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DOLLAR & SENSE: China's perspectives on trade and the economic tension with the US

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(MUSIC)

DOLLAR: Hi. I'm David Dollar host of the Brookings trade podcast, Dollar & Sense. Today my guest is Huang Yiping, Deputy Dean of the National School of Development at Peking University, one of the best known economists in China. And we're going to talk about the role of trade in China's development and also the current tensions between the United States and China. So welcome to the show, Yiping.

HUANG: Thank you. Pleasure.

DOLLAR: So let's start by talking a little bit about the history of trade liberalization in China. You know, what role did trade and investment, foreign investment liberalization play in China's reform starting in 1978?

HUANG: Well, if you look at the history, last 40 years we always say the key process is the transition from a sanctuary plan system to a free market economy, but a large part of it is integration into the global system. So globalization has been a key driver of Chinese economic growth during the last 40 years.

And you look at, for instance, in terms of trade. The export GDP share was only around 5, 6 percent at the beginning of the reform period. Right before the global financial crisis in 2007 I think the number went up to something like 37 percent. So exports became a very important part of the overall economy. Economy's been expanding by exporting a lot to the other countries.

Also, the inward direct, foreign direct investment was also very important after 1993 or '94. I think China was one of the largest recipient countries of FDI for almost 20 years. So you can see on both fronts China was a main beneficiary of opening up to the outside world and globalization.

DOLLAR: So a common view in Washington is that there was a lot of trade liberalization, foreign investment liberalization in China from the beginning of reform up to WTO accession in 2001, but then many American observers feel that opening and reform really stalled in China. Do you have a view about this? I mean, is that accurate? Why did this happen?

HUANG: Well, certainly there was a big step when China joined the WTO. Tariff rates, tariff restrictions came down quite significantly. Then there were probably a period of relatively slower progress. Partly because you had a significant cutting down of the barriers and then the economy continued to expand. So I think it was probably true that the pace of liberalization slowed somewhat, but it continued to a large extent.

I think if you look at what happened in terms of financial liberalization. The Chinese government pushed very hard on internationalizing the currency. And also improving trade relations with neighboring countries. And so I think liberalization continued, but your observation that the pace probably slowed a bit which was probably true.

DOLLAR: Has it accelerated a bit in the last few years?

HUANG: Last few years accelerated mainly in terms of financial liberalization, and particularly opening of the financial service industry. So China is, for instance, lifting the restrictions on the foreign equity shares of financial institutions in China is opening, for instance, the domestic capital markets, particularly the bond markets, to foreign institution investors, central banks, and sovereign wealth funds and so on. So it's been opening quite significantly, but mainly in the financial service industry.

DOLLAR: The Trump administration has a number of specific concerns about trade practices in China. One concerns restrictions on direct foreign investment which you still see in some sectors. You have a lot of sectors that are completely open, but there have been sectors like automobiles where foreign firms have had to operate through joint ventures, and then I know you're a leading expert on the financial sector. You already mentioned there were restrictions on foreign investment in the financial sector, but it's starting to change. So can you say a little bit more about how you see the financial sector reforming and what kind of opportunities that opens up for foreign firms?

HUANG: Right. Well, when China started economic reform we only had one financial institution. That is the Peoples Bank of China which has served both as the central bank and a commercial bank at the time. In fact, the PBOC accounted for something like 93 percent of the whole country's financial assets. So we have a very tiny financial institution, but over the following 40 years we liberalized it and developed it.

Today, if you look at the Chinese system I think that there are two very important features or characteristics. On the one hand, the size of the financial assets is already gigantic. I know one number to look at is the big four banks of the Chinese banks. They now regularly rank among the top five globally. So the size of the financial assets are already quite significant, but at the same time which is probably also true that the government continues to intervene in the financial system, including the setting of interest rate, exchange rate, allocation of credit, and cross border capital flows. So what we call financial repression or government intervention in financial system is still at very high level. I think that is true.

But we needed to look at these distortions in a historical perspective. Number one, the reason why the government continues to intervene in the financial system was because we adopted a gradual dual track liberalization approach. So, for instance, when we open up for free market the central plan system continued for a while. When we allowed the private sector to grow very rapidly we also supported SOEs to continue. And for that reason some distortion or government intervention in the financial system was necessary cause otherwise the relatively less inefficient SOEs won't be able to continue. So that was the reason why policy distortions continued for quite a while.

The second point I think to recognize is, well, we always think policy distortions are bad, government interventions are bad. But you look at what happened the last 40 years, as I said, government intervention was still quite extensive in China in the financial system. But at the same time you look at the performance of the economy, GDP growth on average was above 9 percent. And China didn't suffer from any systemic financial crisis.

If you combine these two things together, and I would say overall despite the distort of the financial system we did pretty well. And, in fact, there was a reason why that's the case. Number one, because we started with a very distorted financial system, but we continue to liberalize. The government intervened in the financial system. It probably caused some efficiency losses, but at the same time it also made some positive contributions because, number one, the banks, I mean, most of them state owned were very effective in converting saving into investment, so supporting to growth was very strong.

At the same time, government ownership of the banks and other financial institutions, actually, to some extent supported the financial stability. Investors or depositors did not lose confidence even when the non-performing loan ratios were rising in the banking sector. So this was why we didn't even have a financial crisis. And the one thing I also say to colleagues is that if China liberalized its financial system from day one of economic reform we probably would have experienced a number of financial crisis already over time.

And the truth is that it's good to move to a market system quickly, but market mechanism will take time to develop. If the market mechanism is not mature it could be disastrous if you just open up, and you could have a financial crisis. So for these reasons I think some degree of government intervention, number one, this was historical reasons, and number two, it actually worked pretty well. But now we come back to today, these already become major constrain for economic development going forward and now we need it to make more drastic changes or push ahead with market already into the reforms.

DOLLAR: Right. I agree with you at this moment China could benefit a lot from some further market opening. Overall productivity growth which was very impressive for a long time has slowed down.

HUANG: True.

DOLLAR: China needs to find new sources of growth. The labor force has basically stopped growing because of demographics, awful lot of capital stock has been built up, and so getting a more efficient financial system to promote productivity growth that's going to be in China's interest at this point.

HUANG: That's right. Particularly if you see the so called ICOR, incremental capital output ratio which basically measures how many units of capital you need in order to produce one unit of GDP. The number was 3.5 in 2007 and now it's 6.3. That's why you hear people all complaining that finance is no longer supporting the real economy. The real story is that the efficiency of financial efficiency is declining. And partly it's related to varying efficient the state owned enterprises, so we need it to make changes now.

If we don't make changes, if the incremental capital output ratio continues to rise we would end up with zero growth.

DOLLAR: Right.

HUANG: That's something we want to avoid.

DOLLAR: Right. That's evidence that more and more investment is not really generating that much.

HUANG: That's right. But that's also why the government now is promoting the so called supply side structural financial reforms. I think the key focus is to improve financial efficiency.

DOLLAR: So I know one of the main purposes of your visit to Washington is a series events on FinTech, you know, financial technology. We just had an event at Brookings. I think it will be online, but at the very least the report that was underlying it will be online.

HUANG: That's right.

DOLLAR: So can you tell us a little bit about China's great leap forward in FinTech? What's behind it and what's being achieved?

HUANG: Well, if you look at the Chinese FinTech industry it's already, like, a leading global development, but if you compare the FinTech industry in China and in Western countries, particularly in the U.S. you will find some differences. In the U.S. when we talk about the FinTech industry the first thing come to mind is crypto currency, block chain technology, and so on. In China it's much more about mobile payment, online credit, and online investment and so on. These are much more about financial inclusion, about access to financial services.

So, the most impressive story about the FinTech development in China is the mobile payment service. We have two major service providers. One is called Alipay. The other is called WeChat Pay, and each of them has more than 1 billion active customers on their platforms. That really promotes the financial inclusion and how not just to make people life easier in daily life, but also promotes economic development.

So, for instance, we found in our studies that adoption of mobile payment service, number one, just simply raises households' average income. Number two, it promotes the increases of the probability an ordinary household to become an informal or formal business operators. And number three, we also found adoption of mobile payment is positively correlated with establishment of new registered businesses. So all of these suggest that not only are lives become easier when you have a mobile phone at hand with a mobile payment. We can buy air tickets. We can order lunchboxes, and we can pay for the phone bills or electricity bills, and so on.

You can also, like, live around your mobile phone. It satisfies almost all of your daily needs for the payment services. But at the same time, it is having a bigger impact on creating jobs, creating new businesses, and raise ordinary peoples' income.

DOLLAR: All right. The last couple of times I've been to China it's very impressive that it's becoming a cashless society.

HUANG: That's right.

DOLLAR: People just pay for things with their cell phone. They use one of these two programs. What you're essentially bypassing the banking system.

HUANG: Right.

DOLLAR: These are through big commercial enterprises.

HUANG: Well, David, part of the reason why this really took off was because the traditional financial system, as we discussed earlier, repressions, financial repression was still pretty serious. The government intervenes in a number of ways, and that actually restricted the extend of financial services provided to, especially, the small/medium enterprises and the poor households. So that's why when digital financial or FinTech start to grow it was immediately welcomed by a very big part of the market.

DOLLAR: So let's come back to the trade issues between the U.S. and China. One of the Trump Administration's concerns is China's industrial policy, particularly the program called Made in China 2025.

HUANG: Yeah.

DOLLAR: Which identifies ten frontier industries, things like electric vehicles, biotech, you know, where the aspiration is for China to become a global leader.

HUANG: Right.

DOLLAR: Personally, I don't see how we can argue with the aspiration.

HUANG: Sure.

DOLLAR: Issue is what are the tools. You often read in the Western press that there are massive subsidies to state enterprises to develop these industries. You know, how do we reconcile China opening up more and --

HUANG: Right.

DOLLAR: -- both countries trying to create a level playing field. How do we reconcile that with this industrial policy?

HUANG: Well, the first thing to start with is to recognize that the SOEs are not the main drivers of innovation in the Chinese economy. If you look at the number of patents created by the companies 70 percent of them are created by private enterprises, only 5 percent provides by SOEs, and 25 percent by foreign investor firms. So the first point to start to argue is that I think massive subsidies to SOEs is probably not the right strategy, and maybe we don't need to worry too much if the Chinese government does it again, but you look around at economy the main drivers of innovation are actually private enterprises which do not receive a lot of subsidy. That's the first point to start it with.

And that is why I think we probably don't need to worry too much about a policy like Made in China 2025. I personally think providing massive amount of subsidies is not the right way of upgrading your industry, and I agree with you if a developing country has aspiration of moving up its economy up the technological ladder and I think they should have the right to do it. But providing direct subsidy, especially the so called picking the winners approach will not deliver the expected result, so I think the approach needs to change. But if we continue with the old approach I don't think we're going to deliver the expected result.

DOLLAR: So President Xi and President Trump will probably meet at the G20 summit in Japan toward the end of June. There hasn't really been much negotiation or preparation but there's always hope. Probably they can't reach an agreement without the preparation, but maybe they can restart serious negotiations.

HUANG: Right.

DOLLAR: So I guess my question is how do you see that meeting, and more generally, you know, what are the prospects for negotiation and for the U.S. and China reaching some kind of a deal.

HUANG: Well, a while back we all were enthusiastic thinking the two sides could reach an agreement, but even then I think we were realistic enough to realize some of the issues are very difficult to reconcile, to agree to both sides. So even at that time we were only expecting a partial agreement, meaning on some issues like opening up of the financial service industry, maybe trying to temporarily reduce the bilateral trading imbalances, and improve protection of intellectual property rights and so on. On things like this we could make efforts and we could sign agreement.

But there are bigger issues I think it might be difficult to deal with. The technology competition now and the role of the government, the industrial policy just mentioned, and the rules of the state owned enterprises in the economy. Many issues I think are much, much more difficult to deal with. So I think now it looks even more difficult to reach an agreement in the near time given the difficulties we just experienced during the last month or two.

They probably will meet at the G20 summit, but it's very unlikely that we'll see an immediate agreement for both sides to sign. So my expectation is that they probably will restart the negotiation. And I'm still hopeful that at some stage there could be an agreement, but again, I think this probably will still be a partial agreement. There will be areas where agreement will be very difficult to reach. So my further expectation is that a partial agreement is possible, but partial decoupling of the economy on both sides has also become very likely so we can continue with some of the trade investments, the relations, but I guess decoupling in the tech sector looks inevitable now. In the financial industry it also becomes a lot more sensitive now. So I don't think we'll continue just integrate in some of these areas.

DOLLAR: Right. So as you say, the technology competition's getting pretty serious. It seems to me it's in both countries' interest to see if we could define a fairly narrow group of technologies where we're not going to cooperate, we're not going to trade and cross invest.

HUANG: Right.

DOLLAR: If we can keep that relatively narrow there's still going to be a lot of opportunities for integration.

HUANG: True, true.

DOLLAR: But then the larger risk is that both sides defines these national security issues in very,

very broad ways, and then we could start to get a genuine --

HUANG: Right.

DOLLAR: -- decoupling of the two economies.

HUANG: That's very unfortunate, as you probably would agree. In today's world it's impossible for any single country to just want to develop its own technological system on its own. Whether it's for China or for the U.S., so hopefully they're be some rooms open for further cooperation.

I think for China the biggest question now is, well, on the one hand, obviously, we will face difficulties at the very high end, but China is still an economy with a GDP per capital of $10,000, so we don't have to rely all these cutting edge technologies to support Chinese growth. We still have room to just catch up and learn from the others, certainly for the next five, ten years and so on. So that competition would be disastrous for China, for the U.S., but there's some room for China to continue to grow even without the most advanced technology.

But the second point I think is how much China can continue to expand and cooperate with the rest of the world in terms of technology. Really depends on what the other advanced countries were to decide. If, for instance, Europe, Japan, Australia, and so on they all want to line up with the U.S. and block the Chinese companies then it will be very difficult, but if the other countries take a much more flexible approach and I think that will be easier for China to cope with some of the difficulties with the U.S. at moment.

DOLLAR: I think that's a very important point because China has serious relations, obviously, with the European Union, Japan.

HUANG: Right.

DOLLAR: Lots of developing world.

HUANG: True.

DOLLAR: Calculated, I think there are over 100 countries that have more trade with China than the U.S.

HUANG: That's right.

DOLLAR: Including every country in Asia except Afghanistan and Bhutan.

HUANG: Right.

DOLLAR: So these are important issues. So if your instinct is right which I think makes a lot of sense that even if there's some kind of deal in the short run --

HUANG: Right.

DOLLAR: -- U.S./China trade relations, overall economic relations are probably going to be difficult --

HUANG: That's right.

DOLLAR: -- for some time to come. So what's the best strategy for China, taking that as a given? Trade and investment strategy?

HUANG: I think the best strategy is to continue with unilateral liberalization. Now, China was successful during the last 40 years, as we discussed earlier, was because China started unilateral reform and opening up. And I think compared to the rest of the world, especially the advanced economies, I think the degree of openness can certainly be increased substantially in many areas. We already discussed some of the service sectors and so on. I think China should continue to liberalize. China benefited from its unilateral liberalization in the past and it can continue.

In fact, that is also a way of increasing the confidence of the rest of the world to continue to cooperate with China. So negotiation with the U.S. will continue and it will be troublesome. Hopefully we'll make some progress over time, but my single most important advise to the policymakers is that get on with the reform and the liberalization that China has been doing for the past 40 years which actually paid off quite handsomely, and I think it will continue to do so.

DOLLAR: Right. So with the U.S. trade measures I would think they'd be some people in China who would take the attitude that China should close itself off because the U.S. is really undermining the globalization that's benefited China, but you're making a very articulate argument that China should do the opposite, should unilaterally open up. That's going to be good for China. It's going to influence partners, Japan, Europe, and, perhaps, the United States.

HUANG: Well, David, I think we had a lesson from history. In Qing Dynasty we faced a difficult environment outside. We shut down ourselves, and I think the result was very undesirable, so we shouldn't repeat that history again. And after all, the outside world develop becomes less favorable now, but I think globalization will continue. I don't think globalization is completely reversed. We see some hiccups and some of the problems in some areas, but overall I think the trade and investment regime will remain largely open.

We will have to deal with some of the problems on the way. For instance, we may also have to deal with other countries more carefully where structure adjustment becomes a bigger issue so we need to play more sensitively. China used to be a small country economy so other people really don't mind whatever pace we expanding, but now we're a large company economy and what the Chinese like to say, whatever we buy international market it becomes more expensive or whatever we sell it becomes cheaper. That's something we needed to pay attention to. So we need to continue to liberalize, but just to keep in mind whatever we do now will have significant spillover effect on the rest of the world, and that's something we need to keep in mind.

DOLLAR: So I've been talking to Huang Yiping an economist at Peeking University, very articulate spokesperson giving us some insight into Chinese thinking about the trade war, how trade has benefited China during its opening up, prospects for a U.S./China deal do not look particularly good right at the moment, but Huang Yiping is advocated that China continue to open up. That's going to be good for China and good for the world. So thank you very much, Yiping.

HUANG: Thank you. It was a pleasure.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar & Sense every other week, so if you haven't already, make sure to subscribe on Apple Podcasts or wherever else you get your podcasts and stay tuned.

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