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China in the Global Economy: Leaping Dragon or Paper Tiger?

by Guy de Jonquières, Senior Fellow at ECIPE

Mao Tsetung famously said that political power grows out of the barrel of a gun. On the global stage, however, enduring power is based on economic heft. By that criterion, China should have a lot of it.

China is, by some measures, the world's biggest economy as well as its largest trader and manufacturer, home to its biggest foreign exchange reserves and now its biggest source of greenfield investments, after years as a leading net recipient of inward FDI.

This endows China with economic muscle – and it is seeking to flex it increasingly assertively abroad: by establishing the Asian Infrastructure Investment Bank, to which more than 50 other countries have signed up; by launching One Belt One Road (OBOR), a hugely ambitious investment project inspired by the ancient Silk Road that may eventually girdle the earth; and by securing the Renminbi's recent inclusion in the IMF's SDR basket, a step towards a full reserve currency role and, in the eyes of some Chinese observers, to challenging the global pre-eminence of the US dollar.

The prospect that Donald Trump's presidency will lead to a shift in policies that would weaken traditional US alliances in Asia offers China new opportunities to extend its international reach. Already, the expectation that Mr Trump will abandon the US-led Trans-Pacific Partnership (TPP) is spurring Beijing to rev up plans for a rival mega-trade deal, the Regional Comprehensive Economic Partnership (RCEP), which would embrace almost every east Asian economy, India and Australasia while excluding the US.

All this has provoked both awe and concern in capitals around the world. In many, China's continued rise to ever greater global influence is viewed as inexorable. As Gideon Rachman, the Financial Times' international affairs columnist, put it in his recent book Easternisation, a historic shift towards Asia is taking place in the world's economic and political centre of gravity, powered by China's continuing ascent.

EXECUTIVE SUMMARY

By some measures already the world's biggest economy, China is seeking energetically to flex its muscles abroad by launching grand projects such as the One Belt One Road investment programme and by establishing the Asia Infrastructure Investment Bank. However, though its influence is growing in much of Asia, China's capacity to wield clout at the global level is often overestimated. Furthermore, it is pursuing costly- and possibly risky - international initiatives at a time when its domestic economy looks increasingly fragile and vulnerable to shocks, and amid warnings that it faces a looming financial crisis. It is beset by slowing growth and other serious problems, notably rapidly rising debt and a rapidly ageing population, to many of which its leaders appear to have no clear solutions. Meanwhile, plans to rebalance its economy and promote much-needed structural reforms have lost momentum. Unless China acts more decisively to overcome those obstacles, they may constrain both its future development and its global economic ambitions.

To be sure, in this view there will be some bumps along the road ahead, just as periodic financial crises punctuated the industrial rise of the US during the late nineteenth century. For China optimists, however, these would be temporary setbacks, from which the country would swiftly recover to regain its relentless upward trajectory.

Yet such visions sit uneasily alongside the growing list of huge problems piling up in China, to many of which its leadership appears to have no clear solutions and some of which it seems to lack the will - and indeed political clout - to tackle decisively. Some are short-term and cyclical. But many are longer-term, structural and increasingly deeply rooted.

That is not to say that China's economy is about to implode or to come crashing down to earth with a bump – though that cannot of course be ruled out, especially since so much publicly available information about its true condition is sketchy, ambiguous or non-existent. However, there is growing evidence to suggest that the economy's glory days are behind it and that visions of its continued rapid advance, based on the implicit assumption that it will somehow go on going on as it did in the past, are mistaken.

That appears to be what some of the country's top economic policy makers fear. One of them, described only as an "authoritative person", told the People's Daily, the Communist Party's mouthpiece, in May that the economy's future course was not U- or V-shaped but a series of L-shaped downward steps. In other words, a steady decline in longer-term growth, not a quick bounceback, was in prospect.

The official's identity, and his or her motives for speaking out, remain subject to much speculation among China-watchers, though whoever he or she is must have had approval from the highest levels of the Party hierarchy. But one, fairly widely shared, interpretation is that the intention was to jolt a sluggish government bureaucracy out of the complacent belief that the economy would somehow recover by itself from its current slowdown and to goad them into action.

TOWERING DEBT MOUNTAIN

The anonymous official's biggest concern, like that of many international investors, is China's towering debt mountain, currently between 250 and 300 per cent of GDP. Its most troubling aspect is not just its size, which is comparable to that in some advanced economies; it is the alarming speed at which it has risen – trebling since 2007 - and continues still to rise, as ever more money is pumped in in an effort to keep growth up and unemployment down. China's chronic addiction to debt has led the Bank for International Settlements, the "central bankers' bank", to warn Beijing that it risks a banking and financial crisis in the next three years. Meanwhile, the country's once robust fiscal condition is deteriorating: the International Monetary Fund calculates that its overall budget deficit, officially targeted at 3 per cent of GDP this year, has actually widened to more than three times that level.

Despite official efforts to restrict its growth, credit is still expanding twice as fast as GDP, as monetary policy veers erratically between bouts of "stop" and longer bursts of "go". Much of the money is going, not into productive investment, but into asset bubbles, into rolling over existing loans to technically insolvent borrowers and into the coffers of state owned enterprises. Yet China's most dynamic wealth and job creators, its private companies, still struggle to raise finance. Their confidence in the economic outlook also appears to be flagging, to judge by the sharp slowdown over the past year in their capital investments, which actually fell in July.

Meanwhile, the economy remains burdened with vast excess capacity, particularly in coal and steel, while zombie companies are kept alive on artificial life support. Here, too, official efforts to impose cutbacks have had to contend with concerns about the potential political cost of depressing the economy and raising the unemployment rate. Beijing recently ordered the coal industry to reverse course by expanding production, apparently out of concern that reductions in output had led to steep price rises. Furthermore, "streamlining" of the bloated SOE sector has in practice often consisted of forced mergers between troubled state-owned companies, in the apparent belief that combining them would by some alchemy transform them into dynamic industrial champions.

Nor is much progress being made towards another key government goal: rebalancing the economy by replacing investment with consumption as the main growth driver. Indeed, China has actually been going backwards. Final household consumption, at 39 per cent of GDP, is not just extraordinarily low by international standards; it is well below its 47 per cent share in 2000. Though services now contribute more in nominal terms to growth and output than do manufacturing and construction, that is largely attributable to a sharp slowdown in fixed asset investment and rapid expansion of financial and property-related services, both fuelled by the bubble economy.

REFORMS RUN INTO RESISTANCE

China's leaders seem to be pinning their hopes for breaking out of this cycle on structural reforms that will revive flagging productivity growth and propel the economy up the development ladder. But since they adopted a sweeping reforms blueprint in late 2013, its implementation, other than in parts of the financial system, has been timid, piecemeal and slow, as it has increasingly run up against entrenched political and institutional resistance.

Some observers believe policy is now dictated by one overriding short-term priority: somehow to keep growth going until the landmark Party Congress late next year, at which five of the seven members of the Politburo Standing Committee, the Party's highest decision-making body, will retire. Then, optimists argue, Mr Xi will at last be free to appoint his own team of loyal colleagues and forge ahead boldly with his agenda.

However, even if he succeeds in further consolidating his grip, big questions remain. One is why, as reputedly the most powerful Chinese leader since Deng Xiaoping, who chairs the key Party groups that have taken control of all the main government policies, Mr Xi has not acted more decisively in the past four years to address the economy's mounting problems. Another is what action the next top leadership will take to deal with them and whether they will succeed.

The answers to both questions are critical not only to the future course of China's economy. They will also matter to the rest of the world, because they will affect both China's aspirations to expand its international influence and its impact on the global economy.

China clearly wields growing clout beyond its own borders. However, its impact is uneven. Regionally, its weight and reach are increasingly felt in east and south Asia. RCEP offers another vehicle for expanding China's influence, though it remains to be seen whether its government possesses the diplomatic and leadership skills needed to weld the grouping's 15 other members, some of them both mutually antagonistic and mistrustful of China, into an effective engine of economic integration.

Globally, it is a different picture. China is still far more of a rule-taker than a rule-maker, a relatively quiescent member of the main multilateral and various regional economic and financial organisations to which it belongs. Despite excited initial speculation that Beijing was setting up the AIIB as a rival to the western-dominated IMF and World Bank, the new institution aims to make only $1.4bn of loans this year, most in partnership with the World Bank. And despite China's strenuous efforts to expand the international role of the renminbi, its share of global monetary transactions has never exceeded three per cent and has recently dwindled.

Nor, contrary to common belief, has China's growth contributed to overall global demand: by running large external surpluses, China has actually subtracted from it. Nonetheless, some individual countries have profited handsomely, notably natural resource exporters such as Australia, Brazil, the Middle East and parts of Africa. The powerful magnetic attraction of its apparently insatiable domestic demand, coupled with generous promises of funding – not always delivered on – have also purchased Beijing influence in capitals around the world.

However, some of the magic charm is starting to wear off. As China's growth has slowed and its consumption of raw materials and energy has slackened, the economies of many of the countries that prospered by supplying them have suffered. And the trend may prove enduring, if China succeeds in its stated aim of shifting permanently from a resource-intensive economy, heavily dependent on manufacturing and construction, to one based far more on services.

More recently, industrialised countries have taken a hit, too, as China has sought increasingly to dispose of excess capacity in products such as steel on global markets at rock bottom subsidised prices. By doing so, it has both exported deflation and is threatening to stir up a trade backlash in both the US and Europe – a risk that may increase sharply if Mr Trump carries out his threat to slap punitive tariffs on Chinese exports.

Global financial markets' exposure to China was underlined when they were rudely shaken last year by its bungled efforts to prop up its sagging stock market and revise its exchange rate policy, and by a surge in capital outflows that drained its foreign exchange reserves by $1 trillion in a matter of months. The situation has since stabilised, though there have recently been signs of renewed outflows, while the Renminbi has continued to weaken, notwithstanding repeated official pledges to hold it steady. China's financial condition remains precarious and vulnerable to shocks that could trigger renewed capital flight and strains on the exchange rate, the effects of which would reverberate internationally. While those risks remain Beijing, ever reluctant to cede control, seems likely to be even more wary of liberalising the capital account, a prerequisite of making the renminbi a fully-fledged reserve currency.

EYE-CATCHING INTERNATIONAL INITIATIVES

That has not deterred Beijing from pursuing eye-catching international initiatives, of which the most ambitious and costly is OBOR, on which Mr Xi has staked much personal prestige. A growing flow of corporate acquisitions abroad, many made at rather full prices, also advertises the scale of China's international economic reach and ambitions. Both trends have aroused concerns elsewhere that China is now bent on exercising global economic dominance. The reality, however, is more complex.

As long as China saves more than it invests, it will continue to run external surpluses, obliging it to export capital to the rest of the world. Given Beijing's failure so far to tackle the structural imbalances in the economy that underlie those surpluses, a wall of Chinese money is likely to continue spreading outwards across the world for a long time yet. But it is far from certain that it will either enhance China's economic strength or procure it greater global influence. Indeed, warning signs are emerging that it is already hitting limits.

One is growing resistance in the US, Australia and most recently Europe to the wave of Chinese acquisitions there. Grisons Peak, a boutique investment bank, calculated recently that western authorities have blocked Chinese deals worth almost $40 bn since mid-2015, while ChemChina's $44bn bid for the Swiss Syngenta group has yet to win approval.

The pushback stems partly from concerns that some planned acquisitions may pose national security risks but increasingly from resentment that, while western economies have become happy hunting grounds for Chinese acquirers, many Chinese industrial sectors remain firmly closed to investors from abroad. Failure by Beijing to extend greater reciprocity risks causing government attitudes to harden and barriers to go up abroad. Meanwhile, in parts of the planned OBOR route, notably in south east Asia, suspicions are being voiced that the project comes with political strings attached.

In addition, the realisation is dawning in Beijing that falling commodity prices and weaker global growth mean that much of the lavish lending by its state development banks and funds to financially shaky and poorly managed developing economies, led by its $60bn loans to Venezuela, may never be repaid. As a result, China is belatedly imposing stricter disciplines on future such loans and directing them to supposedly less risky borrowers in an attempt to stem further losses. Increasingly, state-backed overseas investment is being channelled into projects carrying the OBOR label, though analysts question how financially viable many will be, particularly as some appear motivated more by foreign policy and national security considerations than by the pursuit of commercial returns.

Even when China's overseas investments are in less risky areas and undertaken ostensibly for commercial reasons, their financial rationale can appear questionable. Many of the state-owned enterprises that are leading the charge abroad are highly inefficient users of capital: Dragonomics, a research firm, estimates that those in the construction industry earn on average 2 per cent on their assets, yet pay 5 per cent on borrowed money. China's scramble to acquire oil and natural resources assets around the world, often at the peak of the market, also looks a lot less sensible now that prices have fallen sharply and may never regain their previous highs.

The costs are already being counted. For example, China National Overseas Oil Corporation, the country's largest overseas oil and gas producer, took a loss $1.2bn loss in the first half of this year attributable to writedowns on its investment in Nexen, the Canadian oil sands producer that it acquired in 2012.

Undoubtedly, China has deep pockets. However, they are not bottomless, and its capacity to continue pouring money into foreign projects that earn meagre or negative returns cannot be unlimited. Ultimately, many of the costs of poor investment decisions will be borne by the public finances. And these are already coming under strain from several different directions.

Though tax revenues have remained fairly resilient so far, they are likely to weaken if the economic slowdown proves prolonged. Furthermore, they are being far outstripped by expenditures, which rose more than twice as fast in the year to September. The widening gap has alarmed the authorities and prompted the ministry of finance to warn publicly that it is unsustainable. Earlier this year Mr Xi acknowledged the growing pressure on fiscal resources, saying that it was becoming difficult to continue increasing China's military budget – one of his top priorities – as rapidly as in previous years.

Other big bills are set to fall due. Sooner or later, China will need to tackle in earnest its debt problem by writing off bad loans and recapitalising its banks. So far, it has given no sign that it has any coherent strategy for doing so: indeed, by continuing to pump credit into the economy, it is actually adding to the problem. The longer it delays decisive action, the greater the eventual costs to the economy and to the public finances.

A little further ahead, other big challenges loom. Cleaning up the environment and addressing China's increasingly acute water shortages – both causes of mounting public dissatisfaction and complaint – will come with a big fiscal price tag. And they will have to be borne by a shrinking labour force and a rapidly ageing population that will be more in need of public services and support while generating less economic output and fewer tax revenues out of which to finance them.

Those challenges are not insurmountable. With good policies, careful planning and effective execution they can be managed, if not fully resolved. However, addressing them will call for the commitment of massive resources – political, human and administrative as well as financial. They will also require China's leaders to devote increased attention to pressing priorities in their own backyard.

How far those demands are compatible with a muscular drive to project China's economic presence and influence more forcefully abroad, and to pour substantial resources into overseas investments that risk depleting, rather than enhancing, its national wealth, is highly debatable. If the circle cannot be squared, and if China's expansionary ambitions prove either unaffordable or unrewarding, history may record this as their zenith, and not as the precursor of ever greater and more glorious triumphs to come.