

European issues

n°234

3rd April 2012

China's Strengths and Weaknesses

ABSTRACT :

China is experiencing an unprecedented economic development that both fascinates and, at times concerns the World's most advanced economies. The country has achieved a spectacular economic take off, multiplying its global weight seven times over the last thirty years, to become the second largest power in terms of nominal GDP and the first in terms of exports. Furthermore, China has set up major internationally-orientated industrial companies and is increasing its investments both abroad as well as in new technologies at home, such as renewable energies, to yet further strengthen its position. However, some challenges remain: an economic development that is still too dependent upon exports and investments and which require "refocusing" towards consumption; continuing strong social and geographical inequalities and uncertainty over its capacity to sustain high value-added growth via innovation.

By **Karine Lisbonne-de Vergeron**

Fellow at the Global Policy Institute

INTRODUCTION

China's emergence is an unprecedented, historical phenomenon. With growth rates of around 9% and 10% over the last few years, it is the focus of World attention and the object of intense analysis both of the means by which it has achieved its rapid and impressive ascension of the international league table of economic powers, and of its ability to have benefited from global trade. In particular, many observers believe that the sustained growth of the Asian giants, of which China is the primary example, will lead to a continuous move of the economic centre of gravity from the West to the East – a trend which the current economic crisis in most advanced western countries has accelerated. These analyses are sometimes mixed with concern given the growing relocation of industrial activity to China and more generally to Asia, but also because of the recent growth in Chinese investments abroad, notably in Europe. However although these have increased in terms of purchase of public debt and private assets in some European countries, they remain on the whole limited, especially when compared to European FDI flows into China. At the beginning of February 2012 the Chinese Prime Minister thus recalled that his country neither wanted nor had the ability to "buy Europe". So the questions arise: is China as powerful as some like to

think? What are its strengths and weaknesses? What are the challenges it faces?

1. THE STRENGTHS BEHIND THE CHINESE SUCCESSES

China's rise since the start of the era of reform in 1978, has certainly been exceptional in terms of its degree, but even more in terms of its scale. In 1976 the country totalled 1% of the world's economy; today it represents more than 7%, with growth forecasts taking it in some cases to 20% in 2025 [1] (the European Union would then total 21%, as the USA). Its economic rise to power enabled it to rise beyond Japan in 2010 to become the second economic power in terms of nominal GDP (third if we include the EU). It is now the world's leading export and manufacturing power, having overtaken the USA in 2010 from a quantitative point of view (productivity remaining well below that of the USA). For example, it is the leading car market with 18 million vehicles sold nationally in 2010.

This great leap forward has been indeed mainly fuelled by an economic policy initially fostered by heavy investment and a ruthless priority being given to exports. Hence, in very little time China has become the EU and the USA's second trade partner, and its weight, especially for the EU, is constantly rising (in 2006 the country

1. CEPII, *The Global Economy in 2050*, 15th December 2010.

represented 10.1% of all the EU's exports and imports in goods but 13.9% in 2010; in the same year the USA accounted for 14.4% of the European Union's trade). To this we might add the well known emphasis that has been placed on savings, a major increase in banking services together with a rapid increase in monetary growth and a limited external debt: a strategy altogether relatively similar to that adopted by other emerging countries in Asia.

Possibly one of the most notable facts of the Chinese successes over the last few years, which should become more evident mid-term, lies in the creation of major Chinese groups with a world vision, accentuated by a strategy to move upmarket both industrially and technologically and in a context of increasing Chinese investments abroad – the so-called national "go-global" strategy. In Europe, for example, there has been the Chinese takeover of car manufacturer Volvo by Geely for 1.3 billion € in 2010, of the Hungarian chemical company Borsodchem by the industrial group Wanhua (1.2 billion € in 2011), the acquisition via the State sovereign fund China Investment Corporation (takeover of 9% in the capital of the British water company Thames Water in 2012, and the protocol agreement in view of purchasing 30% of the drilling and production branch of GDF Suez in 2011). Although these major investments still tend to be marginal and although China is only 16th in the World in terms of outward FDI stocks (which represents around 3% of that of the EU), it is generally believed that within the next few years it will become one of the world's main contributors in terms of foreign direct investments.

Domestic investment in new technologies, particularly in renewable energies and services, also highlights a determination to strengthen the scientific and innovative capabilities of the Chinese economy [2]. This is notably based on cutting-edge technology parks such as Zhongguancun near Beijing, which focuses on research activities, the development and production of services and which now hosts nearly 20,000 high tech businesses including some major Chinese (Lenovo) and foreign companies (Google and Microsoft). Thus, although the contribution by the tertiary sector to the Chinese GDP totalled 43% in 2010 (industry 47%), it

is believed that this ratio will inverse rapidly with the share in the tertiary sector taking over between 2016-2020 (51%) to rise to a possible 61% in 2026-2030 – drawing close to the average of 75% estimated by the World Bank for the so-called High Revenue Economies.

But in spite of this undeniable success, the country is still an emerging power: given the unprecedented challenge that its economic development represents – the project to build a fully advanced society on the scale of 1.3 billion people – catching up does not go without major pitfalls. Despite sustained growth the GDP per capita is still far from that of the main advanced economies (it totalled 4,400\$ in China in 2010 compared to 34,700\$ on average in the OECD countries).

2. THE MAJOR CHALLENGES FACING CHINA: RISKS AND WEAKNESSES.

China's problems are typical of those faced by emerging countries but with the specific feature of its scale, its social and political model and the speed with which it has achieved take off. The country will have to address several core issues to develop its economy, rebalance its structure, to guarantee a minimal growth rate in order to maintain social stability as it enters into its second phase of economic transition.[3] In the context of a slowing economy in 2012, initiated by a decrease in external demand, the Chinese authorities' economic priority is quite rightly to maintain stable growth, both short and mid-term. There are notably four central areas of concern:

- China still suffers from an economic model that is too dependent upon exports. This economic policy has of course led to rapid developments in production volumes but since it has been based on an overabundance of inputs (labour and capital), this has also gone hand in hand with some wastage (relatively low yields, high pollution costs and the inefficiencies of a model based on an ability to produce at significant speed but sometimes to the detriment of natural resources, security or maintenance). A clear instance of this are the recent problems relating to the protection of the environment and the prevention of ecological risks linked to the Three Gorges Dam. Another is the difficulty in

2. See also *Contemporary Chinese views of Europe*, K. Lisbonne-de Vergeron (2007), Robert Schuman Foundation and Chatham House.

3. According to the World Bank, growth estimated at 8.5% over the period 2011-2015 could drop to 5% between 2026 and 2030.

launching the Chinese high speed train [4]. As a whole and despite a notable decrease since 2007, the dependency of the Chinese economy on external demand remains high – exports still represented 26% of the GDP in 2011 (35% in 2007) [5]. It is generally thought that the recent decline in Chinese growth (9.2% in 2011 with average forecasts taking it down to 8.5% in 2012) is primarily linked to a slowing in external trade leading to increasing difficulties for SMEs in the export sector and sometimes to social tension [6]. The massive accumulation of foreign reserves, now estimated at 3,200 billion \$, the majority of which is believed to be held in dollars, has also exposed the country to major currency losses despite an increasing diversification of its investments, notably in euros and in yen.

What has been a source of major strength for China over the last few years (the priority given to exports and investments) now needs to be readjusted towards increased domestic consumption. The trend started by the Chinese authorities to re-balance the economy is ongoing, but household consumption is still low and only accounts for 35% of the GDP. As a comparison this share totals between 60% and 70% in most of the OECD economies [7]. More generally, China runs the risk of being caught in the “middle income trap”, a syndrome by which the wage inequality that is typical of an export orientated economy with a low labour cost, limits the emergence of a broad, prosperous middle class, which is essential to stimulate domestic demand. The GINI coefficient that measures differences in incomes in a given society was estimated at nearly 0.41 in China over the period 2000-2010, up in comparison with 1985 (then at 0.26). In other words, inequalities are growing: according to the 12th Chinese five-year plan which calls for a faster change in the pattern of economic development, the average person's income should rise above 7% annually between 2011 and 2016 and go hand in hand with reforms in order to reduce sectoral differences and regulate incomes.

- Social and geographical inequality persists. There is still a gulf between the country's developed and under-developed regions in spite of the progress achieved over the last few years in terms of GDP growth and development policies undertaken by the authorities in

support of the country's central and western areas. In 2009 50% of the GDP was achieved in coastal areas. With a strong rise in urbanisation (the share of the urban population rose from 36% in 2000 to 50% in 2011 and could rise to 65% by 2030), the management of this economic transition is still difficult. The population of migrant workers from the Chinese countryside totals over 150 million, whose living conditions are still precarious, notably as far as social security is concerned. In the face of rising living costs several Chinese towns are short of labour. Although steps have just been taken by the authorities to reform the residence permit system, population growth and social stability is an important challenge for the country more widely. Indeed it is a priority to speed up the development of a full social security safety net (also discouraging excessive savings). Although the goal set is universal coverage by 2020, the challenge seems more important with regards to pensions (it is estimated that less than half of the population had one in 2010) in the face of increasing demographic pressures in the context of an ageing population. The proportion of people aged 60 and over is due to triple by 2050, when they will represent 30% of the population.

- Energy and resource risks are still great. Firstly the country's diminishing own resources: Chinese coal reserves may be exhausted in 35 years time if consumption continues at the 2010 pace, whilst coal still accounts for more than 65% of energy requirements. The situation is similar as far as natural gas and oil are concerned which is leading to greater dependence on imports. China is already the world's biggest consumer of energy and its demand is due to continue to rise with urbanisation and the development of its middle classes. But although the country has made a significant effort in terms of renewable energies (the share of non-fossil energies in the Chinese mix is due to rise to 15% by 2020), energy efficiency is still four times less than that of Europe. Secondly the rapid deterioration of their soil and water resources: 90 % of river banks in the major towns are polluted [8] whilst the overall cost of water shortages was estimated at nearly 1% of the GDP in 2007. Overall, the country's depletion in natural and environmental resources was estimated at 9% of the GNP in 2008. Finally its exposure to soaring raw

4. In particular the collision that occurred in Wenzhou and the delays on the Beijing-Shanghai line in 2011. The Chinese high-speed train network launched in 2007 is the largest in the world.

5. The domestic value added of exports would however only represents 17% of GDP (part of the exported goods are assembled using imported materials and components).

6. For example in Guangdong. See the Economic Bulletin China, Direction Générale du Trésor, n°41, 2011.

7. The Ascent of Asia, Nomura Global Economics. February 2010. Consumption contributed to nearly 50% of Chinese GDP growth in 2011.

8. F. Galland (2008), Géopolitique de l'eau en Chine, Monde Chinois n°15, Autumn 2008.

China's Strengths and Weaknesses

materials prices: energy, agricultural, but also metals, whose volatility has increased sharply over the last few years.

- The challenge of technological innovation and the re-balancing of economic structures call for the strengthening of creativity and education to foster new drivers of growth. Although in 2030 China is due to have nearly 200 million university graduates, i.e. nearly as many as the entire working population in the EU in 2009, the quality of tertiary education is still a challenge given the shortage of skills that numerous Chinese businesses are experiencing [9]. The authorities' goal is notably to attract back highly skilled and talented Chinese currently living abroad (potentially some 500,000 Chinese researchers between 2011 and 2015) but this will also require education reform to foster innovation.

CONCLUSION

China has entered a second phase of economic transition. The main issue at stake, which is a very considerable one, is the quest for stable growth within an advanced economic model, which the increase in living standards and the development of a continent-sized consumer society demands. China's ability to solve its

structural problems and to speed up the re-adjustment of its economy will be decisive for the future and for the country's development and stability but also for the interests of Europe, its leading trade partner. But given the re-balancing of the world economy, the effort to catch-up made by the major emerging countries and the present economic crisis, Europe also has to undergo transition: it has to ensure it is more competitive, that it has greater political vision and more strategic control of its own dimension as a continent.

Karine Lisbonne-de Vergeron

Graduate from HEC and from the London School of Economics in political science, a fellow at the Global Policy Institute in London Ms Lisbonne-de Vergeron has been a strategy consultant for major French and European industrial groups and an associate researcher for the Royal Institute of International Affairs (Chatham House). She is the author of several works on European issues, the most recent being *Chinese and Indian views of Europe since the crisis: New perspectives from the emerging Asian giants*, Robert Schuman Foundation (2012), jointly with the Konrad Adenauer Stiftung and the Global Policy Institute.

9. *China 2030, a joint study by the World Bank and the Development and Research Centre of the Chinese State Council, February 2012.*

You can read all of our publications on our site:
www.robert-schuman.eu

Publishing Director: Pascale JOANNIN

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France, Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.