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The Rise of the Dragon

Back in the 1980s, a select group of economies in Asia came to be known as the "Asian tigers" because of their aggressive approach to economic growth. Included among the tigers were Singapore, Malaysia, Thailand, and Indonesia. All took the view that a combination of low wages and high export sales represented the fast track to economic growth and prosperity. Now these tigers are being overtaken by the "dragon" of Asia—China—which is following the same path, with perhaps even more success.

For decades after the Communists' rise to power in 1949, China was best known for poverty and repression, and its aggression came mostly on the military front. But in recent years *economic* aggression has become the byword. Although both poverty and repression are still the norm, both are changing for the better. China, it seems, is trying to learn from capitalism, even if not converting to it.

China's economic offensive began roughly 25 years ago in its southeastern province of Guangdong. The Chinese leadership decided to use this province as a test case, to see if capitalist **direct foreign investment** could stimulate **economic growth** in a way that could be politically controlled. The experience was deemed a success—economic growth soared amid political stability. What the government learned from the experience helped it smooth the 1999 transition of Hong Kong from British to Chinese control. Most important in terms of China's long-term economic aspirations, many foreign investors came to view the Guangdong experiment as solid evidence that they could invest in China without fear that the Communist government would confiscate their capital. Beginning about 1992, foreign investment began to soar in China.

The annual rate of such investment is nearly 10 times greater than it was at the beginning of the 1990s.

There are two powerful forces that are attracting economic investment to China: **demand** and **supply.** On the demand side, 1.3 billion people live there, some 20 percent of the world's population. Although **per capita income** is still low by world standards, it has been growing at better than 6 percent per year, after adjusting for inflation. At that rate, the standard of living for the Chinese people—and thus their **purchasing power** in world markets—is doubling every decade or so. China is already the world's largest cell phone market, with 200 million customers. Within a few years, it is estimated, China will account for 20 percent of the world's purchases of personal computers. Indeed, China now spends about $40 billion per year on information technology and services, and this amount is growing at a rate of nearly 30 percent per year. Sometime in the next 20 to 30 years, the Chinese economy will almost surely supplant the economy of the United States as the world's largest.

With its population of 1.3 billion individuals, China also offers attractions on the supply side. Although American and European firms with operations in China choose to pay their workers considerably more than state-owned enterprises pay, labor is still relatively inexpensive. Manufacturing and production workers employed by U.S. or European firms, for example, earn under $4 per hour, only about one-fourth what the foreign firms would have to pay in their home markets. And when it comes to highly skilled workers, the Chinese labor market is even more attractive. China's universities produce more than 450,000 engineering graduates each year, including 50,000 in computer science. (By comparison, there are about 30,000 new computer science graduates each year in the United States.) Most importantly, firms can hire those engineers for salaries that are only 10 to 20 percent of the cost of hiring engineers in America or Europe.

The fact that, in many cities, the Chinese workforce is generally well-educated and often English-speaking has helped make China even more attractive to foreign employers. Collaborative scientific ventures between Chinese researchers and U.S. firms are becoming increasingly common. A research team at Beijing University played a role in deciphering the genetic makeup of

rice, for example. American computer hardware and software firms Intel, IBM, Oracle, and Microsoft have shifted some key components of their research to China in recent years. American firms are even setting up customer service-call centers there. Microsoft customers from the United States who call in for help may well find themselves talking with one of that company's 400 engineers who are located in Shanghai.

A single episode in China's recent history offers a fascinating look at the forces at work in that country. Not long ago computer-makers began offering what has become one of the hot-selling items of recent years, the tablet PC, equipped with software that reads handwriting. The development of the software used by the tablet PC illustrates the key elements of China's recent growth.

The Chinese language has thousands of individual characters and no alphabet. As a result, it cannot be easily accommodated on computer keyboards. This fact significantly slowed the sales of computer hardware and software in China during the 1980s and 1990s. In the hopes of tapping the huge Chinese market, Microsoft established a major research lab in Beijing, China's capital, instructing its engineers to devise a means of making computers easier for the Chinese to use. For more than a year, researchers fed a computer a steady stream of handwritten documents, including notes, diagrams, and even shopping lists. Gradually, with the aid of many hours of human programming and learning-by-doing on the part of the computer, the Chinese researchers developed a program that could distinguish words from everything else, and then turn the words into typed text. And what worked for handwriting in China would work for handwriting anywhere. Equipped with this software, a viable tablet PC was born.

Both elements of China's growth—demand and supply—were clearly at work in this process. Without the huge potential market in China, this project wouldn't have been given the priority it was, and might not have been undertaken at all. Moreover, without well-trained, English-speaking Chinese computer scientists at the heart of the project, it is unlikely that Microsoft could have been successful. And the upshot of the project is that a product whose primary impetus came from China is yielding benefits around the world—and making the computer market in China even more alluring to U.S. firms.

China's rapid economic expansion has caused a huge increase in its demand for raw materials and other inputs, many of which are being supplied by Malaysia, Thailand, and Singapore. Although these Asian tigers are grateful for the boom in exports, they are also concerned by the growing competition they face from their neighbor to the north. Chinese medium- and high-tech industries are starting to cut into the market share of the very sectors that have helped fuel the growth of the Asian tigers over the past 20 years. The situation is even more critical in Japan, where wages are much higher than in China, but whose technological lead over China is gradually eroding. "Are we to become a vassal of the Chinese dynasty again?" asked one Japanese official, clearly concerned that his nation's manufacturing firms were having trouble competing with Chinese firms.

Although lower wages among the tigers are keeping them competitive for now, they are concerned about the future, because competition for foreign investment is particularly intense. China's 2001 entry into the **World Trade Organization (WTO)** prompted a surge in foreign investment there, even as China's rivals in the region saw their foreign investment shrink. Without fresh outside capital, the economies of Malaysia, Singapore, and Thailand may all start looking like Japan's, where growth has been essentially zero since the mid-1990s, and where high unemployment is a chronic problem. Eventually, Japan as well as China's other neighbors will adjust to the growing economic presence of China, but the transition may be unpleasant.

Most Americans, however, are more concerned about the likely impact on the U.S. economy of China's capitalist ambitions. Will the dragon consume American firms and jobs as it grows? The short answer is "No." The long answer is that China, like all nations, must in the long run import goods equal in value to those it exports (unless China intends to *give* its exports away, which so far no one is claiming). This means that just as China is becoming a potent supplier of many goods and services, so too it is becoming a potent demander of still other goods and services.

Thus far, the Chinese demand for goods has not been as visible in American markets, because American firms tend to produce goods and services designed for higher income consumers, and China as yet has relatively few of those. In the meantime, the

demand-side influence of the Chinese economy is already showing up, albeit in odd places. To take one example, right now China's most important import from the United States is trash. Ranging from used newspapers to scrap steel, Chinese companies buy billions of dollars of the stuff every year to use as raw materials in the goods they produce. In addition to yielding profits (and employment) in these U.S. export industries, this exportation of U.S. trash reduces the burden on U.S. landfills and, by pushing up the prices of recyclable scrap, encourages more recycling in the United States.

Eventually, of course, we'd like to be sending China more than our rubbish, but that time is coming. As China's economy grows, so too will the number of affluent Chinese, and with 1.3 billion or so potential candidates, that ultimately means *plenty* of consumers for America's high-end goods. Thus, the long-run effects of China's growth will mean a different American economy—we'll be producing and consuming different mixes of goods and services—but America will also be a richer nation. Voluntary exchange, after all, creates wealth, and the Chinese dragon is big enough to create a lot of wealth.

As we saw in Chapter 4, political and legal **institutions** are crucial foundations for sustained economic growth. Despite the advances China has made over the last 25 years, its wealth-creating future may be clouded unless it can successfully deal with two crucial institutional issues. First, there is the matter of resolving the tension inherent when a Communist dictatorship tries to use capitalism as the engine of economic growth. Capitalism thrives best in an environment of freedom, and itself creates an awareness of and appreciation for the benefits of that freedom. Yet freedom is antithetical to the ideological and political tenets of the Communist government of China. Will the government be tempted to confiscate the fruits of capitalist success to support itself? Or will growing pressure for more political freedom force the government to repress the capitalist system to protect itself? Either route would likely bring economic growth in China to a swift halt.

The second potential long-run problem faced by China lies in that nation's cultural attitude toward intellectual property. In a land in which imitation is viewed as the sincerest form of flattery, it is routine to utilize the ideas of others in one's own pursuits. As a

result, patent and copyright laws in China are far weaker than in western nations. Moreover, actions elsewhere considered to be commercial theft (such as software piracy) are largely tolerated in China. If foreign firms find they cannot protect their economic assets in the Chinese market, foreign investment will suffer accordingly, and so too will the growing dragon that depends so heavily upon it.

DISCUSSION QUESTIONS

1. Currently AIDS is spreading rapidly in China, importantly as a result of contaminated blood supplies. If the government fails to stop the spread of AIDS, what are the likely consequences for future economic growth in China?
2. In 1989 a massive protest against political repression in China was halted by the government's massacre of more than 150 individuals at Tiananmen Square in Beijing. What impact do you think that episode had on foreign investment and growth in China during the years immediately after the episode?
3. Most of the advances in institutions in China have come in the cities rather than the countryside. Indeed, local officials in farming villages actively redistribute wealth among villagers to keep the distribution of income among local farmers roughly equal. Thus, a given farmer's success or failure with his crops has little impact on his family's standard of living. Given these facts, where do you think the economic growth in China has occurred over the last 25 years, in the cities or on the farms? Explain.