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Bring China into the WTO☆

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My presentation is going to focus on China. The two most significant events about China are the 'Taiwan independence' issue and China's entry into the WTO. I treat the US–China PNTR (permanent normal trade relation) as a part of China's attempt to become a formal and full member in global trade.

The Taiwan independence issue is dangerous and high in emotion. Many Taiwan residents admit that they are Chinese and are amiable to the one "China" idea, but they may not want to be a part of China governed by the Beijing government, at least not yet. They prefer the 'status quo'. A minority of the residents who remember the colonial era during the Japanese occupation (for 50 years prior to the Japanese defeat in 1945) and then the repressive KMT rule from 1949 to the late seventies, truly harbor negative feelings towards mainlanders. The minority pushes for formal cessation from the Mainland. Beijing, however, sees unification as absolutely unforsakeable.

What the international community worries about is that the radicals on both sides could take extreme actions. The conventional wisdom is that the US can rein in the radicals in Taiwan. The radicals in China, however, may be harder to control.

Still, China as a whole would not be irrational. If waging a unification war has a higher economic cost, she is less likely to start one. The more China is integrated formally into the international economic community, the higher is the economic cost. Therefore, I want to focus on the WTO/US-China issue, which has great economic significance.

It is useful to review China's recent history briefly. At the end of the 18th century, China was a 'sub-colony'. The ponytails Chinese men wore were one of many quaint customs that drew scorn in that era. These customs highlighted China's backwardness and suffering since the mid-18th century under the hand of the incompetent Qing dynasty government.

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The Qing dynasty ended in 1911, but was replaced by a vacuum in which various warlords fought against one another. The KMT, led by the old President Chiang, eventually took control of the country. But, the KMT regime was deeply corrupt and ordinary people suffered. That is why farmers and many other ordinary Chinese supported the communists, who then drove the KMT and Chiang across the strait to Taiwan. The communist regime, however, went through numerous power struggles that put China through a series of catastrophic policy debacles. From the mid-18th century to the end of the 1970s, being Chinese was not a pleasant experience.

Since 1978, the end of the latest such debacle, the infamous 'Cultural Revolution', China has been on a course of economic reform and liberalization. A lot has been done since. Chinese are probably richer than ever. China has experienced a long period of phenomenal growth, and has been able to sweat out the Asian crisis. Yet, China is still neither an economic nor a military power.

Present day China has a very mixed economy. The SOEs (state owned enterprises), which represent established industry, and the private businesses, which represent the upstarts, are fighting for resources and economic dominance. The coastal areas and the inland areas are having a similar struggle. The coastal areas have more of the upstarts while the inland areas are still dominated by the SOEs and the old established order. The economic data are striking: per capita income in the richest coastal provinces reaches US$ 3500, while that of the poorest interior provinces is only around US$ 280.

Modern China is not that different from historical China. If we look back at China's history, we see two strong patterns: isolation and entrenchment by the 'connected'.

During the latter half of the Qing dynasty, China was cut off from the outside world until foreigners forced her to open doors, but only with limited success. The established and entrenched benefited enormously from their economic and political power in an isolationist China, and used their political influence over the imperial government to protect that isolation.

During the KMT era (1920 to pre-WWII), China was still quite isolated. Of course, in that period, world trade suffered generally, not just in China. The establishes were politically connected, the warlords, and the secret society people. Corruption remained widespread throughout the society.

The Communist party's victory was built on a genuine class struggle between an established entrenched elite and a multitude of have-nots. The Communist party, however, ruled China's economy through a coercive system of command and control that destroyed whatever market system China previously had. Those in charge of this coercion, quickly established themselves as a new ruling caste. Party members became the new social elite, and awarded themselves commensurate privileges. The infamous 'Cultural Revolution' was a power struggle, where Chairman Mao used popular resentment against this new elite to launch a bid for power he lost in the wake of the Great Leap Forward. The liberalization that followed the Great Leap Forward had enriched the well connected, and corruption was prevalent. The have-nots rose, at Mao's command, against the established elite in a genuine class struggle. Unless China fundamentally changes her ways, further such rebellions by the have-nots against an entrenched corrupt elite are ongoing dangers.

In the current Chinese economy, yes, more people are getting rich. But the situation is still the same. Students of the Chinese economy recognize several problems:

1. China is still not an open society. There are still entry barriers. The SOEs are not withering as many of us have hoped they would. Many of the established elite still hold power and protect their vested interests. Corruption remains prevalent in China.
2. China still does not have well developed capital markets or financial institutions.

In my opinion, modern China continues to fight against economic entrenchment, just like before.

Prof. Randall Morck at the University of Alberta (who is also a visiting professor at Harvard University) and I conducted a study about 'concentrated' wealth (Morck et al., 1999). In many economies, asset control rights are concentrated in the hand of an economically entrenched elite: those who inherit corporate control and those who are politically well connected. We show that economies with more wealth controlled by such people grow slower. There are several reasons.

1. Genetic traits are known to exhibit regression towards the mean over several generations. The founding fathers of successful companies who initially garnered great wealth and power might have been superb businessmen. Even if this superior ability is partially inherited (and this is far from established), their offspring should regress towards the population average in entrepreneurial ability over only a few generations. If such ability is not inherited, the regression is likely to occur immediately upon the first heirs' ascension. Yet, heirs literally run the economic show in many countries.
2. Agency problems also figure large. The heirs of corporate dynasties often control vast assets via cross-holdings, superior-voting shares, and corporate pyramids. These control devices leave heirs in control of numerous corporations in whose profitability they have a negligible direct interest.
3. The same control devices entrench family control. It is hard to dislodge the entrenched because of their political connections, their super-voting shares, their webs of intercorporate cross-holdings and their corporate control pyramids. Moreover, in many economies characterized by such entrenchment, protection for outside investors' property rights is inadequate.
4. The connected and heirs do not want competition. We actually find that economies with substantial inherited wealth have more barriers to entry.
5. Nor do they see innovation as an unambiguously good thing, for innovations often erode the value of existing capital. Control of the existing capital stock is, of course, the source of the elite's power and influence. Countries characterized by greater inherited corporate control show less private sector R & D spending.
6. Economies with substantial inherited wealth often have poorly developed financial markets and institutions. Capital market development allows the growth of both ordinary competitors to established firms and innovative entrepreneurial firms. The entrenched elites therefore understandably use their influence to limit the development of capital markets and thereby to assure their privileged access to capital.
7. The entrenched elites in many countries plainly do a poor job of managing the capital assets over which they maintain control. Yet, they remain in control.

China's historical curse has been her inability to limit her successive entrenched elites. Consequently, her economic history has been marred by these hindrances. As yet another economic elite forms in her rapidly developing coastal provinces, China once more faces these age-old obstacles to her general prosperity (for a broader and more general discussion, see Olson, 1982).

In many localities, the elite control state-enforced marketing boards that purchase agricultural produce from farmers at low prices and selling them low-quality fertilizer at high prices. The elite, like their predecessors, milk all levels of government for subsidies and intrigue to establish artificial entry barriers against potential competitors. They are up-to-date only in that they repeat many of the same political and social arguments heard from entrenched special interests in the Western countries. The danger is that China has historically lacked the countervailing democratic and legal institutions that, at least to some extent, limit the power of special interests in the West.

China's reform-minded leaders want permanent trade links with the US and seek WTO membership for China because they see these as the most realistic devices for limiting abuses of economic power by both the entrenched party elite in the interior and the newly forming economic elite in the coastal provinces.

For example, the central government cannot currently control local officials' interference in economic affairs to benefit wealthy patrons. To a large extent, this is because China lacks a legal tradition that meaningfully constrains local bureaucrats. This is why the Communist regime made such widespread use of violence and coercion to see its economic policies through.

By casting such constraints as due to WTO rules, or to treaty obligations with the US, China's reformers hope to create such constraints and make them bite. Such treaty obligations, they hope, will deny the current and developing elite the unbridled power past elites have enjoyed. If floating agricultural prices, free market access, and so on become people's expectations of how the world should work, traditional tools of entrenchment like price fixing and market control can be restrained — at least more than in the past.

Also, the market liberalization measures mandated in China's agreement with the US and as conditions for entering, the WTO should reduce restrictions on foreign direct investment into China, and so should break open sectors like banking, insurance and telecommunications, and so on. Openness in the finance-related industries, in particular, is critical to China's growth, for dominance of these industries is a sure way for any elite to entrench itself in power.

Entering the WTO is important for China, not because it gives China access to foreign markets. The importance rests in WTO rules and regulations that would help China fight off economic entrenchment.

Let me now focus more on the capital markets. Growth comes in several ways. Growth can be achieved by working harder and saving more across the board. But the real trick is to grow by guiding resources intelligently towards area with the greatest potential, and allowing other areas to shrink. This is a critical element of Schumpeterian innovation, the process that is thought to drive productivity growth in the West. Governments are unable to perform this capital allocation, not least because they are subject to rent seeking by the entrenched elite and other special interests such as labor unions. Schumpeter argued, and history has shown him right in this, that this allocation is best done by a healthy finance industry, and perhaps especially, by a healthy capital market. A healthy capital market guides rational restructuring. It brings resources to people with ideas but no money and lets them compete with the established elite, who are often bereft of ideas.

The entrenched, therefore, are particularly suspicious of any growth in financing alternatives. These can weaken their market power, because financing helps develop their competition.

China's banking system has undergone reforms. The regional banks are now mandated not to make policy loans, that in the past were used to financing inefficient SOEs. Still, China needs more reforms and liberalization before its banks can fulfill their intermediation role.

For example, new Chinese private enterprises still have difficulty in raising money. They can form joint ventures with foreign firms to obtain financing. But, foreign stakes are often limited. Thus, when the locals have liquidity constraint, so do the joint ventures.

I want to note that China is trying to change this. For example, the central government is trying to liberalize its security market controls. Currently, China has three types of shares: A shares for foreigners, B shares for local, and H shares for Hong Kong people. The government wants to abolish the distinction between A and B shares, so that firms can raise capital by issuing shares to foreigners.

This raises an important question. How attractive is China's equity market to outside investors? Prof. Randall Morck and I conducted a study that raises some warning flags here (Morck et al., 2000). We find that emerging economies, and China's in particular, have equity prices that tend to move together: up together one day and down together on another day.

We asked why. One plausible reason is structural characteristics of emerging economies, like a lack of diversification into many industries, so that all firms' fundamentals are correlated. These structural explanations can be captured empirically. They do not explain our finding.

We find that social institution variables, like measures of good government (low corruption, low risks of contract repudiation and expropriation) and protection of outside shareholders, steal the show.

Our point is that stock prices in emerging markets co-move because little firm specific information gets into stock prices. With less protection for property rights, risk arbitrage is riskier and less remunerative. Political interference also makes predicting gains based on firm specific fundamentals hard. Also, corruption and inside theft may keep increased profits out of the reach of outside shareholders in any event.

Ultimately, informed risk arbitrage retreats and stock prices become relatively uninformative. Indeed, one may argue that noise traders take to these markets like 'fish to water' and stock prices consequently become bubbly. In these cases, stock prices do not serve as good guideposts for resources allocations.

When capital markets are generally like this, capital allocation turns on whether one has connections or not, and whether one is an established player or not. A lot of resource misallocation results.

We also study the implications of greater firm-specific variation in stock prices (Durnev et al., 1999). Presumably, this means more firm-specific information is incorporated into stock prices. We look at the US, industry by industry, assuming that each industry is a country. Doing this, gives us an experimental background where capital markets are fully integrated and subject to identical macroeconomic factors. We find that industries whose stock prices exhibit greater firm-specific variation, grow faster than the US average, have more access to outside financing, and show clear signs of better investment decisions, in that their marginal q ratios are closer to the optimal value.

These results show that the stock market is not a sideshow. When stock prices embody greater firm-specific information, what Prof. James Tobin called the 'functional' efficiency of the stock market is enhanced, and it guides the resources allocation better.

There are a number of plausible theoretical explanations for this result. Here is not the place to expound on them. The point is that when capital markets carry out their intermediation role well, we have better capital allocation.

That is what China needs. The deal with the US is wonderful. Let foreign financial institutions enter China and compete with China's sleepy domestic institutions. They could be key to breaking China's historic pattern of a rising elite stifling further economic growth. That would let China rise to the next stage of development, where it can genuinely reform and liberalize its domestic financial sector.

The US has been good to China. After the Boxer Rebellion, the US spent its share of indemnity money on China's education system and sponsored Chinese students to study in US universities. Solidifying trade relations with China is a continuation of this trend. Pass the deal and help the reformers in China.[2] Ultimately, this will enhance political stability in the region by winding down the cycle of rebellion and exploitation that has so-far cursed China's economic history.

We hereby forewarn, however, that the normalization of China's trade relationships with the world business communities is only the beginning of a genuine long march towards a rational and democratic economic structure in China. China must remain open to the world even after this no longer serves the purposes of her elite. China must continue to earnestly welcome foreign investment, even when this creates competition for established domestic firms. China must bring about the thorough liberalization of her banking and finance sector, for this is essential to prevent entrenchment. In the years to come, China will need engagement with the world's established economies to dislodging those who attain economic entrenchment.

Such an economic democratization in China would be a stark departure from her history, and could be a corner stone of a peaceful and prosperous international relations in the new millennium.

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[2] The US Senate's passed the 'PNTR-China' bill in the third week of May 2000.