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China's Encounter With Globalisation

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China's Economy: Changed by and Changing Globalization

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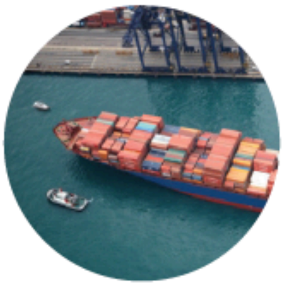
Contents



A more balanced Chinese economy, which focuses on consumption, a more equal distribution of income and wealth, the environment, and managing demographic change, could become a model for other emerging economies and, eventually, for the world.

Abstract

The growth of the Chinese economy has been driven by a deepening integration in the world economy. The shares of foreign trade and direct investment have increased dramatically. These changes created a dual Chinese economy: a domestic sector with low income and prices and an international sector with world market prices. The huge difference between China's Gross Domestic Product measured at exchange rates and at Purchasing Power Parities is a striking indicator of this duality. But this deviation reached its peak more than ten years ago and is declining since 2004 as China is rebalancing its economy from an overwhelming reliance on exports and investment to domestic consumption.

This shift changes China's impact on the global economy. While its exports had pushed down the prices of manufactured goods (and/or increased the profits of their suppliers) and its investment boom raised the prices of commodities, its rebalancing harms commodity suppliers and eases the pressure on other low-wage exporters of goods. A more balanced Chinese economy, which focuses on consumption, a more equal distribution of income and wealth, the environment, and managing demographic change, could become a model for other emerging economies and, eventually, for the world.

China's position in the world has changed dramatically over the last decades. While its share of the world population, roughly a fifth, has not changed so much, its share of the world's gross domestic product (GDP) increased from 1.8% (measured in constant 2005 US$) in 1990 to 8.7% in 2013. Measured in Purchasing Power Parities (PPP) and constant 2011 international US$, the same share jumped from 3.8% to 15.8%. Considered together these figures imply that, in 2013, China's per capita GDP has reached 45.6% respectively (at PPP) 83.1% of the global average. It has been China's stellar growth at about ten times the rate of global growth (between 1990 and 2013) that has led to these changes in its international position.

China's share of the world population is bound to decrease given its lower birth rate. But it has still some way to go before its share of world GDP is commensurate with its population share (i.e. about 20%) and its per capita GDP is at the global average. Certainly China's ambitions will not stop there but it will try to reach higher than average wealth as most OECD countries enjoy. We will look first at the way China has achieved its rapid growth, in particular at the concurrent globalization of its economy. Second we will consider the impact China's growth has on the world economy. Finally, we will discuss the challenges ahead and China's future role.

1.The changing globalization of the Chinese economy

It is common sense today that an economy can only grow when is competitive and a strong exporter. But theoretically, an economy can grow without foreign trade and investment. Actually, the world economy is exactly doing this as it grows without any extraterrestrial flows of merchandise or production factors. There has always been a correlation between the size of an economy and its degree of foreign exposure, measured in the share of foreign trade to GDP. The U.S. and Japan, for example, have long been characterized by very low ratios (below 20%) of exports plus imports to GDP. This does not imply that autarky is a good growth model. There are many reasons based on economic theory (Ricardo and others) and empirical evidence why participation in global markets is likely to enhance growth albeit at the price of certain risks and dependencies.

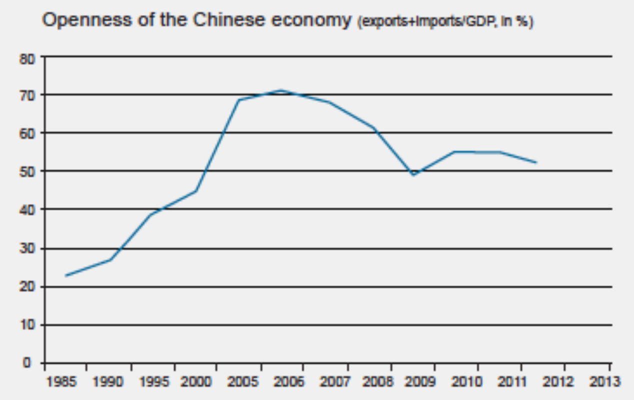
1.1Globalizing China: Exports and Foreign Direct Investment

China, however, has chosen to adopt a growth model, which has relied strongly on external markets and investment. This was a dramatic turn-around given the autarkic ways of the previous Maoist economy. The openness of the Chinese economy (exports plus imports of goods and services as a percentage of GDP) has increased from 22% in 1985 to 71% in 2006. That indicator has declined after 2006 to 50% in 2013 (see Graph 1). This relative decline should not be confused with an absolute decline. Exports and imports have both grown in absolute terms (with the exception of one year: 2009), albeit mostly at a rate below that of GDP growth.

Net inflows of foreign direct investment (FDI) have grown from 0.2% of GDP in 1982 to 6.2% in 1993. After this peak it declined until 2003 reaching 3% of GDP and recovering afterwards to a level of between 3% and 5% (see Graph 2). Again this relative decline corresponds to an almost continuous growth in absolute terms with the exception of a short period (1998-2000) when FDI inflows actually declined.

Both developments are closely linked. A large share of China's exports originated from foreign funded enterprises. Their share of total exports increased from 31.5% in 1995 to 58.3% in 2005 (Gu et al. 2008: Table 2). By 2011, that share has somewhat declined to 52.3%. But the same is true for imports. Zhang (2005?:11) mentions that until 1997 imports by FDI firms increased faster than exports. In 2000, imports by such firms had almost the same level as their exports (117 billion US$ vs. 119 billion US$). This fact can be explained by the necessary imports of capital goods. Later, when production is running, exports outpace imports. In 2010 the respective numbers were 783 billion US$ imports against 862 billion US$ exports, in 2011 864 billion US$ vs. 995 billion US$). The still high share of imports (about 90%) can be explained by two facts: First, exported goods obviously incorporate a lot of imported input of raw

Graph 1



Source: World Bank, World development indicators

Graph 2

Source: World Bank, World development indicators

[1] All data based on World Bank, World Development Indicators.

[2] This figure has been calculated by the author on the base of data from China Statistical Yearbook and World Bank.

chinas-international-investment-position-2014-update).

1.2 The Challenge of Duality

The low share of value added and wages reflects a deeper heterogeneity or even duality in the Chinese economy, which is typical of and common to many emerging or underdeveloped economies. Productivity and wages are very low in the traditional, agricultural sector. Often this sector is informal with a lot of subsistence production, which is not even registered as part of GDP. If the productivity of that sector is high enough to feed a surplus workforce, which can move to the cities and into export-oriented manufacturing then a labor supply emerges, which is very cheap measured at exchange rates.

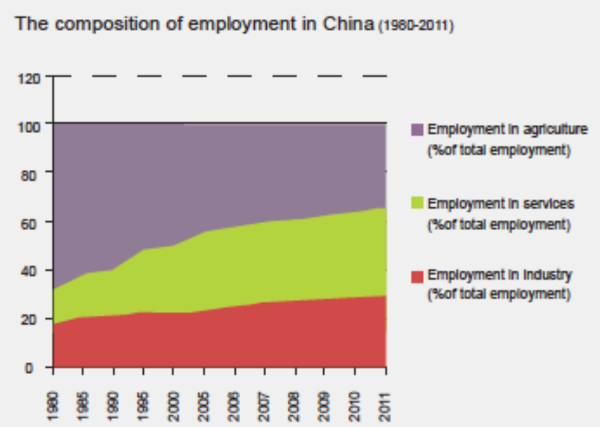
Price levels in less developed economies are usually lower than in advanced economies. But these lower levels hide different structures. Traded goods tend to have relatively higher prices. The less traded a good or service is and the higher its local content is the more its price differs from the price of a similar or equal good in more advanced economies. The Big Mac index, produced by the Economist, illustrates these differences. The latest issue (Economist of July 26th 2014: 58) gives a price of a Big Mac in China of 2.79$ at market exchange rates, compared to an U.S. price of 4.80$, 7.76$ in Norway, 3.64$ in Japan or 1.75$ in India. The price difference can be interpreted as an undervaluation of the Chinese currency vis-à-vis the US$ of about 50%. In 2004, the price difference was still greater with a Big Mac in China costing 1.26 US$ (in the U.S. 3.00 US$). If one compares the wages of workers at McDonalds, which are paid for

China has become the second largest creditor of the world economy (after Japan and before Germany).

materials and semi-finished products. Second, the value added in China makes up only a tiny share of the total value. The latter fact is well known from the value chain studies of products such as sneakers (http://www.soc.duke.edu/~s142tm17/makingshoe.htm; accessed on August 7, 2014) and iphones (Xing 2013). They show that the actual wage cost in China is but a tiny part of the total production cost let alone the final retail price. For all Chinese exports the import content is smaller but still high. A study by McKinsey estimates a value of between 40% and 55% for the years 2002-2008 and concludes that exports drive GDP growth much less than usually assumed (Mc Kinsey 2010).

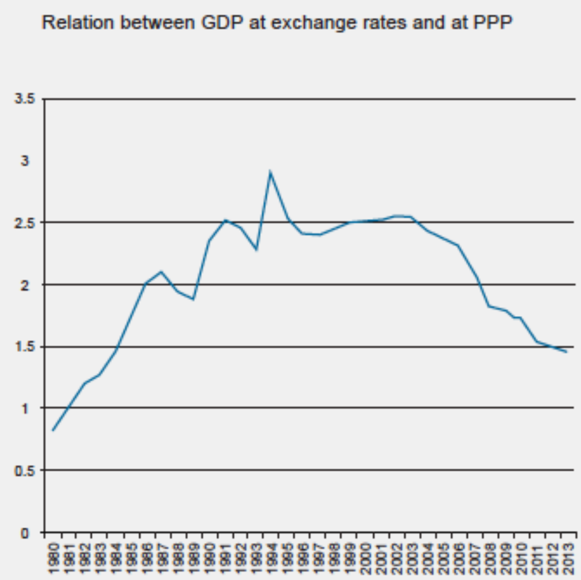
Investment has been driving growth even more than exports. The share of investment in GDP has been over 40% since 2002. But even that high volume of investment could not absorb the even larger savings, which were around 50% of GDP during the last 10 years. This gap resulted in a continuous current account surplus. China exported more goods and services and more capital than it imported. The accumulated surpluses, which were largely invested in US$ (often treasury bonds) reached 1.97 trillion US$ by the end of 2013 (http://rhg.com/notes/chinas-international-investment-position-2014-update). China has become the second largest creditor of the world economy (after Japan and before Germany). Similar to Germany it might have lost some of the value of its current account surpluses accumulated since 2004 due to devaluation, declining market values and capital losses. Still, China's external balance sheet (the sum of its foreign assets and liabilities) remains relatively small compared to its GDP (http://rhg.com/notes/

Graph 3



Source: World Bank, World development indicators

Graph 4



Source: IMF WEO Database; calculations by the author.

virtually identical work all over the world, even higher differences appear. Comparing real wages by taking into account the purchasing power of nominal wages, a study by Ashenfelter (2012) shows that a McDonalds employee in Japan earns 3.0 Big Macs per hour, in the U.S. 2.41, in China 0.57 and in India 0.35.

These differences in prices and wages explain the great weight of the export sector in the Chinese economy. Exports are priced at international prices and include, as we have seen, imported inputs, which are also priced this way. The domestic sector where many more people work and the bulk of goods and services are produced is undervalued. As long as there is an oversupply of labor originating from the rural area and the agricultural sector this duality will continue. The development of the sectoral composition of employment in China (see Graph 3) shows that, in spite of already great changes, the economy is still far from being completely modernized, as the share of agricultural employment in total employment is about a third (still two thirds in the 1980s). Services have overtaken agriculture but in 2011 while manufacturing provides 29.5% of all jobs in 2011 (up from 21.4% in 1990).

These structures explain the difference between China's GDP measured at PPP and its GDP at exchange rates. Since 1981 China's GDP measured at PPP has always been greater than its GDP at exchange rates. This deviation has increased until 1994. Between 1991 and 2003 it oscillated around 2.5. After 2003 the ratio declined to 1.5 indicating a gradual adjustment of exchange rates and price levels (see Graph 4). This trend coincides with a strong increase in Chinese wages. According to the U.S. Bureau of Labor Statistics, wages in manufacturing almost tripled between 2002 and 2009 (http://www.bls.gov/fls/china.htm#manufacturing). In the medium term the wage development underpins a re-orientation of the Chinese economy from exports toward consumption.

The weakness of consumption and the strength of savings is supported by a huge rise of income inequality in China. The rich get an ever larger share of GDP and their propensity to save is much higher than the poor's (69% for the top 5%, 60.6% for the top 10% against about 30% generally; Guo Jiannan 2014). The share of consumption decreased from about 60% of GDP before 2000 to less than 50% after 2007. Guo Jiannan's study based on household surveys puts China's Gini (the most used measure of inequality) at about 0.6 in 2012 com-

pared to 0.47 given by the National Bureau of Statistics and the World Bank. Before the opening of the economy, the Gini has been much lower according to sources quoted by Guo Jiannan (2014): 0.18 in 1978; 0.29 in 1981; according to World Bank: 0,32 in 1990.

2. China's global impact

China's growth has affected the world economy by its enormous size, speed, and export-orientation. The huge export surpluses and the corresponding savings implied repercussion not only on the real economy but also on the global financial system.

2.1. Global Angst in the face of China's rise

By the start of the 2000s, the impact of China's rise became painfully clear. In the U.S. a fierce debate developed about the loss of jobs in manufacturing and the cost and benefits of open trade with China. No lesser person than the famous economist Paul Samuelson (2004) shed doubts at the classical justification of free trade, Ricardo's theory of comparative advantage, taking the U.S. and China as example. The sheer size and age structure of China's labor force plus the fact that it was underemployed and that its surplus was immense raised concerns about the relocation of jobs. To quote Sandra Polaski (2004:): "…if all U.S. jobs were moved to China, there would still be surplus labor in China." China's workers seemed to threaten employment and wage levels in the OECD countries as production was relocated and imports from China replaced domestic production (and/or other imports; see below). Germany, which went through a prolonged recession in the early 2000s, appeared to benefit even less than the U.S. economy from these changes (Dauderstädt/Stetten 2005).

In the U.S. a fierce debate developed about the loss of jobs in manufacturing and the cost and benefits of open trade with China.

China is the world export champion (a title previously held by Germany or the U.S.). But actually China's exports per capita are still only a fraction of Germany's (see table 2). One can but speculate what the consequences for the global economy would be if China ever achieved German levels of exports per capita.

Table 2

Exports per capita (current US$)

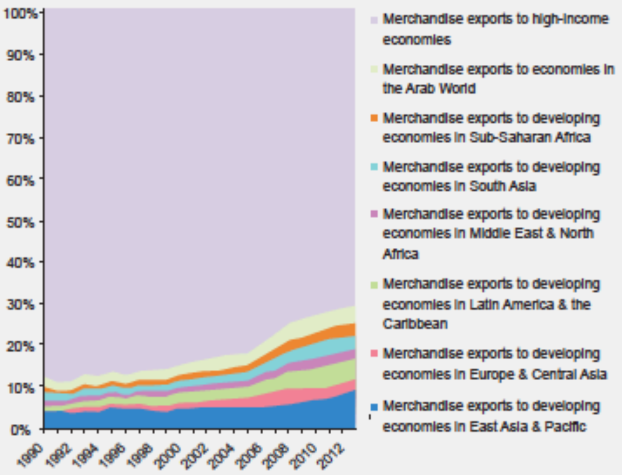
	1990	2000	2005	2013
China	46	220	640	1793
Germany	5352	7660	13859	22845

Source: World Bank, WDI

Graph 5

The regional distribution of China's exports 1990-2012

(% of total merchandise exports)



Source: World Bank, World development indicators

In the end, it is hard to pin down changes in the advanced economies on competition from China. The major consequence has probably been a rise of inequality and wage dispersion. The lost jobs have been largely replaced by other jobs in the non-tradable sector, mostly services. But often these jobs were low-skilled and low-wage. Capital and high-skilled labor (in research, design, marketing etc.) benefitted from the restructuring of global value chains. The higher earnings of those parts of the labor force and investors contributed to the dramatic rise of inequality in the U.S. and other advanced economies.

The other "victims" of China's rise have been the traditional suppliers of low-wage output such as clothing, shoes, toys, and white goods (refrigerators, washing machines). Portugal in Europe and Mexico in North America are such cases. While China's exports to the less advanced economies were relatively small (see Graph 5), its exports to the rich world were large and did replace former suppliers to some extent. To the extent that China is upgrading its exports toward high-tech goods (Huawei or Lenovo are examples) other industries in advanced economies will be affected.

Nonetheless, these exports benefitted consumers in all countries importing from China due to lower prices. Possibly, these lower prices would or could have increased real wages thus compensating a decline of nominal wages by raising their purchasing power. In some cases, where a lack of competition prevented the decline of prices, lower costs in China allowed higher profits for importing firms or foreign investors (as in the case of Apple).

The flip side of China's strong exports and their impact on buyers and competitors is the rise of China's imports. China is the world's second biggest importer after the U.S.. Again, the bulk of China's trade is with advanced economies (see graph 6) although the share of other countries is rising. Imports of manufactured goods make up roughly two thirds of China's imports (primary goods account for the remaining third). China's demand for capital goods, cars and other goods, which are produced by advanced economies helped to stimulate these industries and to create or preserve jobs there. On balance this restructuring of economies from less sophisticated productions such as textile and clothing towards high-tech industries is beneficial for the advanced economies. Germany has succeeded particularly well as the structure of its exports fitted Chinese needs perfectly.

China also imported an increasing amount of raw materials and fuels. World market prices of commodities increased due to this strong demand. Importing countries complained about declining terms of trade. Exporting countries benefitted from rising earnings. The recent growth of Africa can be attributed to a large extent to China's trade with and investment in the continent. Other beneficiaries are the oil-exporting countries and Australia. During the last decades, China accounted for the bulk of the global consumption of steel, cement, copper and other primary goods.

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However, the value of China's exports has continously exceeded that of ist imports. That export surplus corresponds to net capital exports, which represent the difference between savings and investment in China. They can take the form of increasing foreign currency reserves or of foreign investment. Many economists in the West, notably the former

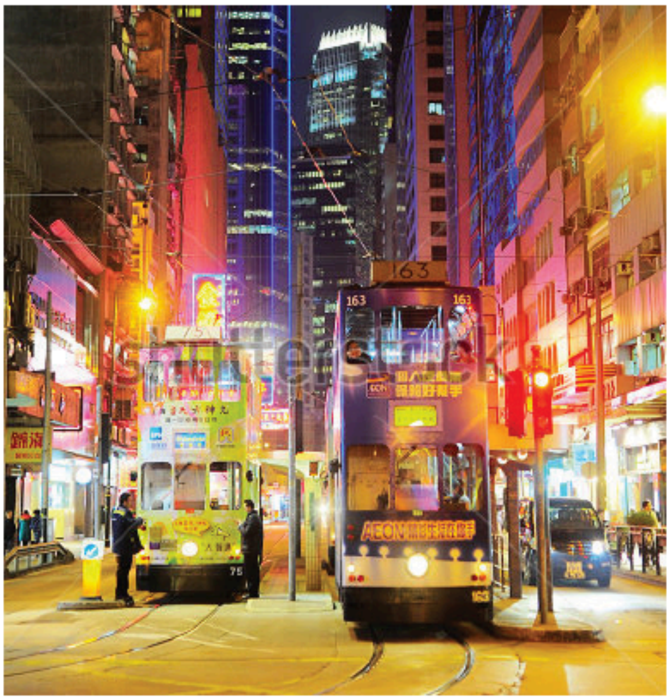
Federal Reserve Chairman Ben S. Bernanke, argued that the low level of interest rates in the 2000s resulted from a global savings glut which was caused primarily by China. Again, the impact of these outflow of savings has been mixed. On the one hand, it supported the exchange value of the US-Dollar and financed American import surpluses. On the other hand, it also kept credit cheap and thus contributed to the bubble in the U.S. asset market, which led to the global financial crisis in 2008/9.

2.2 The challenges of rebalancing

During the last years, China's economy became somewhat less focused on exports and more on consumption. The decline of consumption as a share of GDP (from 63% in 2000 to less than 50% in 2008-2010) stopped and slightly reversed. Net exports as a share of GDP declined from 8.8% in 2007 to around 2.5% after 2010. Gross capital formation, however remained strong. Nonetheless, due to the global recession, GDP growth slowed down from 14% in 2007 to about 7% after 2012, thus indicating a strong decline of capital productivity. This coincides with concerns about China's financial system where some analysts see the next bubble bursting as non-performing loans accumulate. Another risk is the so-called middle-income trap, which has kept growth weak in several countries (e.g. in Latin America) after they had exited from underdevelopment. China could lose its competitiveness in low-wage industries without being able to replace it by a competitive production of sophisticated high-tech goods and services.

These fears may be exaggerated given the strength of China's macro-economic governance. But the global repercussions of China's changing growth model can already be felt. Commodity prices declined in 2011 and have remained mostly weak afterwards. These developments hurt suppliers such as Indonesia or Australia. Other countries like Taiwan, which are supplying mass consumer products such as mobile phones fare better (Economist July 26th, 2014, p. 56-57). As Chinese authorities cracked down on corruption, luxury goods suppliers in advanced countries suffered, too.

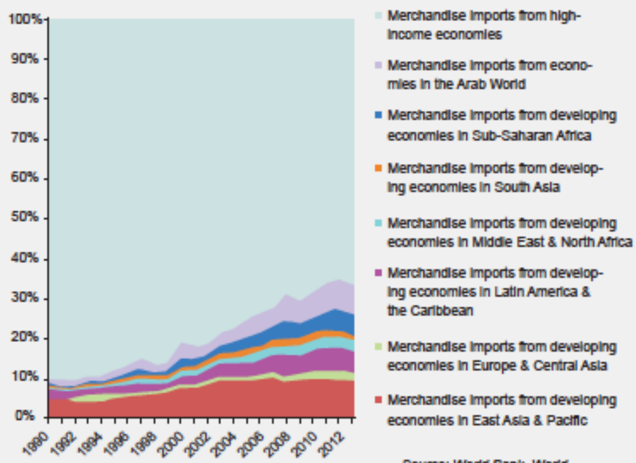
The threat of Chinese low-wage competition is slowly retreating for the rich countries and their potential suppliers. This may be good news for workers and countries like Portugal or Mexico, but bad news for investors who might have to relocate labor-intensive production to still poorer countries such as Bangladesh. Prices of goods



Graph 6

The regional distribution of China's imports 1990-2012

(% of total merchandise imports)



Source: World Bank, World development indicators imported from China could increase when higher wages are not compensated by higher productivity thus keeping unit labor costs stable.

Global capital markets will be affected, too. Lower export surpluses imply less capital exports. If China's current accounts turned negative, it would have to finance these deficits. China could either run down its huge foreign currency reserves or offer Chinese national currency (yuan) to its suppliers. In the first case, a devaluation of the US Dollar could be a consequence. Paradoxically, such depreciation would harm the value and purchasing power of China's net foreign investment position as the same amount of US-Dollars would buy less goods and services in the global market. In the second case, the yuan could become an international reserve currency. Many investors and financial institutions would like to diversify their portfolio and include yuan-denominated assets. Up to now, China's monetary authorities were reluctant to enter this road.

3.Outlook: China's role in shaping globalization

Given its weight in the global economy China has to take an active role in its management. China has benefitted a lot from an open global trade regime and the opportunity to both, attract foreign investment and to store the value of its surpluses in global financial markets. It has regarded the global consequences of its actions with benign neglect. Temporary opposition and critique by other countries, notably the U.S. concerning the undervaluation of the yuan against the US-Dollar have only led to slight adjustments. It should be noted, however, that China's huge stimulus program during the Great Recession (2008-2009) contributed strongly to the speedy recovery of the global economy. For the developing world the "Beijing consensus" of state-led development offered an attractive alternative to the formerly dominant "Washington consensus", which relied on markets, liberalization and privatization to promote growth. Actually, China presented a model that worked, while the Washington consensus has few success stories to show for it.

Given its weight in the global economy China has to take an active role in its management.

What is lacking is a Chinese view on how the world economy should advance and develop. There are some profound problems where China has to offer solutions or participate in elaborating such solutions. One is global demand, linked strongly to inequality; another the sustainability of global growth. A fourth issue is demography. In the context of this paper security and cultural issues are not discussed.

- ***Demand:*** For two decades China has relied strongly on external demand. Obviously, the world economy cannot rely on exports, let alone export surpluses, in order to achieve growth. China has corrected its model and this new focus on domestic consumption should be reinforced and advocated worldwide.

- ***Inequality:*** China's rise has reduced global inequality by raising hundreds of millions out of poverty. But is has achieved this at the price of increasing domestic inequality. That inequality is to a large extent responsible for the high savings rate and thus for the external surplus. In order to establish a more consumption-led growth model China has to continue increasing real wages and social spending. As Piketty (2014) has shown, inequality might become one of the preeminent challenges of the 21st century.

- ***Sustainability:*** China's recent growth has contributed a lot to the depletion of the natural resources of the

planet. Its overwhelming emissions of CO_2 and smog have harmed the global environment and the health and safety of the Chinese population. If China were able and ready to switch to a successful model of green growth, it could become a true world leader.

4.Demography

For a country with a still – in a global perspective – low average income, China has a very low birth rate and is aging fast. It faces huge challenges to manage the transition to a "grey economy", which require appropriate pension systems and efficient services for the older population.

Based on its own stupendous success China could become a global leader by first adopting a model of social and green growth and then exporting it to the world. In the 1970s, Germany thought that its "social market economy" with it combination of growth and equity could become a model to follow ("Modell Deutschland"). It soon afterwards entered a phase characterized by self-doubt and problems such as stagflation and mass unemployment, which stopped its missionary ambitions. China is in many ways in a better position. If it can resolve its own conflicts its role in the world could hardly be overestimated.

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