

Focus on Economics

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Where is China headed and what does this mean for Germany and the world?

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China's impressive economic boom in recent decades rests to a large extent on high growth levels in its exports and investment, leading critics to call this development unbalanced. In this paper we first show that growth in these sectors is not problematic per se, but that it is an issue insofar as misguided economic policy is evident in this area. At this point, the Chinese government has set itself the goal of rectifying these policies, and some measures have already been accomplished in this regard. However, this raises the question as to what a change of course would mean for the world in general and Germany in particular. China's economic partners should prepare themselves for noticeable changes that will by no means only create problems for them but certainly also open up opportunities. The German economy is particularly well positioned in this regard.

From long-lasting boom to a "new normalcy"

As recently as 1980, China was still a *low-income country*, on a par with the Republic of Guinea in terms of per-capita income. As economic liberalisation has progressed, its GDP has risen since then by an average of 10% per annum, thereby swelling to 20 times its size. During the global financial crisis, Chinese growth momentum eased up only slightly. In recent times, however, the economy has cooled down considerably, and growth in the range of 7–8% p. a. should be the normal state of affairs in the medium term. This is congruent with China's five-year plan for 2011–2015, which targets annual growth of 7%.

Characteristics of the boom and starting points for changing course¹

The economic boom is mainly based on sharp increases in exports and investment and is bolstered by a high savings ratio and considerable credit expansion. The discussion below clearly shows that these trends rest to some extent on economic policy interventions of a dubious nature and highlights that certain rectifications have already been undertaken.

a) Exports as growth driver

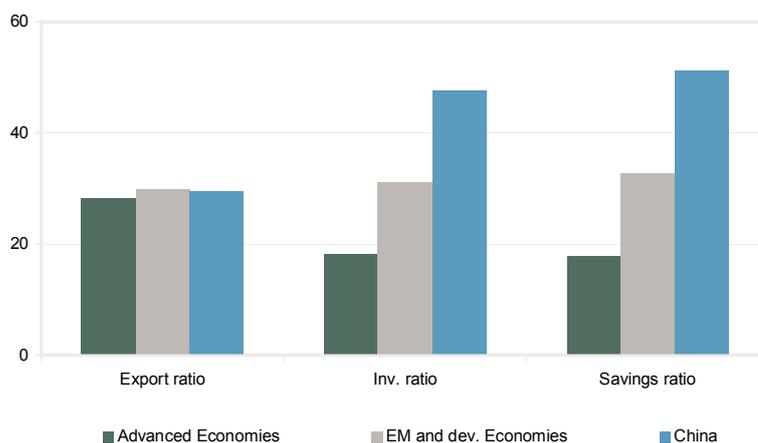
A consistent market economy system was not the stated goal of the liberalisation process that started in the late 1970s but, in any event, private sector and market forces were given considerable leeway. In the manufacturing industry, in particular, this led to sizable private entrepreneurial engagement (often involving the participation of foreign capital) as well as to significant technological advances. In countless areas, China has developed into a producer of cutting-

edge technologies. Its increased international competitiveness is borne out by its balance of payments. Goods exports have increased by a factor of 30 since 1990; China's share of world trade has increased from 1.5 to 10.6% in the same period. This has also made the Chinese economy increasingly dependent on exports, however. Exports of goods and services constitute around a third of China's GDP.

This export ratio of China's is by no means out of the ordinary. The average for all emerging market and developing economies and the average for the advanced economies is almost the same (see Figure 1), as is incidentally the average for the *upper middle-income countries* to which China now belongs. Increasing global economic integration in recent decades is a phenomenon that applies not only to a few "up-and-coming" emerging markets, but to nearly all countries. Thus, China's economic development cannot be called extreme in its dependence on exports.

Rather, the need for a change of course arises from the fact that China's successes as an exporter are not simply based on solid micro- and macroeconomic efforts, but to a certain extent also on dubious economic policy instruments like protectionism, dumping, brand piracy

Figure 1: Exports, investment and savings, each as a percentage of GDP (average 2009–2012)



Source: World Bank, IMF.

and, especially, the undervaluation of the renminbi (RMB), which has at times been estimated at up to 30 % against the US dollar. China's foreign economic policy has led to a misallocation of resources: production areas have been created that would not have been competitive without these interventions (exporting companies and others that substitute imports).

In the area of exchange rates, the change of course is already in full swing. For many years, exchange rate management was the antidote to high current account surpluses. The Chinese central bank continuously siphoned off part of net foreign exchange inflows in order to favour the export economy through exchange rates, but also in order to increase its forex reserves. Since 2010, however, the RMB's undervaluation has significantly narrowed, if it has not disappeared altogether. On the one hand, the central bank allowed for a continuous gradual nominal appreciation of its currency, on the other, inflation in China has been significantly higher than in the USA, which, all other factors being equal, necessarily should lead to a devaluation of the RMB (purchasing power parity approach). The resultant appreciation was thus significantly more pronounced in real terms than expressed in the nominal figures. Forex reserves are barely increasing anymore, and the current account surplus is on the wane. At this point, the RMB is either considered to be more or less correctly valued (EIU) or at most only "moderately undervalued" (IMF). This is also congruent with the

fact that criticism from the USA (where there was once talk of a currency war and retribution was threatened) has largely fallen silent.

Yet, similar positive changes have not been observed among China's other foreign trade policy interventions. Here, corrective measures would be a simple administrative matter, but the pivotal question is whether they are politically enforceable. In 2001, China joined the World Trade Organization (WTO). At the time, the government deftly exploited the attendant need for adjustments in order to trump domestic resistance to the removal of trade barriers. It is to be hoped that the new government under Premier Li Keqiang – an economist no less! – will now be of a similar disposition and will also translate its announced reforms into action.

b) Investment as growth driver

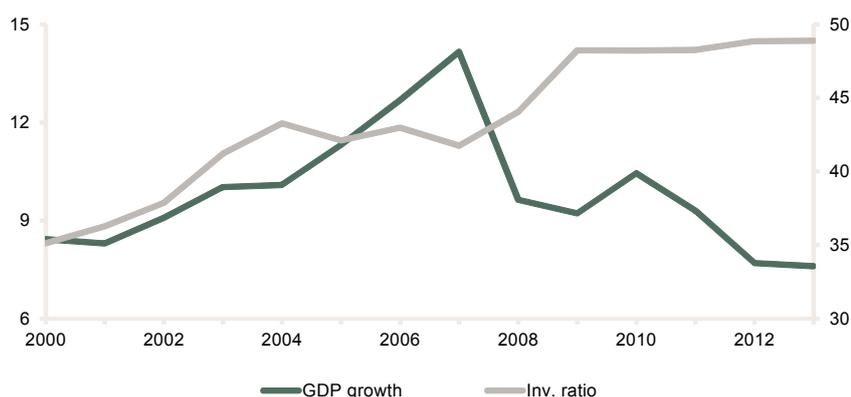
Besides exports, investment is a key growth driver that has remained at high levels for a long time now and has risen again significantly since 2000 to 47 % of GDP (2012). Among advanced economies and emerging market and developing economies as a whole, China stands out with such a high investment ratio (see Figure 1). That said, an above-average investment ratio is not all that surprising initially in the case of a country like China. At the onset of its economic boom, China's economy was still shaped by labour-intensive subsistence farming. An enduring period of rapid economic growth would have been unthinkable without massive increases in capital

stock. China's investment ratio does not appear problematic until one analyses the impact of investment.

The aim of investment is to secure and/or increase material wealth. Thus, a high investment ratio should translate into economic growth. In the case of China, there are clear indications that this has not been entirely the case recently, as it was in the past. Figure 2 shows that up to around 2006 an increase in the investment ratio was accompanied by higher GDP growth rates, which suggests high levels of productivity on investment. However, the two curves have since diverged considerably: while economic growth slowed down starting in 2007, China's investment ratio continued to rise and then settled at very high levels pointing to declining productivity of investment.²

This thesis is supported by the country's ominous economic development in recent times. After the global financial crisis broke out in 2008, the Chinese government launched a massive economic stimulus program. The state invested above all in infrastructure, residential construction and expansion of the production capacities of state-owned enterprises. This government investment in many instances proved to be unproductive, however, and, to a certain extent, the infrastructure created was excessive; many state-built housing units remain unoccupied – there are even reports of ghost towns. The central government's efforts to bolster the economy triggered ill-fated competition at provincial and municipal level in a rush to attain as much (regional) growth as possible. These lower-level state administrative bodies not only deployed their own budgets for this purpose, they also mobilised their industrial companies. This lever is certainly a big one as, regardless of the general trend towards liberalisation in the Chinese economic system, countless branches of industry are still dominated by state-owned companies, in the steel, coal-mining, cement, ship-building, shipping, construction equipment and metallurgy industries, for example. These state-run companies have been heavily investing in expanding their production capacities in recent years. The result, however, was low capacity

Figure 2: GDP growth (in per cent, left) and investment ratio (as per cent of GDP, right) since 2000



Source: IMF.

utilisation and declining profits, with some firms even slipping into loss territory. In mid-2013, the central government (Ministry of Industry) reacted by ordering a reduction in production capacities, specifically citing 1,400 companies by name. It will be interesting to see how this directive is implemented given that it signifies not only job losses, but also a loss of tax revenues for provincial- and municipal administrations, to say nothing of prestige issues. Furthermore, this failed incentive system needs to be changed at the lower levels of government.

c) Problem areas of savings ratio and credit growth

China's investment rests on a high savings ratio in the aggregate economy and considerable expansion of bank lending. The country's total savings ratio, like its investment ratio, is well above average when compared internationally (see Figure 1). As usually defined, the savings ratio includes non-consumption in private households, the public sector (budget surpluses, if any) and businesses (retained earnings). China's private household savings ratio amounts to roughly 30% of disposable income (the figure for Germany is around 11%). It is doubtful whether a savings ratio that high (and, by extension, such low levels of private consumption) is based on voluntary decisions by the parties affected, i. e. whether it reflects people's actual preferences in respect of the breakdown into present- and future consumption. Rather, the high levels of private savings are an expression of social deficiencies. To date, very few Chinese have been able to insure themselves against elementary risks in life, such as illness, old age and unemployment, and existing legal protection mechanisms are inadequate.³ Most Chinese find themselves forced to take precautions against these risks by not consuming and instead saving.

These problematic pressures are also significantly exacerbated by China's single-child policy, rising life expectancy and changing social structures (large agricultural families waning in importance, millions of domestic migrant workers, etc.). More than ever, competent retirement-, healthcare- and unemployment insurance schemes need to be set up.

Although the relevant insurance premiums would also mean forgoing consumption, the creation of an insurance community would allow for these risks to be covered at significantly lower cost than if individuals are left to fend for themselves. This would also provide leeway in terms of lower savings and increased consumption.

The state-controlled banks played an important role in implementing the 2009/2010 economic stimulus program. The Chinese banking market is dominated by a handful of large state institutions. The state not only owns these banks, it also determines their business operations and exercises significant influence over banking supervision, which in turn is subordinate to the political objectives of the government and/or the Communist Party. These circumstances provide the framework in which the massive increase in bank lending is taking place. The loan portfolio of the banking system rose during the 2009/2010 economic programme (nominally) by over 50% and in the 2008–2012 period by 110%. Thus, in relation to GDP, the loan portfolio had swelled over 150% by 2012 (average for *upper middle-income countries*: 116%, Germany: 124%). These loans were mainly taken out by large state-run industrial companies, but also by municipalities (using financial vehicles to circumvent regulations officially preventing them from taking out loans). Private firms and SMEs, on the other hand, continue to bemoan the fact that gaining access to credit has become more difficult for them. In light of the problems, discussed above, that major state companies are experiencing and reports of considerable indebtedness issues on the part of municipalities, it is fair to assume that the quality of bank asset portfolios has become increasingly critical. The fact that the official *non-performing loans* ratio of 1% is nonetheless extremely low is likely to be attributable to statistical tricks such as *rollover*. A further point of concern is that all the figures cited above refer to the official banking market only. In China, however, a large role is also played by so-called shadow banks, which are companies that do banking business without a banking licence. Taking shadow banking into account, the loan portfolio in relation to GDP is esti-

mated at around 220%.

Given the weaknesses outlined in the banking sector, reforms constitute a Herculean task. At this point, the government has already initiated the first measures (e. g. liberalisation of selected interest rates). At least there is no need to worry that China's banking sector will become a systemic risk: the state probably has the financial means to support banks in distress, as it did before in 1997/98, when during the Asian crisis it emerged that certain Chinese banks were effectively insolvent. The government at the time found a superficial solution, setting up *bad banks*, but, then as now, it is the Chinese taxpayer who will ultimately have to cover losses.

What does China's change of course mean for the world?

Above, we have shown that changes leading in the direction of sustainable development are already underway in China. The cautious cooling-off of the economy and the new exchange rate policy are part of this. However, there are many issues that the Chinese government has not yet or only rudimentarily tackled, and it therefore still needs to act. The focus here must be on political trade interventions, infrastructural policy, the problem area of provinces / municipalities / state-owned industrial companies, financial sector reforms and expansion of the Chinese social security systems.

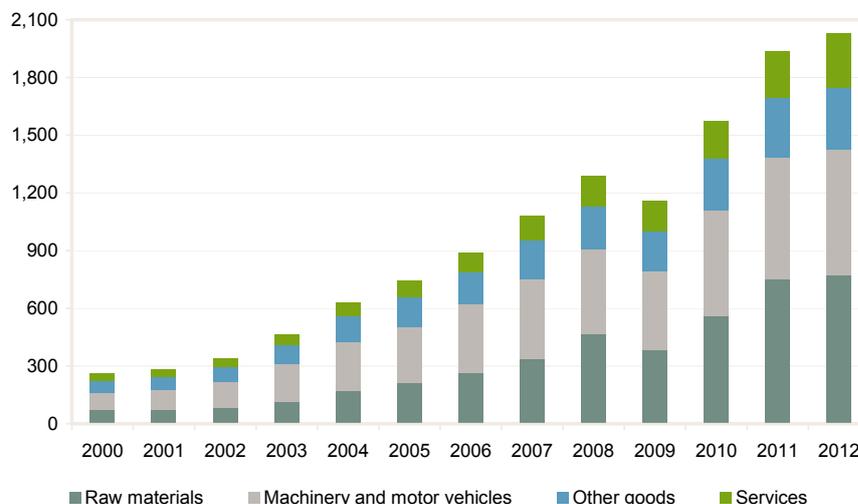
The rest of the world should have a fundamental interest in this and should welcome China's efforts to avoid a hard landing, correct policy errors and settle into a sustainable course of development. So far, however, the world has often sent out contradictory signals to China: China is asked to stimulate its domestic economy (so that exports to China do not suffer), while the rectification of misguided economic policy ("unfair" practices, but also global climate concerns, for example) is demanded in the same breath.

Analysis of Chinese imports over the past few years shows that the rest of the world has no reason to be pessimistic. Chinese imports of goods and services have rocketed since 2000 (see Figure 3). The boom years leading up to 2008 and

the 2009 decline during the global financial crisis are well known, but it should also be noted that imports subsequently increased sharply again and were almost 60% higher in 2012 than they were in 2008. This leads to two conclusions: firstly, that even slightly muted economic growth still significantly bolsters import demand; and secondly, China's changed exchange rate policy is apparently leading to rising imports, namely on account of the appreciation of the RMB, but also by virtue of the fact that foreign currency inflows are not really flowing into forex reserves anymore and are instead being made available for imports.

A structural view of imports is instructive in making forecasts going forward. Figure 3 underscores China's immense thirst for raw materials. A shift in the deployment of GDP from investment to consumption may not change anything here overall but could have an impact on the way in which raw materials are imported. This is in all likelihood also the case with the historically important import category of machinery and motor vehicles; expansion of the domestic consumer goods industry will no doubt also bring elevated imports of this nature in tow. Imported services also deserve our undivided attention. These have increased considerably; the Chinese services balance is negative with a marked rising tendency. One important component of imported services is tourism, with the world currently growing accustomed to Chinese tourists. Given sustained in-

Figure 3: Chinese imports (in USD billions, nominal) since 2000



Source: UNCTAD, IMF, own calculations.

creases in income and decreasing private savings, these services imports are likely to experience continued above-average growth.

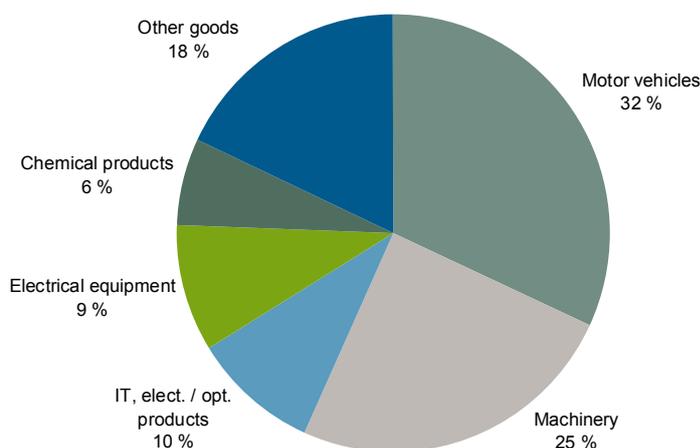
Lastly, there is one more consequence of China's new exchange rate policy. Before, the strong RMB undervaluation was accompanied by a considerable increase in forex reserves. China would use these reserves to go on shopping sprees and purposefully acquired direct investment stakes in a great many companies worldwide, along with bonds. In the future, we should see less Chinese direct investment, and countries like, say, the USA will have to adapt to the fact that their budget deficits will not be as heavily financed by China as in the past.

... and what does it mean for future economic ties with Germany?

We know that the German export economy has benefitted enormously from the Chinese economic boom. Between 2000 and 2012, exported goods to China rose from EUR 9.5 bn to EUR 66.7 bn, while the respective share of total exports from Germany rose from 1.6 to 6.1%. The overwhelming majority of German exports consist of upscale industrial investment goods and consumer goods (see Figure 4). A shift in China from investment-based- to consumption-oriented growth would first require investment in expanding the consumer goods industry, but it would also directly stimulate consumer goods imports. The German export economy is therefore essentially very well positioned for the Chinese market. It must nonetheless brace itself for more significant changes in individual aspects. Yet, the Chinese market has never been an easy one, and over time there have been considerable changes in demand, in government regulations and in competitiveness vis-à-vis Chinese and other foreign rivals. The German economy will probably prove itself capable of rising to such challenges, especially given that framework conditions will not tend to change abruptly but gradually and will also be similarly taxing for competitors.

Foreign direct investment (FDI) also constitutes an important factor in bilateral economic relations. Between 2000 and

Figure 4: Structure of German goods exports to China in 2013 (Jan.–Nov.)



Source: German Federal Statistical Office.

2011, German FDI in China (FDI stock) rose from EUR 5.6 bn to EUR 38.8 bn. Germans hold around 1,600 equity stakes in Chinese firms. In terms of sectors, motor vehicle manufacturing and trade, electrical equipment, chemical products and machinery manufacture predominate – sectors in which German exports are already considered dominant. Chinese FDI in Germany has likewise increased sharply, but at EUR 1.1 bn (2011) constitutes a mere 3% of German FDI in China. The same principles apply to assessing future prospects for German investors as in the case of trade. On the other hand, these prospects may actually improve, should China open up its services market further

and expand its social insurance system (opportunities for banks as well as life and healthcare insurers, etc.).

Conclusion

In recent decades, China has taken a specific path in terms of economic policy, which is only sustainable to a limited extent. The country therefore needs to change course in many areas (and is also already doing so to a certain degree): in its foreign economic policy, its financial policy, its financial sector as well as its social policy. This change of course must not, however, be confined to a few tweaks here and there, but, as we have shown, in some cases major reforms will be required. To delay would be

unwise, since these problems will not solve themselves. In November 2013, the Communist Party's Central Committee announced sweeping reforms, which also include the issues discussed here. It is now a case of formulating specific policies and implementing them.

China's economic partners should support these efforts because if China improves its economic framework conditions, this is good news for the rest of the world, especially since this would be likely to expand, rather than limit, global economic ties. ■

¹ A change of course is needed not only in the areas mentioned in this paper, but doubtless also in environmental policy and regional policy, etc. However, such considerations have been intentionally omitted here.

² Merely comparing the two curves of course only allows for a rough estimate of the contribution to growth stemming from investment. A methodologically and conceptually sound analysis would have to take into account the fact that investment sometimes only gives rise to growth after a time lag, adjustments would have to be made for fluctuations in the degree of capacity utilisation, and net investment would have to be used (since depreciations and amortisations do not affect growth). However, more involved research likewise implies that China's investment ratio is excessive, and that productivity on investment is declining over time (see, for example, Lee, I. H. et al.: Is China over-investing and does it matter? IMF Working Paper, WP/12/277, November 2012.)

³ Existing social security systems are largely confined to the urban population. The rural population, millions of domestic migrant workers and those employed in informal sectors hardly benefit, although by law they are absolutely eligible to a certain extent. Add to this the fact that, in the healthcare sector for example, services granted by law are often of poor quality and/or only available to those willing to pay bribes.