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## SHOULD LATIN AMERICA FEAR CHINA?

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## **Abstract<sup>1</sup>**

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 quarter century. 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, according to official statistics. With some ups and downs, this rate has been maintained with no great changes until the present: the government reported 9.1 percent growth for 2003. Industry has been the main engine of this expansion: production of manufactured goods increased 12 percent a year from 1990 to 2002. The credibility of the official growth statistics is questionable, however. Eliminating the most obvious factors of overestimation, University of Chicago economist Alwyn Young has recently estimated that growth in the reform period was 1.7 percentage points lower than the official figures, and annual per capita income growth was 6.1 percent instead of the officially reported 7.8 percent.<sup>2</sup> The adjustments to the official figures could be higher, but there is no good basis for saying exactly how much. 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 2.2 percent annually. For the region, the 1980s were a lost decade, and from 1998 to 2003 income per capita stalled again. By contrast, per capita income in China has increased sevenfold since 1978 according to official figures (or about four times according to Young's adjustments); the average increase in Latin America has been only 16 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. Unlike China, therefore, in Latin America manufacturing industry has lost share in the economy.<sup>3</sup>

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. In Mexico the *maquilas* have lost 254,000 jobs in the last three years, and inflows of foreign direct investment (FDI) fell from \$26.6 billion in 2001 to \$11 billion in 2003. Foreign investment in Brazil has fallen sharply as well, and last year foreign investment in all of Latin America was down to only 37 percent of

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<sup>2</sup> Young (2003). Note that Young's calculations are for the 1978-1998 period, when annual growth was 9.1 percent according to official figures.

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

its 1999 peak (Figure 1). Perhaps the region no longer offers the same investment opportunities as it did a few years ago; perhaps the political environment in many countries is now less attractive. It is also very possible, however, that China is partly the cause of these trends. After all, China is currently the world's number one recipient of foreign direct investment. In 2002, companies in the United States invested ten times more in China than in 1992.<sup>4</sup> Clearly part of this increase was detrimental to investments in Latin America.

This paper attempts to assess whether fears that China will displace Latin America in the coming decades are well grounded. 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.<sup>5</sup> 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 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 capacity 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

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<sup>4</sup> National Bureau of Statistics of China (2003).

<sup>5</sup> 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).

regions. Section 5 concludes. Table 1 contains a selection of the main indicators mentioned in the paper; it compares China with Brazil and Mexico, the two largest Latin American economies, which are also the largest recipients of FDI, and with the median Latin American and Caribbean country (including Brazil and Mexico).

## **2. China's Strengths**

Countries do not compete with each other, companies compete, as Paul Krugman cautions.<sup>6</sup> 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.<sup>7</sup> 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 deficit spending (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 in growing, exporting and attracting foreign investment than Latin America, but it does not mean that conditions in the region would be better if China lacked these strengths. In fact, we will see later that not everything in China results in strengths, that in many aspects China is not very different from Latin America, and that some features of the Chinese economy, which appear to be sources of advantages, are not so in reality. We will begin with the strengths.

### *A. Size*

China is the sixth largest economy in the world and, at the growth rate that it has enjoyed in the last 20 years, it appears set to become the largest economy in the world in less than 40 years

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<sup>6</sup> Krugman (1994).

<sup>7</sup> *The Economist*, November 15, 2003.

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 only ten years if—an important “if,” as we will see—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).

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.<sup>8</sup> In such a huge economy, companies can exploit economies of scale in production, transport and marketing, which are decisive for penetrating international markets.<sup>9</sup> 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 44 out of 102 countries.<sup>10</sup> This position does not seem very exceptional, although it is 19 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 and El Salvador occupy positions higher than those predicted by their income levels. This is important because the countries that have good positions relative to their income level tend to grow more rapidly later, whereas the opposite is true of countries in low positions (such as

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<sup>8</sup> For the importance of market size in foreign direct investment, see IDB (2001), Chapter 18.

<sup>9</sup> See Hummels (2004).

<sup>10</sup> World Economic Forum (2003).

Venezuela or Paraguay, to mention two Latin American examples).<sup>11</sup> 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 an outstanding case, 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 fourth in the world according to this indicator, outperforming the typical country of any region of the world, including the developed countries. The typical Latin American country, in contrast, 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 2003 alone, international reserves increased by \$117 billion, reaching \$438 billion (or 28.9 percent of GDP at current prices).<sup>12</sup> 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,<sup>13</sup> but high reserve levels exert

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<sup>11</sup> For a technical discussion of this result, see IDB (2001), Chapter 1.

<sup>12</sup> Calculations based on IMF (2004).

<sup>13</sup> As the experience of Chile after the Russian crisis shows, even countries with very strong fundamentals (and capital controls) can experience a severe sudden stop of capital flows, with important repercussions for investment

pressure on the money supply (which grew by 19 percent in 2003) 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). However, price pressures have accelerated recently (inflation has gone from –0.8 percent in 2002 and 1.2 percent in 2003 to 5.5 percent, year on year, in July 2004),<sup>14</sup> fueled by price increases in energy and several other imported raw materials.

### *C. Cheap and Abundant Labor*

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,<sup>15</sup> which is lower than the *minimum* wage in many Latin American countries (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 labor supply. According to official sources for 2001, the working-age population totals 894 million, 83 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 2.6 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).<sup>16</sup> This process is far from being exhausted. It has been estimated that there are 160 million

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and growth. However, the subsequent effects of a sudden stop on the real and financial sectors are milder in countries that are more open to international trade and have less liability dollarization in their financial sectors. Furthermore, these effects can be prevented by a "war chest" of international reserves (Calvo and Talvi, 2004).

<sup>14</sup> Data for 2002 and 2003 come from IMF (2004). The CPI increase for July 2004 is based on reports by *China Daily* (2004).

<sup>15</sup> Calculation based on statistics from *China Statistical Yearbook* reported by the World Bank (2003a).

<sup>16</sup> Brooks and Tao (2003).

surplus workers in the inefficient sectors and, in the next quarter of a century, the rural population could decline by 300 million people.<sup>17</sup>

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. 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.<sup>18</sup>

The reassignment of the labor force into more efficient sectors has been the main source of growth and productivity. The reason is that labor productivity in agriculture is only 19 percent of the rate in the rest of the economy, while productivity in state companies is 29 percent lower than in non-state companies. In the 1990-98 period, when total productivity of factors contributed 2.6 points annually to economic growth, 2.1 points were due to the shift of agricultural employment into other sectors.<sup>19</sup> This source of growth will probably persist for a long time.

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.<sup>20</sup> 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

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<sup>17</sup> Wolf (2003).

<sup>18</sup> Brooks and Tao (2003).

<sup>19</sup> Heytens and Zebregs (2003). The Young study quoted earlier calculates that the total productivity of the factors contributed 1.4 points to annual non-agricultural economic growth in the 1978-98 period, and concludes that the main factor underlying the increase in income levels and product per capita is not physical or technological capital but "labor deepening," which comprises the increase in participation rates, the shift of workers from the agricultural sector into more productive sectors and the increase in education. These factors have also been the main source of productivity growth in other successful Asian countries.

<sup>20</sup> 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.

(where it has added 1.8 points to growth in the last 20 years).<sup>21</sup> The shift of employment from country to city has not helped much because of the modest rural-urban labor productivity gap (typically 30 percent)<sup>22</sup> 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," 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.<sup>23</sup>

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

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<sup>21</sup> 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.

<sup>22</sup> See IDB (1998), Chapter 2.

<sup>23</sup> See OECD (2003), pp. 100-102. An anonymous referee has pointed out that some large institutional investors, such as Calpers, will not invest in China because of its poor labor laws.

until 2040 it will have the six-to-one ratio that China now enjoys.<sup>24</sup> China will then be confronted by an enormous social burden that will require it to raise taxes quite far above levels typical for 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.<sup>25</sup> 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 neglected.

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. In the 2001-05 period the plan is to extend the network by 6,000 kilometers and double the track along 3,000 kilometers of existing lines. On roads, progress has been even more remarkable: in only 12 years, inter-provincial expressways have increased from zero to 12,000 kilometers. In the 1996-2000 period, 216,900 kilometers of new roads were built, an 18 percent expansion of the network. In the next five years, a further 200,000 kilometers are planned. 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, which will take almost 20 years to complete.

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<sup>24</sup> Calculations based on United Nations (2002).

<sup>25</sup> The effect of infrastructure on growth is difficult to disentangle as causality runs both ways, and long gestation periods and quality heterogeneity obscure the connection between both variables. However, empirical evidence clearly supports the claim that infrastructure has important effects on long-term growth (Canning and Pedroni, 1999).

In addition, China's electricity infrastructure suffers from serious limitations, which are in the process of being addressed. The government plans to raise installed capacity from 290 GW in 2000 to 550 GW by 2010; the important—though highly controversial—Three Gorges project is only a minor component of these vast expansion plans. Furthermore, the telecommunications sector is going through an unprecedented boom. China now has more cable television subscribers (100 million) and more mobile telephones (145.2 million at the end of 2001) than the United States. China also has more than 180 million fixed telephone lines (16 for every 100 inhabitants, or 25 if cellphones are included) and 36.6 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.<sup>26</sup>

#### *E. The Ability to Innovate*

With its low level of income, at current growth rates China will take about 25 years 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.<sup>27</sup> China's size, 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 the DVD players and digital cameras produced worldwide, more than a third of the 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

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<sup>26</sup> The infrastructure indicators are taken entirely from Economist Intelligence Unit (2003), pp. 25 and following.

<sup>27</sup> McArthur and Sachs (2002) show that while economic growth in advanced countries relies more on technological innovations, developing countries can grow by assimilating existing technologies. This idea is the basis for the construction of the Growth Competitiveness Index of the World Economic Forum.

Latin American countries are much smaller (0.2-0.6 percent of GDP).<sup>28</sup> 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. 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.

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.<sup>29</sup> 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,

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<sup>28</sup> Data for China are taken from Naughton (2004). For Latin America, see IDB (2001), Chapter 16.

<sup>29</sup> World Bank (2003a), p. 26.

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 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.<sup>30</sup>

The last step in this reform process was the establishment in 2003 of the state-owned Assets Supervision and Administration Commission (SASAC), which exercises direct control over 196 large state companies (whose assets have been officially appraised at a sum equivalent to 116 percent of the country’s GDP), guaranteeing that the three largest companies in the main economic sectors remain state-owned, and that 30 percent to 50 percent will be “national

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<sup>30</sup> *China Economic Quarterly* (2003), pp. 20 and following.

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. A large number of firms are involved: 7,000 companies controlled by the central government and 174,000 owned by regional or local governments, with a startling diversity of types of ownership and control.<sup>31</sup> An explicit objective of the reform is to expand the capacity of state control through the 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 the 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 the 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 and the evidence of experts.<sup>32</sup> Moreover, the Corporation Law has been designed to facilitate the corporatization of state companies; at the same time it imposes earnings reinvestment requirements and requires boards of directors that are detrimental to independent control of private companies.<sup>33</sup>

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. Since China is currently considered the most attractive destination among big international investors<sup>34</sup> and has become the largest recipient of FDI, overinvestment has become a widespread phenomenon.<sup>35</sup> Excess capacity is rampant in steel,<sup>36</sup> aluminum and

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<sup>31</sup> *China Economic Quarterly* (2003), pp. 24 and following.

<sup>32</sup> See the indicators: “*strength of auditing and accounting standards*” and “*pervasiveness of insider trading*,” World Economic Forum (2002).

<sup>33</sup> Boubakri et al. (2001) show that good corporate governance is key to the success of privatizations in developing countries, which suggests that China may pay a hefty price for its deficiencies in this area.

<sup>34</sup> See A.T. Kearney (2003).

<sup>35</sup> According to *The Economist* (2004, page 4) “nine-tenths of manufactured goods are in oversupply, yet investment in fixed assets last year grew by 30 % and contributed 47% of GDP.”

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. In early 2004 the central government expressed concern over excessive investment in construction projects, and warned that overheated investment might provoke price increases led by energy, raw materials and other basic resources China imports.<sup>37</sup> Inflation, however, is not the only major risk caused by overinvestment: 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 2002 the loans-to-GDP ratio rose to 148 percent and the value of the broader money supply in circulation expanded to 175 percent of GDP<sup>38</sup>—in practice access to credit is restricted to state or state-controlled companies.<sup>39</sup> 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 to allocate savings are clearly wanting.

The banking system is dominated by four major state banks originally oriented to 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, 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 2006 those banks will be able to offer services to individuals. Pursuant to

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<sup>36</sup> If all the steel factories currently under construction were finished, China would be able to produce 330 million tons of steel, but the domestic demand will not reach that level until 2010. See Fu (2004).

<sup>37</sup> Fu (2004).

<sup>38</sup> Calculations based on statistics reported by the World Bank (2003a).

<sup>39</sup> 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, according to Duenwald and Aziz (2003).

commitments made by China on 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 bad debts of the four major state banks were equivalent to 26 percent of their assets.<sup>40</sup> The real bad debt ratio is nonetheless thought to be much higher, because of the practice of refinancing financially troubled state companies at interest rates controlled by the government.

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 companies 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, these banks are due to be listed on international stock exchanges in an effort to acquire fresh capital, although it is not clear how they will lower their current bad debt ratios (18 percent and 12 percent, respectively, according to official figures in September 2003).<sup>41</sup>

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,”<sup>42</sup> 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 weak (i.e., when the rule of law is weak, creditors are unprotected, and regulation is deficient)

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<sup>40</sup> Quoted by *Oxford Analytica*, July 17, 2003.

<sup>41</sup> See *Oxford Analytica*, “China: Capital Injections Reflect Serious Intent,” January 12, 2004.

<sup>42</sup> See Caprio and Hanson (1999).

liberalization increases the likelihood of a crisis.<sup>43</sup> 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.<sup>44</sup>

### *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.<sup>45</sup> 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 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 (although the number of authorized companies has risen from a handful in the 1970s to tens of thousands at present, many of them privately-owned).
- Although China is the world's leading pole of attraction for foreign investment, there are still many restrictions and bureaucratic requirements. The process of opening to foreign investment has been uneven from one province to another, and many sectors remain closed to foreign investment in order to protect the market control exercised by state companies. For example, foreign investment in telecommunications is in practice

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<sup>43</sup> Demirgüç-Kunt and Detragiache (1998) and Arteta, Eichengreen and Wyplosz (2001).

<sup>44</sup> Bekaert, Harvey and Lundblad (2004).

<sup>45</sup> Yang (2003).

prohibited, the insurance sector is severely restricted, and the activities of commerce and domestic distribution are subject to many restrictions.

- Because the tax and exemptions regime is very decentralized, tax conditions for foreign companies vary among provinces and sectors, and even from one company to another, according to the timing and conditions of negotiation. As a result of tax competition among the provinces, however, foreign companies receive better treatment than local ones, which is not generally the case in Latin America.<sup>46</sup> This creates an incentive for companies and local investors to use Hong Kong, Taiwan and other places as platforms for supposedly foreign investments.
- In China there is no free movement of international capital. 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). This agency also regulates which domestic financial entities receive the funds from external loans granted to local or foreign companies established in China. Only state companies can place bonds outside China. On domestic stock markets, foreigners may only invest in B shares. These do not have the same rights or trading prices as regular A shares, which are reserved for locals. All outward capital operations require authorization from SAFE, and Chinese investment abroad is regulated and controlled by the China Securities Regulatory Commission.<sup>47</sup>

### *C. Misleading Indicators*

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,

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<sup>46</sup> For a detailed description of the regime for foreign investments, see OECD (2003).

<sup>47</sup> OECD (2003), pp. 90-91.

or at least of investment capacity according to efficiency criteria. According to official statistics, China's savings and investment rates—at close to 40 percent of GDP—are among the highest in the world and almost double 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. It is also possible that the official savings and investment figures are strongly overestimated because of measurement problems. According to some analysts, the real savings ratio could be 30 percent and the investment ratio 27 percent (for 2002).<sup>48</sup>

The indicators taken from the financial statements of state companies must also be viewed cautiously. The recent real-estate price bubble could be encouraging many state companies to inflate the reported value of the real estate they control, and there are very likely other sources of asset overvaluation, because the declared value of non-operating assets is excessive.<sup>49</sup> Aside from these technical details, however, the main reason for caution is that the objective of these companies is not to maximize profits but to maintain state control over key sectors. Consequently, profits and losses do not help to predict the capacity of these companies to expand or survive.

Although there is no precise indicator of local entrepreneurial capacity, China's progress in this field also has to be interpreted with caution. Because of the lack of separation between state and market, business leaders are creating a corporatist association between companies and government, which is not 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.<sup>50</sup>

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<sup>48</sup> *The Economist*, November 15, 2003, p. 68.

<sup>49</sup> *China Economic Quarterly* (2003), p. 22.

<sup>50</sup> Dickson (2003).

#### 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.

##### *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 (Figure 3).<sup>51</sup> 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 ten years' education. As in Latin America, education in China displays 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 curriculum, compared to 100 percent in East China.<sup>52</sup> Many rural schools lack funds and have to survive with donations from parents. 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. Although empirical evidence indicates that human capital has a clear and significant association with growth, low educational levels have not constrained China's growth.<sup>53</sup> The emergence of economic opportunities, however, has raised the return on education, and these increases have been much more pronounced at the highest educational

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<sup>51</sup> Barro and Lee (2000).

<sup>52</sup> The other lagging provinces are Guangxi, Guizhou, Hainan, Heilongjiang, Ningxia, Yunnan and Qinghai. Source: World Bank (2003a, p. 41).

<sup>53</sup> Empirical evidence based on education achievements points towards a positive effect, but the effect weakens and even becomes negative for upper-income countries (Islam, 1995; Barro, 2001). Measurement problems may be the reason for these inconsistencies, as suggested by Coulombe, Tremblay and Marchand (2004), who have found strong effects based on direct measures of literacy-related competencies.

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.<sup>54</sup> These changes were reflected in income concentration: the Gini coefficient of income per capita increased from 0.35 in 1989 to 0.44 in 2000,<sup>55</sup> similar to the Latin American countries with fewer inequalities, such as Uruguay and Costa Rica, although still far from the region's average coefficient (0.53).<sup>56</sup>

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.<sup>57</sup> 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 2001 China had 7.2 million university students, an increase of 29.3 percent from the year before, including 2.5 million engineering students.<sup>58</sup> An estimated 2.8 million university students are expected to graduate in 2004, more than double the number in 2002, and the number is expected to reach 3.2 million in 2005.<sup>59</sup> Since nothing comparable is happening in Latin America, the education structures of the two regions seem likely to diverge.

### *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.<sup>60</sup> According to Kaufmann, Kraay and Mastruzzi (2003), respect for the rule of law in China is below the world average, on a level similar to Mexico or Brazil, and significantly below Chile, Costa Rica and Uruguay (Figure 4). This measure of the rule of law synthesizes various indicators and expert opinions that reflect the degree of respect for rules,

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<sup>54</sup> World Bank (2003a, p. 40).

<sup>55</sup> World Bank (2003a, p. 10).

<sup>56</sup> De Ferranti et al. (2003).

<sup>57</sup> De Ferranti et al. (2003, p. 43).

<sup>58</sup> Economist Intelligence Unit (2003).

<sup>59</sup> *The Economist*, February 14, 2004, p. 37.

<sup>60</sup> Empirical evidence is provided by numerous recent papers, including Easterly and Levine (2002), Rodrik, Subramanian and Trebbi (2002), and Dollar and Kraay (2002). For a survey of earlier evidence see Burki and Perry (1998). However, Glaeser et al. (2004) have argued that while most evidence on the effects of institutional quality on growth is flawed, the protection of property rights and a few other "good" policies, often pursued by non-democratic governments, do spur growth. The quality of institutions is also a key determinant of the location of foreign direct investment. See Wei (2000) and IDB (2001), Chapter 18.

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, Nicaragua and Colombia, and substantially below Chile, Costa Rica and Uruguay (Figure 5). In this system of indicators, corruption means the unlawful appropriation of public resources for private purposes.

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.<sup>61</sup> 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. 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

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<sup>61</sup> For Latin America see IDB (2000). For China the source is Interpol (2004).

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.”<sup>62</sup>

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.<sup>63</sup>

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 dual price system for the main agricultural and industrial raw materials, which was in force until the late 1990s, is a good example: the system attempted to control the prices of the portion of production allocated to state companies, leaving prices free in the rest of the economy. In fact, the system created incentives for the administrators of state companies to exaggerate their declared raw material requirements and sell their surpluses on the free market.

The land ownership control system, still in force, is another notable example. 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 recently reported that 84 percent of sales of land rights in Shanghai in the last two years were made through illegal mechanisms.<sup>64</sup> 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

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<sup>62</sup> OECD (2003), p. 113.

<sup>63</sup> OECD (2003), pp. 118-129.

<sup>64</sup> *China Economic Quarterly* (2003), p. 13.

entities and their officials, following the growth and diversification of private economic activity.<sup>65</sup>

A current issue of debate among development scholars is whether the quality of institutions depends on economic development or is mainly determined by other factors, such as geography or history, which are less amenable to change.<sup>66</sup> The issue is especially relevant for China, where the lack of rule of law and the extent of corruption may eventually bring a halt to private investment and growth. If the quality of institutions is strongly influenced by deep-seated social attitudes toward the economic and political powers, such that respect for an impartial body of laws and an independent judicial system cannot be developed (or, even worse, if economic liberalization tends to further erode the rule of law, as in Russia), then China may eventually face a dead end. As Ian Johnson has put it: “all people who want to change China eventually learn [that] the current system is at a dead end, but its death is not in sight.”<sup>67</sup>

## 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. In this article we have 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

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<sup>65</sup> Johnson (2004) provides a vivid recollection of cases of corruption, with the tacit consent of the judiciary, in local taxation and urban land rights.

<sup>66</sup> This discussion was sparked by an influential paper by Acemoglu, Johnson and Robinson (2001), and followed by Kaufmann and Kraay (2002), who found evidence that, while better institutions help raise income, higher income levels have a *negative* effect on institutions.

<sup>67</sup> Johnson (2004, p. 273).

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 competitions. All of this means that China's supremacy over Latin America is less worrisome and less global than is commonly believed. This also means that public institutions will be the battlefield in the attempt by both regions to attract foreign direct investment and create an environment conducive to private initiative. It remains an open question whether institutions will prove amenable to the changes required to make this happen.

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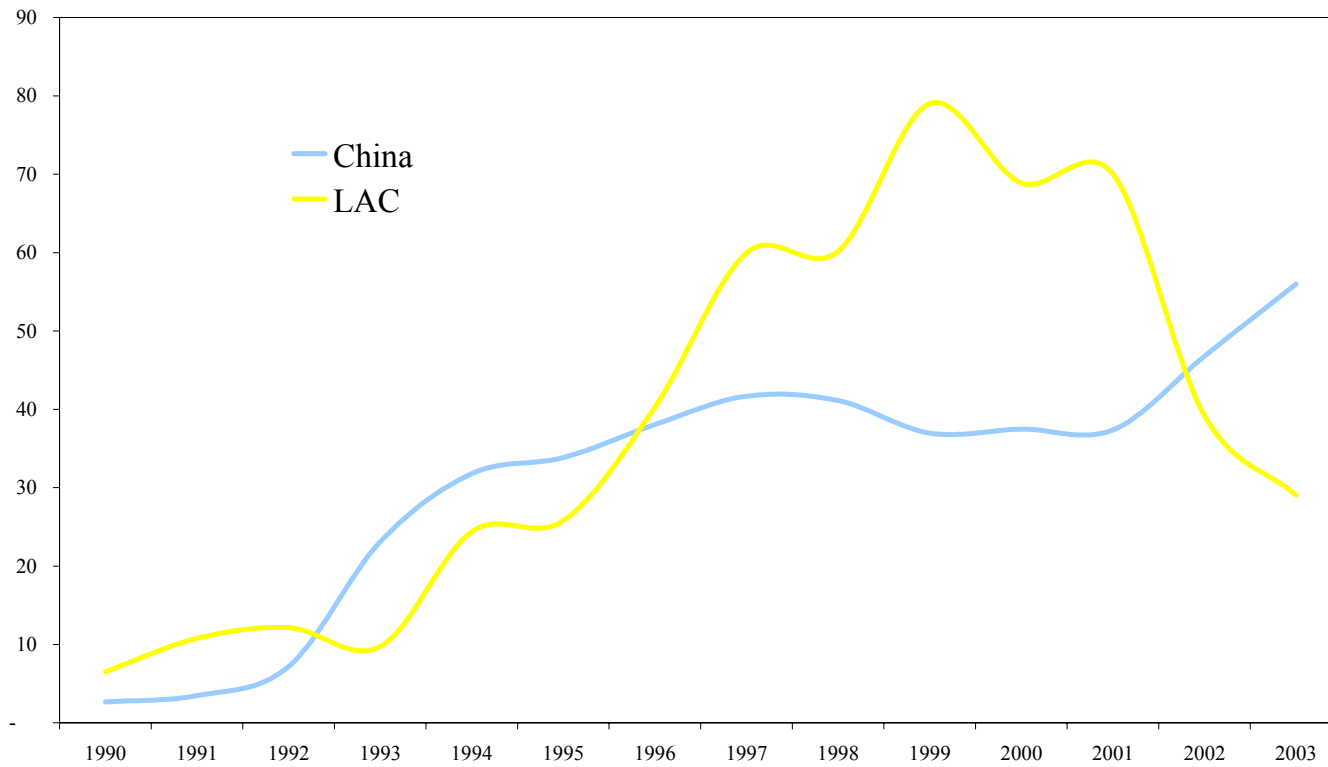
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**Figure 1. Net Foreign Direct Investment (US\$bn)**



*Source:* Economic Commission for Latin America and the Caribbean (ECLAC) for Latin America and the Caribbean (LAC) and World Development Indicators (WDI) and the Economist for China

**Table 1. China vs Latin America**

Selected indicators

Indicator	Units	Period	China	Brazil	Mexico	LAC Median (Number of Countries)	Source
<b>Growth-related outcomes</b>							
<b>1.1 Growth</b>							
Real GDP, growth	Percentage	1990-2002	9.7	2.5	2.9	3.2	(24) Calculated from World Development Indicators (WDI) (2003)
Real GDP per capita, growth	Percentage	1990-2002	8.6	1.1	1.3	1.1	(24) Calculated from WDI (2003)
1.2 Total factor productivity change	Percentage	1991-2000	2.6	-0.3	0.1	0.1	(20) Loayza, Fajnzylber and Calderón (2002)
1.3 Manufacturing value added, growth	Percentage (constant 1990 US dollars)	1990-2000	12	1.3	4.4	2.5	(18) Lall, Albaladejo, Mesquita (2004)
1.4 Exports goods, growth	Percentage (constant 1995 US dollars)	1990-2000	10.9	6.4	13.3	5.3	(20) Calculated from WDI (2003)
1.5 FDI penetration	Percentage of GDP	1999-2001	3.8	4.7	3.0	3.5	(23) Calculated from WDI (2003)
<b>China's strengths</b>							
2.1 GDP	1995 Constant US dollars, billions	2002	1,209	810	375	1,917	(24) WDI (2003)
GDP per capita	1995 Constant US dollars	2002	944	4,642	3,717	2,268	(24) WDI (2003)
2.2 GDP PPP	Current international PPP dollars, billions	2002	5,199	1,171	819	2,448	(24) WDI (2003)
GDP per capita, PPP	Current international dollars	2002	4,054	6,878	7,947	4,769	(24) WDI (2003)
2.3 Growth Competitiveness Index (GCI)	Ranking (out of 102 countries)	2003-2004	44	54	47	63	(21) Calculated from World Economic Forum (2003)
Actual value/1	Scale 1-7 (7-Best)	2003-2004	4.2	4.0	4.1	3.7	(21) Calculated from World Economic Forum (2003)
Expected value/2	Scale 1-7 (7-Best)	2003-2004	3.9	4.1	4.2	4.0	(21) Calculated from World Economic Forum (2003)
2.4 Macroeconomic Stability Subindex (MSS)	Ranking (out of 102 countries)	2003-2004	4	88	72	82	(21) Calculated from World Economic Forum (2003)
Actual value/3	Scale 1-7 (7-Best)	2003-2004	5.1	3.4	3.8	3.5	(21) Calculated from World Economic Forum (2003)
Expected value/4	Scale 1-7 (7-Best)	2003-2004	4.0	4.1	4.2	4.1	(21) Calculated from World Economic Forum (2003)
2.5 Wages /5	US dollars per month	2002	112	78.27	123.71	117	(15) IDB calculations based on official data.
2.6 Overall infrastructure /6	Scale 1-7 (7-Best)	2003-2004	3.5	3.8	3.6	3.2	(21) World Economic Forum (2003)
2.7 Electricity costs	US cent per KWH	2002-2003	5.1	N/A	17.1	10.7	(8) Based on Condo et. al. (2004) pg35
2.8 Port infrastructure quality /7	Scale 1-7 (7-Best)	2002-2003	3.8	3.6	3.1	3.0	(21) World Economic Forum (2002)
2.9 TV subscriptions	Cable TV subscribers per 1000 people	Last year av	68.6	13.8	24.8	19.1	(21) World Economic Forum (2002)
2.10 Telephones	Main lines and cellphones per 100 people	2001	25.0	38.5	35.4	25.7	(21) World Economic Forum (2002)
<b>China's weaknesses</b>							
3.1 Protection of Shareholders /8	Scale 1-7 (7-Best)	2003-2004	3.7	4.7	4.4	4.2	(21) World Economic Forum (2003)
3.2 Auditing and Accounting Standards /9	Scale 1-7 (7-Best)	2003-2004	3.5	5.1	4.8	4.4	(21) World Economic Forum (2003)
3.3 Savings Rate	National savings rate as a percentage of GI	2001	38.9	14.8	19.3	17.8	(21) World Economic Forum (2002)
3.4 Investment Rate	Gross fixed investment as a percentage of GDP	2000	36.3	19.4	20.8	19.6	(19) World Economic Forum (2001)
3.5 Local equity market access/10	Local equity market access	2002-2003	3.5	4.7	3.9	3.8	(21) World Economic Forum (2002)
3.6 Domestic Credit	Domestic credit as percentage of GDP	1990-2002	105.3	44.8	21.4	30.4	(25) Calculated from World Development Indicators (2003) and International Financial Statistics (2003)
3.7 Ease of Access to Loans /11	Scale 1-7 (7-Best)	2002-2003	2.5	3.1	2.3	2.6	(21) World Economic Forum (2002)
3.8 Soundness of Banks /12	Scale 1-7 (7-Best)	2002-2003	4.0	5.9	4.0	4.7	(21) World Economic Forum (2002)
3.9 Financial Regulations /13	Scale 1-7 (7-Best)	2001-2002	3.7	5.3	3.9	4.4	(20) World Economic Forum (2001)
<b>Common weaknesses</b>							
4.1 Rule of law	Standardized values	2002	-0.2	-0.3	-0.2	-0.4	(25) Kaufmann, Kraay and Mastruzzi (2003)
4.2 Control of Corruption	Standardized values	2002	-0.4	0.0	-0.2	-0.4	(25) Kaufmann, Kraay and Mastruzzi (2003)
4.3 Education levels	Years	1999	5.7	4.6	6.7	5.9	(19) Barro and Lee (2000)
4.4 Tertiary enrollment	Gross tertiary enrollment rate (percentage)	2000 or most recent year available	7.5	16.5	20.7	18.2	(21) World Economic Forum (2002)
4.5 Technology Transfer Index	Scale 1-7 (7-Best)	2003-2004	3.7	4.4	4.3	3.8	(21) World Economic Forum 2003-2004
4.6 Procedures to Register a Business	Number of procedures	2004	12	15	7	12	(20) World Bank Doing Business in 2004: Understanding Regulation 2003

Notes:

1/ The Growth Competitiveness Index (GCI) is the average of three sub-indexes: the technology sub-index, the public institutions sub-index, and the macroeconomic environment sub-index. These sub-indexes are calculated on the basis of both "hard data" and "Survey data."

2/ The expected values of the GCI are the estimates from a regression of the GCI over the GDP per capita at PPP values.

3/ The Macroeconomic Stability Subindex (MSS) is an average of indexes of the following variables:

Is your country's economy likely to be in a recession next year?

Has obtaining credit for your company become easier or more difficult over the past year?

Government surplus/deficit in 2002

National savings rate in 2002

Inflation in 2002

Real exchange rate relative to the United States in 2002

Lending-borrowing interest rate in 2002

4/ The expected values of the MSS are the estimates from a regression of the GCI over the GDP per capita at PPP values.

5/ Legal minimum wages for LAC and Average Manufacturing sector wages for China

6/ General Infrastructure in your country is (1=poorly developed and inefficient, 7=among the best in the world)

7/ Port facilities and inland waterways in your country are (1=underdeveloped, 7=as developed as the world's best)

8/ Law protection of minority shareholders' interest in your country is (1=nonexistent and seldom recognized by majority shareholders, 7=total and actively enforced)

9/ Financial auditing and accounting standards in your country are (1=extremely weak, 7=extremely strong, among the best in the world)

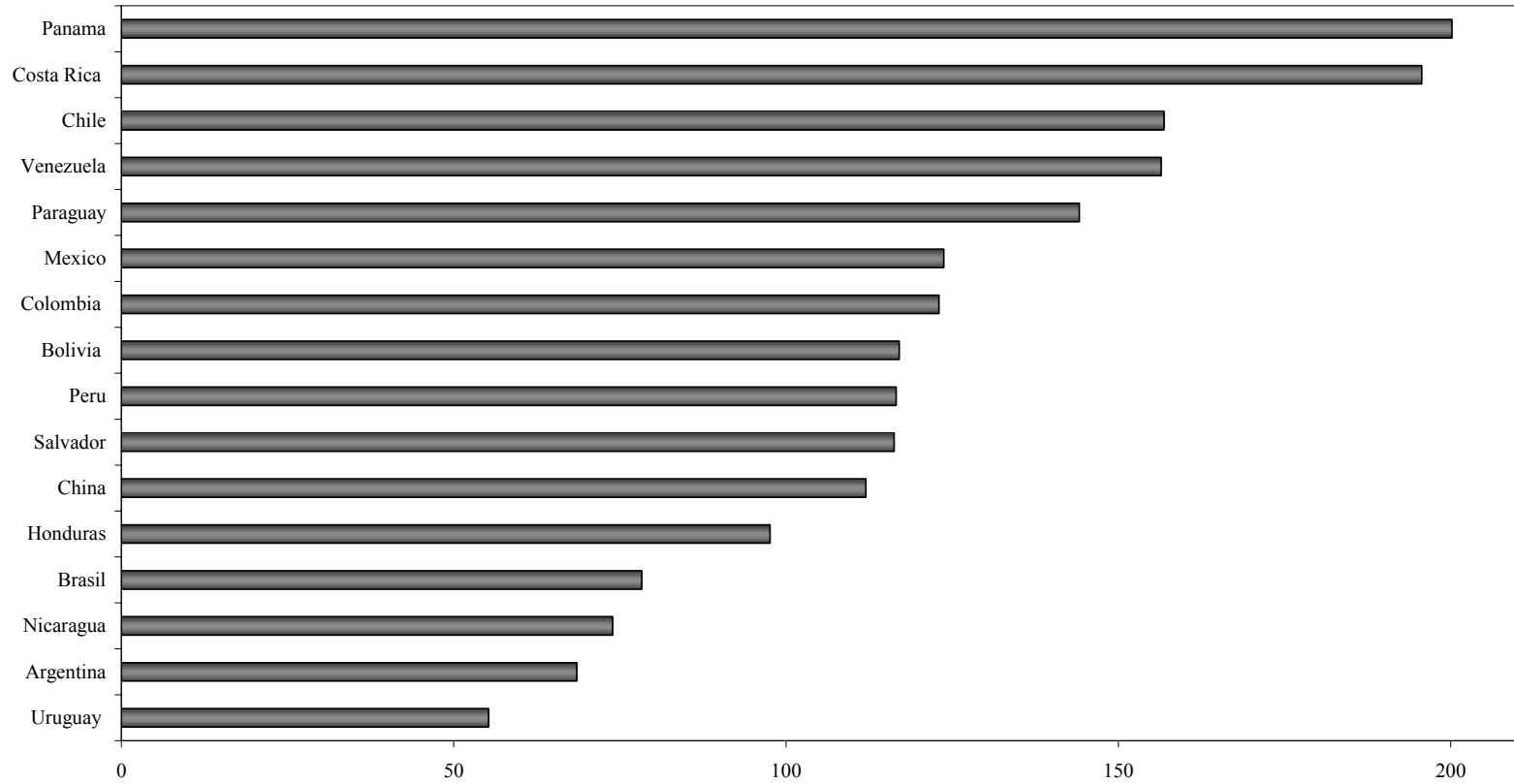
10/ Raising money by issuing shares on the local stock market is (1=nearly impossible, 7=quite possible for a good company)

11/ How easy is to obtain a bank loan in your country with on a good business plan and no collateral? (1=impossible, 7=easy)

12/ Banks in your country are (1=insolvent and may require government bailout, 7=generally healthy with sound balance sheets)

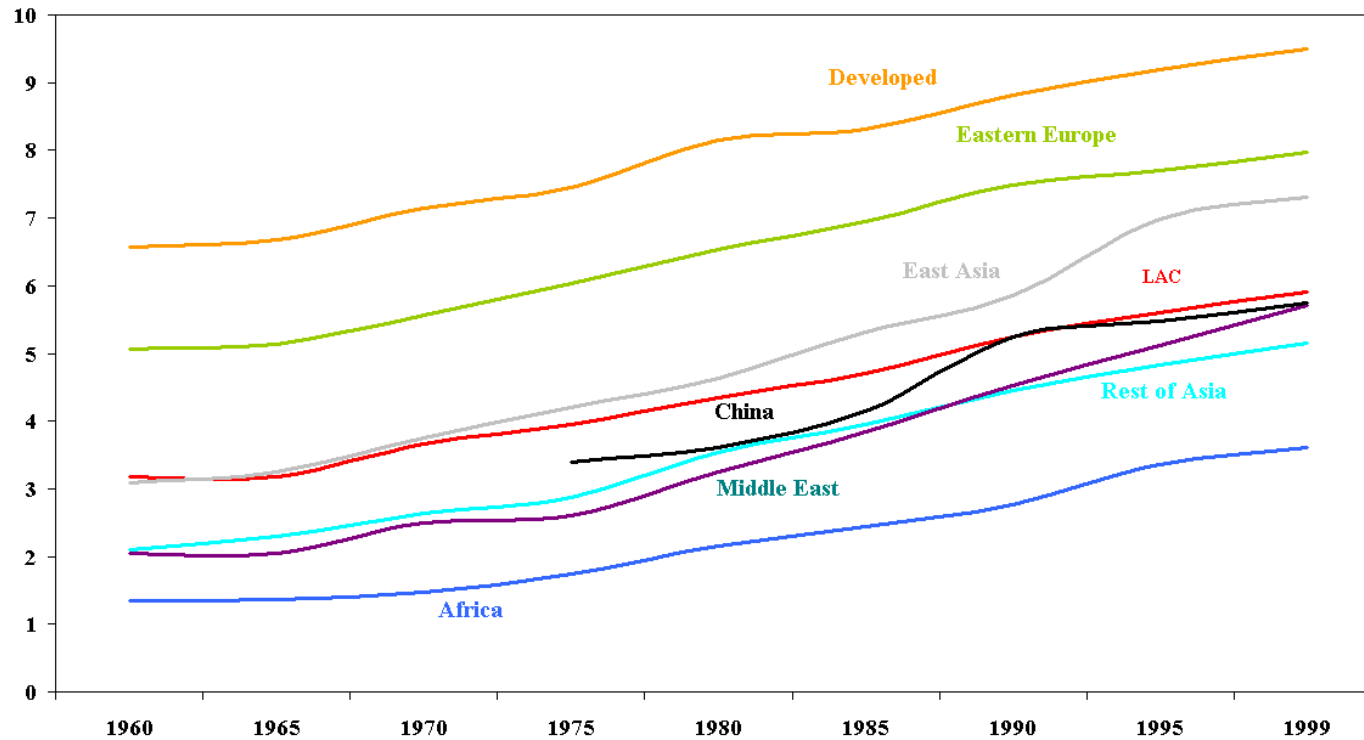
13/ Regulations and supervision of financial institutions are (1=inadequate for financial stability, 7=among the world's most stringent)

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



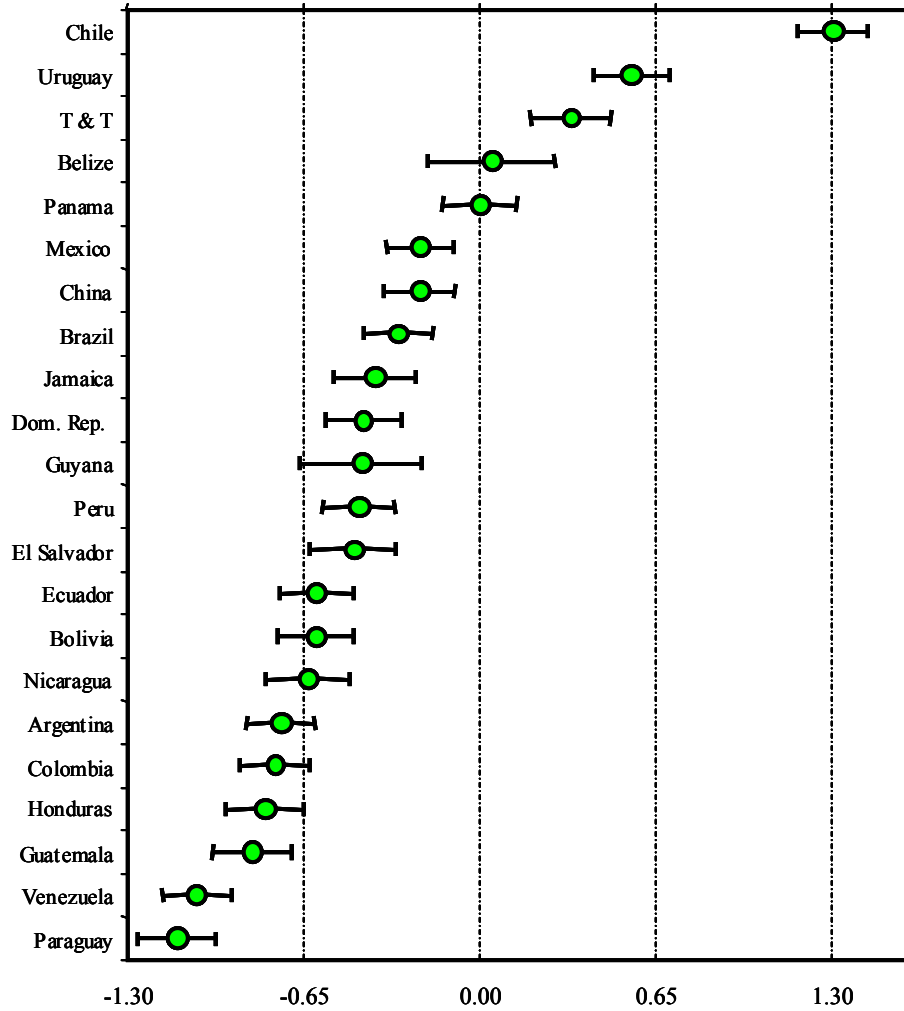
*Source:* Inter-American Development Bank (IDB) calculations based on official data.

Figure 3. Years of Education



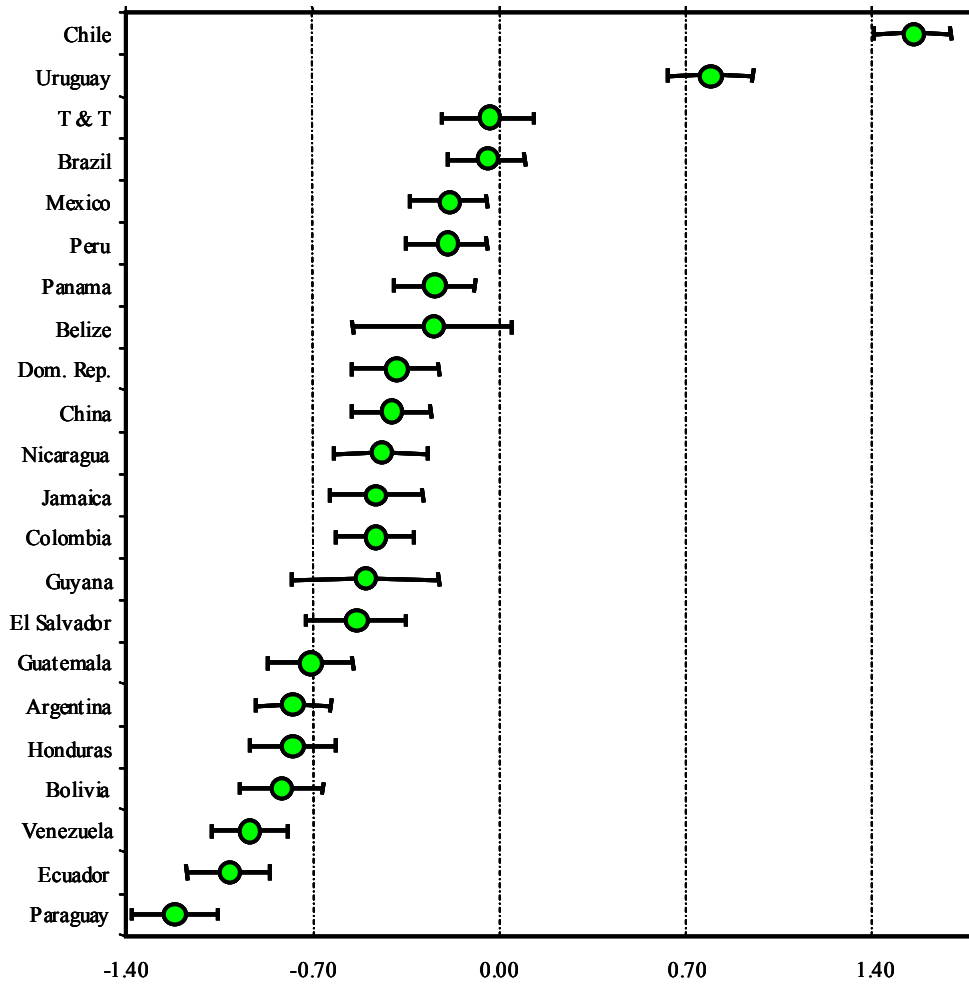
Source: Barro, R. J., and J. Lee 2000. *International Data on Educational Attainment: Updates and Implications*. NBER Working Paper no. 7911. National Bureau of Economic Research, Cambridge, MA.

Figure 4. Rule of Law, 2002



Source: Kaufmann, Daniel, Aart Kraay and Massimo Mastruzzi (2003). "Governance Matters III: Governance Indicators for 1996-2002". World Bank Policy Research Department Working Paper.

Figure 5. Control of Corruption, 2002



Source: Kaufmann, Daniel, Aart Kraay and Massimo Mastruzzi (2003). "Governance Matters III: Governance Indicators for 1996-2002". World Bank Policy Research Department Working Paper.