

Focus on Economics

No. 58, 2nd June 2014

Reforms in China: not only urgent in the country's own interests, but also beneficial to the rest of the world

Author: Dr Martin Raschen, phone +49 (0) 69 7431-2434, research@kfw.de

China's major economic and sociopolitical 'construction sites' form the subject of countless analyses. So much so that, when both China's own interests and those of foreign business partners are considered, the conclusions presented are often unsettling. Take the environment, for example. The world is worried because China's CO₂ emissions pose a threat to the global climate. At the same time, improved environmental protection in China gives cause for concern overseas, because this could stifle economic growth and could rob China – the driving force behind the global economy – of its might. With similarly mixed feelings, the international community is keeping a watchful eye on the problems in China's banking sector, in social policy, demographic development and foreign trade policy. This paper seeks to paint a balanced picture. Indeed, in the areas mentioned above,¹ the departure from a "carry on as we are" approach has had ramifications beyond China's borders and there are also losers overseas. However, well-managed reforms will guide the country down a path towards more sustainable development, thereby opening up new and attractive prospects for foreign partners – Germany in particular.

Damage to the global climate, China would like to become greener

China's CO₂ emissions (see figure 1) have now become the highest in the world. The country is responsible for more than a quarter of global emissions. The main causes behind China's

CO₂ emissions – namely industry, energy and transport – are damaging environmental resources not only on a global scale, but also on a local one. Pictures of extensive air pollution in Chinese mega-cities have been beamed around the world. The quality of both soil and water is poor too. The government is well aware of just how explosive this topic is – not only due to threshold values being (formally) exceeded, but also because the population has become more conscious of environmental considerations and now holds grievances against "the system". The current five-year plan includes ambitious environmental targets.

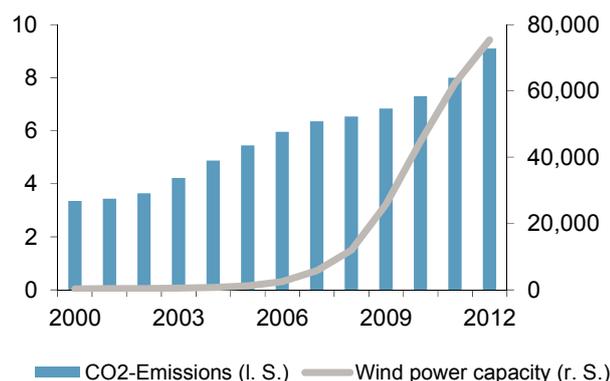
If environmental protection is to become more effective, tighter regulations are not required in the first instance. Rather, the regulations need to be strictly applied. However, this necessitates considerable investment in industry, energy and transport and will increase production costs. The consequences, meanwhile, will be decreasing profitability, job cuts

and, undoubtedly, the closure of entire companies in some cases.

China's foreign partners are observing the matter from different angles. On the one hand, they are urging China to implement effective environmental protection measures out of concern for the global climate. On the other hand, they fear that such a policy would stifle Chinese growth and result in lower demand for imports. However, a one-sided sceptical attitude is unjustified. The fact that China shares a responsibility for the global climate is undisputed. More effective environmental protection is also in the country's own interests, however, since GDP alone is not an indicator of prosperity, as we are all well aware. Ultimately, environmental protection also opens up many new opportunities for the economy, as is already clear today.

China has not only set itself ambitious environmental targets (on paper), but has also achieved a great deal already. Take energy policy, for example. Since 2000, there has been a massive increase in wind farms' capacity to generate electricity (see figure 1) and, meanwhile, China has become the world's largest producer of wind power by a clear margin. There is no contradiction in the fact that, as has been mentioned previously, the country also occupies the top spot on the inglorious CO₂ emissions list. In actual fact, this illustrates both the

Figure 1: CO₂ emissions (t in billions) and the capacity to generate electricity from wind power (MW)



Sources: International Energy Agency, Global Wind Energy Council

sheer size of the environmental problem and the country's high economic growth that is making it difficult to close inefficient thermal power stations. Despite their enormous expansion, wind farms actually only account for 6% of the overall electricity generation capacity.

There are further examples of an "as well as" situation in the transport sector. The level of private transport is rising rapidly. Since 2000, the road network has been extended by a massive 150%, yet the number of vehicles has increased at a much faster rate. The consequences of this include negative repercussions such as dust, noise pollution, air pollution, increased land consumption and so on – problems which are bugbears in industrial nations as well. However, China is also investing extensively in a more environmentally friendly railway system. Indeed, the railway network has been extended by 7,600 km (+13%) since the year 2000, which equates to a quarter of the entire German network (which has shrunk by 9% since 2000). China is also expanding its local public transport in its mega-cities.

Environmental protection is not, therefore, destroying the economic structure; rather, it is changing it. Market opportunities are opening up for Chinese companies with environmental know-how as well as their trading partners. The German economy is already doing good business with China in the aforementioned areas and should still be able to assert itself as an attractive partner in the future.

Financial market reforms: need for action, but no reason to panic

The global financial crisis has highlighted the central economic role played by the financial sector and the damage that misdevelopments in this sector can cause. Against this background, the Chinese financial sector is definitely causing a headache. It is dominated by a few large state-owned institutions. The state not only owns these banks; it also determines their business activity and exercises significant influence over banking supervision, which in turn is subordinate to the political objectives of the government and/or the Communist Party. Lending has increased significantly

over the last few years, while company debts at around 150% in relation to GDP are very high by international comparison. There is doubt surrounding the intrinsic value of quite a number of loans. The portfolio quality could be considerably worse than conveyed by the official non-performing loans rate of 1%. While loan rates have been liberalised since 2013, this is not yet the case for deposit rates, although there are plans to do so.² Besides the official commercial banks, so-called shadow banks – companies that run a banking business without a banking licence – also play a major role in China, which represents a major risk to the sector.

Against this background, there are some warnings of a financial crash (which would force the real economy into a hard landing). On the other hand, however, there are also fears that reform will stifle the economy, as the existing high investments financed by means of loans are one of the fundamental pillars of the economic boom.

These problems are undoubtedly serious and the need for action is correspondingly great. However, simple similarities to other countries that have experienced credit expansion and property price bubbles and then slumped into a deep economic crisis do not apply for a number of reasons. Loans issued by state banks to state-owned enterprises and lower-level territorial authorities are certainly open to criticism when it comes to regulatory policy. Such loans are associated with misallocation of resources and underestimation of risks. However, the underlying guarantee and the high financial clout of the central government³ are reassuring.⁴ The Chinese property market is different from other countries with housing bubbles, as private households predominantly only have low debts and are able to withstand the burden of the debt service, among other things. They have to contribute a large excess towards the financing of property, and property loans for private households are of little significance when compared with lending and GDP.

This is by no means an excuse for doing nothing. Essential elements of the financial market reforms include the commer-

cialisation of the banking business, the establishment of effective financial market regulation and independent banking supervision, the introduction of deposit protection, further liberalisation of interest rates and, finally, the privatisation of the large state-owned banks. The particular challenge is to liberalise the sector at the same time as regulating / supervising it more closely. Although there are many pitfalls on this path, the responsible parties should in principle be able to overcome them. From the point of view of the rest of the world, it is reassuring that the direct risk of contamination is low due to the existing controls on capital transactions.

Of course, the ex-ante impact that the reforms will have on propensity to save, loan offers and so on is unclear. A stable financial sector that operates by the rules of a market economy is, however, clearly more important than maintaining certain quantitative values, particularly in view of the fact that the former unilateral investment- (and export-) driven growth is also unsustainable.

Sociopolitical reforms stabilise the economy and open up new market opportunities

Up until now, only a small number of Chinese have been able to take out comprehensive insurance against basic life risks such as illness, age and unemployment. The existing social security systems are either limited to particular parts of the population, offer only minor benefits or the range of benefits on offer are of a poor quality. Most Chinese therefore find themselves forced to take precautions against these risks by not consuming and, instead, saving. The macroeconomic savings rate at around 50% of GDP is way above average by international comparison. This enabled the strong credit expansion and, in this respect, is also associated with the unbalanced economic growth. Unlike in other countries, private consumption in China is not a growth driver.

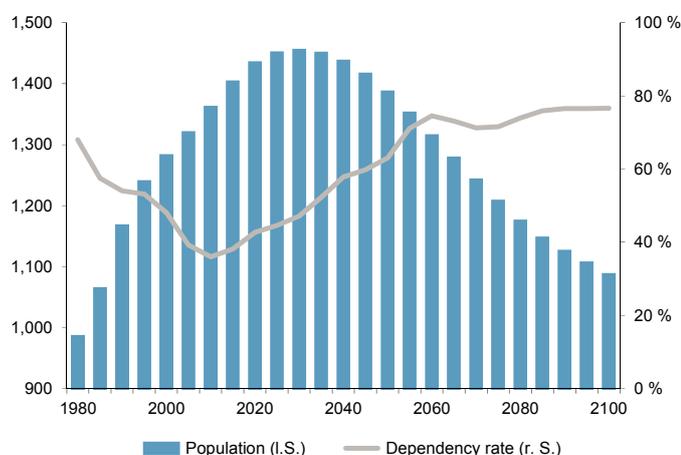
Changes in this sector would be positive for China; it goes without saying that improved social protection is important for the Chinese people. However from the point of view of foreign business partners, there are many positive as-

pects as a result. Firstly, higher consumption stabilises economic development. Secondly, increased consumption leads to more consumer goods being imported and the domestic consumer goods industry being expanded, which in turn breathes life into the import demand for industrial capital goods. In both areas, foreign – and especially German – exporters and investors, are already enjoying success on the Chinese market. Thirdly, higher demand for social insurance benefits is met with a local offering which is still very much underdeveloped. If this causes the market to open up, German providers would also have opportunities in the competition between foreign banks and insurers. Fourthly, further interesting prospects will be generated in individual sectors. Take the healthcare sector, for example. Here, demand is not only increasing due to the expansion of health insurance, but also due to demographic trends (an ageing society, see below) and ongoing urbanisation. The hospital sector has already been opened up to foreign investors to a certain extent and offers considerable opportunities for machinery suppliers, service providers and operators. The German economy is competitive in this sector too.

Demographics: efforts to combat an ageing population

At the end of the 1970s, the government introduced the one-child policy because it feared that the high population growth would result in famine and pose a threat to economic progress. Annual population growth thus sank from 1.25% at the start of the 1980s to the current rate of just 0.49%. At the same time, society is becoming progressively older, as the population statistics impressively illustrate. The working population is an important determinant of a country's economic prospects. The working population produces goods and services in addition to providing for its fellow citizens, be they young or old. Under the one-child policy, the youth dependency ratio initially fell, while the old-age dependency ratio was still low. But in the meantime, an increasing number of Chinese people are retiring from working life. The summarised so-called dependency ratio (young and old in relation to the working population)

Figure 2: Longer-term population trend (in millions) and dependency ratio (younger (< 15 years) and older people (65+) as a proportion of the working population in percent)



Sources: United Nations, Population Division 2012

in China reached its 36% minimum in 2010 (see figure 2). According to the previous projection, it will spike at around 75% over the next few decades, with the population shrinking in the medium term.

The government consequently relaxed the one-child policy in 2013. Couples where one of the partners is an only child may now have two children. From an external point of view, this development could be commented on with concern (with the growing world population being a problem), however the positive aspects will clearly be of greater importance. Initially, the one-child policy represented a major infringement of human rights and caused a variety of serious problems (e.g. the targeted abortion of female foetuses, resulting in today's high level of gender imbalance). Furthermore, the relaxation of the one-child policy is to be welcomed from a purely economic perspective. In 15 to 20 years' time, there will be more workers, which opens up new growth opportunities for the country. Foreign countries will also benefit from this.

Foreign trade policy: previously very questionable, now well on course

It is generally well known that China has had high current account surpluses over the last few years (up to 10% / GDP in 2007) and reported a huge increase in its forex reserves (up to around USD 3,800 billion at present). Both are closely linked in economic terms. The renminbi (RMB) exchange rate does not develop freely

on the foreign exchange market; instead, it is controlled by the central bank. For a long time, exports were favoured and imports curbed (current account surpluses) as a result of the RMB being undervalued. As part of managing the rate, the foreign currencies held by the central bank increased the forex reserves. At times the undervaluation of the RMB compared to the US dollar was estimated to total up to 30%. The trading partners fiercely criticised this as a "beggar my neighbour" policy. The Chinese current account surpluses also contributed to the increase in global external imbalances, which is considered to be one of the causes of the global financial crisis.

This problem has recently become far less of an explosive topic. The central bank allowed a continuous nominal appreciation compared with the US dollar (see Figure 3). As inflation in China was primarily far higher than in the US, which actually resulted in a devaluation, this nominal exchange rate trend represents a much stronger RMB appreciation in real terms. On the whole, the RMB is now valued correctly. Consequently, the forex reserves are barely increasing at the present time and the current account surplus is falling (still only 2.1% / GDP in 2013). It is interesting that overseas the earlier harsh criticism has largely disappeared, but this change in policy was not really seen as being positive. And wrongly so, as this is an important step in the right direction and it also has clear consequences for the real economy. The

reduced preferential treatment of Chinese exporters, the improved price competitiveness of foreign suppliers on the Chinese market and the balanced current account are good news for the country's business partners.⁵

But at the same time, these new developments to a certain extent also have undesirable consequences for some

countries. Over the years, China has invested its forex reserves in industrial countries with current account and budget deficits, particularly in the US. The high level of Chinese foreign direct investments around the world also largely originates from the forex reserves. China's capital exports no longer reach the previous volumes they once did, and

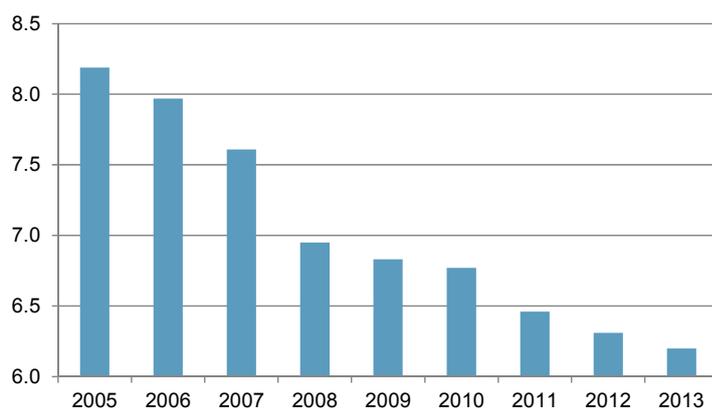
neither will they do so in future.

Conclusion

Over the last few decades, China has made huge socioeconomic progress which has also benefited the rest of the world. But more and more misdevelopments are also emerging. The Chinese government recognises this problem and has already made decisive changes. Whether the entire reform agenda can be processed within the framework of the current political system, or whether the Communist Party's monopoly of power will one day be up for negotiation, remain a burning issue.

The rest of the world must adapt to the changes. It is neither realistic nor desirable to maintain the status quo. When China's system undergoes effective structural reform, thus avoiding a hard landing, and shifts over to a sustainable development path, its partner countries should take an interest in this process and welcome it. ■

Figure 3: RMB – USD exchange rate (nominal, annual average)



Sources: IMF, EIU

¹ This paper does not claim to comprehensively deal with the Chinese reform agenda, but rather deals with topics that are of concern to the international community. The call for progress in the field of governance, for instance, is entirely free from conflict. Corruption, complicated bureaucracy and a lack of legal certainty, etc., all place a strain on the economic climate. The government has promised improvements that would benefit domestic and foreign companies alike.

² Cf. Schoenwald, S.: Interest rate liberalisation in China – necessary, but risky. KfW Research "Economics in Brief" No. 45, 24 April 2014, <https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-Volkswirtschaft-Kompakt/VK-Nr.-45-April-2014.pdf>

³ 2013 budget deficit / GDP only 1.8%, state debt / GDP only 16.2%.

⁴ The state already saved a number of banks 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.

⁵ Nevertheless there are still grounds to complain about China's foreign economic policy; key issues are (more subtle) protectionism, dumping and brand counterfeiting.