EU-ASIA ECONOMIC GOVERNANCE FORUM

China's economy at a crossroads

Author: Dr. Detlef Rehn, freelance economics journalist

"When China sneezes, the global economy catches a cold." It was with these words that Financial Times columnist Martin Wolf described the panic that rocked international stock markets in July and August 2015. This was triggered by the Shanghai stock market suffering multiple collapses within a short space of time and the government consequently devaluing the renminbi yuan (RMB yuan). In addition to this, weaker monthly figures in terms of capital investments, industrial production and exports indicated a significant economic slowdown (see also Paul Linnarz, 'Keine Panik, alles "new normal"' [No panic, this is the "new normal"], KAS China country report, September 2015). Since then, the situation in China has calmed down somewhat, among other things thanks to state stimulus packages that include a reduction in interest rates and the reserve ratios for banks. The international stock exchanges have also recovered from the rather turbulent developments of the last few months. Yet despite all of this, the world must now accept that the days of seemingly unending growth in the Chinese economy are over. Whether China manages the transition towards slower, yet more sustainable development, is a question that, in light of the major importance of the country for the global economy, is being keenly debated all over the world.

The end of rapid growth

Until recently, the world was used to seeing high growth rates reported from China. Indeed, economic output increased by an average of almost 10% per year in real terms from 1978, the start of the country's policy of reform and opening, up to 2014. Among other things, the rise to become the world's second largest economy was driven by high levels of investment in construction of residential dwellings, as well as in infrastructure and ramping up industrial capacities. Millions of new workers also made their way from the country into the cities. Driven by an extended period of low costs and the massive market, foreign companies had invested more than US$ 1 trillion by 2014, turning China into the "workbench of the world". This was accompanied by a visible increase in the standard of living. For example, while per capita income in the country was only around US$ 200 at the start of the 1980s, this had increased to more than US$ 7500 by 2014 (World Bank, World Development Indicators). Even if tens of millions of people are still living in poverty, China is already classed as an "upper middle income country" in the terminology of the World Bank, comparable with Romania, Turkey or Malaysia.

Yet such rapid development also has many drawbacks. For example, total income is very unevenly distributed. Serious environmental pollution and widespread corruption also have a negative impact. Rampant house and apartment construction has created a bubble that threatens to burst at any time. The high level of growth recorded over the last few years has also severely increased the country's debts: According to information provided by Bloomberg, private households and companies had debts totalling 207% of the country's gross domestic product (GDP) at the end of June 2015. Back in 2008, this figure was just 125%

("China debt-to-gdp ratio just climbed to a record high," Bloomberg, 16th July 2015).

Growth has now been slowing down considerably for several years. Exports declined following the international financial crisis, and China also became less attractive for many foreign companies due to rising location costs. Productivity is also in decline: As determined by consultancy firm McKinsey, production of one GDP unit today requires 60% more capital expenditure than between 1990 and 2010 (McKinsey Global Institute, The China effect on global innovation, October 2015, page 2). The consequence of these developments is that economic output "only" increased by 7.4% in real terms in 2014. In 2015, it is unlikely to even hit 7%. In the first nine months, the increase was 6.9%. The International Monetary Fund (IMF) is forecasting GDP growth of 6.8% for 2015 and a subsequent weakening to 6.3% growth in 2016 (World Economic Outlook, October 2015, Table A4, page 172).

The Chinese government is sending out a calm and relaxed message. Chinese television broadcaster CCTV quoted Prime Minister Li Keqiang on 27th October 2015 with the words: "China never said that the economy must grow by 7% this year" (CCTV.com, 27th October 2015).

New five-year plan: The "new normality"

Yet despite this, China must prepare itself for different times and the political leadership is facing a dilemma. On the one hand, its needs to be able to offer its own citizens future prospects in terms of jobs, increasing income and better living conditions. This requires continued strong growth in the economy. On the other hand, the country is facing a number of structural and social problems.

With its 13th five-year plan, which covers the period from 2016 to 2020, China is keen to make the transition to a new development phase. A plenary session of the communist party's central committee approved this plan on 29th October 2015. It will be finally approved during the next plenary session of the People's National Congress, China's parliament, in March 2016.

The main theme of the plan is the "new normality". The development model is to be restructured so that it no longer relies on the same methods to target growth primarily through industrial manufacturing, investment and exports, accepting over-pollution of the environment and overexploitation of natural resources: In the future, it will focus on private consumption, services and innovation. The goal is to establish a "moderately prosperous society" by 2020. The target here is to double the economic output and per capita income of both the urban and rural population, measured against the level from 2010. Unlike past agreements, the new plan does not include any stipulation of concrete GDP growth rates. During an explanation of the plan's basic concepts on 3rd November 2015, however, party chief Xi Jinping stated that "annual growth for the 2016-2020 period must be at least 6.5%" in order to meet the aim of doubling output ("Xi expounds on guidelines for the 13th Five-Year Plan," Xinhuanet 3rd November 2015)

Private consumption: New growth driver

Up until the end of the 1980s, private consumption in China represented more than 50% of GDP. Since this time, the quota has dropped significantly due to the focus on investment and exports. According to information provided by the World Bank, it represented 37.7% in 2011 (World Bank

Indicators, Household final consumption expenditure (% of GDP)). To reduce the level of dependence of domestic economic development on overseas demand, the Chinese leadership therefore already decided in its 12th five-year plan (2011-2015) that a stronger focus should be placed on domestic consumption as the "driving force" of growth (China Business Review, 1st July 2010). Yet in light of only moderate success, this restructuring is obviously rather protracted. According to market research institute Nielsen, if the Chinese state specifically targets stimulation of private consumption over the course of the next few years, its contribution to GDP (currently around 38%) could increase to 46% by 2025 (Louise Keely, Demand Institute/Nielsen, China's Transition to a Consumer-Led Economy & How Businesses Can Help, Nielsen/USA, Blog, 4th August 2015). However, this value is several percentage points lower than in other emerging economies (World Bank Indicators, loc.cit.).

Creating new jobs will be extremely important in this process. The government rates the short-term prospects for this – at least – as very good. Although growth slowed down in 2015, significantly more jobs than the ten million new positions originally targeted were created from January to September 2015. It is highly likely that the labour-intensive services sector was the primary source of work for those seeking employment, as it recorded above-average growth in the first nine months of the year. At the same time, the official unemployment rate was 4.05% (State Council, PRC, press release, 27th October 2015). The labour market is also set to remain stable in the cities in 2016, as state economic stimulus measures such as interest rate reductions start to take effect. Yet without reforms, among other things to state-owned enterprises and in the social security system, there is a risk that fewer jobs than planned may be created (R. Lam et al., "China's Labour Market in the 'New Normal'", IMF Working Paper, July 2015).

In the mid to long term, however, the prospects for the labour market are not as positive. The rapid ageing of the Chinese population is likely to reduce the labour surplus from as early as 2020/2025. To counter this trend and achieve a balanced demographic structure, the political leadership passed a resolution at the end of October 2015 to replace the previous one-child policy with a two-child policy. The potential success of this change remains highly unclear.

Faster urbanisation also serves to stimulate consumption. Although some 55% of the Chinese population is already estimated to be living in cities (Xinhuanet, 20th January 2015), many of these people are migrant workers who do not have any official residential status and are therefore excluded from the social security system. To quote the party chief Xi Jinping according to the Xinhua news agency (Xinhuanet 3rd November 2015, loc. cit.), "To make the migrant workers 'real' urbanites is significant for the labour supply, consumption demand, stabilising the property market and expanding urban infrastructure investment, Xi said."

Urbanisation is set to become a key driving force of economic development, and services will assume ever greater significance in this framework. China has a lot of catching up to do here in areas such as medical care, training, all types of insurance and financial services, transport, logistics and telecommunications. Deployment of this potential is not least dependent on making existing rules more transparent, as well as eliminating administrative hurdles and market access restrictions (OECD, China in a Changing Global Environment, Executive Summary, March 2015, page 3).

China is generally striving to further expand its social network over the course of the next few years. For example, social security is to be improved in such a way that all registered citizens enjoy benefits ("Highlights of Proposals for China's 13th Five-Year Plan", China Daily, 3rd November 2015). The idea behind this is that citizens receiving benefits are then likely to save less money for emergencies, so more funds should be available for consumption.

Another key objective is to overcome poverty once and for all among parts of the population. At the end of 2014, just over 70 million people in rural areas were still living below the poverty line of 2300 RMB yuan annually (US$ 376 based on the 2010 exchange rate). According to party chief Xi: "If the government takes concrete and effective action, China can lift 10 million people out of poverty every year from 2016 to 2020," Xinhuanet, 3rd November 2015). Among other things, these include improvements to rural infrastructures, as well as better training and healthcare provision. However, according to Xi: "Eliminating poverty in rural areas is the most difficult challenge in building a 'moderately prosperous society,'" (Xinhuanet, 3rd November 2015).

China is keen to become a "world manufacturing power"

In the course of the last few decades, a significant portion of China's economic upturn can be attributed to manufacturing, often focussing on cheap, low-end mass products. While this has made China into the world's largest producer and "world champion exporter", a slowdown in growth and increasing location costs are now forcing the country to look for ways of establishing industrial manufacturing at a new, higher level.

Innovation, quality and efficiency are the keywords here. In May 2015, the government passed the "Made in China 2025" plan, which the country is keen to use to become a "world manufacturing power". Germany's "Industry 4.0" programme served as the model for this. The focus is on ten industrial sectors, including new information technologies (Internet of Things, cloud computing, Big Data), NC machines and robots, the aerospace sector, railway technology, electric mobility, energy equipment, new materials, as well as biopharmaceuticals and medical engineering. Alongside this, some 15 Innovation Centres are, for example, to be established and 40% of key components and materials sourced from within China by 2020. China's general objective with the plan is to make industry more efficient and more integrated than before.

The prospects of "Made in China 2025" can differ quite markedly, depending on who you speak to (X. Lee, "Made in China 2025: A New Era for Chinese Manufacturing", CKGSB Knowledge, 2nd September 2015). Many commentators consider the plan to be very important because it is being coordinated by a high-ranking "management team" at the state council (government). However, others believe that the plan will only help achieve more modest goals such as improvements in quality, greater digitalisation and productivity, as well as increased use of NC machines (Economist, Special Report: Business in China, 12th September 2015). However, the envisaged leap to the cutting edge of technology is likely to be far more difficult.

According to McKinsey, China has the potential to become the world's leading innovator, despite its many problems (McKinsey

Global Institute 2015, loc.cit.). Chinese companies are already highly innovative when it comes to efficiency-orientated products and are also making very rapid progress in improving consumer products. However, they are far less adept at implementing new engineering findings. Yet the influence exerted by China on global innovation is likely to be visible everywhere by 2025, as many more foreign companies than before will then use the country as a location for fast and affordable technological developments.

Foreign trade: Even more globalisation targeted

Due to the economic slowdown, significant capacity surpluses have been created in a whole host of important industrial sectors over the last few years. To counter this, the political leadership in Beijing has launched multiple major initiatives. The founding of the Asia Infrastructure Investment Bank (AIIB), a multilateral development bank, and the "One Belt, One Road" strategy in particular have attracted a great deal of attention. These projects should contribute to improving the infrastructure heading west from China to the Central Asian states and heading south into South-East Asia. China hopes this will enable it to develop new sales markets, trade routes and energy sources (Mercator Institute for Chinese Studies, One Belt, One Road: China is Building a Global Infrastructure Network, June 2015).

Both initiatives are still in their infancy, thus many issues still need to be clarified. Although neither the US nor Japan were involved in the foundation of the AIIB, both countries have expressed fears that China is seeking only to challenge the existing international financial system with the new establishment and that the bank's transparency is not guaranteed. One objection to this is that the involvement of almost 60 states should provide for sufficient control and also prevent the financial resources from only being deployed in countries favoured by China (D. Dollar, China's rise as a regional and global power: The AIIB and the 'one belt, one road'", Brookings Institute, summer 2015). Aside from this, the US should be happy that China is assuming greater global responsibility (ibid.). Officially, the US now seems to have given up its resistance against the investment bank ("White House declares truce with China over AIIB", Financial Times, 27th September 2015).

At the start of October 2015, the US joined Japan and ten other countries in the Asia-Pacific region to agree on the key elements of a free trade agreement (Trans-Pacific Partnership, TPP). In principle, China could also be interested in getting involved here. However, it remains to be seen whether the country is likely to aim for this (S. Hsu, "China and the Trans-Pacific Partnership", The Diplomat, 14th October 2015). In addition, China has already been discussing a trilateral free trade agreement with Japan and South Korea for some time now. These discussions may now gain new impetus, as Japan's relations with China and South Korea, which were rather frosty for many years, appeared to start warming up in autumn 2015.

Outlook

Although the speed at which China's economy is growing has slowed, if this leads to more stable and sustainable development, the IMF believes it is a price worth paying (IMF, China, Country Report, 14th August 2015, page 19). In any case, China is unlikely to reduce its reform efforts, as in contrast to a minor economic dip this would actually have very negative consequences in the mid to long term, not only for China itself, but also for the entire global economy.

The unavoidable reforms include changes at state-owned enterprises. Although raising finances is far easier for these enterprises than for private companies, this in turn has negative consequences for productivity growth (ibid., page 16). Other necessary measures affect the taxation and social security system, the question as to how debts should be addressed, as well as the future international role of the RMB yuan.

The statement by Jin Zhongxia, the Chinese Executive Director at the IMF, on the new country report shows that China seems generally willing to continue along its path of reforms, even if there are still differences of opinion on a whole host of issues. Indeed, should the various changes lead to domestic political tensions, for example, it remains to be seen whether the leadership will continue to display the same willingness for reforms as is currently the case.

About the author: Dr. Detlef Rehn lives and works in Japan as a freelance economics journalist. After studying in both Bonn and Beijing and subsequently holding the position of research associate at the Bonn East Asia Institute, from 1990 until his retirement in May 2014 the graduate economist worked as a correspondent in Taipei, Seoul and Tokyo for the German Office for Foreign Trade (Bundesagentur für Außenwirtschaft, BFAI), which subsequently became Germany Trade and Invest (GTaI).

Konrad Adenauer Stiftung

Social and Economic Governance Programme Asia / Japan Office

OAG-Haus 4F
7-5-56 Akasaka, Minato-ku
Tokyo, 107 0052 Japan
Tel. +81 3 6426 5041
Fax. +81 3 6426 5047
KAS-Tokyo@kas.de
www.kas.de/japan/en
www.facebook.com/KAS.Japan