 2005. This time, the Japanese government itself would attract a risk

8 Hong Kong Monetary Authority, annual reports for 1999 and 1998, Annexes and Tables, Table J.

9 The lower number is from an Ernst & Young report dated November 2001, the latter from a Goldman Sachs report.

premium and would find itself in the same shape as the banks in the late 1990s. This time, the biggest total impact would be on the remaining place where Japanese institutions have huge pools of assets, namely the United States. South Korea would be hit proportionately the hardest of any country in the world.

## CHINA AS AN ISLAND OF STABILITY AND STIMULUS

As most of Asia was shaken by the Japanese financial earthquake, wrongly labeled a currency crisis because the most vivid manifestation of the crisis was a series of devaluations, one country stood out as a source of stability: China. China gained a great deal of credit at the time for holding its currency steady. My analysis indicates that it would not after all have made a great deal of economic difference if China had floated its currency. But it certainly avoided another round of confidence crisis at the time.[10]

One can debate how important it was to the region that China held its currency up under pressure. Perhaps it was mainly of symbolic and psychological benefit. But what will engender no debate is how helpful it has been that China has managed to sustain growth of 7 to 8% at a time when most of the region has been experiencing some combination of stagnation and recession. In 2001 even Hong Kong, Singapore, and Taiwan are in recession, but still China grows at 7% or so. As it grows, its rising imports sustain jobs throughout the region. Because China is only about one-quarter the size of the Japanese economy, even vigorous Chinese growth cannot completely offset the tsunamis of trouble coming from Japan (and in 2001 from the U.S.), but the direction of China's impact is clear; it is throwing life jackets to drowning neighbors. These life jackets are very substantial because China's growth rate is high and because its economy (see below) is much more open than Japan's. One of the more intriguing aspects of an economist's life in today's Asia is watching wealthy Hong Kong, long the region's most vigorous,

10 Some writers have made much of a Chinese "devaluation" in 1994 as a precursor of the Asian crisis. That understanding is incorrect. At the time China had a dual currency system, with 85% of foreign exchange trades at the market rate and about 15% at the official rate. China removed the official rate, thereby devaluing 15% of its currency. The overall devaluation was just a few percent. Other than that, China's currency had drifted gradually over many years from an artificially set rate toward its market value—the model of a responsible currency reform.

resilient economy, plead to Beijing for more and more help from a still-impoverished mainland.[11]

From 1996 to 2000, a time when Pacific Asia has been in great difficulty, China's imports from the region (Japan, Korea, Taiwan, ASEAN) grew from $76 billion to $122 billion, an increase of 61%. (Imports are an appropriate measure of the stimulation of jobs and production.) During this entire period, China ran a small trade deficit with its Pacific Asian neighbors.[12] This was an important help to countries struggling to recover from a period of distress.

## THE COMPETITION FOR FOREIGN INVESTMENT

These positive facts about China are frequently offset in the conventional wisdom by the perception that China is such a strong competitor, perhaps an unfair competitor, for investment that it is effectively sucking the fuel for growth out of its neighbors. Certainly, the rise of China's foreign direct investment (FDI) is spectacular—and the absolute numbers are much larger than those of its neighbors. China is now consistently the world's second largest FDI recipient after the United States and the United Kingdom, with more than U.S. $40 billion flowing in each year. The impression that this is coming at the expense of its neighbors gains credibility from the observable truths that Thailand is struggling to maintain its position in key industries in the face of Chinese competition and that numerous electronics companies are moving their operations from Malaysia to China.

The causes of such trends need to be verified carefully, however. Industrial location has always been dynamic in Asia. The textile industry migrated successively from the U.S. to Japan, from Japan to the four tigers, from the four tigers to ASEAN, and so forth, while all of them maintained dynamic growth. As wages rise in Korea, it is only natural that lower-level industries migrate to areas, until recently Indonesia, Malaysia, and Thailand, where wages are lower.

11 Specifically, the Hong Kong government has been pleading for the mainland to send more tourists and to allow mainland Chinese to invest in the Hong Kong stock market.

12 Data from CEIC, plus China Statistical Yearbook 1998 for 1997 ASEAN data that are missing from CEIC.

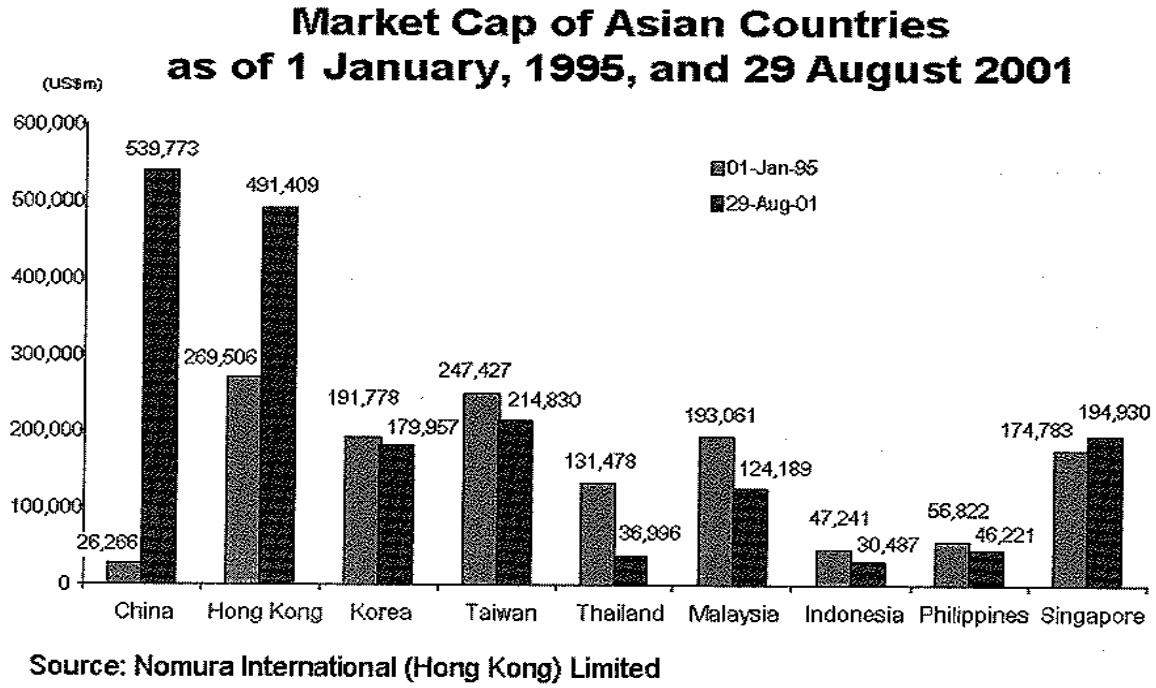
Given the rapid growth rates in Pacific Asia, these shifts take place quite rapidly. At the time, nobody accused Malaysia of taking unfair advantage of Korea. Since China has many of the poorest people, but is rapidly improving efficiency, it is natural for China to take its place on the ladder.

To get a sense of the dynamics, it is useful to look first at portfolio investment. The following chart shows the market capitalization of various Asian stock markets in 1995 and in mid-2001. China goes from nowhere to being the largest market, and Southeast Asian markets fail to grow or even contract.

It seems obvious what has happened here. The money has moved out of Korea, Thailand, Malaysia, Indonesia, and the Philippines, and has moved into China. But, in fact, that could not have happened. Foreigners were largely prohibited from investing in China's stock markets, and Chinese were largely prohibited from investing outside China. So, virtually all the increase in China's markets came from China itself.[13] The other markets declined because investors at home and abroad found them intrinsically unattractive.

The situation with foreign direct investment is more complicated, but the results are very similar. Start by comparing China with Japan. FDI into Japan in the 1990s was $39 billion, in China $309 billion. In this period, the Japanese economy was four times larger and was undergoing a financial squeeze that elsewhere would have created an enormous boom of mergers and acquisitions, a wide range of cheap assets, in short a field day for investors at home and abroad. Yet, it attracted only a tiny fraction of the FDI that China did. One conventional response to this is, well, China has cheap wages and a huge market. But the size of a market is measured by dollars, not by population, and Japan's is four times bigger than China's. And the U.S. did not need cheap wages to attract foreign direct investment. In the year 2000, FDI to the U.S. was $281 billion, to China $42 billion, and to Japan $29 billion. Most importantly, at this time when China seemed to be hogging FDI, Japan's inflow of FDI took off like an airplane.[14]

13 Foreigners were and are only allowed to invest in a very small proportion of shares called B-shares. During the period covered in the graph, B-shares were unpopular with foreigners. They rose dramatically in mid-2001 when the Chinese government for the first time allowed Chinese to invest in B-shares.




Source: Nomura International (Hong Kong) Limited

**Figure 7-1.**

There are two lessons here. First, Japan's FDI has not been low because somebody else has been stealing it but rather because Japan's institutions discourage foreign investment. Hostile takeovers are almost impossible. Substantial companies are usually members of groups that sustain their members even when the members are not viable. Regulators make life very difficult for foreign investors. A rejection of foreign investment in favor of domestic bank loans for financing companies is part of the core philosophy of the wartime mobilization system; it is precisely parallel to the nationalistic attitude toward foreign investment that so long retarded economic growth in Latin America and the Philippines. The takeoff of foreign investment in recent years has occurred because Japan's financial crisis has weakened those hostile institutions; it remains relatively low in the face of rapid growth because those institutions still exist.

Korea's experience has been similar. For most of its modern history, the country took a very nationalistic attitude toward foreign investment and structured its whole economy to encourage funding

14 Data for these graphs came from the CEIC/DRI database

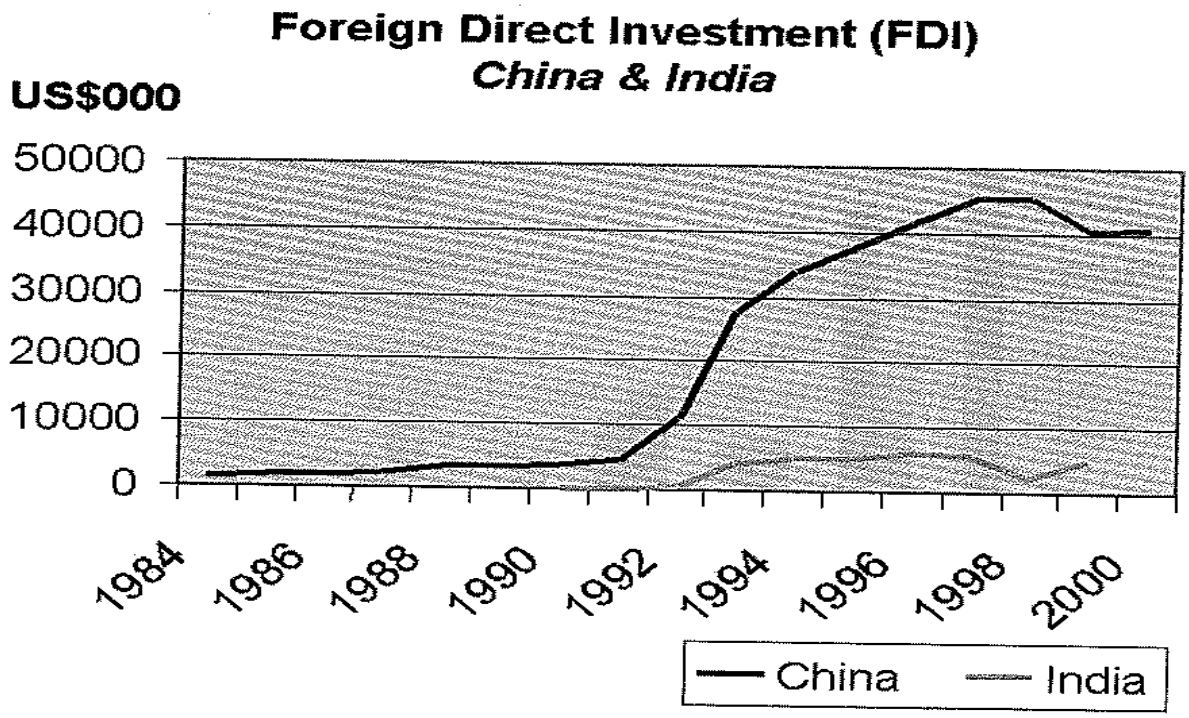



Figure 7-2.

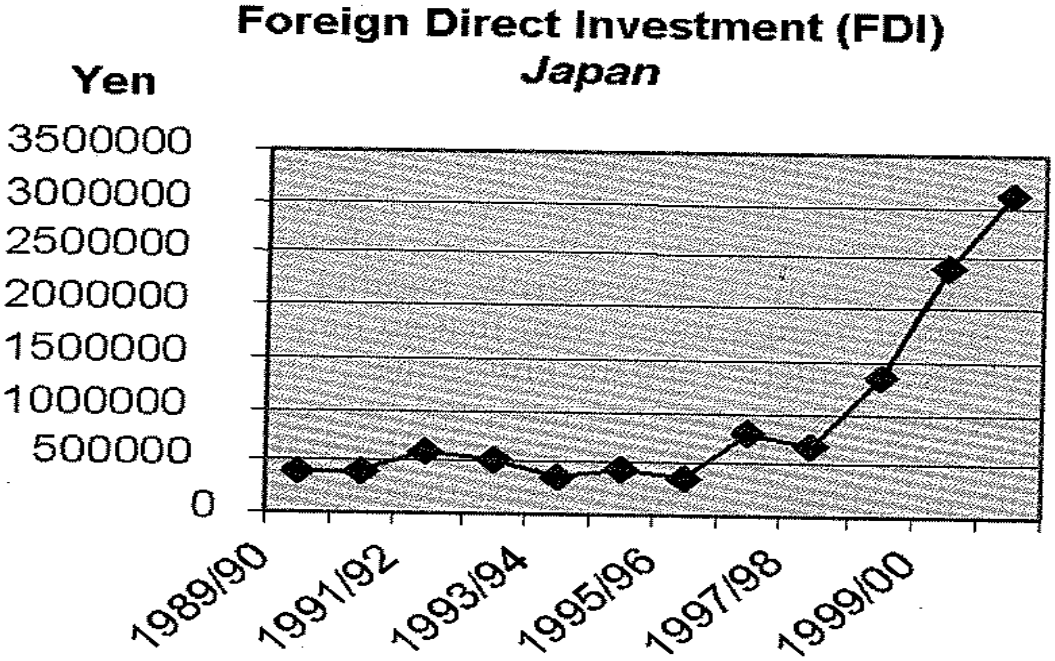



Figure 7-3.

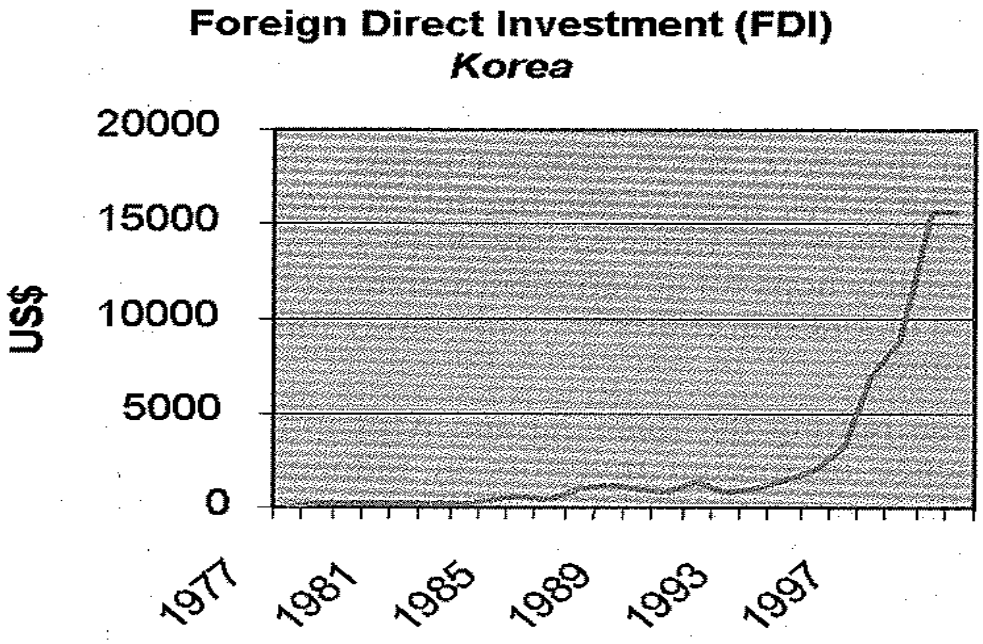



**Figure 7-4.**

through bank lending rather than through acceptance of foreign investment. Only as the banks got into serious trouble after 1997 did foreign direct investment become possible in scale, and even then it had to face hostility from managements, huge demonstrations by organized labor, resistance by government departments, and price demands that usually exceeded anything the market would be willing to pay. Nonetheless, faced with crisis Korea was able to rapidly expand FDI, and Korea's rapid reforms made investors interested in investing. Korean FDI also took off like an airplane, despite wages an order of magnitude higher than China's. So there is no shortage of FDI available to countries that decrease their hostility to foreign investors (Japan and Korea) and that undertake massive reforms, which make their economy more attractive to foreign investors (Korea and China). Foreign direct investment is not a zero-sum game. In fact, it is the shared experience of those of us in investment banking that the amounts of money looking for profitable homes far exceed the homes available.

Even India rose rapidly from $103 million to $5.2 billion between 1990 and 2000. That is the fastest growth rate of any substantial Asian economy, and it occurred during the strongest growth period of FDI in China.

So, what is going on in Southeast Asia? In Indonesia, there has been enormous violence and political instability. Riots, including mass arson, rape, and murder specifically directed against the largest foreign investors, the overseas Chinese, drove investors away.[15] Since the crisis, most of the big Indonesian companies, including ones that have the funds to pay, have stopped paying their debts, because they hope for government assistance and because Indonesian law and Indonesian courts will only rarely force an Indonesian to pay a foreigner.

Even putting the financial and Afghan crises aside, the recent experience of foreign investors in Indonesia has been horrific. Perhaps most notably, a consortium of seven leading phone companies, including ATT, invested with World Bank support in the Indonesian telephone company, Telkom. Once worth $18 billion, it is now worth $2 billion. Now the system is decaying, ATT and Ariawest are suing for $1.3 billion, and the foreigners have been threatened with violence.[16] Similarly, in one of a spate of such cases, Manulife, faced with the default of its 50% partner, the Dharmala Group, in an Indonesian insurance company, sought to buy, at a court-supervised auction, the shares of its partner from the government agency that had sequestered them. A representative of a company called Roman Gold showed up at the auction accompanied by police and, after alleging (falsely) that the shares being auctioned were fraudulent and that the real shares were owned by Roman Gold, had directors of the company arrested and threatened the Canadian President Director with arrest.

Throughout the recent period, foreign investors have been routinely deprived of their rights by the printing of fake shares, by violence or threats of violence, by bribery of the courts, and by courts

15 Ponder an investor reading the *Washington Post* on October 10, 2001, in an article by Rajiv Chandrasekharan entitled "Anti-U.S. Demonstrations Sweep Indonesia": "A spokesman for...the Islamic Defenders Front said it has begun compiling a list of the names, passport numbers and addresses of U.S. citizens in Indonesia. The spokesman, Ridwant Sodri, said the group had received the information from members who work for the immigration department. "We know where the Americans are," Sodri said. "We will make them leave."

16 See, inter alia, Paul Clement, "Bad Connections," *Asia Inc,* October 2001, pp. 22-23

that make decisions on nationalistic grounds rather than on the law. A November 2001 World Bank report said, "[T]here is a clear perception that actions by the authorities reflect a systematic bias against foreign investors and an unequal application of the law in favor of domestic debtors."[17] Thus, foreign investment has declined in Indonesia because of deterioration in the investment environment while FDI has increased spectacularly in Northeast Asia due to an improvement of the environment. There was a chance for some renewed foreign investment after Megawati came to power, but fundamentalist demonstrations and specific threats have ensured that investors will stay away. Even the vulture funds have fled Indonesia.

Thailand's problems are slightly subtler. Beginning in 1997, foreigners found that, as in Indonesia, Thai law makes it almost impossibly difficult for a creditor to collect from a debtor who does not want to pay. New bankruptcy laws touted as addressing this problem have in some ways made it worse, and new Prime Minister Thaksin has committed to weaken creditor rights even further. More strategically, all Asian countries including Thailand have to keep moving up the industrial ladder as their wages rise. They start with agriculture and textiles, then move up successively to, for instance, televisions, steel, computers and software. Like Thailand, other Asian countries including Japan, South Korea and Taiwan started by exporting primary products or basic manufactures such as textiles and toys, but as their wages rose, they graduated to higher and higher products so that today their principal exports are things like computer chips. They were able to do this because, from the earliest days of their postwar economic takeoffs, they emphasized educating their labor forces and elevated their people to among the most educated populations in the world—in some ways exceeding U.S. levels. Thailand, however, has remained a stubbornly elitist society and refused to educate more than a tiny elite. Only 14% of Thais graduate from high school, and people who haven't graduated from high school can't make computer chips. Thailand's development ladder has hit a low ceiling, and nothing other than improved education can move the ceiling up. Thaksin's first budget reduces real education expenditures. Key Thaksin economic policies have discouraged both foreign and domestic investment. For instance, shortly after taking

17 "Jakarta Receives Low Marks," *Asian Wall Street Journal*, November 6, 2001, p. 3

office he raised interest rates in the face of an extremely weak economy and fired the central bank governor for refusing to go along; the decision made investment more expensive and harmed the overall economy, but it was helpful for bank profits and for wealthy families whose businesses had large foreign debts. For politicians who make decisions like this, it is of course convenient to blame China. But it turns out there is nothing to blame for. Foreign direct investment in Thailand has risen rapidly in the last decade.

Malaysia has a moderately well-educated population and a large number of electronics factories, many of which are visibly moving to the area around Shanghai. Surely this results from unfair competition. Well, no. To see this, one can start by looking at the chart of stock market capitalization, an area where there is no competition with China. Malaysia's market cap has declined by 45%. Why? Malaysia imposed capital controls, making it difficult for investors to get their money out, and making it impossible to hedge currency risk. In a nationalistic move, it banned trading of its stocks in Singapore, thereby making trading of its shares less convenient. After the Asian crisis, it forced good companies to rescue bad ones, severely damaging the interests of shareholders in the good companies. For instance, the shares in a good bank widely held by foreigners declined 27% in one day after the government ordered it to merge with a weak bank. After Prime Minister Mahathir Mohammad and then-Deputy Prime Minister Anwar Ibrahim fell out, the companies associated with Anwar did very badly, leading investors to conclude that there was high political risk in joint ventures or other investments in the major Malaysian companies. These latter reasons are the same reasons why foreign direct investors have shied away from Malaysia recently. The movement of companies to lower-cost locations is a given. What is new and important in Malaysia is that, because of corporate governance problems, the flow of new direct investments is inadequate to keep Malaysia moving up-market the way it did in the past. Despite this, Malaysia's proportionate share of global foreign direct investment is 1.6 times its share of the world economy, whereas China's is 0.9 times.

In the Philippines, infrastructure is inadequate, government corruption makes investments unpredictable, the courts are

immensely interventionist and hostile to foreign investors, and there are major risks of Chinese being kidnapped in the north and of Americans and other foreigners being kidnapped in the south. The current government came to power by coup and there have been two attempts at counter-coups, all of which was unsettling for foreign investors. Conditions improved markedly under former President Ramos, and so did foreign investment, but the improvement reversed under Estrada and has not revived under Arroyo.

Singapore, where wage levels are nearly as high as the U.S., has been among the world's top three recipients of high tech foreign direct investment, precisely because it does not have the investment problems that occur elsewhere in Southeast Asia. Singapore's high and rising wages have always meant a rapid flow of companies to nearby Malaysia, where wages are lower and the infrastructure and business environment have until recently improved steadily. But Singapore has continued to upgrade itself and has not accused Malaysia of stealing its rightful FDI. The only way to accommodate one's own rising wages is to keep moving up the technology ladder.

The deterioration of Southeast Asia has immense strategic importance. ASEAN was the third world's most effective free-trade advocacy group. Pirates increasingly endanger the world's most crucial sea-lanes. The juggling of conflicting and unreasonable territorial claims by six countries, including China, has collapsed since Gus Dur fired the group under former Indonesian foreign minister Ali Alatas that had managed this problem.[18] All this is quite serious. But it is caused by home-grown problems, not by China.

Given the attention that India has received recently, it is an important case. Both China and India have populations of around a billion people and very low wages. In the year 2000, India received $5.2 billion of foreign direct investment whereas China received $42 billion. In percentage terms, FDI in India has increased extremely rapidly—by 5049% from 1990 to 2000—so it is hard to argue that other countries are holding it back. Why is it so low? The difference between China and India is basically one of attitude. Kentucky Fried

18 It is perhaps worth noting that China, by far the biggest of the disputants, has the most extensive unreasonable claims along with Taiwan's identical claims, Taiwan has been the most militarily aggressive in pushing its territorial claims, and Malaysia has been the most aggressive in colonizing islands economically.

Chicken (KFC) is welcomed everywhere in China, whereas it is harassed by everyone from the bureaucracy to protectionist interest groups to Hindu fundamentalist groups in India. (KFC has over 500 restaurants in China, is quite profitable, and is opening over 100 new ones per year. What counts to China is that it employs over 30,000 Chinese and in 14 years has purchased 240,000 tons of local Chinese chickens.[19]) Enron made the most prominent foreign investment in India, a large power plant with government guarantees, and the government did not pay its bills or honor the guarantees; there is not a single case in China of a major city or provincial government not honoring explicit written guarantees like this. The appropriate contrast is with Motorola in China, whose fortunes are closely and helpfully watched at Politburo level.

Perhaps the most telling case study of India-China contrasts is the phone industry. China encouraged competition, allowed substantial foreign involvements early, and focused on getting phones to its people. As a result, in the summer of 2001 China passed the United States as the country with the most mobile phones—about 120 million then, 136 million as the year 2001 closes. India pursued opposite policies, with the result that only 4 million Indians have mobile phones. Not surprisingly, the biggest Nokia factory, and the biggest mobile phone factory in the world, is going up in Beijing, in a huge, two-kilometer-long development that will include major operations of most of Nokia's key global suppliers. India does not get the foreign investment because its government focuses on protecting narrow bureaucratic and corporate interests rather than promoting the interests of the Indian people in having phones.

The United Nations Conference on Trade and Development (UNCTAD) computes an overall index of a country's share of world FDI benefits compared to its share of world GDP. A country that is getting its exact proportionate share of global FDI benefits would have an index number of 1.0. In the index, China comes out just below the average at 0.9. If one looks only at the most important component of the UCTAD index, share of global FDI compared with share of global GDP, China comes out just slightly above average at 1.1. China shares its broad ranking with Gabon, Moldova, Papua New Guinea, and Australia, and is edged out by countries like

19 "Number of China's KFC restaurants tops 500,"

Malaysia and Hungary. By comparison, the U.S. gets an overall ranking of 2.3, Germany 2.5, and the United Kingdom 3.8.[20] The UNCTAD does not adjust for the key Chinese peculiarity: at least 20% of FDI in China is not foreign. Chinese send their money out of China and bring it back as foreign investment in order to circumvent China's domestic tax and regulatory system. If one makes this adjustment, it is clear that China is receiving less than a proportionate share of global FDI. There is certainly nothing predatory or disproportionate about China's foreign direct investment numbers.

## THE SPECIAL CASES OF TAIWAN AND THE ELECTRONICS INDUSTRY

Taiwan is one of the most remarkable growth stories in history, but now it has serious problems that are a key part of the story of FDI in China. After Hong Kong, Taiwan is the second largest investor in China. One of the key facts about FDI into China is that the biggest portions are from other Chinese, another reason why China cannot be considered to be stealing FDI from its neighbors. The Taiwan economy has four parts:

- A Japanese-style banking system that now has the same problems as the Japanese banking system but less severe;
- Traditional export industries like clothing and shoes that have become uncompetitive as wages have risen but have been held in Taiwan by political restrictions limiting investment in the mainland;
- A wide range of big conglomerates controlled by the Kuomintang Party—the counterpart of China's state enterprises—many of which are in trouble but are not being reformed the way China's are; and
- A world-beating electronics industry that is the Asian analogue of Silicon Valley.

20 See United Nations Conference on Trade and Investment, World Investment Report 2001, pp. 254-255.

A year ago, three of the four parts were in trouble but were being held up by the huge growth and profits of the electronics industry. The global electronics bubble, focused around Silicon Valley, was partly a result of a technological revolution, but was also the result of Asian economic developments. Japanese financial mismanagement has flooded the world with cheap money for many years, and in the 1990s, this was particularly true. Japanese money, unable to earn a decent return at home, flooded into the U.S. and funded an otherwise unsustainable current account deficit, keeping interest rates low and money so plentiful that anyone with a persuasive smile and a not-completely-ridiculous business plan could get millions of dollars of venture capital. The associated economic boom, the longest in U.S. history, was also made possible by the fact that, unlike the situation in any other similar boom in American history, inflation stayed low. It stayed low in substantial part because inexpensive goods from China made it possible to satisfy demand without encountering shortages and raising prices. Aside from the U.S., the biggest beneficiary of this boom was Taiwan.

Now the electronics bubble has burst. Today, therefore, all four parts of the Taiwan economy are in trouble, and all are to some extent rushing to the mainland in a desperate effort to reduce their costs and save themselves. The Taiwan government's unwillingness to reform has greatly exacerbated this situation. Three years ago, Taiwan was in far better shape, and more structurally resilient, than South Korea; today that has reversed. The traditional industries must move or go bust. Likewise, the electronics industries must move or go bust, triggering a nascent migration that is likely to change history.

Interviews with Taiwanese business leaders on the mainland suggest that there are over 40,000 Taiwan companies operating on the mainland now, with some $70-100 billion U.S. dollars of Taiwanese investment. Surveys show that about 36% of Taiwan's large companies have invested in the mainland and only about 22% are not considering mainland investments.[21] In Shanghai alone, by the end of the year 2000 there were 3,833 Taiwanese investment projects with contracted investments of US$6 billion.[22] 500,000

21 Zhongguo Xinxi Bao, May 28, cited in "36% of Taiwan firms investing in mainland, http://www.chinaonline.com/industry/financial/NewsArchives/cs-protected/2001/June/B201( 12/16/2001)

Taiwanese are legally registered as working residents of China, and Taiwan business leaders on the mainland say there are probably more than 1 million Taiwanese working there. These figures mean that about 10% of the Taiwan workforce of 9.8 million is already working on the mainland, and that number will now escalate sharply. Taiwan business leaders on the mainland say that about 20% of these expatriates, or 1% of Taiwan's total population, are likely never to go back, and most of the mainland-based Taiwan executives we spoke with said they would try to resist any effort to make them return to Taiwan. They say that opportunities and challenges on the mainland are superior, and living conditions are cheaper and better. There must also be a certain attraction in being, typically, one of a dozen Taiwan managers of a factory that mainly employs thousands of Chinese women aged 18 to 24; not surprisingly, Taiwan wives are pushing to move to the mainland along with their husbands.

On that point, Taiwan statistics show that there are already 100,000 official Taiwan-mainland marriages, certainly a drastic underestimate of the actual number.[23] The implication of these marriage pressures is that a great many more Taiwanese will soon be living on the mainland, and there will be a great deal more mixing between Taiwanese and mainlanders on both sides of the Taiwan Strait.

Some Taiwan companies are even moving their headquarters to the mainland—so far, very few, but the number could grow. Taiwan's most popular snack food company, the Want Want Group, which specializes in rice crackers, has decided to move its headquarters to the mainland, where 28 of its factories and 90 percent of its sales are located. In announcing the decision, the group mentioned that, because the Taiwan government has delayed setting up direct trade, transport, and postal links with the mainland, it takes one to two days to travel from Taipei to Shanghai rather than three

22 "Taiwanese businesses invest US$6 billion in Shanghai," http://www.chinaonline.com/features/eyeontaiwan/currentnews/secure/C01103005.asp

23 The figure on marriages was reported by Taiwan's Mainland Affairs Council Vice Chairman Chen Ming-tong at a press conference on August 10, 2001, which was reprinted in MAC New Briefing No. 0243, August 13, 2001, p. 1. This raised enough social issues that the Taiwan government organized four camps on the theme of "Warm Taiwan Feeling and Happy Future Life—2001 Get–together for Mainland Spouses."

hours. The Taiwan factory, like the mainland operations, will become just a subsidiary of Singapore-listed Want Want Holdings. Because mainland tastes are the key to sales, all product research and development will move out of Taiwan[24].

The flood of Taiwan direct investment onto the mainland inexorably overrides the previous bars to direct trade and transport ties. In 1995, 72% of the Information Technology (IT) products manufactured by Taiwan companies were actually made in Taiwan, 14% on the mainland. In 2001, Nomura estimates only 35% will be made in Taiwan, 51% on the mainland.[25] This is a breathtaking shift. If the factories are going to move to the mainland, then Taiwan must in substantial part look to regional service functions as Hong Kong does. But who wants a regional service center that can't deal directly with the region's main market and main supplier, namely China?

Concerns about the sudden migration of Taiwan's manufacturing to the mainland must be balanced against the tremendous expansion of markets that Taiwan companies receive because of their access to the mainland. Taiwan companies dominate such sectors as snack foods and canned noodles. Walking down the streets of China's major cities, one constantly encounters Taiwan stores like Hang Ten athletic wear. Chinese department stores burgeon with Taiwan products. Taiwan runs a large trade surplus with the mainland because Taiwan is more of a protectionist toward mainland goods than vice versa. And Taiwan companies dominate U.S. markets in many sectors precisely because of access to cheap mainland labor and land. In fact, a large proportion of China's exports to the U.S. actually are the exports of Taiwan and Hong Kong companies. So Taiwan is getting rich from the mainland and expanding the reach of its industries even as it worries about the speed of the shift of manufacturing.

Economic integration will change Taiwan-mainland politics. The central argument of the Lee Teng-hui era was that 50 years of estrangement had alienated Chinese and Taiwan culture. With

24 "Strait Move: Taiwan's Want Want Group to relocate headquarters to Shanghai," , 5 October 2001

25 Powerpoint presentation by Kentaro Azuma, Nomura Securities, dated October 2001.

interchange on the current scale, that argument, once valid, will no longer apply to the same degree.[26] Of course, contact can bring friction, too, as seems to happen with Macedonians and Albanians. But at the cultural level what is happening between Taiwan and the mainland is clearly the opposite of estrangement. Shanghai is just a nicer place to live. Taiwanese expatriates are even forming a "Taiwan city" within the boundaries of Shanghai's new development area, Pudong. Beijing-Taipei politics so far is a separate issue, of course; neither government has learned how to modulate its tone. But the social foundation of the political relationship is shifting. It is intriguing to note that, in a recent survey by a Taiwan magazine, 45% of Taiwan business leaders indicated they would be interested to seek membership in the principal mainland legislative and political consultation bodies – the National Peoples Congress and the Chinese Peoples Political Consultative Conference – now that Jiang Zemin has opened Party membership and other political bodies to businesspeople.[27] It is important to note in this respect that Taiwan's business leaders, particularly in the traditional and electronics sectors, are not primarily from mainlander migrant families but rather are predominantly from native Taiwanese families.

As the Taiwan-mainland business relationship is transformed, the global electronics industry is transformed too. 90 percent of all the world's scanners are made by Taiwan companies, but of that 90 percent 85 percent come from mainland factories. The U.S. seems destined to remain the technological and conceptual leader of the electronics industry. China appears destined to produce most of the hardware. Korea and Taiwan will retain an ability to custom design technologies, to custom design production processes, and in general

26 The estrangement argument certainly did, and does, have significant validity. But it is also important not to overlook the deep cultural ties that have not been overridden. Taiwan companies by the hundreds have been going to the edge of bankruptcy in Taiwan rather than moving to Malaysia because they felt such strong cultural affinity with the mainland that they were only willing to consider mainland relocation sites. On a similar note, venture capital funds have discovered that, if they want to train management teams to take over operations on the mainland, they need to do it in Taiwan rather than Hong Kong, because the business cultures in Taiwan and the mainland are so similar whereas British rule for a century and a half has fundamentally altered the business culture in Hong Kong.

27 Zaobao.com, October 1, 2001, cited in "Survey: 45% of Taiwan businesspeople willing to join NPC, CPPCC," http://www.chinaonline.com/features/eyeontaiwan/currentnews/secure/C01100404.asp

to innovate rapidly, that mainland China can only aspire to when it has produced a much larger educational elite. In the meantime, all the basic technologies are moving to the mainland. The following chart shows the percentage of various Taiwan electronic products that come from mainland factories. [28]

Since virtually every maker of notebook PCs is planning to start manufacturing in China, that category, currently negligible, will be large within a few years. Quanta is completing a billion-dollar factory, and others are not far behind. Similarly, China has only a few chip factories, and only one that comes close to state of the art, but soon it will have many.

As of November 2001 it has become legal for foreign companies to list on the mainland's stock exchanges. This will give companies like Unilever the ability to raise money inexpensively in China. The biggest beneficiaries of this new opening will almost certainly be the Taiwan companies with large mainland operations. In addition to raising cheap money, a listing in Shanghai will provide these companies with local political color. While this will greatly benefit the companies, it will create a challenge for the Taiwan stock market. This in turn will pressure the Taiwan stock market to clean up its act. If the Taiwan stock market were as clean and transparent as Hong Kong's, then it would, like Hong Kong's, have a clear competitive advantage over the mainland's primitive and corrupt markets. But, while Taiwan is substantially ahead of the mainland, it is not far enough ahead to have Hong Kong's advantages.

China's prowess simply extends the process of Asian globalization that has been occurring for half a century. Americans have depended for their socks, shoes, and shirts successively on Japan, South Korea and Taiwan, Thailand and Malaysia, and now China. This process has made both Americans and Asians prosperous—Americans most prosperous of all. Not only is China successful in the commodity aspects of the socks business or the scanners business, but it has helped bring down U.S. costs, expand U.S. businesses faster, and enhance the global market share of U.S. companies. As long as both parties manage themselves well, the benefits are both strong and mutual. So far, the U.S. and China have

28 Chart prepared by Citigroup, Hong Kong

managed themselves very well indeed. Japan and Thailand have, for very similar political reasons, mismanaged themselves and slipped precariously on the ladder. Taiwan can go either way. It is in for a rough patch because of a period of mismanagement, but Japanese-style policies have not damaged Taiwan's economy as much as they have damaged Japan.

## THE COMPETITION FOR EXPORTS

Just as competition for FDI is easily exaggerated if one is unaware of the amounts of money looking for a home, so too the traditional view of Asian countries exports has failed to recognize how rapidly the world market expands. For decades now there have been predictions that Asian export-led growth would slam into a ceiling when the export market was exhausted. The original fear was that Japan would swamp all world markets. Then the NICs (later called, with greater political correctness, NIEs) created the same fears. At one point Foreign Policy magazine proclaimed in a major article, that there would be "No More NICs"[29] and the Council on Foreign Relations simultaneously published a study to the same effect.

At that time, I went around pointing out, aside from how rapidly world markets were expanding, the extraordinary diversity of Asian exports. Thailand, for instance, had created a significant industry using village women to paste together half-cashew nuts into much more valuable whole cashew nuts, and had discovered that it could conquer the market for leather seat covers for BMWs. And, to those of us who saw the early signs, it was clear that the NIC to end all NICs, namely China, was about to succeed the same way its predecessors had succeeded. The following decade saw the greatest development of the NIEs, including China, of any in history.

The market expands. Not only does the U.S. make more money making chips than it did making shoes, but also, after a while, LL Bean figured out how to make niftier and trendier shirts and shoes that sold even though they were made by high-priced Americans. Both the fear that one or another group of Asian countries were about

29 Broad, Robin & John Cavanagh: "No More NICs," Foreign Policy 72 (Fall 1988).

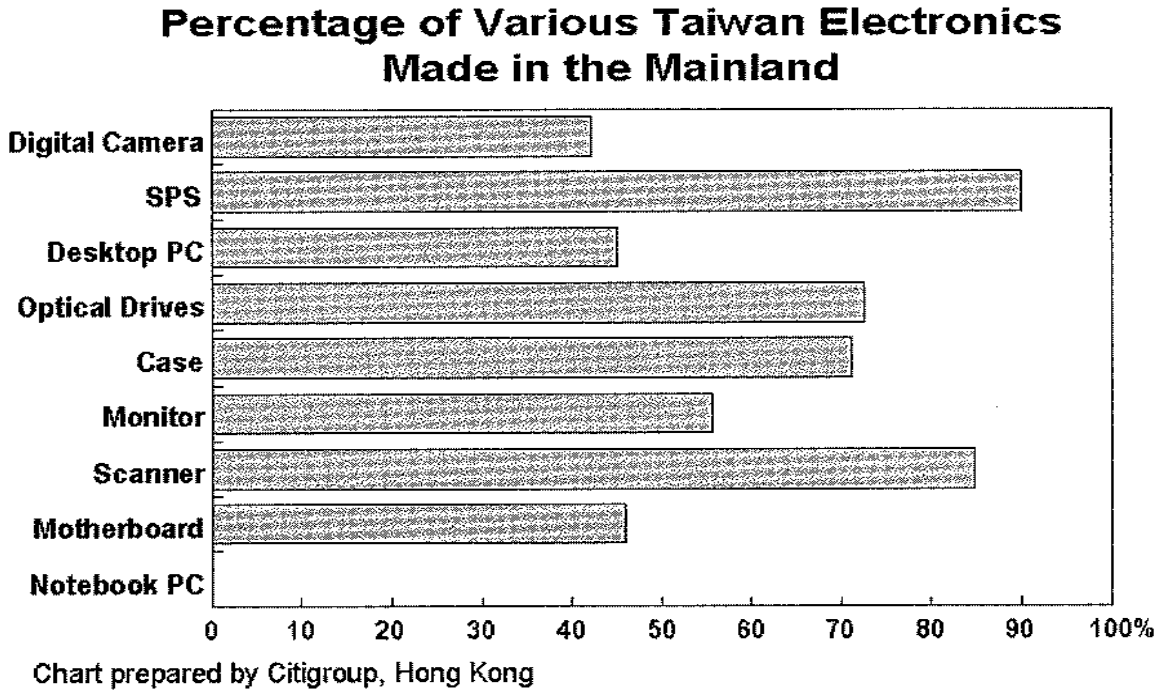



**Figure 7-5.**

to take over the world, and the fear or hope that Asia would exhaust the global market, have proved unfounded decade after decade.

Having said that, a chart of Asian exports raises issues about the relationship between China's success and other Asians' problems during the current difficult environment. [30] These issues are very similar, with a few extra wrinkles to the issues about foreign direct investment.

Several things seem to be going on simultaneously here. First, exports follow foreign investment, and China's foreign investment, which started later than the others and has found a warmer welcome, is rising relatively faster. Second, China's wages really are very low, as Japan's, Taiwan's, and Malaysia's once were, and other things being equal that means a rush of exporters of lower-end, labor-intensive goods to China. Third, China's extraordinary rate of reform means that other things are more than equal. Few exporters go to Bangladesh or Zaire for cheap wages; they go to China because the

30 The chart is from *China Investment Strategy Weekly Bulletin* #01.12 (October 18, 2001). P. 1

infrastructure is good, the labor skilled and disciplined, the business practices rapidly improving, and the attitude welcoming. Fourth, much of Asia became highly dependent on a single industry, electronics, and the electronics bubble has now burst, so for a time the expansion of the top end of the export chain has gone into reverse. Fifth, a remarkable proportion of Asian exports went to Japan or was dominated by Japanese companies, and with Japan in trouble, many of these local networks of Japanese companies aren't performing the way they once did. Sixth, since the end of the Cold War, the impetus of reform has been lost in Southeast Asia. In that region, only Singapore has plans for dramatic reform, and even there implementation is proceeding rather slowly. Taiwan so far is following Japan's resistance to reform. The only transformative reforms are occurring in South Korea, which, due to rapid reform and a highly educated population, is not likely to have problems maintaining its market share. This could be proved wrong if the post-Kim Dae Jung government fails to revive reforms.

Cold War fears kept the Asian reforms going, kept Korea emulating the painful market openings that had succeeded for Japan's consumer electronics industries, and kept Malaysia emulating what Korea was doing. With the end of the Cold War, the fear of losing everything subsided and much of the reformist impulse subsided too.

Here I need to indulge in a theoretical aside. People in my industry, investment banking, are conscious of the two motivating forces in the market, fear, and greed. Formal economics is almost all an elaboration of the rational consequences of greed. The economics of fear is much less developed, but fear has been the crucial backdrop to two decades of Asian reforms. Fear is why Cold War-era Korea and Thailand, facing immediate threats to their national existence, reformed decisively albeit reluctantly, and lack of fear is why the Philippines and Latin America failed to do so. (Filipinos were protected by U.S. bases and therefore didn't experience the level of fear that other Asian countries did.) Before the Asian crisis of 1997-'98, that fear had given way not just to complacency but even to an arrogance that Asian growth was always going to be superior to growth elsewhere, particularly to growth in what many Asians perceived as an incompetent U.S. that couldn't manage its budget

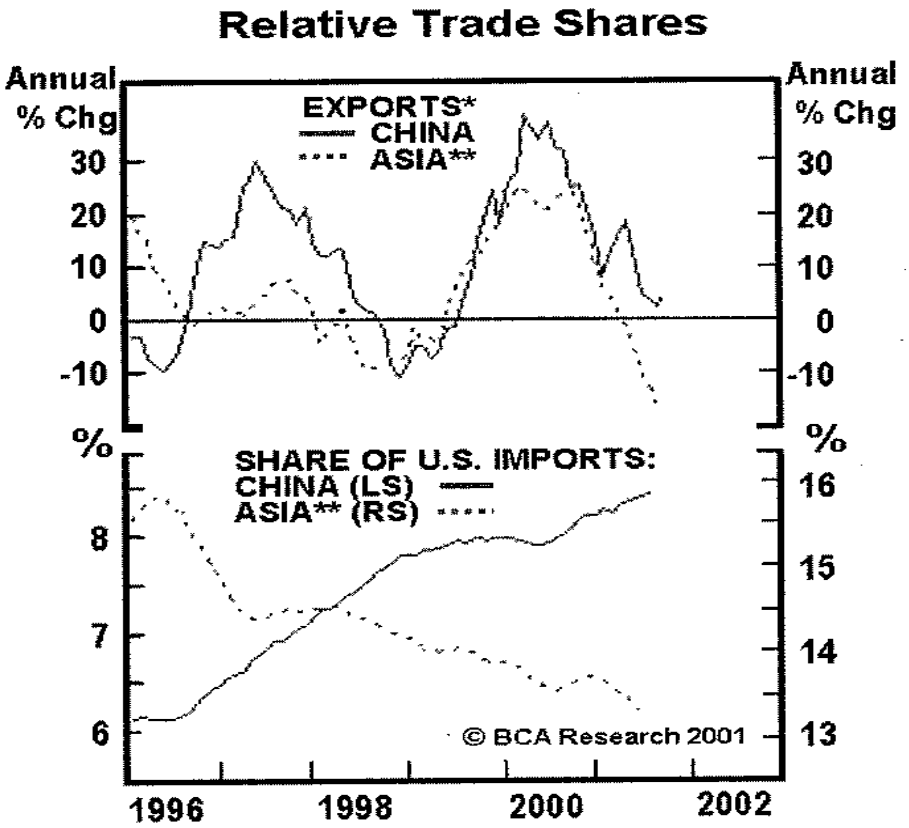



**Figure 7-6.**

deficits and couldn't organize a proper industrial policy. The message seemed to be that superior Asian growth was part of the genetic code.

With the Asian crisis, much of the arrogance vanished. Now the wolf at the door is not the communist guerrillas but globalized competition. Things happening in Mexico threaten Thai auto parts and assembly businesses. Developments in Silicon Valley could threaten Hyundai Electronics and force Samsung Electronics and Taiwan Semiconductor to run for their lives. But for most Asian governments the fear has not returned. The feeling that superiority is part of the genetic code has not yet been revised, despite awful performance of late. The age of Japanese-style mobilization has ended, but the implications are poorly understood by local politicians

who are still blaming their problems on evil speculators. Lacking its Cold War motivations, the U.S. is no longer pushing and subsidizing reform in the old way. A new generation of democratic leaders responds primarily to domestic pressure groups, not to strategic fears. Southeast Asia could get shocked back into reformist fervor, and Chinese competition could provide part of the shock. Or Southeast Asia could descend into the kind of un-fearful torpor, focused on domestic political pressures, that has marked most of Latin America and the Philippines for the past half-century.

China still has the fear. Its leaders saw what happened to the U.S.S.R. Its leaders have had to watch the banks' non-performing loans and the state enterprise losses the way Americans watch the NFL scores. Like South Korea's Park Chung Hee and Taiwan's Chiang Ching Kuo before them, they have had vivid reminders that they are not in office because people love them, not because they were elected, but rather because they perform in protecting the nation and delivering better standards of living. Any time they fail to perform, they will be gone. So far, they are performing.

The tech bust will reverse eventually. The U.S. and Europe will recover eventually, and the pie will begin to grow again. There will be plenty of opportunities for Southeast Asians to grow if they take advantage of them. The theory of comparative advantage and the postwar experience of Asia speak eloquently that no nation can have a comparative advantage in everything, not even the U.S. and certainly not China. In fact, China has an exceptional advantage in labor-intensive goods, which are usually at the low end of the technology spectrum, and an exceptional disadvantage in goods that cannot take advantage of its cheap labor.[31] The ongoing migration of industry out of Japan will provide Southeast Asia with many supply-side opportunities, and the expanding consumer market of China will provide vast new markets. Most countries on the Asian periphery have infrastructure and labor force education vastly superior to China. China is in fact becoming a big investor in certain Southeast Asian countries as it moves, like Americans and Japanese

31 The economist C.H. Kwan has reminded us that China's skewed advantage toward the low end has led to deterioration of its terms of trade and kept the currency from rising.

before, to take profit from producing behind Thai and Malaysian protectionist barriers.

China's strength will contribute to the potential for regional recovery. But that will not be enough. What is happening in Indonesia is a tragedy. Japan is on the cusp between reform and tragedy, currently leaning toward tragedy despite the forthright words of Prime Minister Koizumi. Taiwan, Thailand, and Malaysia don't face potential tragedy but they are not, or at least not yet, moving forward decisively. The good news is that decades of economic success based on reform have raised a group of superb economists to prominence, and success has given them credibility, so that the advantages of reform and liberalization are widely accepted and the way forward is reasonably clear. Nobody really doubts that Thailand needs to educate its people, give creditors some rights, and privatize its state enterprises. The bad news is that, lacking the old fears, entrenched interests are winning key battles against reform.

These countries have always been reluctant reformers, but they have had sufficient motivation to move forward when they had to, and they have had examples of success to emulate. Their current travails, and rising popular insistence on improved performance, may well provide the motivation. At the moment, they also have models of reform to emulate, but they are different countries: South Korea and China.

The hope for the region is that China's (and secondarily South Korea's) continued success will provide the kind of model for emulation that Japan provided in Phase One. What could cause collapse of Southeast Asia into an Asian Balkans would be demagogic local politicians dodging reform by painting their problems as all the fault of "unfair"competition from China. Even Japanese politicians have been tempted by such demagoguery, and they have recently tried such ploys as demanding that China revalue its currency upward and imposing tariffs on Chinese mushrooms and straw. Any encouragement of such a tactic for avoiding reform will prove disastrous for Asia.

## PHASE TWO: CHINA LEADS, JAPAN LAGS

Phase One of Asian economic development was the phase of the financial mobilization economies. Driven in varying degrees by the imperatives of wartime mobilization and of socialist ideology, these economies used state control of the banking sector to channel resources into large-scale industry and huge conglomerates and for a time created the most rapid economic growth rates that large populations have ever experienced in known human history. They then created some of the biggest financial bubbles in human history. In Phase One, Japan was the leader and other Asian economies to various degrees emulated Japan, particularly in using government ownership, control, or regulatory power to channel capital into favored sectors and companies. Phase One came crashing to an end with the problems of the Japanese banks in the late 1990s.

The game in Phase Two is to deal decisively with the residual problems of the bubble economies and to move decisively toward real market economies that respect market allocation of resources.

## CHINA AS A REFORMIST LEADER

China has distinguished itself above all others in the region in decisive reforms. First, instead of waiting for a crisis to hit, as Thailand, Korea and Indonesia did and as Japan is doing, China recognized by the early 1990s that it faced a potential crisis if it did not act on its major problems. Early on, it identified those major problems as inflation, state enterprise losses, bank non-performing loans, and corruption.

Upon becoming Prime Minister, Zhu Rongji enacted tough monetary and fiscal disciplines that quickly reduced inflation (retail price index) from a peak of 25% in November 1994 to zero in September 1997. It is now fluctuating around zero. This was particularly difficult politically, because both Chinese and Western analysts blamed inflation-fighting austerity as part of the cause of the disturbances of 1989. In the process of bringing inflation down, the government popped a property bubble that could easily have grown into the kind of problem that so devastated Thailand and Japan. (Even Hong Kong's politics have been sullen and embittered because

of the popping of the Patten-era property bubble and the associated 53% decline in property prices.)

Later, a boom in Shanghai nonetheless inflated a huge property bubble, with half of available space in Pudong unoccupied. There was widespread belief both that this bubble would pop in a devastating way and that the government would be stuck with the consequences. But the Shanghai government, where both Jiang Zemin and Zhu Rongji had previously been mayors, let the market work its way. Rents declined by as much as 80%, something that Japan and even Hong Kong have refused to allow, and the market began to clear. Today, the residential market in Shanghai has largely cleared and the office market is filling up rapidly.

Zhu also dealt decisively with the problem of moral hazard. In several countries, including most notably Indonesia and South Korea, financial institutions' belief that there was an explicit or implicit government guarantee behind loans to favored companies, and that there was an implicit IMF guarantee to get the countries out of any trouble, led to huge inflows of funds for companies and projects whose viability was not properly investigated. This has been widely judged a major cause of the scale of their subsequent crisis. In China this problem centered on the international trust and investment companies or ITICs. The most prestigious of them was CITIC, or China International Trust and Investment Company, and the most active was GITIC, the arm of the Guangdong provincial government. Guangdong had managed to grow 15% a year for almost two decades, something that no country-sized entity (60 million people in Guangdong) had ever managed to do in known economic history. Using comfort letters and verbal assurances but not explicit government guarantees, GITIC enticed foreign investors to lend it billions of dollars even though they knew that GITIC was increasingly focused on property speculation and that its officers were living lifestyles that could only be supported by corruption. (Visiting bankers were invariably picked up in GITIC executives' Mercedes 500s. Many of these executives had the blatant appearance and manner of crooks.) As deflation killed their property speculations, GITIC became insolvent.

Foreign bankers assumed that, as elsewhere, the government would bail out these powerful and favored friends. Zhu Rongji decided instead to let GITIC go bankrupt. The political uproar in Beijing threatened to damage Zhu's position fatally. The foreign bankers were furious. Third world governments were expected to bail out their corrupt businessmen; not to do so was unforgivable. Meanwhile it became clear that Beijing had been in the process of withdrawing even formal guarantees for even the most powerful companies like better-managed CITIC, China's largest and most prestigious company. For a long time, foreign bankers refused to provide new loans or to roll over old ones. China lost tens of billions of dollars of loans it would otherwise have had. For a while, Zhu's position looked precarious. But in the end even most foreign bankers agreed, very grudgingly, that he had done the right thing and decisively banished the problem of moral hazard. Since that time, other ITICs have quietly been closed and foreign bank lending has been premised primarily on sound projects and creditworthy companies. While domestic banks are still required to lend to an array of state enterprises, such lending has been severely curtailed, the vast majority of such companies have been sold off or sloughed off, and the remaining SOEs and collective sector firms have experienced drastic and painful reorganizations.

China addressed corruption, a problem that spread frighteningly fast and became omnipresent, through a series of campaigns that netted a number of high officials. But the primary thrust was to clean up the army. Like its Indonesian and Thai counterparts, the Chinese army had become heavily involved in business. The air force bottled Dr. Pepper soft drinks and many army officers were spending their energies marketing Baskin Robbins ice cream. Nationwide the army was the most prominent proprietor of hostess bars, karaoke lounges, and brothels. Outside key cities, the army set up checkpoints and would not let cars enter the city unless they paid for an army car wash. The navy manufactured cigarette-type boats to facilitate its business of stealing cars from Hong Kong, and the army stole huge cranes from Hong Kong's port to help with its construction projects. Everyone wanted the army as a partner, because it had good communications, good logistics, business sense, and no need to pay taxes.

When Jiang Zemin announced that the army was to be expelled from business within a year, most analysts, including this one, were totally skeptical. But a year later, the task had been largely accomplished. The army still owns a number of businesses, including defense contractors and telecoms, but it reluctantly gave up most of its businesses. By mid-1999, the effect on the economy was quite dramatic. For instance, the statistics showed a 40% annual rise in imports of food and beverages, a puzzling development because of what was then a weakening economy. It turned out that the Chinese people were not buying more food and beverages that year; rather, it was coming in through legal channels and getting counted for the first time, instead of being smuggled in by world history's biggest smuggler, the pre-1999 Chinese army. The expulsion of the army from most business also appears to have contributed substantially to another key development: the gradual rise of government revenues from only 10% of GDP to 14%, a vital margin in a nation with China's many problems and fissiparous tendencies. While such efforts have by no means ended China's corruption, which remains omnipresent, they have excised the most dangerous single cancer and a few other big ones.

China's other reform thrusts have been even more dramatic. The government decided that saving the banks required a cleanup of the banks' customers, the big state enterprises. Over the past five years, the state and collective enterprises have laid off more than 47 million people—equivalent to about two-thirds of the entire workforce of Japan. It has also sought to cut government employment in half, from 8 million officials to 4 million, and has largely completed the task at the central government level. And it has undertaken a vast reorganization of its stricken banking system—still stricken, but making rapid progress.

## CHINA AS A PHASE TWO LEADER

In addition to leading Asian reforms, China shows increasing signs of becoming Asia's leader into an era of globalization and truly market-oriented reforms. In each area, the pattern is the same: China is in a deeper hole than virtually anyone else, but it is digging out faster and has a vision of the future that is more distinctively modern. Its political courage in confronting frighteningly large problems is

providing it with a leadership role. This shows up in a wide range of areas.

China is creating a more open economy than most of its neighbors, particularly Japan. As we have noted, China welcomes more FDI in any single year than Japan did in the entire decade of the 1990s. Japan is changing, but China is changing faster. Chinese trade is 44% of GDP, whereas Japan's protectionism limits trade to only 15%.[32] (Japan's imports as a share of GDP are remarkably low compared to all other OECD members, because of its protectionism, and import limitations hobble export competitiveness. As an island economy, Japan should logically have a much higher trade dependence ratio than continental economies like the U.S. or China, but Japan's protectionism makes its ratio far lower.) In every major Chinese city, one can stand and watch streets full of Buicks and Jeeps and Mercedes Benzes and (mostly) Volkswagens—the opposite of Japan's and South Korea's relatively closed markets. Likewise, the difference is evident going through Customs in Tokyo and Beijing. In Tokyo, the Customs officer inspects every passport and opens enough bags that one can almost always see, in each Customs line, somebody's bags being opened. In Beijing, hundreds and hundreds of foreigners pass through the Customs area without even seeing a Customs inspector; I go for years of frequent visits without seeing anyone's bags opened.

Another indicator of a more open economy is China's attitude toward foreign involvement in its telecommunications industry. Very early, China accepted Motorola technology as its standard for cell phones. Japan on the other hand tried to create a distinctive standard specifically designed to exclude Motorola. The results have been important. Motorola followed up its initial billion-dollar investment in China with further large investments—profitable and successful ones—and because of this and other decisions the expansion of cell phones in China has reached the remarkable level

32 Year 2000 data from CEIC. Some analysts have suggested doing purchasing power parity adjustments on the denominator of this ratio, but not on the numerator, thereby lowering the Chinese ratio. This makes no sense, because China's export goods embody its cheap land and labor in a particularly concentrated fashion. If the fundamental source of the disparity were not Japanese protectionism, then Japan's trade:GDP ratio would not be so much lower than the U.S. and other OECD countries.

described earlier. Ironically, the huge trade battle that the U.S. had with Japan over the latter's efforts to restrict Motorola had the effect of opening up a competitive market in Japan and resulted in the emergence of one of Japan's most dynamic industries. The contrasting approaches of the two countries illuminate the degree to which in many key areas Chinese leaders focus on delivering service to the population and economic growth to the country whereas Japanese politicians have focused on protecting favored companies. Obviously, all countries seek to protect certain industries and countries, and China protects a wide range of industries, but its commitment to opening up far exceeds Japan's.

China is scouring the world for foreign best practice and attempting to import the best from a wide variety of foreign locations. In developing its Securities Law, for instance, it looked at Taiwan, Hong Kong, the U.S., London, Stockholm, and others. It is particularly open to imports from its fellow Chinese societies in Hong Kong and Taiwan. In the China Securities Regulatory Commission: the Chairman is a lawyer who practiced successfully in New York; the Deputy Chair, Laura Cha, previously held the same position in the Hong Kong Securities and Futures Commission; the principal advisor, Anthony Neo, was Hong Kong's toughest Chairman of the Securities and Futures Commission; and at least half a dozen of the top staffers did internships at the Hong Kong Monetary Authority. Beijing's central bank has been seeking to hire its deputy governor from Hong Kong's leading regulators. The draft regulations on foreign investment in China's stock markets propose to emulate Taiwan's Qualified Foreign Institutional Investor system. In all of this, Beijing's mentality is reminiscent of Japan in the early Meiji era, when it was choosing a British Navy, a German educational system, and so forth, but it is the opposite of Japan today.

Chinese openness extends to the social area. Chinese students are required to take seven years of English, and they really learn it; China has far more pupils studying English than the U.S. does. The top Chinese officials are increasingly fluent in English. (Premier Zhu Rongji, in every meeting I have attended, has always used a translator but has always made a point of correcting the translator on some fine point of English. He and President Jiang make jokes in English and sing English songs.) Students in Guangzhou begin English in

primary school, and college students in Shanghai's and Beijing's good universities speak much better English than their Hong Kong counterparts, despite a century and a half of British rule in Hong Kong. Chinese executives working overseas take their families with them. Their Japanese counterparts usually leave the families at home. Urban China is increasingly full of well-educated women leading companies, and successful women entrepreneurs dominate many of China's rural town and village enterprises, phenomena still very rare in Japan. Above all, the entire Chinese elite seeks to send its children abroad, mainly to the U.S., for their advanced education. It is difficult to find any comparable example of a major civilization entrusting the higher education of its elite children to a foreign power with a different ideology. In Japan, only recently did having a Harvard degree cease to carry a stigma. Despite its dictatorial politics, China is creating an exceptionally open, cosmopolitan society.

China has also created an exceptionally entrepreneurial society. A vast upwelling of peasant entrepreneurship created over 100 million rural jobs during the initial phase of reform. Likewise, employees of urban state enterprises who had little to do on their day jobs became street vendors, restaurant owners, baby-sitters, milk deliverers, and many others. A generation of increasingly liberated women started their own enterprises, some of which became very large and successful. Schoolteachers gave children eggs and paid for the schools with chickens raised by the children. The Philosophy Department of the Institute of Marxism-Leninism started a consulting business. Until 1998, army officer entrepreneurs engaged in just about every line of business that exists. Government offices adopted an entrepreneurial attitude. This resulted in corruption, both from bureaucrats starting businesses in the sectors they regulate and from officials' omnipresent efforts to get a piece of the action through imaginative fees, but it also resulted in a government sympathetic from top to bottom with the aspirations of entrepreneurs and foreign investors. While it is almost impossible to imagine Indian or Egyptian bureaucrats taking an entrepreneurial posture, such positive attitudes pervade China. This development of entrepreneurship in a Bolshevik society precisely parallels what happened in Taiwan a generation earlier. The explosion of entrepreneurship in response to

liberation of capital and labor from Phase One controls parallels what happened in South Korea after 1998. Today, the four most entrepreneurial economies in the world are the United States, Taiwan, mainland China, and Hong Kong. Lacking reform, Japan is stuck in Phase One and is so far missing the explosion of entrepreneurial activity that is occurring in its neighbors.

In key areas, China is moving toward transparency more quickly than its neighbors. Its stock market has begun introducing requirements for quarterly reporting, something the tycoons of Hong Kong have so far successfully resisted. In the spring of 2001, the CEO of Bank of China did a roadshow about the condition of his bank. He noted that during the previous year his bank had transferred an enormous volume of bad loans to an asset management company but that the bank's bad loans reported for 2001 remained at about the same level as early 2000. He said forthrightly that the report of the previous year had been misleading and that in the meantime the bank's management had figured out that the only way they would be able to fix the bank would be to come clean completely. He said that not only would Bank of China provide accurate numbers from now on but also they would open their books to review by Citibank. By way of contrast, in Japan and Taiwan not only do the banks drastically mis-report their condition but also they are encouraged to do so by government policy. Around the same time as the speech by the Bank of China executive, Japan was still trying to find a way to avoid or limit IMF scrutiny of its banks.

In this, and in all the other areas, it is important to emphasize that China remains in a deeper hole than its neighbors. Its banks are almost certainly in worse shape than Japan's. Its officials are almost as corrupt, except at the very top, as those of Thailand, Indonesia, and the Philippines, and are shamed by the relative honesty in Hong Kong, Taiwan, Singapore, and Japan. China's people are incomparably poorer. Its state enterprises are in worse shape than Japan's favored companies. But what impresses the neighbors is that China is addressing its problems decisively. What impresses the analyst is that, in the process, China is repeatedly embracing the standards of the modern market economy to a degree that most of the neighbors still shun. This quality of politically courageous decisiveness is creating an aura of regional leadership around China.

Because there is such a long lag, typically a decade, between changes in reality and changes in perception of that reality, these observations are sometimes shocking to the point of inspiring disbelief. But the facts are not really in dispute. Most visitors to China come away surprised at the level of open debate and transparency. Consider a recent comment from a former senior U.S. Treasury official about a conference in Beijing sponsored by the State Council:

Several dozen foreign businessmen and economists participated in the session along with a large number of ministers, other top officials and nongovernmental economists from China itself. The conference was stunning for its openness and candor. It was as freewheeling and spirited as any seminar at my Institute and any other American think tank or university: Chinese government ministers sharply criticized each other. The minister for economic restructuring berated the ministers who continue to run and defend the failing state enterprises. Nongovernmental economists stridently attacked the ministers and other government officials. One harangued the government for running an "approvals economy" that was bereft of real reform. Corruption, manipulation of data, the continued coddling of vested interests and other highly sensitive issues were openly discussed. Prominent government critics were accorded full opportunity to join the discussion. One, Mao Yushi of the Unirule Institute, has been publicly chastised and mildly disciplined for espousing political and economic reform. He was seated in the front row and participated fully in the debate.

There were several conferees from other parts of Asia. A high official from South Korea observed that such openness would be impossible in his own country. He and others doubted that it would even be countenanced in Japan. [33]

Of course, one must not overstate this openness and transparency. The Chinese media still may not call for a change of government and party leadership or say the wrong things about Taiwan. Foreign media and the internet remain heavily censored. But foreign newspapers are far less controlled than they were in Singapore just a

33 C. Fred Bergsten, "A Glimpse of the Other China," Institute for International Economics," http://www.iie.com/papers/bergsten0901.htm

few years ago, and in the economic arena it is remarkable that Chinese practice is pulling ahead of Japanese practice, and it is remarkable that desire to improve the economy has led to open, public debate about the most sensitive and divisive issues. Elsewhere in the third world, such areas are typically the last to open up. Once the decision has been made to go public about corruption, the horrible condition of the banks, the huge problems of unemployment, and the other most sensitive domestic issues, the spread of the basic principle of openness and discussion to less sensitive areas is much easier.

Returning to structural issues, China has embraced competition to a greater degree than many of its nominally capitalist neighbors. Two decades ago, China had one "godawful" airline. Now it has 31 quite acceptable airlines. That sudden expansion of competition could never have happened in Japan or Thailand.[34] Previously there was one telephone company, now six. Competition among them led to a collapse of profit margins, and consequently of the stock prices of China Unicom and China Mobile, in the summer of 2001. Not coincidentally, that collapse of profit margins coincided with the Chinese people having more mobile phones than any other population in the world. Such a policy approach was politically unthinkable in Japan, even when Japanese per capita incomes were already 25 times those of contemporary China. Only the Wall Street Journal publishes more articles extolling the virtues of competition than the leading newspapers controlled by the Communist Party of China.[35] This is ideologically weird, but it is reality.

China has also shifted from export-led growth to domestic-led growth at a relatively early phase of its development. Here is another important contrast with Japan. By the late 1970s, it was clear that Japan's squeezing of its consumers, protection of its domestic market, and reliance on export-led growth were bad for Japan and bad for Japan's trading partners. In 1986, the Japanese government

34 The fact that China has so many airlines cannot be explained away by its large population. Japan's economy is four times larger than China's, and GDP is the best measure of potential airline traffic. The average Chinese, making $853 per year, can't take a lot of airplane trips.

35 English translations appear from time to time in *China Daily*. See also *Beijing Review* (North American Edition) #43, the cover of which is headlined: "Breaking Monopoly: Telecom, power, railway and civil aviation sectors will be the major targets of reform."

acknowledged this and published its own Maekawa Plan recommending a shift to domestic-led growth. But LDP politics prevented implementation. At a far earlier stage of development, China decided in 1998 to shift to domestic-led growth. Today, net exports contribute minimally (or even negatively in 2001) to Chinese growth, and the economy's reliance on housing, cars, retail consumption, and infrastructure for growth has permitted it to grow over 7% in a year when even Hong Kong and Singapore are in recession. The Chinese shift also has important implications for future trade relations; over the long run, the deep structural trade problems that have bedeviled Japan's relations with all of its major trade partners will not be duplicated by China. (This beneficent long run effect will not, of course, help much in the next few years.)

Another critical area of economic progress results from what one might call political differentiation. In the process of reform, China and Japan both have faced a difficult problem. The ruling parties are both tied into groups of companies and industries in ways that hamper their freedom of management action. It has long been one of the clichés of the China skeptics that the Chinese Communist Party could never effectively reform the state enterprise sector, because its roots to that sector are its source of funding and of control over jobs. Similarly, Japan's LDP is tied to certain industries, notably, banking, construction, property, retail, and heavy industry, and to a variety of cartels, quotas and monopoly arrangements, in ways that more resemble an equity stake than a regulator's management of interest groups. When we think of Japan, we normally think of it as having a structure similar to our own, but the Democrats and Republicans are quite separate from the government itself and from their constituent interest groups. Not so in Japan and China, where the government, the ruling party, and the interest groups have been far less differentiated.

China's problem was worse than Japan's, but in China, the party made the tough decision to substantially separate itself from its state enterprise base. The vast majority of state enterprises have been sold. The biggest and most strategic ones have been retained but are being rigorously reformed and forced to adapt to market standards. The banks are being told to collect their loans and, if the companies can't be made viable, to sell them off at huge discounts or in limited

numbers to bankrupt them. In Japan by contrast, the LDP leaders have pushed one of the richest and most successful economies to the verge of economic debacle rather than cut themselves loose from their corporate base. For instance, a construction sector that already employs twice the fraction of the work force that other rich economies do (10% rather than 5%) is kept going through the largest subsidies in the history of the world. The banks are instructed to keep the favored companies alive. (Taiwan is doing the same thing with the big insolvent Kuomintang conglomerates.) China's Huarong, Asset Management Corporation, which holds bad assets from the banks, is trying to sell them off at an expected 60% discount to face value.[36] Japan's Resolution Collection Corporation, the counterpart of the U.S. Resolution Trust Corporation, buys up bad property assets from the banks but never sells them because it wants to protect the interests of the banks and the property industry.[37]

The differentiation of the ruling party from the government and from its constituent interest groups is a major challenge of modernization. China is passing the test, Japan so far flunking.

## CHINA AS A STRATEGIC LEADER

Living in Asia and visiting many countries, one thing quickly becomes clear: to the extent that any country is Asia's leader, China is. It is the leader because it is acknowledged as the leader. Despite China's recent progress, this is peculiar. China is still so poor compared to Japan, and compared to Korea or Taiwan, that it is difficult to compare with those wealthier societies. For instance, in

36 James Kynge, "China to auction state assets at a deep discount," Financial Times, October 30, 2001, p. 1. The article also provides useful insights on the difficulties investors in China face because of weak property rights, weak legal system and so forth. The actual discounts to investors have so far been even larger than Chinese officials anticipated.

37 In the 1980s the U.S. Resolution Trust Company took on the assets of the failed savings and loan companies and sold them promptly for whatever the market would pay. This deeply depressed the prices of real estate in parts of Texas and had parallel effects elsewhere, but the financial cleanup set the stage for the U.S. boom of the 1990s. The RCC approach sets Japan up for endless stagnation or worse. Another intriguing aspect of the RCC is that 53.3% of the assets it purchase from the banks were acquired for one Japanese yen each, meaning that the loans were completely hopeless but the banks and the government were unwilling to follow through and bankrupt the companies involved. It is likely that in a high proportion of cases this is because of yakuza (gangster) involvement as well as political sensitivities.

the year 2,000, using mid-year exchange rates, China's per capita GDP was $853 while South Korea's was $9,811 and Japan's was $38,000.

Similarly, China is weakest of the three Northeast Asian states militarily. A large army at home must never be mistaken for an ability to project force abroad. Both Japan and South Korea can project substantial force outside their borders. Although China has large ground forces and nuclear weapons that are useful in defending China against attack and in deterring foreign attacks, it cannot project any significant force onto its neighbors. Its navy cannot patrol the coast of Asia in the way that Japan's can. Gigantic China has a small fraction of the modern air capability that Japan, South Korea and Taiwan have.

Despite these weaknesses, China has become the region's acknowledged leader because it is perceived as having superior management. Because of this management, people explicitly or implicitly project its economic growth, and the corresponding growth of military potential, far into the future and draw exciting conclusions. In the shorter run, they conclude that, when facing problems, China will analyze them rationally and if necessary take difficult decisions in its national interest. Ironically, this development gives China the kind of leadership position based on economic management that Japan was acquiring in the 1980s.

It is important to understand and acknowledge this. At the same time, it is at least equally important to remember how backward China is. It is only a few years since people were projecting that Japan would take over the world, that it would dominate every modern industry and would buy up everything of value in the U.S. Today, projections of the China "threat" often seem to bring forward capabilities that China might have decades hence. Moreover, notwithstanding China's large population, this impoverished income level means that the Chinese economy is small. Harvard University economist Richard Cooper reminds us that the Chinese economy is about the size of Italy's and, if it achieves 15 years of continued rapid growth, will just then begin to approach France's size.[38]

38 Purchasing power parity adjustments are not done here either. Those adjustments provide a good measure of relative living standards, but not of relative international weight. For economic purposes the best measures of international weight are direct

There has been some interest recently in building up India as a strategic counterweight to China. At first glance, this makes some sense. The two countries possess similar-sized populations. India has had a more impressive navy, with for instance three carriers to China's none, and it has been far more assertive militarily with its neighbors, having had decisive involvement in the breakup of Pakistan, extensive military involvement in Sri Lanka, and a gradual assertion of hegemony over Nepal—none of which has any counterpart for China. All of this might seem to make India a potentially potent counterweight. But the numbers speak strongly as to the future of any India-China competition. China's economic growth rate is far higher than India's. In the year 2,000 China received $42 billion of foreign direct investment, India $5.2 billion. China exported $249.2 billion, India $44.3 billion. India's risk ratios run about three times as high as China's. Its separatist problems extend to some of its most important regions, its level of domestic violence is far higher, and it is constantly on the brink of major warfare with Pakistan. India is more obsessed with being considered a big power than China is, and it is far tougher on its neighbors than China, but its reach exceeds its grasp. China is becoming a geopolitical power through superior domestic economic management. More subtly, South Korea is likely to follow suit.

## THE RISKS

Japan's current problems, compared with its previous extraordinary prowess, remind us that it is intellectually risky to project trends into the future with straight lines.

While this paper has talked about the present, it has implicitly projected a future in which China is the regional leader in a variety of senses and Japan risks being sidelined for an extended period. There are substantial risks to such a projection. The good risk is that Japan might "get its act together" and become a source of stability rather than instability, providing an alternative pole of leadership rather than continuing to deteriorate into the sick man of Asia. To accomplish this will require will some great shock to the Japanese

indicators like trade and investment. For military purposes, unadjusted numbers are most appropriate because China purchases most of its sophisticated military equipment abroad at international prices.

system, followed by a substantial reorganization of the economy and politics. A shock is certainly coming; one can only hope that it comes early, that it entails few malevolent consequences, and that the ensuing reforms will come quickly. The whole world will be better off if Japan achieves an early revival.

The bad risk is that China could still fail. Its leadership during the past generation has displayed remarkable wisdom and courage. In terms of the population involved, its achievement is the equivalent of quadrupling the incomes of the former Soviet Union, Eastern Europe, Western Europe, the Middle East Africa, and South America. But China is far from being out of the woods. The horrible condition of its banks, many of its biggest enterprises, its physical environment, and of the more-than-half-billion people who live on less than a dollar a day can only be ameliorated by continuation of a quality of leadership that is historically quite rare anywhere in the world. China also must manage internal migrations involving populations several times the size of major European countries, and it is increasingly dependent on energy imports just at a time when the Terrorist War could destabilize Saudi Arabia and world energy supplies. Were China to experience even a relatively short period of weak leadership, all these problems would likely go critical at the same time. The turnaround from miracle to basket case could happen within a couple years. Since there is a major leadership transition in 2002-2003, it is vital to keep this risk at the forefront of consciousness.

Until one of these changes occurs, China is the principal source of stability and growth in Asia and Japan is the principal source of instability and risk. China is the principal regional leader toward a market economy and free trade, and Japan is the principal inhibitor of such trends. To a generation reared on the Cold War, or even to one that reads the words of some of China's current propagandists, such a situation is ideologically untenable. But, however ideologically weird, it is reality. As Deng Xiaoping told his countrymen, it doesn't matter whether the cat is black or white, only whether it catches mice.

To say this is not to announce or advocate a reversal of alliances. U.S. economic interests in Japan remain larger than its comparable interests in China, and U.S. sympathy for Japan's relative democracy

remains a powerful binder. The U.S.-Japanese alliance has served the cause of regional peace well, and probably will do so in the future.

What does all this mean, then? It leaves Americans caught between hopes and fears, or between contradictory fears. Anyone who has reflected on the chaos of Asia over the twentieth century must fear Chinese weakness. Had China and Korea been strong and unified, we would not have had the Sino-Japanese War, or the Russo-Japanese War, and World War I and World War II would have been European War I and European War II. For the past century, Chinese weakness, like Korean weakness and division, has proved horribly damaging to U.S. interests.

Now that China is becoming stronger, we also fear its strengths. By making the most optimistic assumptions about its capabilities and the most pessimistic assumptions about its intentions, it is possible to get ourselves really worked up. Both ends of the U.S. ideological spectrum, the *Weekly Standard* and the *New Republic*, advocate building a whole foreign policy on such ideological stretches.

We are further confused by the fact that we Americans are ourselves divided in the way we think about Chinese strengths and weaknesses. The U.S. executive branch has learned, and re-learns at the beginning of each new presidency, to fear Chinese weakness and to appreciate the Chinese contribution to stability in places like Korea. The U.S. Congress and media fear Chinese strength and are virtually unaware of the dangers of weakness; they tend to be equally unaware of the contribution that a more confident China can make to stability. The military has tended to be divided. Those who have dealt directly with China tend (not universally but most frequently) to discount Chinese capabilities and to believe in their counterparts' moderate intentions. Those who write contingency plans from a distance, and who read many statements by the Chinese counterparts of Curtis LeMay fluffing up their rooster feathers in moments of stress, have often exaggerated both capabilities and intentions.

The wisest policy is to keep our own capabilities strong enough to deal with any contingency, taking full account that China's capabilities will grow and its intentions could worsen, but to posture ourselves so as not to provoke the very thing we fear. A few U.S. scholars have recently proposed that the U.S. should act to hinder

China's continued rapid growth. It should go without saying that positioning ourselves as a blockage on Chinese peoples' path out of two centuries of miserable poverty and starvation would be the most certain way to provoke an enmity that could persist for centuries. Faced with such policy proposals, a Wilsonian idealist would have to question the commitment to human rights of anyone proposing to hinder one-sixth of the human race from rising above $853 per capita. In fact, such language is too measured. Much of the world would view such a policy that kept half a billion people living on a dollar a day as just short of Hitlerian.

A geopolitical realist would have to ask two questions about such a policy. First, if such a policy succeeded, what would be the consequences? The key to the answer is the fact that China's 7 to 8% annual GDP growth, while very impressive compared to other countries, is just barely enough to keep the country from falling catastrophically short of creating the 13 million or so jobs it needs each year to compensate for layoffs and demographic change. If China is overwhelmed by a tide of unemployment, we will revert swiftly to the Chinese chaos and cultural despair of most of the past two centuries. A world in which China returned to cultural despair of the Cultural Revolution era after having observed all the recent lessons of asymmetric warfare would be catastrophic for U.S. security, and the associated controls could well be catastrophic for our democracy. Conversely, if such a policy failed, if the U.S. tried to halt China's growth but failed, how many generations would suffer from the subsequent cold or hot war between the two great nations? How unified would we be, and how solid would be our alliances, if there were a persuasive argument that the war began with our own attempt to keep an impoverished people down? Better to keep U.S. powder dry and the door to future amity open.

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