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## Innovation is the key point: the next decade for China and Asia

Reporter: XIE Xinchun



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### MAGGIE XIAOYANG CHEN

Associate professor of economics and international affairs, George Washington University. Professor Chen's research focuses on multinational firms, international trade, and regional trade agreements.

There are mainly two ways to increase our productivity. One is by increasing the productivity of individual firms through innovation so each firm can become more productive. The other is by increasing our efficiency in resource allocation, so the more productive firms will receive more resources while the least productive firms exit the economy.

**Reporter:** The topic of the conference you attend in Shanghai forum is ‘how Asian economy returns to prosperity’. What kind of standards do you use to evaluate and predict Asian economy development? Based on those standards, what is your expectation for Asia’s economy in the future?

**Maggie Chen:** The standards I typically look at are very similar to what everybody else uses and include, for example, GDP growth rate, export and import growth rates, inflation, debt-to-GDP ratio, FDI, and capital inflow/outflow. Based on these standards, I think Asia’s economy is still going to be one of the fastest growing economies in the next decade. Asia is still going to be the region where we will see stable growth, even though not as rapid as in the last decade. And this growth will still mainly be driven by trade, FDI, and investment in general, but hopefully the

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contributions of domestic demand, services, innovation, and productivity growth will increase in the meantime. So overall I'm still optimistic, but of course there are concerns such as the region- and even world-wide implications of China's slower growth.

**Reporter:** We can see that regional economic integration has become a mainstream in the world. So do you think that a higher degree of regional economic integration will be beneficial for Asia's regional economy development and stabilization, why?

**Maggie Chen:** Regional economic integration is definitely an unstoppable trend. It is happening everywhere and will continue to happen. I think overall it's beneficial for Asia's economic development and stability to promote regional economic integration. It provides not only more export and import opportunities for firms in Asia but also more FDI from multinational firms both within and outside Asia. Further, economic integration in Asia will lead to more cooperation between Asian countries that go far beyond economic integration. And especially when the U.S. is promoting TPP and TTIP, it's very important for Asia and particularly China to have counterpart partnerships and integrated blocs.

However, there're obviously issues. First, for example, the TPP currently does not involve China and Asian regional trade agreements are likely not going to involve the U.S. But there will be overlapping countries between these two types of trade agreement, which means that China and the U.S. could become sort of "spoke" countries in these agreement networks. If I were a firm, I would be interested in locating myself in the hub countries like Vietnam and Malaysia, which would have agreements with both China and the U.S., instead of the spoke countries. That would make the hub countries more competitive in terms of, for example, attracting FDI. That's one of the issues we have to think about. Second, even though regional economic integration can provide more stabilization by diversifying markets, it can

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also propagate economic crisis. If some negative shocks happen in one of the member countries, they can be propagated to the other member countries because of the deep trade and financial linkages.

**Reporter:** So to what extent do you think Asia's regional economic integration can go? Can we form an integrated block like EU?

**Maggie Chen:** I don't think we are able to achieve the same level of integration as the EU, at least in the short term. EU is the most integrated economic bloc that we have seen in the world. The bloc is far beyond trade and even economic integration. Asia is different. In Asia, countries are overall less developed and their differences in stages of development are also greater. Because of that and cultural and historical reasons, countries' economic objectives are also very different. So I don't think we would be able to integrate as much as the EU. However, to get things started, trade liberalization is definitely the most important step right now. But even that requires a lot of work and effort because when you involve so many developing countries, negotiations can be very hard as everyone wants to protect their domestic sectors like agriculture and services.

Overall though, I think it's definitely a very nice step forward even if we may not be able to achieve as much integration as the EU. And maybe that's good because when you have deep integration like the EU, you could have many serious problems like the ones we have seen such as the transmission of crisis I mentioned earlier.

**Reporter:** What difficulties do you think may be confronted in the process of promoting a further development of regional economic integration in Asia?

**Maggie Chen:** I think one issue, as I said, is that most of the countries involved are developing countries and even these developing countries are in very different stages of development. So when you try to integrate all these countries, you have to balance

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the interests of these very different countries and that's very hard. It's hard to harmonize the interests of so many different countries and come up with policies that everybody is willing to say yes to. For example, agriculture is always an area where integration can be difficult to push forward, and service is another sector. No countries want to become too dependent on foreign providers in these sectors. So these can be some of the challenges for integration.

Also, we have so many agreements, one on top of another. Like in Asia, ASEAN has signed agreements with China, India, and so on and, in addition to ASEAN, China has signed agreements with Singapore and South Korea. These agreements have become, what we often call, a spaghetti bowl. All these agreements have different rules such as the rules of origin and different depth. It's very difficult for firms and even countries to understand and navigate the system. If I were a Chinese firm and I wanted to invest somewhere, it could be very difficult to decide where, how much, and what to invest, because it's hard to tell which country would give me the best market access and the lowest cost. We know one of the most important features of globalization today is production fragmentation. Many firms segment their production and locate different stages in different countries to maximize profits. But when you have so many agreements intervene together, it's very difficult for firms to figure out the best production and location strategy. These are some of the challenges we will confront.

**Reporter:** Now we use “new normal” to define the world economy development situation after financial crisis of 2008, and Chinese chairman Xi Jinping also put forward the concept of the new normal of China's economy. So how do you think of China's new normal, such as the decline of speed for china's GDP development? And what are the international and domestic reasons for it?

**Maggie Chen:** The speed of China's growth has significantly slowed down. The reasons behind it, I think, are quite obvious. Our growth in the last decades was driven by investment, trade, and certain industries like construction and manufacturing. The

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dependence on these growth engines could lead to a lot of risks and the economy as a result could be vulnerable. For example, when industrial countries like the U.S. and western European nations went into recession, the weaker foreign demand significantly reduced our export and total economic growth. As for infrastructure investment and construction, they cannot go on forever and therefore cannot be a sustainable source of growth. Also, China in the past several decades achieved one of the greatest structural transformations in history with millions of labor moving from agriculture to manufacturing and became the world's largest manufacturing economy. But we are now getting to a point where not much more labor can be allocated from agriculture to manufacturing and labor cost is rising rapidly. So all of these factors contributed to the slowdown of China's economy, which means that we have to find other engines of growth.

As we all know, we are now trying to change from investment- and export-led growth to more a domestic-consumption driven economy. We are also in the process of the next structural transformation, transforming from a mainly manufacturing economy to a more diversified economy. I think it's also very important to increase our TFP (total factor productivity) and to become a more innovative economy. In the last few decades, our productivity growth is slower than our GDP growth. There are mainly two ways to increase our productivity. One is to increase the productivity of individual firms through innovation so each firm can become more productive. The other is to increase the efficiency in resource allocation, so the more productive firms will receive more resources while the least productive firms exit the economy. That way, the aggregate productivity of the country will be improved, which is important for China's continuing growth.

**Reporter:** In 1990s, Japan has experienced a financial crisis arising from Real estate bubble. Both as east-Asian countries, do you think there's any similarity between the current situation of china's economy and that of Japan in 1990s? In order to avoid china's economy falls into so-called "hard landing", what policies

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do you think can prevent china from repeating the mistake of Japan?

**Maggie Chen:** Yes, there are many similarities, like the bubbles in the housing market and the asset market and also the fact that both economies have been dependent on exports for growth. But there are also differences. For one, China's stage of development is very different from Japan's stage of development at that time. Japan at the time was already a developed country with high GDP per capita, but China now still has relatively low GDP per capita. That is one big difference between Japan in the 1990s and China now. That also means China can avoid going into the same situation as Japan did. China still has a large scope for economic transformation and growth. For example, China's service sector is still very open for more liberalization and growth. So China has more growth potential than Japan in the 1990s. In terms of economic policies, we need to avoid making the same monetary and fiscal policy mistakes Japan made and promote new sources of economic growth.

**Reporter:** One of the most important aspects of the new normal in china is industrial structure adjustment, which is also experienced by other developed countries before. Compared to those countries' experience, what do you think is the specific feature for this round of adjustment in china, and what is the experience that can be used as reference from other developed countries for china?

**Maggie Chen:** Countries that have experienced successful industrial structure adjustment are mainly in Asia and include, for example, South Korea, Japan, and Singapore. There's a lot of experience we can learn from them. The feature that differentiates China from all of those countries is that China's first round of transformation was moving the country from an agriculture economy to a manufacturing economy. That process made China the largest manufacturing country in the world. Now we are entering the second stage of transformation, which is

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hopefully transforming the country to a more diversified economy. We should not give up manufacturing, but we should diversify our economy to have both manufacturing and service. So that's where we are at this point.

I think we can look at South Korea to learn from their experience. For example, we can learn from their R&D policies. South Korea encouraged firm innovation by providing credits and subsidies. We have already done a lot of that, but we could still improve the efficiency and the payoff of our innovation policy to better allocate the physical and human capital. We should have our own high-tech, high-quality firms and also gradually move up the value chain from mainly low-end manufacturing to an economy with also high-end, high-quality, high-skill manufacturing and services. Innovation and human capital are the key. Given that the survival rate of new firms is very low, what the government needs to do is to better identify companies with promise and potential, including both startups and existing companies, and offer them incentives to innovate, expand, and improve quality and productivity. Governments should also try harder to promote cooperation between universities and industries.

**Reporter:** Your main research interests are in the field of international trade. Under the environment of global new normal, what do you think should Chinese export-orientated enterprises choose for their development path?

**Maggie Chen:** China's export enterprises used to compete on prices. Now they should try to improve the quality of their products and services and the reputation in foreign markets. Just like what Japan and South Korea did. And after accumulating more export experience, these export companies can learn and expand across markets and products. The diversification is useful for growth and risk reduction. Some of these firms can also become multinational firms. There's evidence that suggests exporting can be a stepping stone for FDI. For example, I could start as an exporter, but after I understand the foreign market a little better, I can directly invest in that country to reduce trade or production costs and increase market access. These can be

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the next steps for Chinese export companies.