CRITICAL ISSUES IN CHINA'S GROWTH AND DEVELOPMENT

Critical Issues in China's Growth and Development

Yum K. Kwan and Eden S.H. Yu
City University of Hong Kong

ASHGATE

Published by
Ashgate Publishing Limited
Gower House
Croft Road
Aldershot
Hampshire GU11 3HR
England

Ashgate Publishing Company
Suite 420
101 Cherry Street
Burlington, VT 05401–4405
USA

Ashgate website: http://www.ashgate.com

British Library Cataloguing in Publication Data

Library of Congress Cataloging–in–Publication Data

ISBN 0 7546 4270 4

Contents

PART III: INTERNATIONAL FINANCE

PART IV: SOCIOECONOMIC ISSUES

List of Contributors

Guoqiang Bin is a Ph.D. candidate at Lingnan (University) College, Zhongshan University, China.

Chi–Chur Chao is Professor in Economics at the Chinese University of Hong Kong.

Leonard K. Cheng is Professor and Head of Economics at the Hong Kong University of Science and Technology.

Yin–Wong Cheung is Professor of Economics at University of California, Santa Cruz,USA.

Win–Lin Chou is Professor in Economics at the Chinese University of Hong Kong.

Belton M. Fleisher is Professor of Economics at Ohio State University, USA.

K.C. Fung is Professor of Economics at University of California, Santa Cruz, USA.

Javier Gardeazabal is Associate Professor at the University of the Basque Country, Spain.

Roger H. Gordon is Professor of Economics at University of California, San Diego, USA, and Research Associate of the National Bureau of Economic Research and the Centre for Economic Policy Research.

Hitomi Iizaka is a Research Associate at the Department of Economics, University of California, Santa Cruz, USA.

Yum K. Kwan is Associate Professor of Economics at the City University of Hong Kong.

Derek Laing is Associate Professor of Economics at the Pennsylvania State University, USA.

Lawrence J. Lau is Kwoh–Ting Li Professor of Economic Development and Senior Fellow of the Hoover Institution at Stanford University, USA.

Siu Fai Leung is Associate Professor of Economics at the Hong Kong University of Science and Technology.

Ninghui Li is Associate Professor at Institute of Agricultural Economics, Chinese Academy of Agricultural Sciences, China.

Wei Li is Associate Professor of Business Administration at the Darden Graduate School of Business at the University of Virginia, USA.

Chelsea C. Lin is Assistant Professor of Economics at National Dong Hwa University, Taiwan.

Francis T. Lui is Professor of Economics and Director of the Center for Economic Development at the Hong Kong University of Science and Technology.

Zihui Ma is a Ph.D. candidate at the Hong Kong University of Science and Technology.

Chuhwan Park is a researcher at Electronics and Telecommunication Research Institute in Seoul, Korea.

Yuan Shu is Professor of Economics and President of Lingnan (University) College, Zhongshan University, China.

Alan Siu is Associate Professor of Economics at the University of Hong Kong.

Jesús Vázquez is Associate Professor at the University of the Basque Country, Spain.

Henry Wan Jr. is Professor of Economics at Cornell University, USA.

Ping Wang is Professor and Chair of Economics at Vanderbilt University, Research Associate of the National Bureau of Economic Research, and Vice President of the East Asian Research Institute, USA.

Isabel K. Yan is Assistant Professor of Economics at the City University of Hong Kong.

Eden S.H. Yu is Chair Professor of Economics at the City University of Hong Kong.

Heng–fu Zou is Professor of Economics at Peking University and Wuhan University, China, and Senior Research Economist of the World Bank.

Editors' Introduction

This book consists of 13 chapters selected from a total of 44 papers presented at the International Conference in Honour of Professor Gregory Chow on 'China and the World Economy.' The conference was organized by the City University of Hong Kong, and took place June 14–16, 2002. A world renowned economist, Gregory Chow has made path–breaking contributions in econometrics, dynamic economics, and the Chinese economy. Since the gradual shift from a predominantly central planned economy to a market based economy in the late 1970s, China has experienced unprecedented economic growth. To contribute to understanding current rapid economic growth and development, this book examines a number of critical issues in the following four areas: economic growth, foreign direct investment (FDI) and trade, international finance, and socioeconomic issues. These topics constitute the main themes of the four parts of the book.

Part I consists of four chapters which investigate, respectively, how higher education, tax reforms, the size of the Chinese market, and access to advanced technology affect the rate of China's economic growth. In the first chapter, Belton M. Fleisher examines the impact of China's higher education on its economic growth. Fleisher presents statistical evidence of the positive contribution of a relatively small proportion of university graduates on China's economic transformation. However, he argues that China's potential for further growth could be hampered by a lack of sufficient university graduates. Furthermore, Fleisher points out that it would be desirable for China to improve resource allocation for higher education.

In Chapter 2, Roger H. Gordon and Wei Li examine the positive role of the tax system in China's recent breathtaking economic transformation. The early tax reform and resultant fiscal decentralization in the 1980s facilitated local governments' collection of profit tax from small and new firms, leading to strong local government support for firm entry. While this tax policy led to a high growth rate, it also generated many tax distortions that grew in importance over time. The reform of the tax system in the 1990s, shifting away from corporate taxes and tariffs towards a value–added tax, substantially reduced these tax distortions while still preserving many of the incentives encouraging entry and growth.

In Chapter 3, *How Size Matters to Future Chinese Growth: Some Trade–Theoretic Considerations*, Henry Wan Jr. explores the ramifications for China's economic potential of the facts that China is the world's largest in population and second largest in total real output. He shows analytically that size matters from a variety of perspectives, including factor proportions, terms of trade, economies of scale, market power and policy coordination. He explains the recent strong performance of China's economy and predicts its future economic prospects in light of the importance of a nation's size.

In Chapter 4, Heng–fu Zou presents a model of endogenous economic growth integrating product innovation and physical capital accumulation. He examines the long–run relationship between product development and capital formation. Following the line of research by Romer and by Grossman and Helpman, Zou further distinguishes the role of product development and capital accumulation in endogenous growth. He demonstrates how these two factors can determine long–run growth rates. Zou also explores the effect of international technology transfers from a developed country to a developing economy. He shows that the rate of capital accumulation in the less–developed country is partially related to the rate of product development in the developed nation.

Part II consists of three chapters which address the following three interesting questions. What are the attributes of a region in China that can attract foreign investment? What are the main determinants of locational choices by Hong Kong and U.S. firms for their direct investments in China? And what influences the extra–regional trade and intra–regional trade of the world's three major regions?

In Chapter 5 on regional attributes, public inputs and tax competition for foreign investment in China, Chi–Chur Chao, Win–Lin Chou and Eden S.H. Yu examine the determinants of inward foreign direct investment (FDI) into various regions of China. Although the growth rate of the Chinese economy is remarkable, it is very uneven across regions. Why would foreign firms invest in only a few areas in China? Chao, Chou and Yu construct a theoretical model, incorporating region–specific (geographical location, human capital, regional GNP etc) and economy–common factors (tax incentives and preferential treatment), to explain regional competition for FDI. A panel data set is used to estimate the determinants of FDI inflows into China for the period of 1985–2000. Their findings reveal that tax competition is not effective in attracting FDI.

Chapter 6 *An Econometric Estimation of Locational Choices of Foreign Direct Investment: The Case of Hong Kong and U.S. Firms in China*, by K.C. Fung, Hitomi Iizaka, Chelsea C. Lin and Alan Siu, examines the locational choices of Hong Kong and U.S. direct investment in China for the period from 1990 to 1999. They consider the implications of regional GDP, local labor costs, and regional labor quality for FDI. Their empirical results reveal some similarities and differences in the significance of these factors. Local GDP in China significantly influences investment inflows from both origins. Nonetheless, investment from Hong Kong is more sensitive to local labor costs, whereas U.S investment is more sensitive to the quality of labor.

In Chapter 7, Leonard K. Cheng, Siu Fai Leung and Zihui Ma investigate the extra– and intra–regional trade of the world's three major regions: the Asian Pacific Rim economies (APRE), the European Union (EU), and the North American Free Trade Area (NAFTA) for the period 1980–1995. Utilizing the concept of Revealed Comparative Advantage, they show that all three regions have a comparative advantage, relative to the rest of the world, in technology intensive products in addition to having comparative disadvantage in natural resource intensive products. Two models are tested for intraregional trade. Based on the empirical results, the authors reject a proportional–spending model, and argue that a gravity model provides a better account of the intra–regional trade intensities of the EU and NAFTA.

Part III deals with several emerging issues of international finance. The three chapters in this part address the following questions. What is the role of trade and financial linkages in the contagion of financial crises during the 1990s? How valid is the overshooting hypothesis of Dornbusch? How well has Hong Kong's currency board performed?

In Chapter 8 on trade, financial linkage and contagion of currency crises, Lawrence J. Lau and Isabel K. Yan examine the role played by international trade and financial linkages in the 1994 Mexican and 1997 Asian crises. They construct a new index of trade competitiveness among countries. On the basis of this index, they find that trade has become increasingly competitive in the last decade. This index is useful in identifying countries vulnerable to crisis contagion.

Chapter 9, *Exchange Rate Dynamics: Where is the Saddle Path?* by Yin–Wong Cheung, Javier Gardeazabal and Jesús Vázquez, offers an alternative perspective on the validity of the well–known overshooting hypothesis of Dornbusch. These authors show that the saddle–path dynamics inherited in the standard Dornbusch overshooting model and the cointegration between exchange rates and prices do not co–exist. They also verify that the Johansen procedure has the ability to discriminate between saddle–path dynamics and cointegration. Their empirical example suggests that the empirical data they examined may not exhibit saddle–path dynamics.

In Chapter 10, Yum K. Kwan and Francis T. Lui deploy the structural vector autoregressive model to evaluate the empirical performance of the currency board system used by Hong Kong since the early 1980s. They argue that Hong Kong's stable fiscal policy plays a key role for the apparent success of the currency board regime. Furthermore, the currency board can explain about two–thirds of the reduction in output and inflation volatility.

The three chapters in Part IV tackle a host of critical socioeconomic issues in connection with China's rapid economic transformation over the last two decades. The issues are related to the efficacy of the household registration rule, the relationship between bankers' behaviour and share prices, and the implications of China's agricultural policy for its food supply and welfare.

In Chapter 11, Derek Laing, Chuhwan Park and Ping Wang develop a Harris–Todaro framework of rural–urban migration in China. They explore the impact of the household registration rule on migration and urban employment. They argue that enforcing the registration rule to discourage illegal inter–regional migration could lead to a higher job finding rate and a lower urban unemployment rate. Their finding will provoke some controversy among academics.

In Chapter 12, *The 'Banker Effect' on Chinese Stock Pricing*, Yuan Shu and Guoqiang Bin construct a model to analyze pricing in the Chinese stock market. They examine the dynamic relationships among 'stock banker' behaviour, stock price, and corporate performance. Their main finding is that stock pricing can be significantly influenced by bankers' behaviour, while there is no significant relationship between share concentration and corporate performance.

In the final chapter, *China's Food Economy and Its Implications for the Rest of the World*, Ninghui Li utilizes a computable general equilibrium (CGE) approach to examine the impact of China's agricultural policy on its national food provision and the effect of changes in foreign market conditions upon the supply of and demand for food in China. By linking China's Agricultural Policy Simulation Model (CAPSiM) with the Global Trade Analysis Project (GTAP) model, Li provides a projection of China's import and export of major agricultural products up to 2020 and the welfare gain or loss under various scenarios.

This volume provides a useful handbook for readers to gain a good understanding of various critical issues in China's international trade and economic development. The papers included pay tribute to Gregory Chow, who recently retired from Princeton University after a distinguished half–century academic career. Professor Chow has played a pivotal role in cultivating a generation of younger and active economists from China, trained in modern economics, now spreading all over the world.

The editors would like to acknowledge the support of the following institutions in co–organizing the international conference which resulted in the papers selected for this volume: Chinese Economics Association in North America (CEANA); Chinese Economists Society (CES); Institute of Economics, Academia Sinica of Taiwan; Lingnan (University) College at Zhongshan University of China; Lingnan University of Hong Kong; and the School of Economics at Renmin University of China. Our thanks also go to the Department of Economics and Finance and the Research Center for International Economics of the City University of Hong Kong for organizing the conference. Last but not least, we would also like to thank the authors who presented their work at the conference, the reviewers for their assistance in the selection of papers for this volume, and the able assistance of Liling Feng, Eric Lam, Ryan Man, Keiko Shinohara and Kevin Yuen. Without their effort, this book would not have become a reality.