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China's progress: can it breach the Great Wall?

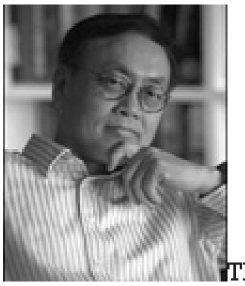
With China's ascent as the world's second-largest economy, it may just be a matter of time before it eclipses the United States in productivity. But can it evolve to become a high-income, consumption-driven economy like the US?

Today, Asian economies are producing more than 30 per cent of world output. China's spectacular transformation in less than two decades, producing an estimated 12 per cent of global output in 2009 is certainly indicative of its strong economic potential, given its high population figures and relatively low labour costs.

Yet scepticism surfaced at a plenary session at INSEAD's Leadership Summit Asia held recently in Singapore. Despite the "tremendous" opportunities in the region, there were several calls for structural changes which might otherwise hinder China's progress in reaching the plateau of the world's advanced economies.

"Even when China reaches the size of the US economy by 2025, it will still be relatively poor," said Haiyan Wang, Adjunct Strategy Professor at INSEAD and Managing Partner of the China India Institute, noting that China's income per capita would be only a quarter of that of the United States. "It still has a long way to go," she said, addressing several areas in need of transformation. First, China has to shift from an export-driven economy to one relying on domestic consumption. Second, China has to move toward innovation and away from imitation. But "innovation will happen, driven by the sheer number of scientists and engineers, government pumping in a lot of money and the spillover effect from MNC (multinational corporations') labs in China," she added.

Rise of Chinese competitors



These same multinationals in China are already transforming themselves from being isolated centres in the value chain to fully-integrated operations with local research and development centres with product development capabilities, said **Edward Tse**, Senior Director and Chairman for Booz and Company in Greater China. With 20 years of management consulting experience under his belt, Tse said, "China strategy is not about entering the China market. China strategy is about how to develop global strategy with China at its core." More significantly, he noted the emergence of Chinese firms that have become "very aspirational, very ambitious, very fast-learning and very adaptive local competitors," making China one of the most competitive markets in the world. Telecoms giants Huawei and ZTE were cited as prime examples of Chinese companies which have capitalised on low-cost manufacturing to grow not just at home but to also establish significant global footprints.

"They don't try to compete head-on with MNCs at the top-end of the market," said **Rajeev Singh-Morales** of Alcatel Lucent on the emerging trend of highly-competitive Chinese players. Instead, they go after the huge mid- and mass-market segments that MNCs do not always have the capabilities to pursue, he said. Once established – either through imitation or their own local R&D – they then move into the premium markets. The very best Chinese competitors begin to encroach on the turf of the MNCs with products which are perhaps 80 per cent as good as those of the MNCs, but at 40 per cent of the cost, and sell at 40-50 per cent of the price, he said.

The role of government

Whether Chinese companies can truly globalise was however subject to some debate. Among the charges levied: their reliance on low-cost state capital, unsophisticated financial management capabilities with organisational challenges, particularly in managing across diversity, as well as political sensitivity and controls. "So far the Chinese model has been quite successful, but over time the Chinese have to consider how to manage the role of government in the market," said **Zhuang Juzhong**, Deputy Chief Economist of the Asian Development Bank, based in Manila. "How you are going to handle it is going to be a complicated issue."

While changes in the value chain, increases in R&D expenditure and developments in technology are on the cards, the policy imperatives are significant. "We need to eliminate market distortions and rigidities because reform is not complete," said Zhuang. Furthermore, a shift toward domestic demand requires structural changes, a point also echoed by INSEAD's Wang. "Income has been growing slower than GDP so one of the key areas to focus now is from becoming a strong country to making its people rich," she said. Increasing the minimum wage could be one way of boosting domestic consumption.

"(The current) context is a very strong government, that they can do their own thing without inputs from other parts of the country," said Tse of Booz. "With China continuing to rise and looking to play a larger role in global geopolitics, inevitably the current political context will have to evolve. There is no way that this context is stationary."

Breaching the 'Great Wall'

Concerns have been raised about China's ability to surge ahead economically without introducing institutional reforms regarding the rule of law, democracy and so on.

"My guess is China will not be able to penetrate the wall," said Ilian Mihov, INSEAD Professor of Economics and Dean of Research, referring to a perceived threshold of US$12,000 income per capita, beyond which countries find it difficult to progress beyond without institutional change. Unless Beijing succeeds in making "deep structural reforms" of its "relatively poor quality" institutions, income per capita in China might not break the 'Great Wall' barrier.

Mihov cited the example of Singapore where efforts to create a stable, efficient business environment have seen its income per capita levels rise significantly, while oil-rich Venezuela has hovered between $8,000 and $12,000 since 1960 as a result of its dithering institutions. "There is not a single country that has good quality institutions and is poor," he said. "The gap between rich and poor is driven by poor productivity that is linked to poor quality institutions and poor business environment." These may include factors such as corruption, poor governance and regulatory control and the lack of accountability. "Growth happens not when MNCs come in, but when you create the business environment for the people in your country to build small and medium enterprises," he said.

Another possible impediment in China's way may lie in its ability to innovate. Here, lessons can be similarly drawn from the experience of Japan that was once poised to dominate the world economy. In fact, Japan grew much like China today, by replicating and improving what other advanced economies had already done. "With replication, you can grow very fast," said Mihov. However, once countries have reached a certain threshold, the only way to sustain growth is by innovation, he argued.

With current growth rates, he projects that China will reach the 'Great Wall' in about seven to 10 years. Without reforms, China might then stagnate at income levels of around $10,000-$12,000, far behind the per capita income levels in the US of $47,000, according to World Bank estimates.

"Governments can stop economies from rising. The way that governments handle the transformation will answer the question of whether this shift will happen or not."

INSEAD's Leadership Summit Asia was held at the school's Asia campus in Singapore on November 12.

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