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75007 Paris

Les Matinales du Club

The prospects for the Chinese economy after the constitutional reform

Session summary

CHAIRED BY CHRISTOPHE DESTAIS , Deputy Director, CEPII

Speakers

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Maximilian Kärnfelt

The West has had an optimistic view of China, considering that growth would eventually entail a genuine liberalization on both its economy and society. However, recent events – the constitutional reform – tend to question this optimistic view.

There are two ways to interpret the recent constitutional change in China:

- Has Xi Jinping centralized power to become a historical figure who controls everything?
- Or is centralization the best way to overcome some challenges?

My talk will focus on the constraints – geopolitical ad well as financial – faced by China:

- The fundamental problem China is facing:
    - Escaping the middle income trap
- Domestic side:
    - Engineering continued growth
    - Stabilizing the financial system
- International side
    - BRI (Belt and Road initiative)
    - Foreign acquisitors
    - Capital controls

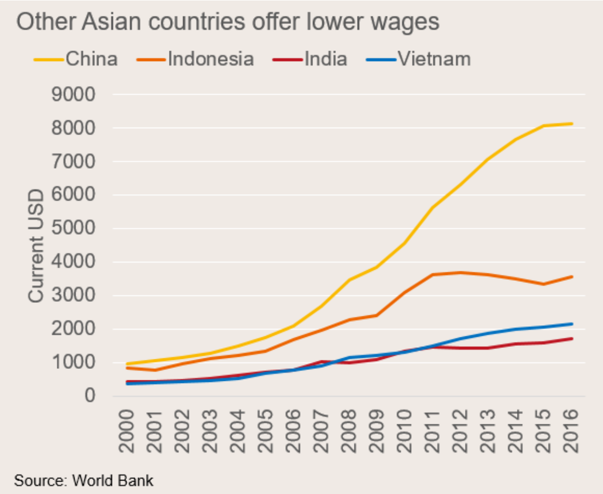
China has been growing tremendously over the last 40 years (the longest continued growth in world history). **300 million people have joined the middle class**. China overtook Japan and Germany and is now the 2nd largest economy in the world.

China's share of global GDP and exports have been quite stable until the 90's, when it started to rise as a result of China opening its borders, allowing more private enterprises, etc. This rise has been boosted after China joined WTO in the early 2000's. However, **since 2014 the share of exports has started to fall and the share of world GDP has flattened.**

Many impressive cities have emerged in recent decades. The main drivers of this development have been targeted investment in infrastructures and airports and a climate of security allowing foreign companies to set up factories for manufacturing. However, urbanization is still far from complete.

China doesn't look like a western economy as the State plays a much larger role, with **national government expenditures amounting to 25% of GDP in 2017.** The public sector is even more important that what this figure suggests, as SOE (state-owned enterprises), that are owned by the state but not on the state budget, employ 62 million people (8% of the working population). China is not a fully urbanized country, and a lot of people work in the primary industry (agriculture, mining, forestry, etc.) despite this sector only contributes up to 0.4% to GDP growth.

The gradual increase in wages has been accompanied by the emergence of a new middle class (around 300 million people belonging to the middle class). **The large advantage of China is thus being eroded. Indeed, after the 2000's, the Chinese GDP/capita really took off and is now much higher than in countries like Indonesia, Vietnam or India.**



Xi Jinping is at the head of a country in transition from low wage manufacturing to something else. This brings us to **the main problem face by China: the middle income trap**. Indeed, it seems that middle income countries are likely to go through a long period of growth slowdown.

To overcome this problem, China should:

- Establish new more productive industries. If it fails to do so we'll either see a rise in unemployment or a slowdown in income growth.
- Improve education
- New technology should be developed to accompany the new productive industries
- Develop countryside
- Address existing problems:
  - Financial problems
  - Environment
  - Demographics: partly due to the one child policy, the work age population is falling. One of the consequences is a drop in investment due to the lack of savings.

Other Asian countries have escaped the middle income trap, like Japan and the Asian tigers. They liberalized their financial system, notably by creating a deep bond market, they opened up to foreign investments and they all democratized.
But during this process of liberalization, all these countries have been through severe financial difficulties. Japan had the so-called lost decade, and Asian tigers faced the Asian financial crisis.

However, **China faces different constraints and is thus more reluctant to open up than other Asian countries:**

- China is not a US ally and hasn't been democratized in the wake of World War 2, contrary to other Asian countries. China sees itself more as a rival to the US and anticipates on a potential - despite unlikely - conflict with the US. Given that the **communist party rules the country, it would be held responsible in case of a financial crisis** damaging the economy, and is thus very reluctant to open up and to liberalize too quickly.
- China occupies two volatile territories and in the wake of colored revolutions throughout the world, it fears the consequences of too an important foreign influence on these territories.
- There are very large vested interests, with big banks having no interest in allowing foreign competition.

Instead of following the usual path of liberalization, the government leads the way through a range of initiatives:

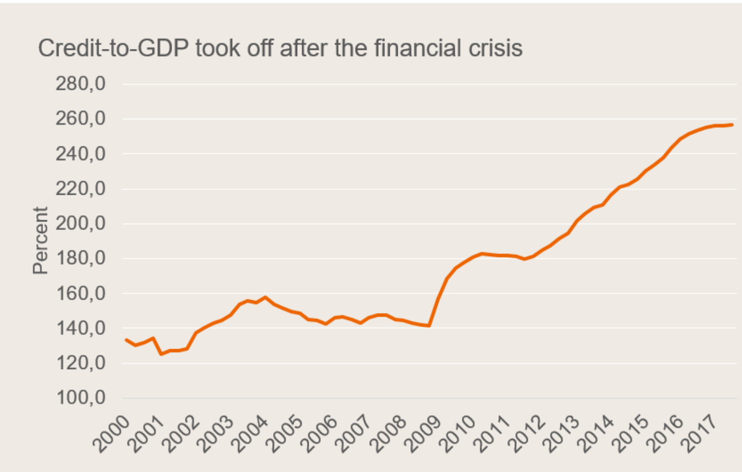
- On the domestic side: 2020 Targets (doubling GDP from 2010 to 2020), Quality Growth (against pollution and other growth side effects), Made in China 2025, Supply Side Reform (reducing overcapacities in oil and coal) and the Deleveraging Campaign (reducing the use of credit).
- On the international side: Belt and Road Initiative and purchases abroad.
- On the finance side: Liberalization, capital account and internationalization of the renminbi. The problem with these financial reforms is that they might be incompatible with the regime.

What had been done on the domestic side:

- Development of the car industry, high speed railways have been built across the country (with 25 million kilometers of high speed rail now operational) and nuclear power plants are being built too
- Science and technology budget increased by a factor 23 since 2000
- University enrollment is up although still quite low

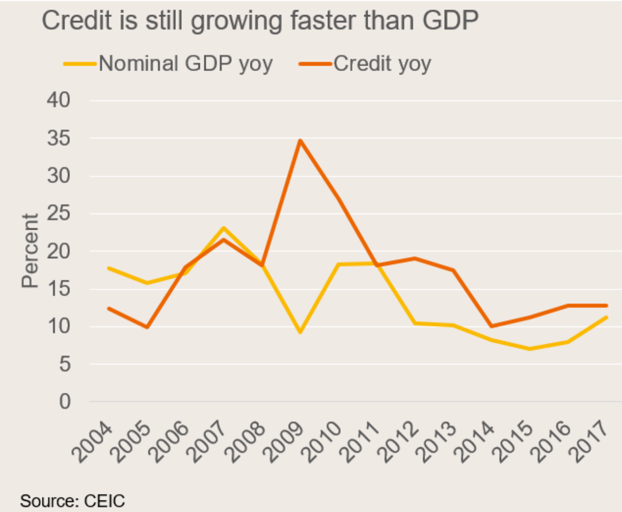
But this state-driven development is based on incompatible policies. For instance, the 2020 targets can only be reached through high growth rates. In order to maintain its credibility, the government uses implicit guarantees and extended loans to help unprofitable state-affiliated businesses and thus artificially boost the Chinese economic activity.

About the financial system:
Since 2000, credit as a share of GDP doubled, from 130% to 260% of GDP. This doesn't include government debt and a part of the shadow banking system. A reason for this huge credit extension is QE after 2009.
The corporate sector is particularly indebted, as well as households.
The unit of GDP generated by one unit of credit has been falling since 2004: the banking system is expanding at a higher pace than the economy. Credit is not put to productive use and we see a rapid increase in real estate prices. The official ratio of non-performing loans is 2.5%, but this figure seems to clearly underestimate the reality.



Source: Bank for International Settlements

To address this issue, the government launched his “deleveraging campaign”, which has been a little bit effective. **The problem is credit expansion is still higher than GDP growth. The reason for this is that the government has not decided to fully use monetary policy**: they have not raised interest rates very much, and not restricted liquidity. First, the government wants to make sure the 2020 targets will be reached. Second, they fear that these monetary policies might trigger a financial crisis.



<u>What had been done on the international side</u>:

- Need to ensure commodities which are needed for new industries.
- Need to establish over-land trade routes to Europe for instance (through railways and pipe lines)
- Need to develop technology and know-how
  - ⇨ All this results in large scale outbound investment

About OBR:
On the sea part: China is building ports and railroads in Africa to ensure their access to key commodities.
A very important railway corridor will be built to connect the West part of China to the closest seaports.
This project has also a strategic side: in case of a conflict with the US, China will be supplied despite a blockade.

China purchased various companies in Europe and in the US. On the other hand, China restricts foreign investment as foreign influence should be avoided. In order to acquire new technologies, China is then forced to invest in R&D or to purchase companies abroad. **Because of these purchases, Chinese external commitments are large and China has to set up capital controls to stabilize its exchange rate.**

<u>Conclusion:</u>
Due to its geopolitical constraints, China will not develop as other Asian countries did. The country faces geopolitical threats and the Party wants to remain in power: a liberalization is unlikely. Though China wants to establish key industries but this state-driven approach is more expensive than letting the private sector do it. That’s why the finance system is overloaded and capital control is used to stabilize external commitments.
The problems in the financial sector are severe and will probably hamper growth after 2020.

Emmanuel Véron

1) The end of three decades of “growth miracle”
2) Political system of China: what is the “Xi era”?
3) One Belt one Road
4) The pursuit of reforms and the expansion of China

1) <u>The end of three decades of “growth miracle”</u>

The affirmation of the Chinese power is part of a triple ambition:
- Rebalancing levels of development of China’s internal regions, factors and economic growth
- A transformation of the domestic financial system, necessary to address the issue of indebtedness.
- The implementation of the “One Belt One Road” (OBR) to remedy the country’s industrial overcapacity situation.

Increasing urbanization is an issue, with a target of 1 billion citizens in 2030. The state aims at strengthening three mega-regions (Pearl River Delta, Yangtze River Delta and Beijing-Tianjin-Hebei Metropolitan areas)

2) <u>Political system of China: what is the “Xi era”?</u>

There are three pillars of unequal importance: the Party, the Administration and the Army. The PCC controls:
- Armed forces and security
- Appointment to the Party, the State and the Army
- The media
- The judicial system

About the constitutional reform: **The Politburo Standing Committee of the Communist Part of China has now 7 members (instead of 9) who are linked with Xi Jinping. On top of them, two people are key to the regime: Wang Qishan, who is at the head of Security Affairs, and Liu He, first vice-Prime Minister.**

3) <u>One Belt one Road</u>

The cities located on the coastline play an important role in the development of OBR.
The OBR initiative is often described as a way for China to reshape the Global Order. In fact, this attempt to influence the rest of the world takes three directions:
- Integration of existing institutions
- Reinvigorating institutions so far useless of inefficient
- Creation of new institutions

4) <u>The pursuit of reforms and the expansion of China</u>

To better address financial risks is one the government’s three 2018 priorities. China will also strengthen financing support to serve the Belt and Road Initiative.

The Ministry of Finance is forming an international financing cooperation center in a bid to build a long-term, stable, sustainable, risk-controllable and diversified financing system.
China will facilitate international tax coordination and cooperation, contribute to eliminating discrimination in tax policy making and implementation, while encouraging more countries to

participate in the BEPS (Base Erosion and Profit shifting) project.

Moreover, **some of the biggest Chinese companies will integrate the Chinese Stock Exchange**.

Made in China 2025:
This program aims at improving innovation, as well as integration of information technologies, at strengthening of the environment-friendly industry, and finally at restructuring and internationalizing the manufacturing sector.

Q&A

Why is it impossible to have a comprehensive list of the OBR projects and to measure the size of the project?

Maximilien Kärnfelt: OBR is more of a "campaign" than of a single project. It is then subject to changes and shifts, and opacity is in its nature. We cannot know how much it will cost, and anyway the amount of projects will shift back and forth overtime.
OBR will thus be subject to changes overtime. We can draw a parallel with the supply-side reform, which started as a project to reduce overcapacities, and now involves the upgrading of the Chinese industry.

Emmanuel Véron : For the next 10 years, the OBR initiative will be completely linked with China foreign policy. OBR is likely to be used as a label put on many different kinds of foreign projects.

What is your assessment of potential growth?

Maximilien Kärnfelt: There is actually a difference between the growth targets and the actual growth. I believe that potential growth is going to decrease a little bit (even if in 2017 the Chinese growth passed expectations). For instance, we've seen recently a fall in PMI index.

Can you elaborate on the reform of the SOEs?

Maximilien Kärnfelt: Some progress has been done, like mixed ownership aimed at improving corporate governance and making SOEs more profitable. But paradoxically, at the same time some private companies get state-controlled… I think it's in the nature of the regime to be in control, and I'm not really optimistic about the success of the SOEs reform.

Some banks involved in the financing of the OBR initiative might have risky exposures abroad or even domestically. What is your assessment on these financial risks?

Maximilien Kärnfelt: In China we never really know where does the state budget begins and where does it end. It seems that when Chinese banks lend money to Chinese railway companies, they don't intend to make a profit on this. These banks are anyway more or less clearly linked with the State, and can eventually be paid back through taxpayers' money.

If a systemic financial crisis occurred in China, do you think the government would have the means to bail out the financial system?

Maximilien Kärnfelt: Due to the political situation and the need for stability, it seems impossible for China to face a financial crisis. The administration would lock the banks and restrict withdrawals.