

China's Impact on the Global Economy: A personal view¹

Notes for talk Strategy Unit, Cabinet Office

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Overview

In the next two to three years China will almost certainly become the world's largest trading entity, in terms of inward and outward trading flows. It has, since last year, been the holder of the largest foreign exchange reserves. It has posted growth rates of around 10 per cent over the last two decades. It overtook the UK to be the world's largest economy last year, and is due to overtake Germany, some time this year, as the world's third, leaving it behind Japan, and the US. Its economy is about a third the size of the US, though, according to Goldman Sachs, it will be the world's largest economy sometime in the 2020s. Added to this are some other facts that are well known. It is the world's largest user of all primary energy sources other than oil, and is likely to overtake the US for this in 2009 or 2010. It is the world's largest destination for Foreign Direct Investment. Discounting invisible services, it is the world's largest exporter, after Germany. Chinese savings have reached almost 2 trillion US dollars. Only last December, based on a 2 per cent flotation, Petro China was ranked the world's largest company. In 2007, over 20 Chinese companies have entered the Fortune 500. China now invests in over 160 countries and territories. Its stake in Africa and the Middle East has increased dramatically over the last three years. It has over 900 investments in Germany, and 350 in the UK. Over 200 of its companies have listed on the stock exchange in Hong Kong, taking their first steps towards internationalisation.

The outside world reacts to all of this with a combination of fear and amazement. For some what is happening a great opportunity. British companies like Tesco who account for something like one pound in every

¹ Dr Kerry Brown shared his thoughts on China's impact on the global economy in a presentation at Strategy Unit, Cabinet Office on 18 April 2008. This document was provided by Kerry and is a summary of his key points.

eight spent by shoppers in the UK have dramatically increased their stake here, buying into their Taiwanese partner Happy Shopper and opening up shops now in Shenyang, Shanghai, Qingdao and Beijing. Wal Mart remains even larger, employing over 38 thousand people in China, sourcing something like 18 billion dollars worth of business here. Others however, in the US and the EU in particular, look at the massive trade deficits, running now at over 270 billion for both of these, and worry. They see imbalance, with the deficits becoming political problems, that need to be addressed. Last December, the EU trade commissioners met with their Chinese counterparts, as part of the EU China dialogue, to address this, and other issues. The matter is still unresolved.

As we travel towards the Olympics, next August, these issues will intensify. In this talk, I will put them in context, firstly in their historical context, and then in their international context. I will then talk about what options there are at the moment, and the current challenges. I will then look at possible outcomes.

Some history

China is now one of the world's most open economies. Even at the peak of its drive to industrialise, Japan only allowed 1 per cent of GDP to be international trade activity. China has allowed over 4 per cent, a very high figure.² In the process of opening up its economy, which started with the reforms proposed at the Third Plenum of the Tenth party Congress in 1978, China has so far attracted 700 billion dollars in investment, a great deal of it concentrated in the coastal regions of China. It has attracted this from over 500 thousand joint venture partners. This journey has happened with astonishing speed. As the World Bank make clear in their report, *Dancing with Giants*, issued earlier last year³, about the rise of India and China, while other countries may have developed and industrialised, it is the scale and speed of what China has done in the last three decades that has been unprecedented. In 1971, in the depths of the Cultural Revolution, China was one of the most closed

² See Barry Naughton, *The Chinese Economy*, MIT 2007

³ Available at

<http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTCHIINDGLOECO/0..contentMDK:21038746~menuPK:2842045~pagePK:64168445~piPK:64168309~theSitePK:2841990,00.html> (accessed 20th April 2008)

economies in the world, with only Hong Kong as a trading portal. It had few airlinks to the outside world; it had, in 1967, withdrawn its ambassadors from all countries except Egypt. It was truly isolated. Even the visit of Nixon in 1972, while historically and symbolically very important, could not fundamentally change the fact that in terms of human capital, infrastructure and the basic economic model, China was highly undeveloped. The initial moves in both the late Qing period (1644-1911), and the Republican period (1911-1949), to bring investment into China had paused, and then ceased. Shanghai in the 1920s and 1930s was a centre of commerce for the region, attracting famous figures from the West like Albert Einstein and Charles Chaplin. But the war against the Japanese, and then the civil war, effectively destroyed this era, along with a great deal of the infrastructure, both manufacturing and transport, that China had. The Communists in 1949 inherited a country torn apart by war, and economically crippled. In the 1950s, there was investment in the form of technical help and personnel from Russia. But political problems in the late 1950s led to this being withdrawn. For much of the 1960s and early 1970s China operated as an autarky, with heavy central government planning, state control of over 99% of the economy, and no foreign investment to speak of. Even the UK company Shell, who had been in China since the 1890s, closed their office in Shanghai in 1967.

Mao's replacement as leader of China, Deng Xiaoping's innovation from 1978 onwards, at the head of a new leadership, was to restore economic good management. The first joint venture law allowing limited kinds of foreign investment was passed in 1979. Coca Cola was first imported the same year. In 1983-84 the household responsibility system was implemented, allowing Chinese farmers to sell surpluses back to the state at a small profit. The town and village enterprises were set up, along with the five initial Special Economic Zones, including Shenzhen, Zhuhai, and Xiamen. These were to be the incubators of China's growth throughout the next two decades, creating in effect a vibrant private sector that, according to the OECD report in early 2005, now accounts for anything from 50 to 70 per cent of China's GDP growth.⁴ Deng Xiaoping himself admitted, in a speech in the late 1980s, that the

⁴ See: http://www.oecd.org/document/21/0,2340,de_2649_201185_35331797_1_1_1_1,00.html

dynamism and success of the TVE's had been a wholly unforeseen result of the reform process.⁵ More predictable had been the immense increase in the amounts of foreign investment and foreign personnel coming into the country. But unlike at the end of the Qing, and the Republican period, when key parts of the economy were under the control of foreign interests, Deng's government were determined to keep control. An industrial policy framework was set up, so that key strategic sectors were protected, like telecoms, finance, and energy.

Political and economic problems in the late 1980s and early 1990s, some of which were China's fault, some of which came from outside, meant that there was only sluggish growth in 1990 and 1991. But in 1992, Deng Xiaoping undertook, at the age of 88, his final tour of the southern area of China. He made a clear statement during this event, both in Zhuhai and Shenzhen, that the reform process could not be turned back. China was very much open for investment. China had clear technical and capital needs that this investment was going to address. From 1992, China experienced a massive surge in FDI, a phenomenon that has continued to this day. State owned enterprise restructuring under Premier Zhu Rongji continued in the late 1990s, meaning that the non state sector had to use workers laid off by State Owned Enterprises. But by 2000, and China's final entry into the WTO, China had never looked in better shape economically. It had over the last five years met its main stipulations under the WTO agreement, the final part of which was to open its retail banking sector, which it did in December 2006. This year, China's contribution to global GDP growth will be greater than America's. With fears for a possible global recession because of problems in the US economy, China has never been more important in our global system.

The International Context

China has achieved most of these things in a world dominated by the power of one country, the USA. Since the fall of the Soviet Union in the early 1990s, the US has dominated international economic and military systems. Its military

⁵ See Kerry Brown, *The Rise of the Dragon, Chinese Inward and Outward Investment in the Reform Period*, Chandos, 2008, Chapter Three.

spending alone outstrips the other closest ten contenders combined. Its economy remains by way and afar the world's largest. It continues to play a key strategic role in the Asia Pacific region. It remains the world's largest consumer market, and its banks remain the worlds most significant. Politically, America is still dominant.

But the US has a long history of isolationism, and there are many Americans who feel that the expectations towards the global role of their country are too high. They are concerned about the loss of manufacturing capacity in the US, the high rates of personal debt, and the fact that their country remains by way and a far per capita the largest user of energy, and the largest polluter. There is an increasing sense that things cannot carry on as they have since the end of the Second World War, when America really assumed its current dominant position. Increases in information technology, and in the globalisation of companies, have made people much more plugged in than they were ever before. When China experienced a dramatic fall in its stock market from February this, bankers in New York and London started to worry. There is a feeling now that the world is overdue for change.

What might start to rank beside the US as a major international force?

Perhaps the most obvious is the EU, now the world's largest trading entity, and the largest trading partner of China. The EU has delivered peace to Europe for the last 62 years, since 1945, when it had been riven by war, and economic devastation. In the 18th and 19th centuries, Europe had experienced war almost every decade. The French British wars in the 1810s, the wars between Austria and France in the mid part of the century, the wars between Bismarck's Germany, and Italy, in the latter part of the century. And then the two devastating world wars which had their origins in complex relationships between countries in Europe in the first decades of the 20th century.

The one indisputable achievement of the EU is that it has delivered prosperous growth for the last 60 years, a longer period of continuous peace than any other in human history. This is often forgotten in the arguments about the EU in the UK and elsewhere in Europe. What began as a small

forum for economic co-operation, largely around steel and primary metals, now stands, in 2008, as one of the most important political and economic achievements of our time, with 27 members, extending from Poland in the east to Spain in the West. With almost half a billion population including some of the world's most successful economies, the EU is a formidable entity. But it suffers from one crucial weakness. Unlike the US, which is a unified sovereign state, the EU is a combination of different states, each with very different interests. The EU is, in any matter, only as strong as its weakest member. In trade negotiations, if consensus and unity can't be delivered, then nothing can be said. Within the EU, certain countries protect their own key industries. France, for instance, protects its agricultural workers, despite attempts by the recently elected new president Sarkozy to address this. Italy and Germany protect manufacturing. The UK's great strength is in financial services, and it has opened its economy to this in order to maximise the benefit. But it has so far refused to join the euro for fears that in key areas of economic policy making, it will have devolved too much power to the central EU government in Brussels.

The EU remains a highly complex entity, and one with some great strengths, and some similarly great weaknesses. Looking elsewhere, one can see the strength of the Middle Eastern block of countries in energy supply; Russia has, since reforms implemented by Putin over the last decade, made a comeback, increasing its economic profile. Brazil and India have also become more economically important in the global economy. A description of this context would be simply that while there are several distinct poles of power, the US remains the dominant one. But China is increasingly attracting attention as a country that in terms of size, importance, and impact, can certainly play a major role as a regional, and global power.

Internationalisation

All these various blocks work in an international system in which links between countries, the sharing of information and the generation of wealth and prosperity between countries, has never been greater. China may have 1.5 trillion us dollars sitting in its central bank reserves. But the world's top

investment banks and fund managers have 14 trillion US dollars under their management. UBS alone has 2.5 trillion. In a single day in London, 3 trillion dollars goes through the capital markets. We are in a position in which private capital far outweighs that of the state. Multi national companies like BP, Shell, Microsoft, or General Motors, often employ hundreds of thousands of people across many different states. Their shares lie in the hands of people in dozens of different territories. While they might be domiciled in the UK, they can frequently have their main business interests the other side of the world. Information transfer technology has eased this process. The internet now carries information to all corners of the planet, radically changing working patterns and company behaviour. We are living in what some have called the post modern society.

Others have argued that in fact despite the great strides forward, the fundamental template of developed societies has not changed greatly over the last decades. Flight technology is the same as it was 30 years ago. The same goes for engine technology. In our daily lives, we are dependent on technologies that were first really new decades ago. Adaptation and modification are the main accomplishments of this society rather than radical innovation. Where we have most internationalised is in terms of our problems. Energy shortages now rapidly become global, because of the shared reliance, and need for these things. The destruction and pollution of the natural environment is a problem no single country can, or has the ability, to solve. The success of the UN, for instance in being able to confront these issues is very patchy. As one commentator in the US said recently, we are still living in a world of nation states, but facing global, not national threats. We sometimes need a wholly new model of statehood to start addressing the threats and challenges that face us.

China's Role

There are ways in which China can offer something new to this vision of development. According to the World Wildlife Fund report on China's Outward Investment, if it were to adopt the western model of industrial development with the same energy intensity and resource use, the world's resources will be

exhausted by 2032.⁶ Just in terms of car usage, China would be looking to move from having something like 15 cars per thousand people now to something like 500 per thousand for the UK, and 800 per thousand for the US. Looking at the problems caused by car congestions and car usage in China's main urban centres, it is pretty clearly that even anything remotely close to these figures is unsustainable. China has been seriously looking at new forms of car technology, which are low in pollution and high in energy efficiency. The current five year plan running from 2006 to 2010, makes clear that China's efforts on this front are a priority, and that energy efficiency, sustainable development, and environmental protection are critical. It is understandable that China's does not want lectures from developed countries about problems that, in many ways, they have helped to create. But as Premier Wen Jiabao has repeatedly made clear, there is a commitment at the highest level in China to addressing China's environmental problems, particularly those around air quality, and water.

The more daring step would be for China to devise a model of development that takes the best from the western models, but then adapts it, and uses it, for China's own specific challenges. This could present a new phase of development not just for China, but for human society. It would also mean that the template of internationalisation, which in some ways has been created by developed countries, would be fundamentally altered by developing countries, like China and India.

This will present a real challenge. A lot of the elites in developed countries have vested interests in the current model of internationalisation. It is in their interests for things to proceed like this. On the IMF, only 6 per cent of voting rights go to developing countries. 61 per cent belong to the EU and the US. This means that the decisions of the IMF are simply not heeded outside the developed world. There are equal amounts of imbalance in other international fora, like the World Bank, which seem weighted towards the interest of the developed world. In an era of internationalisation, surely it is time to level this

⁶ See: Pamlin, Dennis and Long Baijin, '*China's Outward Investment Flows*,' World Wildlife Fund, April 2007, available at www.panda.com/invest

playing field out. And surely China's impact will help to clarify why, and how this should be done.

A similar opportunity presents itself with China's outward investment. Chinese investment in Africa, for instance, has increased dramatically over the last few years. It has been active in resource allocation, and energy projects. It is the largest overseas investor in South Africa. In some countries, it has suffered political criticism. This led to the appointment of the Special Rapporteur for Africa last year. Whatever the positives and negatives, there is one undisputed fact. China's involvement in Africa has led to more economic development than the many years of western development and aid money. This is something it is uncomfortable to accept in the West. But it has to be accepted. There needs to be less immediate criticism of what China is doing, and more attempts to see things from both sides. Chinese investment in less developed areas of Europe like Poland, or Eastern Europe, can be beneficial to both economies, delivering growth in one area, and securing technology for China. Huawei and Nanjing Automobile Company have been investors in the UK. China Development Bank has bought a minority share in Barclays. The objective for all of these is to create 'win win scenarios'. The attempt by China National Overseas Oil Corporation in 2005 to take over Unocal in the US created political problems, however, and shows that in their ambition to go global, Chinese companies have some major challenges. But as the current five year plan makes clear, they stand at the forefront of China's own attempts to internationalise itself. Chinese entrepreneurs are becoming a more and more visible force in the world, with some of them already doing deals for mergers and acquisitions in the US, and the EU. Chinese outward investment presents a real step forward, something unprecedented, that China has never undertaken before. We in the west need to have a logical, consistent response to this, saying where we want to see investment, how it should be done, and what we can both get from this.

Conclusion

China is still only 5% of the global economy. The average Chinese GDP is still very low, meaning that it is a country with a lot of poverty. It is, in essence, two distinct economies, one in the western area, which is undeveloped, and the coastal area, which has been booming for much of the last three decades. Shanghai is now starting to really make an impact as a global commercial centre. In the west, we are still ignorant about China, knowing too little. The average Chinese knows far more about the west than the average westerner does about China. 200 million Chinese are learning English. 750 thousand Chinese have gone abroad since 1980 to study. In all sorts of areas, China is starting to make an impact. But it is also aware of the great challenges ahead. In the coming year, there will be a mixture of political and economic challenges. These will need to be faced. But it is becoming clearer what China's future path must be. And it is also clear that for the developed world, we have to react intelligently and strategically to what China is doing, accepting its aspirations, but also being aware of our own national self interest, and being clear about the ways we can work together, and the places we need to collaborate, and to resist.

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