China Supply Shock

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Globalism offers to every country that shows a commitment to market liberalization the opportunity to be part of a global marketplace. The first countries to liberalize their economies after World War II were the US and the UK, with the former starting the process in the 1970s and the latter most noticeably in the 1980s. These two countries—along with the World Bank and the International Monetary Fund—became the earliest and strongest advocates of market liberalization (i.e., the domestic economy and external sector deregulation and re-regulation processes discussed in Globalism).

The next group of market liberalizers included the other countries of the Organization for Economic Cooperation and Development (OECD). Initially, the OECD consisted of the Western industrial countries plus Japan, Australia, and New Zealand. Later, Korea and a number of 'newly-industrializing countries' were invited to join the OECD as they succeeded in liberalizing their own economies.

In the late-1970s, following President Nixon's visit, the Communist Party of China began to open the country up to the rest of the world. With time, the Party talked of building its own brand of market economy. It would do so gradually, not in the shock therapy way that later would be tried in the Soviet Union. When China joined the World Bank in the 1980s, their threat to rejoin the world began to look serious. To be a member of the Bank and the IMF, countries have to disclose economic and financial data that Communist Bloc countries previously had considered too sensitive for outside consumption. The Party was signaling they were willing to bear even this potential embarrassment, if it meant they could tap first into the knowledge and then into the markets of Western economies.

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My first visit to China on behalf of the World Bank was in 1986—half a decade after the 'opening' began. My hotel—then the finest in Beijing—felt darkly Soviet. It had poor lighting and even poorer service. The World Bank training program on financial

analysis of projects for banking officials was held in a large room in a still dingier cigarette factory. So eager were my trainees for knowledge on "Western economics" taught by a World Bank representative that the seminar room was packed. The dozen or so who gathered below my speaker's perch at one tea break chattered in Mandarin about my American Express card as they felt the card and passed it around.

Their curiosity about the card was different from that of New Guinea villagers staring vacantly at the magic of a televised image. These banking trainees were building knowledge for a future in which they not only would have such a card in their pockets, they would help their banks to develop and distribute them to Chinese society. Many had read volumes of material in Chinese language, translated from English-language texts on economics and finance by other Chinese with no material experience in market economics. They knew about credit systems from textbooks. But some of them were only just then getting to run their fingers over a real credit card. The technology for stamping the cards accurately was not yet present in their country.

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In the 1990s, I would return to China many times on assignments for the World Bank and the Global Environment Facility (GEF). This time the task was to help reduce pollution by increasing the efficiency with which the economy operated. There is a long and fascinating story on <u>Market Liberalization and the Environment</u> that I will have to tell in a separate article. Because of China's population and its potential impact on the globe, nobody wanted Chinese economic growth to go forward without efficiency improvements. If it did, the resulting pollution could swamp the globe.

Much of the Chinese economy was organized around clusters of enterprises intended to provide village-level self-sufficiency. There reportedly were many reasons for this—the transportation system was inadequate for large-scale, centralized production facilities; diffuse clusters of self-sufficient production minimized the risks to the economy from a Soviet attack that, for decades, seemed imminent; small production facilities required less organization and management sophistication.

For whatever reasons, the Chinese economy consisted of under-scaled enterprises that used production technology from two or three generations back. There were no

market-based prices to tell producers which inputs were truly scarce and which ones were relatively abundant. There was no market competition to force producers to convert raw materials efficiently into finished product. The predictable result (to a Western economist) was extremely inefficient production. Incompletely burnt fuel went up the smokestack (along with lead particles that were not efficiently getting molded into batteries in a local battery plant we visited). Everywhere one looked, inefficiently converted raw materials were flowing as effluent into ponds and streams.

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By the late-1990s, we no longer talked about financial versus economic analysis prices in China. Centrally administered prices were by then largely passé—with the important exception of the currency exchange rate, of course. Things looked and felt different around the Chinese countryside. The battery plant that had been poisoning its workers and its local community had paid for its own renovation with the lead saved by the more efficient production equipment that had been installed. To see a drab old Mao suit now, you would have to travel deep into a residential area and look for an eighty-year-old retiree. Everybody else was wearing stylish, Western-oriented dress afforded by the rising incomes of an economy that had been growing relentlessly at 8+% per year for nearly two decades.

Eastern China was no longer the backwards country that I had visited initially in 1986—barely a decade earlier. In most industries, China still was not the cutting-edge technology leader. But Chinese industry was rapidly adopting the best available off-the-shelf technology available. The first stage of the liberalization process—deregulation of the domestic economy—had yielded great rewards for the Chinese economy. And it had made possible the second step of market liberalization that China would avidly pursue in the 1990s and beyond: deregulation in terms of its ties with the rest of the world. As with the first stage, however, China would pursue this step gradually and on its own terms. It was only with this second stage of the liberalization process, when Chinese manufactured goods began flooding onto global markets that the world really started to appreciate the impact of China's gradualist liberation model.

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China focused the first stages of external sector liberalization on a few coastal Provinces. Infrastructure was added there, and special laws were enacted to create the country's own local version of Globalist, export-led development. Like Japan and Korea before them, the focus would be upon tradable goods manufacturing where China had cost advantages. One big cost advantage, of course, was a huge ("large" is an inadequate term) and high quality labor force. Even focusing upon creaming the top 50% of that labor force and concentrating on a few coastal regions only, as the export-led growth strategy initially did, one is dealing with a labor supply equal to one-half of the total US workforce.

China's exports consist largely of manufactured goods (See related article on Industrialization and Economic Development). China imports components, raw materials, and technology for producing those goods and has a small trade surplus with the rest of the world. The country's exports to the US tripled between 1996 and 2003. So did its exports to the rest of the world. And so did China's imports (See China's Imports and Exports). Exports and imports are likely to continue rising far into the future.

For some reason the rest of the world is having difficulty grasping the magnitude of the supply shock implicit in improving the efficiency of an economy with a population of 1.3 Billion people—about 20% of the people on the Earth. Based on population alone, China's liberalization stands to add to the global economy the equivalent of double the capacities of North America and the European Union combined. Perhaps more poignantly, China has almost as many workers with an IQ above 115 as the US economy has workers, period.

Manufacturing workers in China make 5% to 20% as much pay as US workers (at current exchange rates) and still receive a huge improvement in well-being by working in what in the US are pejoratively called manufacturing "sweatshops". Those jobs are far better than the jobs available to them in the old state, provincial, and village-level enterprises. And there are many, many more workers yet to be released from these inefficient public enterprises.

As liberalization moves forward and the swamp of waste is gradually removed from the Chinese economy, more supply will be forthcoming. As export-led

manufacturing moves inland to areas now barely touched by this phase of market liberalization, the global supply of manufactured goods emanating from China will continue to increase.

China is a late-arriving Korea rendered twenty-six times bigger. Or a much-later-arriving Japan rendered ten times bigger. Take China's sheer size and impose it on the attributes of other Asian countries that have liberalized and Globalized their economies, and what do you get? You get global supply shock, big time.