China and the WTO: *Interview with Marshall Meyer (edited transcript)*

Knowledge@Wharton: China just celebrated its tenth anniversary of joining the World Trade Organization (WTO). What has joining the WTO meant for China?

Marshall Meyer: The short answer is, "Everything." The changes in China have been dramatic. You can see the inflections in virtually every plot of the economy that you lay out. The obvious changes: Trade has gone up as a result of joining the WTO. GDP has gone up. As a consequence of the concentration of trade in the costal cities of China, especially the special economic zones, the migration of peasant workers from countryside to city and back has increased enormously. Another small inflection point, interestingly, is that the rural-urban income gap didn't decrease, but it stopped increasing rapidly about the time of [China's joining the] WTO -- I assume as the result of wage remittances to the migrant workers. So overall this has had an enormous impact on China, probably far greater than anybody anticipated.

Knowledge@Wharton: Did some sectors in China benefit more than others as a result of China joining the WTO? And were there other areas of the economy that may have suffered because of it?

Meyer: Yes, there are actually some losers in this. There are some spectacular winners. The big winner, of course we know, is manufacturing. Within manufacturing, the big winner is electronics. China's biggest export is electronic goods, computers and the like, not needle goods anymore. These industries have burgeoned. Much of the work is assembly work, like Foxconn is doing for Apple and others. But a lot of the work involves manufacture of components and modules, things like power transformers, electric cords and so forth. So the manufacturing sector in general, electronics in particular, has benefited.

The next sector that has benefited is the automotive sector. Huge quantities of automotive components are coming out of China. As a consequence, auto assembly has burgeoned in China. Some could argue that the center of the auto industry has moved from Detroit to Shanghai. All this I think is a consequence of WTO.

Where have there been fewer benefits or even negative effects? The answer is the countryside of China. The migration has depleted the countryside of many working-age people. In the documentary film *The Last Train Home*, the protagonists are a working couple who leave their children with the grandparents in Sichuan province and they migrate to work in Shenzhen.

Chinese agriculture is in a bind as a consequence of WTO. China has had a number of experiments with land reform. The effort in 1978 under Deng Xiaoping was pretty successful. With the household responsibility system, they got productivity up. Today, however, China is still struggling with further land reform. There were some initiatives to give the peasants control over their land. But they've not really succeeded in assembling large enough plots of land to produce efficiently, even given the low labor cost. For example, two crops in China are very much at risk. One of those crops is cotton. They can not find enough people to harvest the cotton. As a result, some of that cotton is going to stay unharvested. The tomato crop is in the same situation. This is a delicate fruit and still grown on very small plots with hand harvesting. The companies that are manufacturing tomato paste, which is the base ingredient in ketchup and other condiments, aren't doing very well. In fact, they lost money at the end of last year and will lose again this year because of labor shortages and raw material costs going up.

Knowledge@Wharton: What has joining the WTO meant for the competitiveness of Chinese firms? How have they had to transform themselves into global producers? What can companies in other parts of the world learn from China's experience?

Meyer: We've got to separate two parts of the Chinese economy. First, there's the foreign-invested assembly economy. Think of Taiwan's Foxconn, or of Samsung, which has huge investment in China. By some measures, Samsung is the largest manufacturing firm in China. These firms have entered China, drawn on a low cost labor supply that until recently has been very, very reliable, and pursued low cost manufacturing for export. Their competitive advantage is cost. The margins are razor thin and they're a bit at risk because the cost pressures are coming from two sides. We're still seeing some appreciation of the RMB, plus there have been wage increases.

The wage increases are driven by supply and demand. One of the interesting, and I think very significant, inflection points which we didn't understand until about a year ago is rural wages. This is called the Lewis Turn or the Lewis Turning Point [named after Nobel laureate William Arthur Lewis], where as an economy moves toward industrialization, labor supply shrinks first in the countryside, then in the city, and wages increase. Well, what did we see? We saw as early as 2003 -- this is only two years after WTO -- wages in the deep interior provinces of China like Gansu began to go up dramatically. Agricultural wages increased at a rate of 10% or 15% a year, sometimes more than that. The folks who acquired these data out at the Gansu Agricultural University looked at it and came to the conclusion that this Lewis Turn occurred in about 2003 -- again, only two years after WTO.

Then the migrant laborers' wages, in the cities, began increasing dramatically in 2006, a few years later, and by 2007 wages were going up 20%. In fact, the labor shortages provoked a new labor law in China. The 2008 labor law, Labor Contract Law [or LCL], gave workers in principle some of the same rights as tenured professors. But that's a response to the labor shortages.

Knowledge@Wharton: China's growth has been driven mainly by exports. As the U.S. and Europe face economic problems and growth slows there, how sustainable is China's growth?

Meyer: The export economy, in my judgment, is unlikely to continue to grow at the same rate. And why is that? We talked about the cost squeeze on the exporters. And of course economic conditions in their principal markets, whether it's the EU or the U.S., are soft. That's a nice term. So as a consequence, their ability to sell unlimited amounts of relatively low cost goods in these markets is going to be crimped somewhat and there are lots of reports now of plants closing, particularly in Guangdong province. The numbers are beginning to show a slowing of exports. It's pretty clear now that this export model is not sustainable.

That said, the Chinese economy has other places to grow. And here's the irony: The place to grow is in the countryside of China. Finally at long last the traditional marketing system, the traditional distribution channels in rural China are giving way to much more modern systems. And as the large firms in China begin to penetrate the countryside, which for a long time they ignored, that'll give a little further headroom to China, but not nearly as much headroom as we've seen in the last ten years.

Knowledge@Wharton: Do you think that the growth of the domestic market will be fast enough and deep enough to offset the shrinking of the export demand?

Meyer: I don't know and here's why. There's yet another competing force called population. China is aging. Last year, in 2010, the dependency ratio -- non-working to working population -- reversed. It had been going down through 2010, and beginning last year it started going up. China has made some small modifications but hasn't fundamentally changed the one child policy. Even if they did, it wouldn't make any difference for 15 to 20 years at least. The best projections I see suggest that China's going to have an upside-down population pyramid very quickly. I sometimes describe it as a pagoda, looking very much like Japan today.

And what happens when the population ages? There's a reluctance to spend money, at least on consumer goods. We see this actually in marketing surveys in China -- that many people, although they have money, are reluctant to spend. So the question is, what steps could be taken to unleash the buying power of domestic consumers? Now again there's a group in the countryside, a very large group -- not the wealthiest in China, but not poor -- who have untapped spending power and simply haven't had access to goods which they'll now have. But how much more spending is going to take place in the urban populations as they think about getting older, requiring Social Security support, if they can get it, medical services, etc.? I don't know. I think that's the big question mark for China.

Knowledge@Wharton: You referred to the Lewis Turn as a major inflection point for China. If you look to the next ten years, what other inflection points do you see coming down the pike?

Meyer: There are a couple of inflection points. One will be next year, when the government will change. We have no idea what the policies of Xi Jinping are going to be. We simply don't know. He's been very careful. Will he be another Hu Jintao? Will he be another Zhu Rongji? Nobody knows. That's probably the most fundamental inflection point coming up soon. It will take a few years to know what direction China takes.

I think continuation of the present policies will alone retard or slow or cap economic growth a bit because under Hu Jintao there's been a resurgence of the wealth, and to some extent the power, of the state enterprises in China. Fewer are employed by the states; the SOEs are responsible for less and less of overall output and GDP, but still their centrality in the economy has gone up. And the question is whether there's going to be a second and vigorous wave of privatization in China turning toward a more capitalist system. We don't know the answer to this question, but that's a very fundamental question.

A second inflection point will occur if under a lower growth scenario different provinces go in different ways. You've perhaps read about Bo Xilai who is the party secretary of Chongqing. He's advocating a very domestic-centric set of policies: We should produce for the people's needs here in China. There's also a little bit of Maoism associated with Bo. His policies are very inward looking -- "take care of the people."

If you go down to Guangdong, which has been the export engine of China, you'll see a different scenario. I keynoted an economic forum in Guangdong in June. The conversation was entirely about building and rebuilding the export industry. So the second inflection point would be this kind of internal conversation, if you will, between a policy of focusing on the home market and focusing on the needs of the people versus maintaining the export machine. How that would play out politically I have no idea, but clearly something like that is coming along.

The third inflection point involves innovation. China has a set of policies designed to promote innovation. Whether they'll have the effect, no one knows yet. Among other policies, just like their targets for GDP growth, their targets for patents, the rate of patenting in China far exceeds the patenting in the U.S. And although many, many of the patents are so-called service patents of short duration, many of them are not renewed because they're of no economic value. The number of patents of economic value is hard to determine. But in any case there is a commitment to patenting. Political advancement depends on GDP, but for some officials it also depends on patenting.

Exactly where does the policy stands? That is a little unclear. As always, the rule in China is it's going to vary by province, so it's hard to tell. But that innovation inflection point, if it works as anticipated, could counteract some of the other forces I'm describing.

Knowledge@Wharton: China has been trying to globalize its currency, the renminbi or RMB. How do you see that playing out over the next ten years or so?

Meyer: By globalizing the RMB, you mean rendering the RMB convertible on the capital account. That would allow bond markets to open up. If you don't have convertibility, it's very hard to get global investors in there to purchase bonds.

But here's the rub. Look at M2 in China, the money supply. It's like a rocket. It's going up a lot faster than GDP. You're looking at numbers in the vicinity of 20% a year. And the question is, what's the source of it, and can they reverse this at the source? And the source, ironically in my judgment, lies in China's currency policy.

Why is that? Let's suppose I am an investor and I take a dollar to the Peoples Bank of China, and I need RMB. They give me the RMB, although in decreasing amounts. I think we're at about 6.4 right now. They hold onto the dollar. They don't sell that dollar because they want to keep the country export-competitive. Rather than selling the dollar, they hold the dollar and the central bank reimburses the commercial bank where I exchanged the money, effectively not with fresh RMB but rather with what are called sterilization bills, which are long-term, low-interest notes. Okay? The banks are required to hold them in their reserves. It's one of the reasons the reserves are so high.

The consequence of this is that on the one hand, you've got all this currency around. On the other hand, banks are finding it harder and harder to loan money because the reserve requirements go up. That's a check on inflation.... I really don't understand the intricacies of the system. I'm not sure anyone here does. But if [those bills] circulate, they create inflation because there's so much money around. If they don't circulate, they crimp loans; they crimp industry. So China's in a bit of a bind.

Imagine what would happen if suddenly the RMB were fully convertible. What would happen is people are going to wake up and see what we've seen anyway, but aren't fully taking into account, and that is that prices are very high in China. If you look at food prices in China, sure, rice and cabbage are cheap compared to the U.S. But if you look at the price of pork, it's not a lot different. Look at milk, that's not a lot different. And Chinese incomes, at least by the official statistics, are a lot lower than U.S. incomes. There will be a lot of unanticipated consequences of freeing up the RMB. Yet there is no alternative to it because basically the people of China are paying the price of an RMB that's pegged at a fairly low level at this point.

Knowledge@Wharton: Hypothetically, let's assume you were invited by the Chinese government to offer some advice on how they should navigate the next ten years of participation in the WTO, so as to maximize the benefit to the Chinese economy and the world economy. What advice would you give them?

Meyer: Oh, it would be unequivocal. They wouldn't listen to it, but it would be unequivocal. The people of China aspire to become middle class. And yet the business model China has been using under the WTO has run its course. Costs have gone up. Labor is tight. The population is aging. What's the solution to these problems?

Well, the solution doesn't lie in pouring more concrete, which is what they did in response to [the global financial crisis of] 2008. The fixed asset investment just blew through the ceiling. No, the solution lies in the quality of your people. As a consequence, to move up the value chain, you've got to upgrade the skills of your folks.

I'd stimulate the demand side by trying to provide social safety nets where none now exist. That's very important so that the aging population, the aging consumer class, is willing to spend a little more. At the same time, you're going to have to upgrade the skills of people, probably at all levels, including managerial. So one recommendation is they send their most promising people here to Wharton. Seriously. This is so they learn the skills that are needed to run very complex, very sophisticated enterprises. But more generally, I would recommend that they try to take some of the folks whose experience is in manual labor and train them to be sophisticated technicians so that China can continue to grow, relying on higher value-added industries and shed the lower value-added industries. That would be my recommendation.