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Should Latin America Fear China?

by

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Abstract[1]

This paper compares growth conditions in China and Latin America to assess fears that China will displace Latin America in the coming decades. China's strengths include the size of the economy, macroeconomic stability, abundant low-cost labor, the rapid expansion of physical infrastructure, and the ability to innovate. China's weaknesses, stemming from insufficient separation between market and state, include poor corporate governance, a fragile financial system and misallocation of savings. Both regions share important weaknesses: the rule of law is weak, corruption endemic, and education is poor and very poorly distributed.

JEL classifications: E66; O57; P52.

Keywords: China; Latin America; economic growth; investment climate.

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1. Introduction

China has been the world's fastest-growing economy in the last three decades. Since the start of the economic reform process in 1978, the economy has shown an average real growth rate of 9.4 percent per year. Eliminating the most obvious factors of overestimation that these official statistics may have, University of Chicago economist Alwyn Young has recently estimated that growth has been 1.7 percentage points lower, and annual per capita income growth has been 6.1 percent instead of the officially reported 7.8 percent.[2] However, even with Chinese growth rates that are two or three points lower than officially reported, Latin America does not shine in comparison. The region's overall average growth since 1978 has been only 2.3 percent annually. Thus, while per capita income in China increased more than sevenfold between 1978 and 2005, according to official figures (or about four times according to Young's adjustments); the average increase in Latin America in that period was only 20 percent. An while manufacturing has been the leading sector in China, with average growth rates over 12 percent, the performance of the Latin American manufacturing sector has also been disappointing: its annual average growth in the 1980s was 0.3 percent, and in the 1990s only 2.5 percent.[3]

Since China joined the World Trade Organization in December 2001, these divergences have attracted growing attention because of fears that competition from Chinese products was having a devastating effect on clothing *maquilas*, electronics products industries and many other industrial products from thousands of companies around Latin America. Competition from China may be one of the reasons for the decline in foreign direct investment to Latin America (see Figure 1). In Mexico, inflows of foreign direct investment (FDI) fell from $26.6 billion in 2001 to $11 billion in 2003 and 960 firms left the country in that period, with an estimated loss of over 300,000 jobs (254,000 in the *maquilas* alone).[4] Although these trends partly reversed in 2004, with FDI rising to $14.4 billion and an estimated increase of 70,000 *maquiladora* jobs, fears have mounted again, as FDI fell back to $11.3 billion in 2005. For Latin America as a whole,

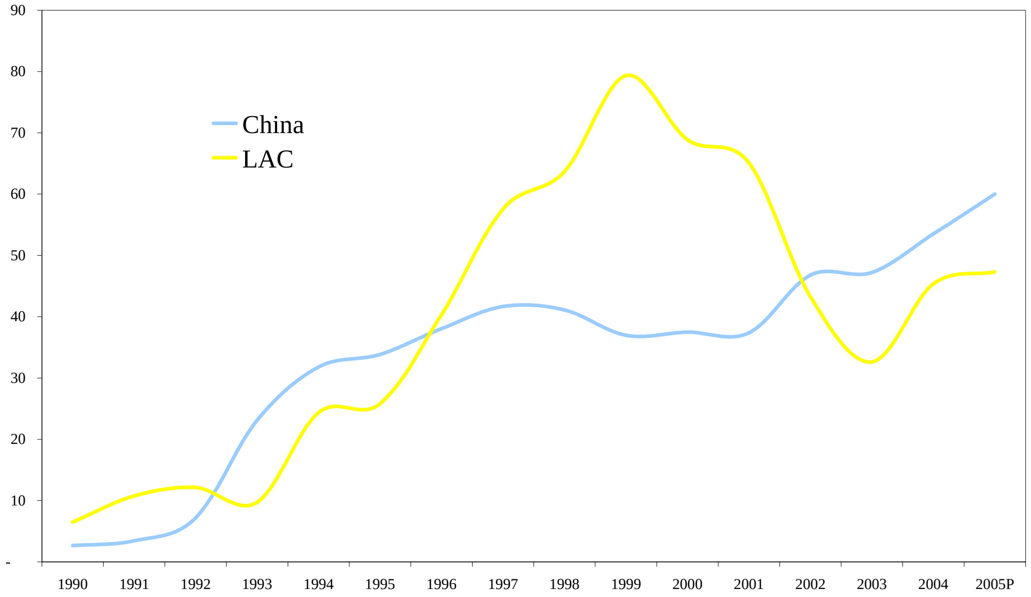
[2] Young (2003). Note that Young's calculations are for the 1978-1998 period, when annual growth was 9.1 percent according to official figures. In the opposite direction, however, the results of a national economic census conducted in 2004 indicate that the economy is 16.8% larger than previously reported and growth rates between 1994 and 2004 up to 1.5 percentage points higher than the official 9%. See *Oxford Analytica*, "China: Census expands size of economy", December 22, 2005.

[3] See Lall, Albaladejo and Mesquita (2004). It should be noted, however, that, according to Young, manufacturing is the main source of overestimation of growth.

[4] *Oxford Analytica*, "Mexico: Maquiladoras Sector will Increase Activities," March 29, 2005.

although FDI has risen from a low of $32.6 billion in 2003 to $47.3 billion estimated for 2005, it is substantially below the peak of $79.3 billion reached in 1999.[5]

Figure 1
Net Foreign Direct Investment (US$bn)



P Preliminary
Source : Economic Comission for Latin America and the Caribbean (ECLAC) for Latin America and the Caribbean (LAC) and World Development Indicators (WDI), the Economist (2004) and WEO (2005) for China

[5] FDI figures come from Cepal (2005). Data for 2005 are estimates.

This paper attempts to assess whether fears that China will displace Latin America in the coming decades are well founded. Several papers have tackled this issue from a microeconomic perspective, comparing factor endowments, export structures or key cost components such as labor or transportation costs.[6] This paper approaches the issue from a different perspective: it attempts to provide a comparison between China and Latin America based on the main variables that are closely associated with growth and/or with the ability of countries to attract foreign direct investment, along the lines of recent empirical literature. While this approach does not lend itself to empirical testing, it provides a more comprehensive and balanced view of China's economy, which may be useful both to prospective investors and to practitioners and analysts, especially those already familiar with Latin America.

This paper argues that China's strengths in relation to Latin America derive from the size of the economy, the country's macroeconomic stability, the abundance of low-cost labor, the rapid expansion of its physical infrastructure, and its ability to innovate. China's main weaknesses are a by-product of the lack of separation between market and state. This results in poor corporate governance, a fragile financial system and a tendency to misallocate savings, which is currently manifested through excess investments in many sectors. China also shares with Latin America several deep deficiencies. In both regions, the rule of law is weak and corruption endemic, education is poor and very poorly distributed, and broad-based innovation is discouraged by the lack of respect for property rights, and by norms and practices that inhibit competition. In the medium term, both China's and Latin America's abilities to correct their institutional flaws will determine their ability to achieve higher income levels and fully integrate into the world economy. Following this introduction, Section 2 describes China's strengths, Section 3 discusses China's weaknesses, and Section 4 considers important deficiencies that are common to both regions. Section 5 concludes.

[6] For a comparison of factor endowments and export structures in China and Latin America see Schott (2004). For a comparison of transportation costs and their role in export competitiveness see Hummels (2004).

2. China’s Strengths

Countries do not compete with each other, companies compete, as Paul Krugman cautions.[7] China’s growth is not at the expense of Latin America’s, even though some foreign investments have preferred to go to China. In fact, the growth of China has most certainly been favorable to Latin America. The reason is simply that China is the most powerful source of world economic growth. Since 1995 China has generated one fourth of all world growth, even outperforming the United States when calculations are made at purchasing power parity values.[8] This results in expanded markets and better export prices, especially for primary goods, which are a very important source of external revenue for Latin America. Another result is higher world savings, which help finance countries with external deficits, as is usually the case of Latin American countries and the United States, whose enormous current account deficit (which benefits Latin America) can only be sustained by the direct external financing that it receives from China (and other Asian countries). Consequently, when underscoring China’s strengths in relation to Latin America, it is important to bear in mind that the comparison is useful for understanding why China is more successful than Latin America, but it does not mean that conditions in the region would be better if China lacked these strengths.

A. Size

China is the sixth largest economy in the world and, at the growth rate that it has enjoyed in the last decades, it appears set to become the largest economy in the world in less than 40 years when GDP is valued at market exchange rates. But if GDP is valued at purchasing power parity rates, China is already the world’s second largest economy and would overtake the United States in less than a decade if current growth rates in both countries are maintained. Its importance in international trade is also impressive, as China is more integrated into world trade than other countries such as India, Brazil and the United States. While these countries’ exports and imports are no more than 25 percent of GDP, China’s trade represents 50 percent of its GDP (at market value).[9]

[7] Krugman (1994).

[8] *The Economist*, November 15, 2003.

[9] However, this ratio would fall to around 42 percent with the recent revision of the size of the economy mentioned in a previous footnote.

Size is a source of advantages because it helps attract foreign investment to exploit the domestic market and to produce for export, taking advantage of the enormous supply of labor, which is China's most abundant resource.[10] In such a huge economy, companies can exploit economies of scale in production, transport and marketing, which are decisive for penetrating international markets.[11] The size of Chinese cities also offers an opportunity to exploit economies of agglomeration, facilitating the formation of company clusters that complement and compete with each other. This factor is crucial for developing and exploiting skilled labor resources and expanding sectors that depend on knowledge and innovation. In the case of China, however, other factors prevent companies from using these advantages to the fullest, such as the special status enjoyed by state companies and the poor climate for innovation, as we will see later.

B. Sustained Growth

The best-known international competitiveness indicator is the Growth Competitiveness Index published annually by the World Economic Forum. Its latest edition ranks China 49 out of 117 countries.[12] This position does not seem very exceptional, although it is 23 places higher than the position held by the median Latin American country. Because of its construction method, the index tends to be closely related to the countries' income level, which means that richer countries always tend to occupy higher positions. After controlling for income levels, however, China turns out to occupy an extraordinary position in relative terms. In Latin America, only Chile occupy a position significantly higher than that predicted by its income levels. This is important because the countries that have good positions relative to their income level tend to grow more rapidly later and conversely.[13] For this reason, the indicator is a good barometer of the quality of the environment for the *future* development of productive activities because it incorporates factors that are crucial for economic growth, such as macroeconomic stability, the quality of institutions and the environment for technological improvements and innovation.

What makes China outstanding in comparison to Latin America, according to this competitiveness indicator, is the stability of its macroeconomic environment. (As we will see, the quality of its institutions and the environment for innovation leave much to be desired, although they are not bad for their income level). China ranks 33rd according to this indicator,

[10] For the importance of market size in foreign direct investment, see IDB (2001), Chapter 18.
[11] See Hummels (2004).
[12] World Economic Forum (2005).
[13] For a technical discussion of this result, see IDB (2001), Chapter 1.

outperforming the typical country of any developing region. The typical Latin American country ranks at 82, revealing that Latin America is the region with the world's most severe macroeconomic instability.

More specifically, what underlies this indicator is the level and stability of economic growth and the good risk ratings that international analysts assign to China on the basis of its growth record, low inflation rates, low levels of government debt and the soundness of the country's international reserves and external balance. Naturally, there is a certain amount of circularity: since China has experienced rapid and stable growth in the past, it receives good risk ratings that maintain the expectation of sustained growth, which becomes a self-fulfilling prophecy. The opposite could be said of most Latin American countries. These expectations, however, are a double-edged sword; although they provide time to solve macroeconomic or structural imbalances, they also provide a temptation to ignore those imbalances. This could be the case for the weaknesses of the Chinese financial system, which we will address further below. It is also the case of the repressed appreciation of the renminbi, whereby an excess supply of foreign exchange has given rise to an accumulation of international reserves of gargantuan proportions. In 2005 alone, international reserves increased by $209 billion, reaching $818.9 billion (or 42.8 percent of GDP at current prices).[14] Such a stock of reserves represents a "war chest" that, along with other features of the Chinese economy, offers protection against the risks of a sudden stop of capital flows and other external sector risks, but high reserve levels exert pressure on the money supply[15] and on the prices of key assets, such as real estate, and may eventually lead to inflation. What seems to have prevented inflation until now is the combination of high rates of income growth (which boosts money demand) with rapid productivity increases (which ameliorate the effect of labor and other input cost increases).

C. Cheap and Abundant Manpower

The abundance of cheap labor is China's most evident advantage in attracting foreign investment and exporting manufactures. The *average* wage in manufacturing industries was only $112 a month in 2002,[16] which is lower than the *minimum* wage in many Latin American countries

[14] Calculations based on The Economist Intelligence Unit and *The Economist* online.

[15] Broad money (M2) supply grew 18.7 percent in 2003, 14.1percent in 2004 and 17.9 percent year-on-year to September 2005. Source: The Economist Intelligence Unit (2005).

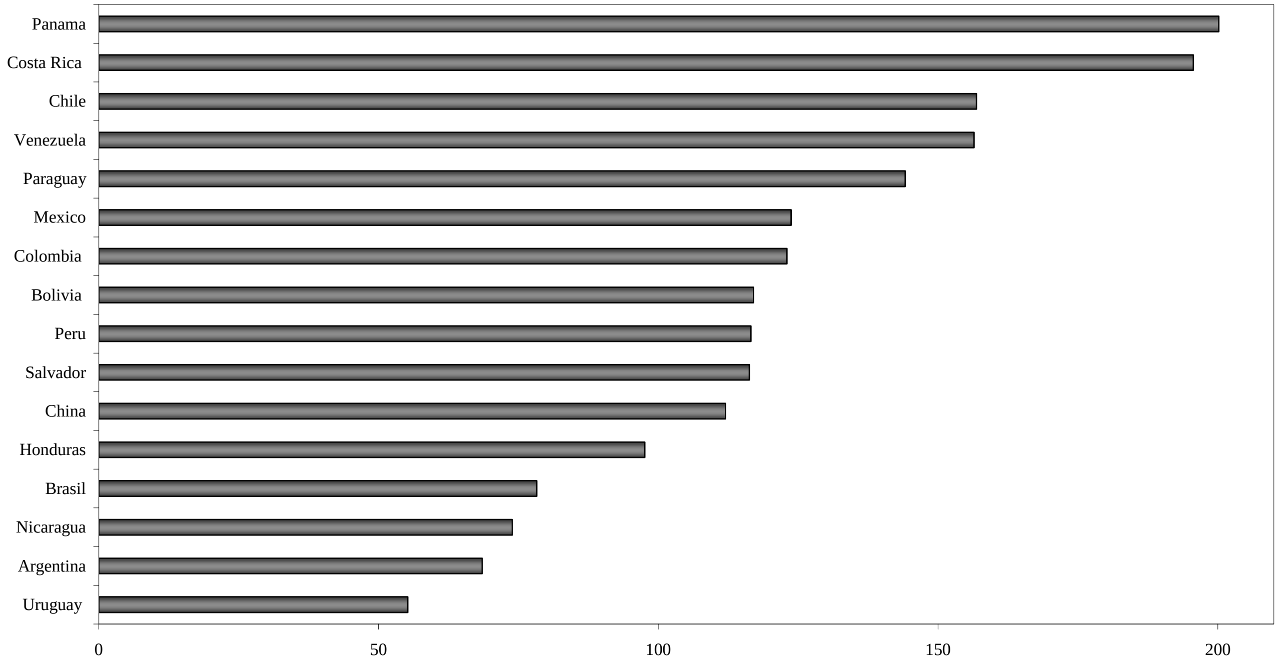
[16] Calculation based on statistics from *China Statistical Yearbook* reported by the World Bank (2003a).

(Figure 2). In 1990 the average wage was $36 a month, which implies a 9.9 percent annual wage increase since then. This is not substantially different from the economic growth rate of that period (9.7 percent) or the growth rate of workers' productivity in the overall economy (8.5 percent).

Even though industrial wages have been rising at the rate of economic growth, this does not mean that there are restrictions on the (total) labor supply. According to official sources for 2003,[17] the working-age population totals 897 million, 84.8 percent of which effectively participate in the labor market. This is one of the highest labor participation rates in the world, possibly thanks to the culture of incorporation of women and the low fertility rates promoted by the communist system. Although employment in the overall economy has grown only 2.5 percent annually since 1980 (and only 1.1 percent since 1990), the most dynamic sectors have not suffered from labor shortages thanks to redundant employment in agriculture and state companies. Employment outside these two sectors has grown 7.9 percent annually since 1980 (or 5.3 percent since 1990).[18] This process is far from being exhausted. It has been estimated that there are 160 million surplus workers in the inefficient sectors and, in the next quarter of a century, the rural population could decline by 300 million people.[19]

[17] National Bureau of Statistics of China, *China Statistical Yearbook*, various years.
[18] As calculated by Brooks and Tao (2003) up to 2001.
[19] Wolf (2003).

Figure 2. Minimum Wages in Latin American Countries and Average Wages in China, 2002 (US dollars per month)



Source: Inter-American Development Bank (IDB) calculations based on official data.

Despite the importance of rural-urban migration, the phenomenon is constrained by a multitude of restrictions, which are only gradually being relaxed. The most important has traditionally been the household registration system (*hukou*), which is required in order to remain in the cities and have access to jobs and the basic services of education, healthcare and social security.[20] Migration has also been limited by emigrants' fear of losing their land ownership rights in their rural areas of origin, and by the stricter limit on the permitted number of births per household in the cities. Since 2001, people with stable employment and residents have been allowed to register in over 20,000 small towns and cities without fear of losing these rights, and several taxes on migrants have been dismantled. Severe restrictions persist in most large cities, however, and some time will pass before the 2001 reform is fully applied, even in the small cities.[21]

[20] For instance, while 67.7 percent of local residents in a sample of five major cities have access to health insurance, just 12.4 of migrants do. See OECD (2005, p. 52).

[21] Brooks and Tao (2003).

The reassignment of the labor force into more efficient sectors has been the major source of (total factor) productivity increases, which have contributed around 4 percent per year to GDP growth over the past two decades. Taking into account the differences in the average level of labor productivity between agriculture, manufacturing and the service sector, the OECD has calculated that about one-fifth of the change in income per capita since 1983 has come from the reallocation of labor. But the actual contribution of the sectoral reallocation could be higher, since the productivity of the marginal worker who leaves agriculture is estimated at one-sixteenth that of the marginal worker in the urban areas. Although the contribution of sectoral change to GDP growth weakened in the second half of the nineties, it has picked up since 2000 and it is certainly far from exhausted.[22]

Latin America has also witnessed a significant migration of workers from rural areas to the cities. In 1980, half the population of the typical country of the region lived in rural areas: currently only one out of three people lives in the countryside.[23] This process, however, has not resulted in appreciable increases in productivity. In contrast to China, productivity has contributed very little to growth in Latin American countries, with the single exception of Chile (where it has added 1.8 points to growth in the last 20 years).[24] The shift of employment from country to city has not helped much because of the modest rural-urban labor productivity gap (typically 30 percent)[25] and because the sectors with the highest productivity in the cities have generated few jobs. As a result, Latin America, unlike China, has not succeeded in using the surplus labor from its inefficient sectors.

One of the reasons for this difference, although clearly not the only one, is the extremely protectionist nature of Latin American labor legislation in comparison with China’s or, more accurately, with China’s dynamic sectors. Labor laws in Latin America regulate in considerable detail the length of the working day, as well as vacations and other worker benefits. Laws further regulate the conditions for the dismissal of workers and the compensation that employers must pay when they cannot demonstrate compliance with these conditions, which is typically fairly high. China has no similar national labor code. In the traditional system of the “iron rice bowl,”

[22] OECD (2005), Chapter 1.

[23] According to World Bank (2003b) statistics, the median percentage of rural population in the region was 50.1 percent in 1980 and 36.5 percent in 2000.

[24] Loayza, Fajnzylber and Calderón (2002). According to these authors’ calculations, Chile is the only country in which productivity contributed to growth in the 1980s and 1990s.

[25] See IDB (1998), Chapter 2.

state companies were responsible for the obligations of labor protection and social security, which they independently granted to their workers as a mechanism for maintaining discipline in exchange for life-long job security (benefits that, in other respects, were very generous, and remain an unresolved problem for many companies). This traditional system, however, has led to demands for improvements in pay, non-wage benefits, and hiring and dismissal conditions which vary from region to region, and which are partly negotiable between private companies and the local authorities and/or the labor unions. Consequently, current labor legislation for private companies provides less protection of employment conditions and job security than typical laws in Latin America, and its application is also much less predictable.[26]

Although China possesses an enormous reserve of rural labor that could sustain growth during the coming decades, the longer-term prospect is hardly encouraging because of the demographic trends stemming from the one-child policy. For every person over 60 years of age, there are currently some six of working age. It has been thus for more or less half a century, but that ratio is beginning to fall, and as of 2040 there will be only two working-age people for every person over the age of 60. Latin America is starting from a younger demographic base, so that until 2040 it will have the six-to-one ratio that China now enjoys.[27] China will then be confronted by an enormous social burden that will require it to raise taxes quite far above the levels typical of Latin America.

D. The Physical Infrastructure Boom

China’s transport, communications and energy infrastructure was, until 20 years ago, very much below the standard of Latin America’s most developed countries. Although serious deficiencies persist, and it is difficult to meet the fast-growing demand for infrastructure services of all kinds, recent improvements have been truly noteworthy, especially in roads, ports, telecommunications and electricity, which will likely contribute to sustaining growth. Because of the privatization process, many Latin American countries have also made good progress, although concentrated largely in the areas of telecommunications and, to a lesser extent, electricity and ports. In China, government investment in public works has grown faster than the economy as a whole (rising from 2.6 percent of GDP in 1991 to 3 percent in 2002). This has not been the case in Latin America, where investment in areas that have not attracted private sector attention has been

[26] See OECD (2003), pp. 100-102.
[27] Calculations based on United Nations (2002).

neglected. Total (public and private) spending in infrastructure in Latin America is currently less than 2 percent of its GDP, down from 3.7 percent during 1980-85.[28]

China's railways, which are the backbone of the transport system, have received large investments in recent years, including a second line from Beijing to Kowloon (Hong Kong) and the extension of the network to distant areas such as Kashgar in Xinjiang and to Tibet. The total length of railways in operation reached 61,000 kilometers in 2004, up from 53,400 in 1990. High-speed rails lines will reduce the travel time between Shanghai and Beijing from 13 hours to less than five, as part of an ambitious scheme to construct 5,400 kilometers of high-speed rail track between 2006 and the end of the decade. On roads, progress has been even more remarkable: since the early 1990s, inter-provincial expressways have increased from zero to 34,300 kilometers in 2004, and the total length of highways rose to 1.9 million kilometers. Port facilities have improved appreciably in recent years. China has 200 ports, some of them among the 10 largest in the world. Many ports, however, are too shallow for large container ships. The most important project aimed at resolving this problem is the expansion of Shanghai's port, the first phase of which was inaugurated in late 2005. The whole project will take another 15 years to complete.

The serious limitations facing China's electricity infrastructure are also in the process of being addressed. The government plans to raise installed capacity from 290 GW in 2000 to 550 GW by 2010. The telecommunications sector is going through an unprecedented boom, and China now has more cable television subscribers (115 million at the end of 2004) and more mobile telephones customers (335 million in 2004) than the United States. China also has 312 million fixed telephone lines and 94 million Internet subscribers. According to the government, the extension of the optical fiber network will bring broadband multimedia access to all urban homes by 2010.[29]

E. The Ability to Innovate

With its low level of income, at current growth rates China will take over two decades to reach half the income per capita (PPP) of the United States. A small economy in this situation would use all of that time to continue exploiting external technological development. China's size,

[28] Fay and Morrison (2005).

[29] The infrastructure indicators are taken entirely from Economist Intelligence Unit (2006), pp. 26 and following, and *The Economist*, March 30, 2006, p. 69.

however, imposes the need to conquer increasingly sophisticated goods markets with ever-higher technological and innovative content, and this is exactly what China has done. Supported by a massive flow of FDI in high-technology sectors, China is becoming the top provider of several electronic goods. Along with Hong Kong, it is already supplying more than half of DVD players and digital cameras produced worldwide, more than a third of DVD-ROM units, personal computers and notebooks, and at a least a fourth of the mobile phones and color television sets. China has transformed the supply structure of the electronics industry and already accounts for 30 percent of all exports of electronic goods from Asia.

These achievements are the result of a long-term, multi-pronged innovation strategy that started in the 1950s with the support of technologies deemed critical for national defense, and moved in the mid-1980s to the adoption of key advanced civilian technologies. R&D commitments have been climbing in recent years and now exceed 1 percent of GDP. With the important exception of Brazil, where R&D represents 0.9 percent of GDP, R&D efforts in most Latin American countries are much smaller (0.2-0.6 percent of GDP).[30] The government has long recognized that planners do not have the technical capabilities to evaluate the technology being created, and they have therefore encouraged research institutions to commercialize their research product. Innovation is also supported by industrial policies in software and integrated circuits, which provide research funding, preferential procurement policies and tax exemptions. Crucially, both foreign-invested and domestic firms enjoy preferences, and policies are generally across-the-board, without any attempt to "pick winners" within the sector. Research incentives seem to have paid off handsomely: according to a 2000 R&D survey, some 60 percent of China's R&D outlays are now being made by enterprises. Innovation has recently been encouraged further by the creation of Chinese technology standards, as opposed to global technology standards. This gives Chinese firms a competitive advantage, since it delays the entry into the Chinese market of foreign technology-holders and gives Chinese firms bargaining power with foreign suppliers over technology and intellectual property. This strategy has been instrumental in the development of some new digital technologies to the advantage of Chinese (and Taiwanese) firms. Despite (or because of the failure of) some earlier attempts, Latin American governments dismantled their incipient industrial policies in the 1990s and only now are starting to reconsider them.

[30] Data for China are taken from Naughton (2004). For Latin America, see IDB (2001), Chapter 16.

However, the environment for innovation in China has several limitations, many of them similar to those found in most Latin American countries. Starting new companies is hindered by irksome procedures; access to credit and capital markets is very limited; property rights are weakly protected; and competition is restricted by geographical and infrastructure barriers that raise the cost of transport and by a multiplicity of local protection mechanisms for industries in the form of operating permits, requirements for use of local raw materials, taxes and other restrictions.[31] It is time to see the other side of the mountain.

3. China's Weaknesses

The overriding weakness of the Chinese economy is the lack of separation between the state and the market. It is not simply that the state interferes strongly in the decisions of other economic agents, as happened in Latin America before the wave of structural reforms of the last 20 years, but that the state is the most important agent in domestic and international production, as well as in marketing decisions. In fact, the state is still the main employer and the main channel for the allocation of savings in the economy. The lack of separation between the state and the market extends to all aspects of economic activity. This is aggravated by the fact that the state is not a cohesive centralized entity but a thousand-headed hydra that operates at all levels.

As this section will show, the lack of separation between the state and the market is evident in poor corporate governance, major risks in the financial sector and the use of a variety of controls that favor state-owned enterprises and reduce market discipline. A current manifestation of inadequate market discipline is the problem of overinvestment in many sectors.

A. State-Owned Enterprises and Corporate Governance

In China it is not possible to precisely define the dividing line between public and private property. The introduction of non-state forms of production began with the system of rural responsibility that led to the privatization of agriculture (although not rural land, which remains under state or community control) and to the proliferation of "town and village enterprises," small and medium light manufacturing firms. The success of this experiment led the government in 1984 to initiate a reform process in state industrial companies, which is continuing. The objective of the process was not privatization as such but the strengthening of the capacity of

[31] World Bank (2003a, p. 26).

state control over key sectors of the economy as a means of preserving the existing political system. In the process, the Chinese state has experimented with an enormous variety of forms of state, collective, foreign and individual ownership, all of which currently coexist around a nucleus of large state companies, which in 2001 accounted for 47.3 percent of investment in the fixed assets of the economy and 44 percent of industrial production. Even then, however, the number of state companies had already fallen by two-thirds from 87,900 in 1995 to 34,500, as a result of the strategy of "grab the big and let the small go" announced by Zhu Rongji in 1998.[32] As a result, the share of state- and collectively controlled firms in the business sector declined from 46.5 percent in 1998 to 36.7 percent in 2003, measured by value added.[33]

The last step in this reform process was the establishment in 2003 of the state-owned Assets Supervision and Administration Commission (SASAC), which currently exercises direct control over 169 large state companies, guaranteeing that the three largest companies in the main economic sectors remain state-owned, and that 30 percent to 50 percent will be "national champions" or "globally competitive" multinationals by 2010. This does not mean, however, that the other state companies will be privatized, but rather that they will have to support themselves. An explicit objective of the reform is to expand the capacity of state control through laws and regulations on ownership and corporate governance. The preferred way to restructure state companies throughout China is to set up an operating company to hold productive assets. This company is in turn owned by a holding company, which is also state-owned. These holding companies exercise control and assume responsibility for the social obligations that all state companies had in the past (education, housing, social security). Many state-controlled operating companies offer shares on the stock market, a mechanism that in practice also contributes to expanding state control because minority shareholders lack the rights that are common in other countries. In addition, the reliability of accounting systems and external auditing is seen as very poor, and the practice of selling shares among holders to manipulate their value is rampant, according to the international indicators of the World Economic Forum. Moreover, the Corporation Law has been designed to facilitate the corporatization of state companies; at the

[32] *China Economic Quarterly* (2003), pp. 20 and following.

[33] OECD (2005), pag. 81.

same time it imposes earnings reinvestment requirements and restricts the composition of boards of directors in ways that are detrimental to independent control of private companies.[34]

Since state-owned enterprises are structured to respond more to the political and strategic objectives of the Communist Party than to market signals, it is not surprising that investment decisions are often flawed, leading to overinvestment. Foreign firms are also encouraged, especially by local governments through a variety of incentives, to invest in sectors that may bring political recognition. Excess capacity is rampant in steel, aluminum and cement, sectors that are under the control of the government, but it is also noticeable in automobiles, electronics, communications equipment and many other sectors with high foreign participation. The major risk caused by overinvestment is that many state-owned firms may find it impossible to honor their financial commitments with the already overextended official banks.

B. Financial System

The financial system has traditionally been at the service of state companies, and it is without doubt the Achilles' heel of the Chinese economy. Although China has one of the deepest financial systems in the world—in 2004 the stock of domestic credit rose to 160.7 percent of GDP and the value of the broader money supply in circulation expanded to 184.9 percent of GDP[35]—in practice access to credit is restricted to state-controlled companies and the largest firms of the private sector. Small and medium size businesses, which account for more than half of GDP, receive less than 10 percent of total bank loans.[36] In the opinion of businesses consulted by the World Economic Forum, access to credit is more restricted than in most Latin American countries, where typical ratios are 30 percent of GDP. Since equity market access is also tilted in favor of incumbent (and especially state-owned) firms, efficient methods of allocating savings are clearly wanting.

The banking system is dominated by four major state banks originally oriented toward separate sectors: the Bank of China, the China Construction Bank, the Industrial and Commercial Bank of China, and the Agricultural Bank of China. There is also the People's Bank of China,

[34] However, the legal framework for the private sector will probably improve with a new bankruptcy law to be adopted in 2006 that is acknowledged to follow international best practice, and with the likely implementation of the 2004 constitutional amendment that recognized property rights.

[35] Calculations based on statistics reported by The Economist Intelligence Unit (2006), p. 61.

[36] OECD (2005), page 142. According to Duenwald and Aziz (2003) loans to state companies in the strict sense were 67.6 percent of GDP in 2000 out of a total equivalent to 124.6 percent of GDP in that year.

which operates as central bank (and until recently as regulator of the banking system), along with many state-owned commercial banks, most of them regional. Until 2003 there was only one private bank other than branches of foreign banks, which could only offer international services. Since 2003 foreign banks have been able to provide services in local currency to Chinese companies, and as of the end of 2006 those banks will be able to offer services to individuals. Pursuant to commitments made by China upon its accession to the World Trade Organization, various geographical restrictions on the operation of foreign banks will also be eliminated in 2006.

These limitations contrast with the freedom of entry and operation that has existed in most Latin American financial systems since the reforms of the 1990s. However, the main weakness of the Chinese financial system is not related to these restrictions but to the quality of regulation and supervision. According to official figures at the end of 2002, the non-performing debts of the four major state banks were equivalent to 26 percent of their assets.[37] As of September 2005, the non-performing loan ratio of the big four banks had declined to 10.1 percent,[38] due to the policies adopted to clean up their portfolios, as summarized below. However, the real bad debt ratio is thought to be higher, because of the practice of refinancing financially troubled state companies at interest rates controlled by the government.[39]

The government has taken several measures to deal with the problems of the major banks. In 1998 they received a $33 billion capital injection, and their bad debts were transferred to asset management corporations for liquidation. In 2003 the Chinese Banking Regulation Commission was established, and in January 2004 a new capital injection of $45 billion was granted to two of the four largest state banks (Bank of China and China Construction Bank), which raised their capital to risk-weighted assets ratio from 7 percent to 16 percent (the international standard is 8 percent). In 2005, a further $15 billion was injected into other of the four big banks (Industry and Commerce Bank of China), and in late 2005, the China Construction Bank was listed in Hong Kong and raised $8 billion from international investors in the world’s largest initial public offering for four years (the Bank of China is expected to follow

[37] Quoted by *Oxford Analytica*, July 17, 2003.

[38] The Economist Intelligence Unit (2005), p. 28.

[39] According to “A Survey of China” published by *The Economist*, March 25th, page 13, “UBS, an investment bank, reckons that the non-performing loan stock of the big four and other Chinese banks is now only around 30%, half of its peak in the late 1990s (though that would still make China’s one of the worst banking systems in Asia).”

suit soon).[40] However, the banks will remain under central government control and their management exposed to political influences.[41]

Many Latin American countries have experienced banking crises in the last 20 years, which have forced them to strengthen their systems of supervision and prudential regulation, raising them above current levels in China. Needless to say, the macroeconomic volatility characteristic of Latin American countries is a source of vulnerability that China has not had to face, at least so far. But there is ample evidence that financial liberalizations often turn sour in countries that lack adequate institutional infrastructure. This is because the previous system of interest rate controls and directed credit may have created weak bank portfolios and failed to promote a good "credit culture,"[42] concerns that fully apply to the case of China. Research on financial crises has also shown that when basic institutions that govern credit markets are flawed (i.e., when the rule of law is weak, creditors are unprotected, and regulation is deficient) liberalization increases the likelihood of a crisis.[43] This means that, while current conditions in the financial sector pose a threat to the stability China has enjoyed, the process of reform and eventual liberalization will not be risk-free.

Given the difficulties of reforming the financial sector, equity market liberalization could in principle make a major difference in China. Countries that are more financially developed experience a larger than average boost from equity market liberalization, which suggests that China could obtain an important benefit. Again, however, this effect tends to be muted in countries, like China, with poor legal systems and weak investor protection.[44]

C. Trade Regime and International Transactions

Like Latin America, in the last 20 years China has drastically cut tariffs and eliminated most restrictions on imports. The average tariff rate fell from 43.3 percent in 1985 to 12.7 percent in 2002, following a slightly slower process than Latin America's, but one similar in scope.[45] Shortly after Latin America, China unified its exchange market in 1994, and in 1996 the main restrictions on foreign exchange trading associated with international trade

[40] The Economist Intelligence Unit (2005, p. 27).

[41] See *Oxford Analytica*, "China: Capital Injections Reflect Serious Intent," January 12, 2004, and "China: Party Stays in Charge Amid Bank Reform", October 6, 2005.

[42] See Caprio and Hanson (2001).

[43] Demirgüç-Kunt and Detragiache (1998) and Arteta, Eichengreen and Wyplosz (2001).

[44] Bekaert, Harvey and Lundblad (2004).

[45] Yang (2003).

were eliminated. In other respects, however, international goods and capital transactions are subject to restrictions that do not exist in Latin America. Only authorized companies may engage in international trade transactions. Until 2005, regulations prevented privately-owned entering a number of sectors, such as infrastructure, public utilities and financial services. All incoming capital is deposited in a special account, and payments or transfers against these accounts require approval from the State Administration of Foreign Exchange (SAFE). Until early 2006, foreigners were only allowed to invest in B shares, which do not have the same rights as regular A shares. (New rules allow some overseas investors to buy A shares as long as they purchase at least a 10-percent stake in the listed company and hold the stock for at least three years.) All outward capital operations require authorization from SAFE, and Chinese investment abroad is regulated and controlled by the China Securities Regulatory Commission.[46]

D. Misleading Indicators, Uncharted Paths

Because of the lack of separation between the state and the market, many economic indicators must be interpreted with caution. We have seen, for example, that financial depth does not reflect ease of access to credit because the credit systems are largely controlled by the state. For the same reason, the total savings ratio is not a good indicator of the economy's investment capacity, or at least of investment capacity according to efficiency criteria. According to official statistics, China's savings and investment rates—at close to 50 percent of GDP (or 44 and 40 percent of GDP, respectively, according with the recent revisions to 2004 GDP[47]) —may be the highest in the world and more than double the typical rates in Latin America. It might be thought that rapid economic growth is the natural result of these rates, but causality could go in the opposite direction. The real engine of growth is found in the reassignment of labor into the most efficient sectors, where intensities of capital use are lower than in the state companies, and which to a large extent finance their investments through external savings—that is, from foreign investment. Although the private sector has been the main source of growth, China is not evolving into a typical capitalist economy. Because of the lack of separation between state and market, business leaders are creating a corporatist association between companies and government, which is not

[46] OECD (2003, pp. 90-91).

[47] *Oxford Analytica*, "China: Census Expands Size of Economy," December 22, 2005.

going to lead to an expansion of spaces for private initiative on market conditions, but rather to a symbiosis of the interests of government and large private companies. A recent study found that over 40 percent of private entrepreneurs in companies with annual income over one million renminbis (US$120,800) have become members of the Communist Party, while only 5 percent of the general population are party members. Business associations, which are growing in number, are also beginning to play a similar role, supported by the conviction among business people that they can influence official decisions.[48]

4. Common Weaknesses of China and Latin America

With its growing economic weight in the world, its high savings and investment ratios and its prodigious industrial capacity, China can seem like a developed country. But it remains an economy with a low level of economic, social and institutional development, and as such shares a series of weaknesses with Latin American countries. As economic development progresses, these weaknesses may become more troubling. Some observers even talk of an eventual "Latin Americanization of China: the possibility that growing income inequalities and an ill-regulated rush to privatize could precipitate economic and political upheaval."[49]

A. Limited and Unequal Education

The labor forces of China and Latin America currently have similar levels of education: a little under six years on average, according to the well-known Barro and Lee database.[50] China has made rather more rapid progress than Latin America, but both regions have lagged behind the East Asian tigers and are far from achieving the education levels of developed countries, where the labor force has an average of 10 year of education. As in Latin America, education in China is marked by considerable regional inequalities. For example, enrollment rates in junior secondary education vary from 49 percent in Tibet, and about 60-70 percent in other seven lagging provinces, to about 99 percent in Beijing, Shanghai, Tianjin and Zhejiang. In the lagging provinces only 70 percent of the students complete the nine-year compulsory education

[48] Dickson (2003).

[49] "A Survey of China", *The Economist*, March 25th, page 5.

[50] Barro and Lee (2000).

curriculum, compared to 100 percent in East China.[51] Many rural schools lack funds and have to survive with fees and donations from parents, a practice that the government hopes to eradicate by the end of 2007. Absenteeism and early school dropout are frequent, despite the compulsory nine years of study.

As in Latin America, the improvement of education at low and middle levels is constrained on the supply side by limitations on resources and glaring organizational deficiencies, and on the demand side by a lack of economic incentives to encourage families to keep their children in school. The emergence of economic opportunities, however, has raised the return on education, and these increases have been much more pronounced at the highest educational levels, as in Latin America. For example, the gap between the return on university and primary education rose from 25 percent in the late 1980s to almost 80 percent in the late 1990s.[52] These changes have reflected in income concentration: the Gini coefficient of income per capita increased from 0.35 in 1989 to 0.44 in 2000,[53] and to nearly 0.5 in 2005 according to some sources,[54] not far from Latin America's average coefficient (0.53).[55]

Another common feature of education structures in China and Latin America is the concentration of public expenditure at the tertiary level. In contrast to the United States or South Korea, where public spending per student is less at the tertiary than the secondary level, Mexico and Chile spend more than twice as much on a university student than a secondary student. In China the gap is 5:1.[56] This spending effort reflects the priority that the government is giving to higher education in a bid to speed up the country's technological progress. In 2004 China had 13.3 million university students, up from the 2000 level of 5.6 million, with engineering and management being the two most popular courses. China had 820,000 students in postgraduate programs (up from 301,000 students in 2000), as well as 115,000 students studying abroad.[57] Since nothing comparable is happening in Latin America, the education structures of the two regions seem likely to diverge.

[51] The other lagging provinces are Guangxi, Guizhou, Hainan, Heilongjiang, Ningxia, Yunnan and Qinghai. Source: World Bank (2003a, p. 41).

[52] World Bank (2003a, p. 40).

[53] World Bank (2003a, p. 10).

[54] http://www.chinadaily.com.cn/english/doc/2005-06/19/content_452636.htm

[55] De Ferranti et al. (2003).

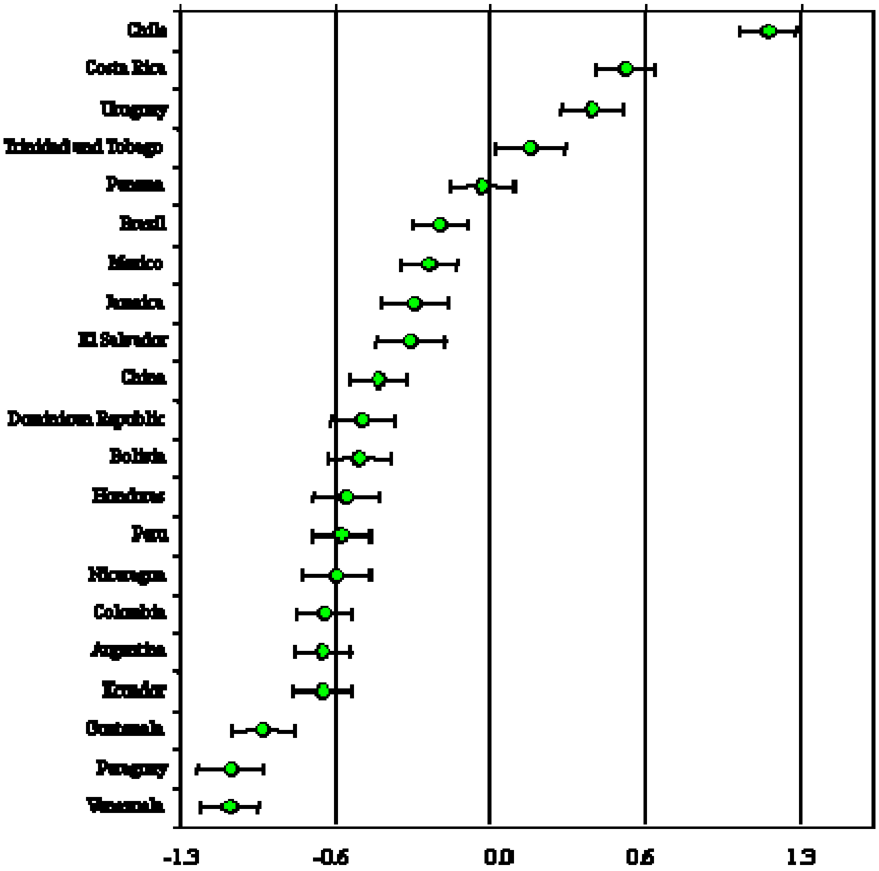
[56] De Ferranti et al. (2003, p. 43).

[57] Economist Intelligence Unit (2006, p. 23).

B. Corruption and Absence of the Rule of Law

If anything is important for development, it is institutions, and particularly respect for the law and control of corruption.[58] According to Kaufmann, Kraay and Mastruzzi (2005), respect for the rule of law in China is below the world average, on a level similar to El Salvador or Dominican Republic, and significantly below Chile, Costa Rica and Uruguay (Figure 3). This measure of the rule of law synthesizes various indicators and expert opinions that reflect the degree of respect for rules, contracts, legal security and property, with the backing of the judicial system. In regard to control of corruption, China ranks even lower, on a level with the Dominican Republic, Jamaica and Honduras, and substantially below Chile, Costa Rica and Uruguay (Figure 4). In this system of indicators, corruption means the unlawful appropriation of public resources for private purposes.

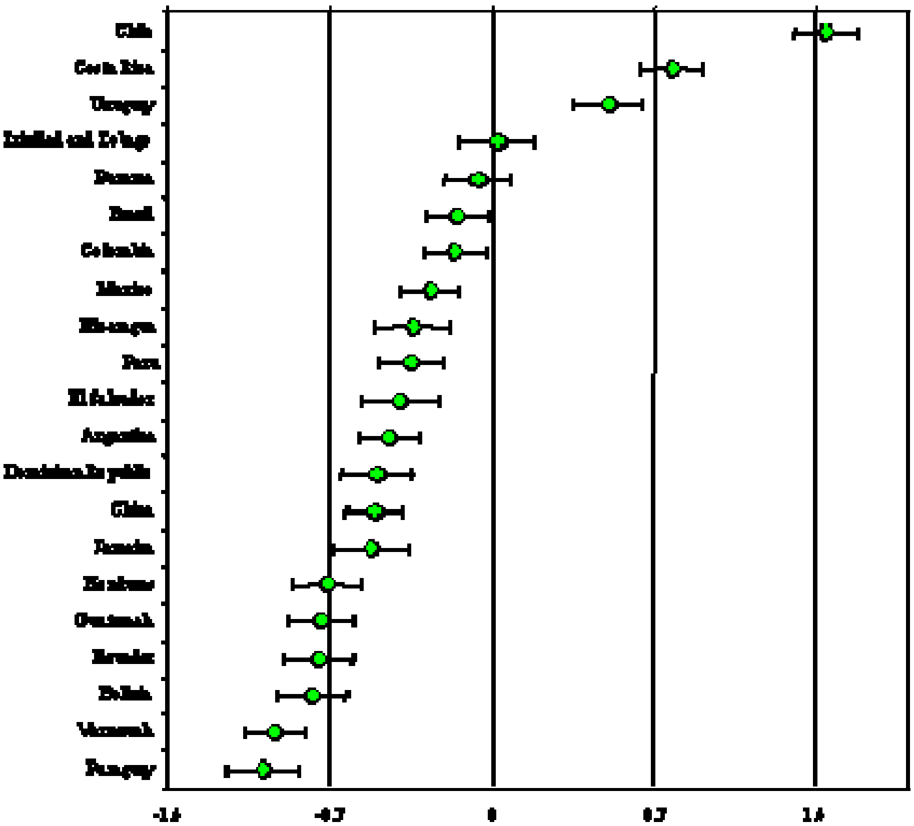
Figure 3. Rule of Law, 2005



Source: Kaufmann, Kraay and Mastruzzi (2005).

[58] Empirical evidence is provided by numerous recent papers, including Easterly and Levine (2002), Rodrik, Subramanian and Trebbi (2002), and Dollar and Kraay (2002).

Figure 4. Control of Corruption, 2005



Source: Kaufmann, Kraay and Mastruzzi (2005).

Although the rule of law is almost as weak in China as in the average Latin American country, there are appreciable differences in how the problem manifests itself. While in Latin America the homicide rate in the average country is 13 per 100,000 people, in China it is only 2.2.[59] China also has low rates of other forms of violence and anti-social behavior, such as robbery or sexual crime, which traditionally have been strongly punished. In China the weakness of the rule of law is much more evident in the lack of secure property rights, especially in rural areas, the weakness of contracts and the unpredictability of judicial decisions.

Although the judicial systems of both China and Latin America suffer from serious weaknesses, the origin of these deficiencies is radically different. In Latin America, justice operates with complex and formalistic procedures derived from the Napoleonic Code that delay decisions, lessen their transparency, and limit access to the courts. Because of Latin America's legalistic tradition, lawyers are numerous and play an important role in economic activities.

[59] For Latin America see IDB (2000). For China the source is Interpol (2004).

China, on the other hand, has no tradition of this kind. During the Mao Zedong period the law was subordinated to political ideology and the judicial system was virtually nonexistent, although there were summary judicial mechanisms and mediation systems controlled by national and local authorities.

Since 1978 a body of laws has been created by transplant from abroad with little adaptation, and an incipient legal tradition has slowly begun to emerge. In 1985 there were only 13,403 qualified lawyers in all of China, and half of them worked only part time. By 2000 the number of lawyers had risen to 117,260, mainly full-time. Nonetheless, it is mistaken to think that the rule of law will prevail as a direct result of the number of lawyers, courts and cases settled. Except in some of the large coastal cities, most of the more than 200,000 judges in China are retired officials of the People's Liberation Army who lack legal training and independence. Even more serious, the incipient legal system seems alien to Chinese cultural tradition. As one report has noted, "In many respects it is like a transplant or graft that is in danger of being rejected by the many natural antibodies it encounters."[60]

Both in China and Latin America, legal gaps and the lack of consistency and credibility of judicial decisions militate against a broad-based system of innovation. In both regions protection of intellectual property rights is weak and ineffectual. Even so, China has made substantial progress in the last 20 years by setting up specialized courts to deal with property rights, and a patent registration system that has gained credibility, as reflected in the growth of applications (over 170,000 in 2000). Like Latin America, however, China has not yet assimilated a culture of respect for international intellectual property, while the rules for the protection of patents, trademarks and commercial rights are imprecise and of limited effect.[61]

A judicial system such as China's is hardly immune from corruption. More generally, however, the problem of corruption in China stems from the omnipresence of the state in its attempt to control economic decisions so as to preserve the power of the Communist Party. The reform process initiated in the late 1970s has prompted a continuous conflict between the need to create new spaces for decision-making by economic agents in order to improve efficiency, and the expansion of potential sources of illegal income in the effort to maintain state control over other spaces. The land ownership control system, still in force, provides a good example.

[60] OECD (2003, p. 113).
[61] OECD (2003, pp. 118-129).

Corruption originates in two simple facts: all land is owned by the state, and the value of rights of use is determined by administrative decision. As a result, access to land is difficult without making illegal payments to the district or municipal officials who control rights of use. A press source reported that 84 percent of sales of land rights in Shanghai in recent years were made through illegal mechanisms.[62] Other recognized areas of corruption are residence permits, customs and banks. A striking and especially problematic feature of corruption in China is its growing decentralization as a result of the erosion of central state control over subnational entities and their officials, following the growth and diversification of private economic activity.[63]

5. Conclusion

China's rapid growth, ability to attract foreign investment and success as an exporter are causes for concern among entrepreneurs and governments in Latin America. Although it is wrong to believe that good performance by one country comes at the expense of others, China is forcing Latin America to rapidly restructure some of its productive sectors in order to defend its position in international markets. This paper has shown that China enjoys great strengths relative to Latin America, deriving from the size of the economy, the macroeconomic stability that China has enjoyed up to now, the abundance of low-cost labor, the rapid expansion of its transport, electricity and communications, and its ability to innovate.

But China does not only have strengths. Its principal source of weakness is the lack of separation between market and state, which explains the lack of efficiency of China's state enterprises, the deficiencies of its corporate norms and the fragility of its enormous financial system (the economy's high level of savings notwithstanding). In several ways the Chinese economy does not differ substantially from that of the typical Latin American country. The rule of law is weak and corruption is endemic. Education is poor and very poorly distributed, despite important advances in scientific and technical areas at the university level. Conspiring against innovation are the lack of respect for property rights, the difficulty of starting businesses, and the norms and practices that inhibit competition. All of this means that public institutions will be the

[62] *China Economic Quarterly* (2003, p. 13).

[63] Johnson (2004) provides a vivid recollection of cases of corruption, with the tacit consent of the judiciary, in local taxation and urban land rights.

battlefield in the attempt by both regions to attract foreign direct investment and create an environment conducive to private initiative.

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