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113

On the Brink: Contemporary Transformation of China's Economic Growth Model

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March 2020

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Introduction

The extraordinary economic performance of China between the onset of the reform era in the early 1980s and the global financial crisis was mainly driven by export-led economic growth model, which was supported by high productivity of labour-intensive manufactures, low wages, and export-stimulating policies. The export-led model reached its peak in the decade between 2001 and 2011, where exports as a share of China's GDP increased from 20% in 2001 to a height of 36% in 2006.[1] High price competitiveness of Chinese products pushed many other manufacturers of consumer products (from Europe, Japan, and the US to some extent) out of the foreign markets, providing high export revenues to Chinese enterprises (mainly, state-owned ones), which were partly reinvested to productive capacities and partly accumulated in the form of international reserves.

The global financial crisis has changed the global environment dramatically. Exports as a percentage of GDP dropped abruptly, falling by 25% during the 2011 crisis.[2] This fall was due to a sharp decline in external demand from markets in Europe, North America, and Japan. In 2001–2011, the cost of labour in China increased relative to other Asian economies, such as Vietnam, resulting in an increase of Chinese investment towards lower-cost Asian economies. With China's working-age population as a proportion of the general population peaking in 2012, the country was facing further increases in the cost of labour.

The sharp drop in foreign demand revealed vulnerabilities of traditional economic-growth model – its extremely high dependence on global environment. Excessive supply led to economic slowdown from the previous double-digit rates, lowering even paces of international reserves accumulation and rising deflationary pressure. Despite the subsequent revival of foreign demand, its quality and consumers' preferences have changed. Low-cost advantages have given place to innovativeness and quality of produced goods, their adaptability to streamlined manufacture. Rapid development of information and communication technologies pushed demand for services and network commodities, resulting in new challenges as well as new forms and instruments of global competition.

It became obvious that the China's economy entered a critical stage of its development. It needed to integrate into new reality, diversify its economic growth sources, adopt structural reforms, as well as find new instruments and mechanisms of their implementation in order to transform into a higher-value knowledge and technology-based economy.

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[1] *'World Bank Open Data Statistic Database'. Available from: https://data.worldbank.org/indicator/ne.exp.gnfs.zs*

[2] *Ibid.*

The foundation for 'unprecedented' economic and social reforms was laid at the third plenum of the 18th Congress of the Communist Party of China (CPC). It resulted in issuing the comprehensive Directives Paper that defined strategic priorities for the next 20 years. The Congress was followed by the 13th Five-Year Plan (2016–2020) adopted in 2016. The latter declared paramount objectives (including quantitative targets) for sustainable development until 2020, 'launching the first stage in the new reform trajectory'. The objectives can be categorized into several broad fields,[3] but this paper will focus on the three main pillars, which predetermine strategic long-term transformation of China's economic growth model.

- Diversification of economic growth sources, associated with intensive transformation from export- and investments-led economic growth model towards consumption-led growth.

- Outward investment expansion through the system of domestic incentives, as well as implementation of multilateral initiatives driven by both economic and political factors.

- Shift from capital accumulation-led labour-intensive growth to innovation-led growth, rapid development of high-tech industries, strategic positioning as a 'science and technology superpower'.

Shift Towards Consumption-Led Growth

Extremely high dependence on external markets produced a spillover effect of double-digit export-led growth before the crisis. The 2007–2008 global financial crisis marked the starting point of the rebalance of the Chinese economy away from an export-led model and towards a consumption-driven economy. Realizing the risk of export-driven economic growth model, the government set a course for strategic transformation of its economic growth strategy from an export-led to a consumption-led one, with the use of fiscal and monetary instruments.

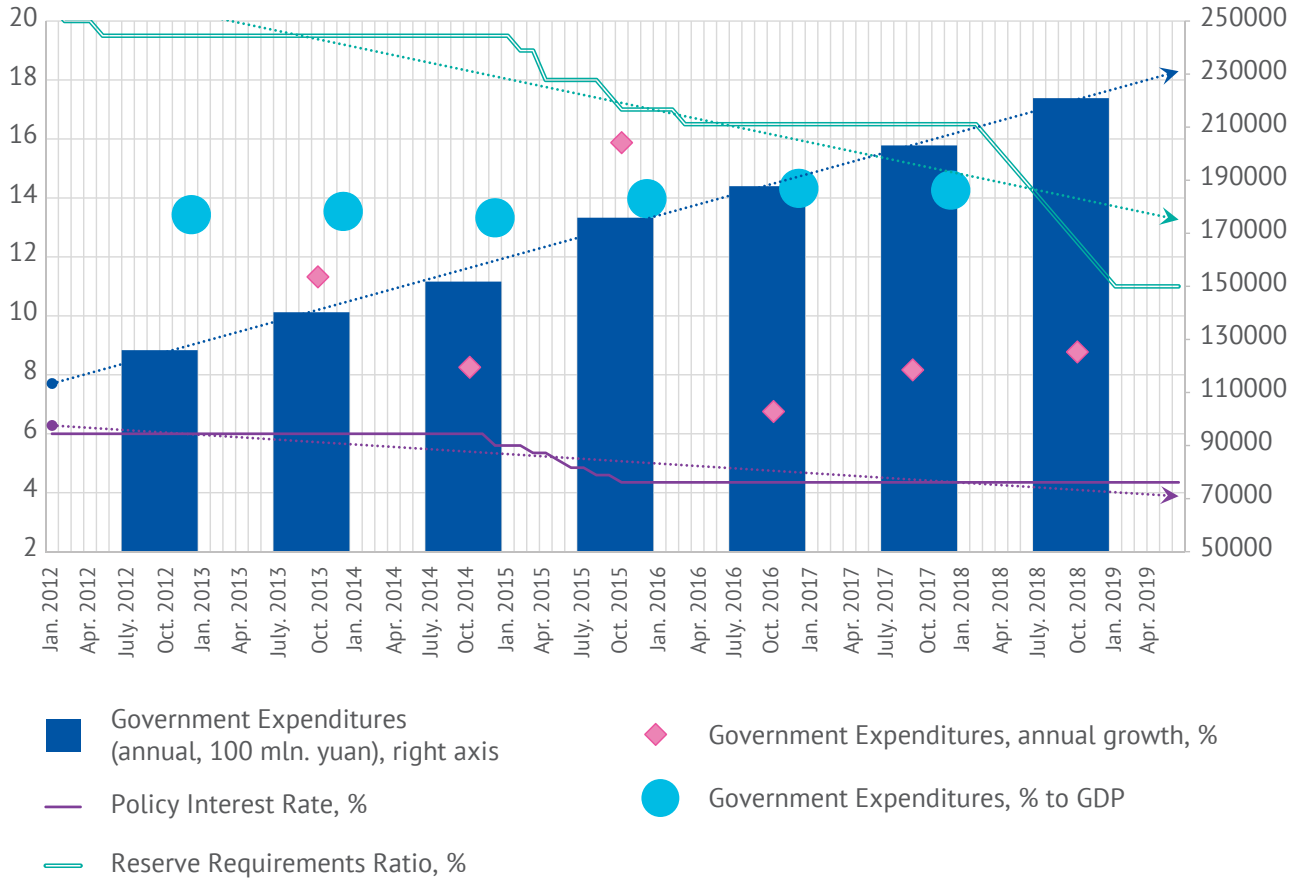
China tends to provide higher disposable income through fiscal instruments, strengthening social protection of the population and developing social welfare. In order to stimulate private consumption and meet demand for cash, the People's Bank of China (PBC) started with injecting more than $42bn

[3] *Michel, A & Bai, G, 2016, 'China's 13th Five-Year Plan. In Pursuit of a "Moderately Prosperous Society"', CEPII Policy Brief, no. 12, p. 2.*

into the economy in early 2014. Stimulating fiscal policy became a key instrument of structural transformation in the following years. In 2017 and 2018, China made 1.02 and 1.3trn yuan in tax cuts, respectively. The stimulation package, announced for 2019, totals 2trn yuan and includes mainly cuts in the value-added tax (VAT) and social security tax (SST).

The monetary authorities set a course on monetary easing. The policy interest rate was decreased several times in 2015 and the PBC cut reserve requirements ratio for all banks several times in recent years. The markets expect further cuts in the required reserve ratio (RRR) by the end of 2019. Moreover, the RRR for smaller banks are around 2% lower than for large banks. On the one hand, monetary easing aims at improving the transmission mechanism of its monetary actions and increasing credit supply to small and medium-sized business, as well as higher access of smaller banks to financial resources. On the other hand, the monetary authorities are interested in boosting domestic consumption, providing cheaper credits, and lowering households' propensity to save.

TRENDS IN CONSUMPTION-STIMULATING POLICIES, 2012–2019



Source: compiled by the authors.

While the success of the e-commerce market in China has played a role in the movement towards a consumption-driven economy, it is only part of a wider urbanization of Chinese society. A key aspect of China's re-orientation towards a consumption-driven economy was the mass urbanization of China, which began in the 2000s. The mass urbanization of China involved heavy investment by the state and state-owned enterprises in infrastructure and housing. The global financial crisis pushed the government to roll out a massive 4trn yuan stimulus package via Chinese bank loans towards Chinese state-owned companies and local government and to invest in infrastructure projects.

After the 2007–2008 crisis, overall growth in the Chinese economy slowed, but consumption expenditure picked up, replacing investment, which had been responsible for 60% of increases in real GDP during the 2001–2011 period as the largest contributor to economic growth. The revival of consumption as a driver of growth, together with weak global demand following the 2007–2008 crisis and the increase in the cost of production, reduced the likelihood of a return to export-reliant low-cost manufacturing. Thus, after 2011, China moved towards achieving a solid, sustainable economic growth driven by domestic consumption. The results of consumption-stimulating policies are obvious. China's private consumption-to-GDP ratio rose from 35.5% in 2010 up to 39.4% by the end of 2018. Consumption expenditures contributed more than 76% to the country's GDP growth in 2018, and the figure in expected to increase in 2019 to almost 80%.

China is still far from implementing its consumption potential. Its Consumer Potential Performance Index (CPPI)[4] is still lower than 1, and Chinese households underconsume, implementing their consumer potential by no more than 62%. However, China has demonstrated rapid growth of its CPPI in recent years, from 0.39 to 0.61 during the seven-year period. Rapid urbanization and middle-class growth, associated with consumption-stimulating policies, may stimulate national demand.

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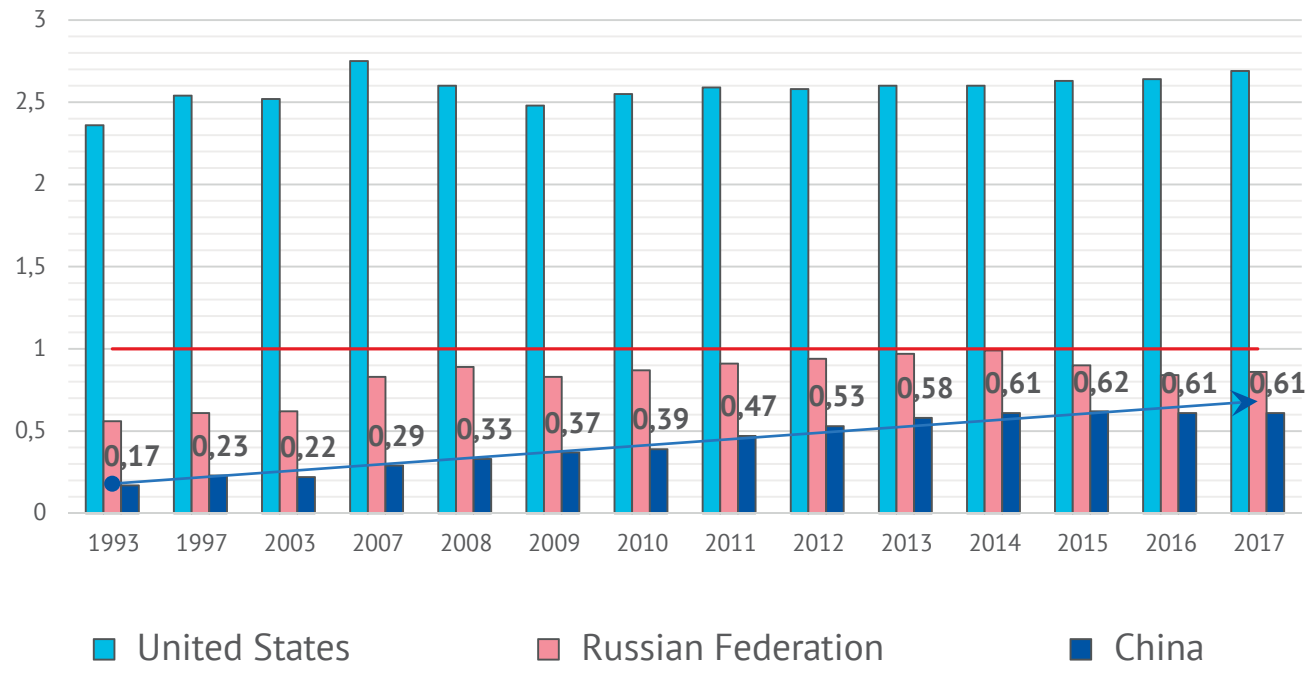
[4] Consumer Potential Performance Index (CPPI) was introduced into the research terminology by E. Arapova in order to identify the consumption pattern of each country, track the contemporary trends, and compare the consumer potential of various regional actors. The CPPI is a quotient obtained when real values of household final consumption expenditure per capita in a country (i) at time (t) are divided by its predicted values (calculated on the basis on panel data regression for a group of 78 countries for 25 years from 1993 to 2017). If the index is lower than 1, this means that the country underconsumes, and its household consumption expenditures are lower than the potential level. If the index is higher, than 1, this means that the country overconsumes, its consumption is higher than the predicted level.

CONSUMER POTENTIAL PERFORMANCE INDEX (CPPI) DYNAMICS, 1993–2017



Source: calculated by the authors.

Nevertheless, China's transformation to the consumption-driven economy is curbed by its domestic structural imbalances. China still remains a vast country with high inequalities in income between the groups of rural and urban population. Moreover, the stimulus package led to an overcapacity in the construction and housing sectors, as well as in steel and concrete production. In order to deal with the issue of overcapacity, the state enacted a number of government policies to increase consumption areas, such as the housing and the car markets, which eventually overheated them. These stimulus packages have now become one of the main barriers to China's transformation towards a consumption-driven economy. These packages have led to a large accumulation of debt among Chinese corporations and households. As the Mercator Institute for China Studies (MERICS), a German think-tank, highlighted, 'China's corporate debt to GDP ratio, a measure of corporate leverage, is now among the very highest globally. It has risen nearly 65% within a decade, the fastest increase among the major economies.'[5]

[5] *'China's High and Rising Corporate Debt. Examining Drivers and Risks', 2019, China Monitor, Mercator Institute for China Studies, August 22. Available from: https://www.merics.org/en/china-monitor/chinas-corporate-debt*

High levels of Chinese corporate debt have reduced Chinese corporations' capacity for business to business (B2B) consumption. As Chinese corporations are both large investors and consumers, their large debt has slowed their consumption, stunting the overall level of consumption in China. At the household level, a simpler problem has arisen. In the period between 2008 and 2017, total debt within the nonfinancial sector, i.e. government, corporate, and household debt, was almost double the worldwide ratio of 242% as a share of GDP.[6] This makes the country one of the world's most indebted emerging economies. Therefore, the capacity of Chinese households to increase consumption is limited by their large increase in indebtedness, which therefore prevents China from fully moving towards a consumption-driven economy.

New Directions of China's Investment Strategy

The Go Global strategy (or Go Out policy), which started in 1999, pushed and supported Chinese enterprises to become multinational companies. The policy was officially launched in 2001 to coincide with China's admission to the World Trade Organization (WTO), and Chinese private companies joined the policy in the same year. The Go Global strategy allowed the Chinese state to guide strategic companies – both state-owned enterprises (SOEs) and private businesses – to secure resources, knowledge, and access to offshore markets. The policy reached its peak under the Wen Jiabao and Hu Jintao (Hu–Wen) administration (2002–2012). The principal investments under the policy pertained to securing access to energy and metal natural resources. Such investments accounted for 70% of total outflows from China between 2005 and 2014.[7] The other main beneficiaries of Chinese investment under the Go Global strategy were the automotive, technology, and shipping sectors, and Africa was the region that received the most of Chinese investment.[8] This early period of outward investment under the Hu–Wen administration is known as the 'Go Global era 1.0'. A later period that saw Chinese SOEs secure access to overseas markets in key areas, such as oil and gas, is referred to as the 'Go Global era 2.0'.[9]

[6] *Ibid.*

[7] *'China Go Global', 2014, OECD. Available from: https://www.oecd.org/china/china-go-global.htm*

[8] *Ibid.*

[9] *'Chinese Enterprises Enter 'Go Global' Era 4.0.', 2016, The State Council of the People's Republic of China, April 11. Available from: http://english.www.gov.cn/news/top_news/2016/04/11/content_281475325205328.htm*

Under the Xi Jinping and Li Keqiang (Xi–Li) administration, Chinese investment moved towards a 'Go Global era 3.0', in which China directly invested in overseas markets, locating company assets and production abroad, and acquiring or merging foreign companies and infrastructure. Key to this period was the need to create an innovation-driven economy. Core to the 'Go Global era 3.0' was a strategic plan entitled 'Made in China 2025',[10] whereby the government aimed to upgrade ten strategic industries, including robotics, aerospace, pharmaceuticals, car manufacturing, IT, and transportation. The logic behind 'Made in China 2025' was to overcome the middle-income trap by moving China's manufacturing sector up the value chain. By forcing companies to invest and move part of their production overseas, the Chinese state hoped to drive innovation in these companies – a skill they would need in order to compete and survive in international markets.

Another key aspect of the 'Go Global era 3.0' include the implementation of the Belt and Road Initiative (BRI) and creation of its two related but independent investment vehicles, the Silk Road Fund and the Asian Infrastructure Investment Bank (AIIB). The scale of BRI investment is estimated to reach between $1 and $8trn.[11] The BRI will involve at least 70 countries directly across Africa, Asia, Europe, Latin America, and the Caribbean. Another 60 countries, including South Korea, have signed BRI agreements despite not being directly affected. The BRI will allow the Chinese state to directly support Chinese companies to gain a foothold in international markets. The BRI also creates Chinese-owned and -designed infrastructure networks, such as rail and telecommunications networks, allowing spillover effects by offering Chinese private companies, which already contribute to such networks in China, a comparative advantage across these BRI networks. This will lead to the final era of the strategy, the 'Go Global era 4.0', which will see private Chinese enterprises as the main driver of overseas investment. This would enable the latter to raise private funds both inside China and on the international market. These companies would be less guided by the Chinese state and would be reactive to economic market drivers.

'Go Global eras' 3.0 and 4.0 under the Xi Jinping administration have created new directions of outward investment strategy for China, which allows China to push its economy further up the value chain. Thus, China hopes to increase the overall wealth of its workers, helping to create a more balanced consumption-driven economy.

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[10] *'Made in China 2025', 2015, The State Council of the People's Republic of China, July 7. Available from: http://www.cittadellascienza.it/cina/wp-content/uploads/2017/02/IoT-ONE-Made-in-China-2025.pdf*

[11] *'China's Belt and Road Initiative in the Global Trade, Investment, and Finance Landscape', 2018, OECD Business and Financial Outlook. Available from: https://www.oecd.org/finance/Chinas-Belt-and-Road-Initiative-in-the-global-trade-investment-and-finance-landscape.pdf*

New challenges, e.g. exhaustion of export-led economic growth model, resulting in slowing pace of economic growth, shift towards consumption-led growth, rapid growth of capital-intensive sectors, replacement of labour-intensive industries, as well as China's strategic positioning as a 'science and technology superpower', predetermine recent trends in the country's foreign investment strategy. Despite a 17% decline of outward direct investments (ODI) in 2018 (caused by policies discouraging capital outflows, the rising sanction tensions, and increased screening of inward investment in North America and Europe), China is still the world's third-largest investor behind the US and Japan.[12]

Following contemporary challenges and its strategic priorities, China's outward investment policy has recently begun to demonstrate signs of significant change.

Changes in forms of investments. Chinese corporations shift from being minority stakeholders looking for profit to acquiring foreign companies, to increasing their share in various projects, participating in decision-making, and in using infrastructure facilities to meet their own strategic priorities. In recent years, China's corporations have become among the largest initiators of mega-deals in the form of mergers and acquisitions (the most recent cases are Italy's Pirelli, Switzerland's Syngenta, Spanish energy company Repsol's offshore business, etc.).

Changes in sectoral destinations. Income-stimulating policies (monetary easing and fiscal expansion) and rapid growth in incomes and wages deprive China from its traditional comparative advantages. As a result, the country is no longer interested in investing primarily in commodities but rather in manufacturing and high-tech industries. Moreover, the recent years have seen substantial increase in ODI to service sectors and participation in large infrastructure projects. In 2018, amid rising concerns about China's investment expansion in recipient countries, investments in transport, infrastructure, and real estate declined. At the same time, such sectors as financial services, health and biotech, consumer products and services, and automotive saw the biggest increases. China is expanding investments into relatively more hi-tech projects, including alternative energy, biotechnologies, etc. The number of acquisitions of hi-tech companies and manufacturing companies is also on the rise. State-supported investments in sensitive technologies and critical infrastructure have risen significantly.

[12] *'World Investment Report. Special Economic Zones. Key Messages and Overview', 2019, UNCTAD, Geneva.*

Changes in motivation. Resource-seeking and efficiency-seeking motives of outward investments give place to strategic asset-seeking purposes. When making investment decisions, Chinese companies are driven by the motive to get access to technology, strategic facilities, knowledge, or competences that are not inside the firm, as well as to expand the network of business contacts and improve business reputation. Market-seeking motivation seems to be a second-important type, its contentment has been changing. As a percentage of state-owned or state-supported enterprises is high, their outward investment policy is driven to a relatively lesser extent by profit-maximizing factors but rather by strategic economic and political ones. Instead of being motivated by the will of avoiding transportation and trade costs (or by tariff jumping motives), China tends to consider foreign markets more as destination for its labour force, because of rising social tensions inside the country.[13] Moreover, it is becoming important to have physical presence on the market to prevent competitors from its occupation.

Technological Transformation

Reducing technological gap with the developed world and transforming innovations into a driver of economic growth is China's third strategic priority. On the one hand, its achieving is associated with the country's outward investment strategy (enhanced direct investments into high-tech industries and enterprises abroad). On the other hand, it is encouraged by domestic policies.

The country's strategy of technological development bases on several documents: The National Outline for Medium- and Long-term Science and Technology Development Programme (2006–2020); Five-year Science and Technology Development Plan; 'Internet+' strategy and the 'Made in China 2025' roadmap. The main instruments contributing to technological transformation are:

- the authorities' heavy investments in technologies;
- rising governmental expenditures on research and development at the level of higher education system and research institutes;

[13] *Arapova, E, 2018, 'Kitai: Mezhdunarodnoe Vzaimodeistvie v Usloviiakh Vnutrennikh Vyzovov', Mirovaia Ekonomika i Mezhdunarodnye Otnosheniia, vol. 62, no. 6, p. 77–85.*

- stimulation of innovation development through free trade zones;

- intensive development of a wide net of international bilateral and multilateral agreements on science and technology.

China's successful innovation-stimulating policy resulted in substantial changes in directions and sectoral structure of technological flows.

First. China used to be blamed for cloning US technologies and business models ('Copy-to-China' strategy). In recent years, the trend has reversed. Some experts stress an evolution from 'Copy-to-China' to 'Copy-from-China', when Western companies are 'looking to China for aspiration, especially in Internet-related areas.[14] Thus, China transforms gradually from a recipient of foreign technological ideas into a driver of technological innovations.

Second. 'Chinese industries are not only getting closer to the technological frontier in conventional areas such as electronics, machinery, automobiles, high-speed railways and aviation, but also driving technological innovations in emerging areas'.[15]

Third. Chinese enterprises tend to be rather successful in 'creation of new combinations of component technologies'.[16] As China for decades used to be a global 'assembly manufactory' and the core element of global value-added chains, different research and development (R&D) activities base inside the country, providing opportunities for new technological combinations.

Forth. China is moving from medium-level technological track to a high-tech one. The country has already reached maturity in machinery and electronics, as well as infrastructure construction and logistic chains. At the same time, it starts encouraging high-tech sector development, such as smart and clean energy systems, new energy vehicles, automation and robotics, advanced medical equipment, biotechnologies, etc.

The sectoral priorities are closely connected with contemporary trends on the advanced markets, as well as potential challenges and risks to China's long-term sustainable development. The three main fields of innovation development can be outlined:

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[14] *Gaus, A, 2018, 'Chinese Tech Firms Are Increasingly Being Copied by U.S., Not Just Copying', The Street, June 28. Available from: https://www.thestreet.com/technology/china-not-the-world-s-tech-copycat-anymore-14636273*

[15] *Yanfei, L, 2018, 'Understanding China's Technological Rise' The Diplomat, August 3. Available from: https://thediplomat.com/2018/08/understanding-chinas-technological-rise/*

[16] *Ibid.*

- **Agricultural technologies** – as the problems of ensuring food security become more acute. Positive population growth and rapid middle-class growth increase demand for agricultural products. At the same time, relatively lower productivity of agricultural workforce, together with rapid urbanization and gradual degradation of agricultural land, lower agricultural supply.
- **Energy** – mainly new and renewable sources of energy (solar, wind, biomass, and nuclear fusion)[17], advanced nuclear energy. China remains one of the largest energy consumers amid the increasing scarcity of traditional energy sources. The contemporary policy aims at establishing a clean, low-carbon, safe, and efficient modern energy system for sustainable growth, and achieving the goal of non-fossil energy accounting for 15% of primary energy consumption by 2020 is officially declared in the 13th Five-Year Plan.[18]
- **Cyberspace** – including next generation information and telecommunication technologies, big data and supercomputers, robotics, and e-commerce, which have both economic and political motives. Besides the expected sufficient returns due to excessive demand on these types of technologies and services both on domestic and external markets, they become a strategic instrument for strengthening China's positions in the system of international relations. The 'international status' notion has been gradually changing, now it is determined not just by military or economic power but by countries' 'power of opinion', their positioning in information and digital space.

Conclusion. Implications for the Future

1. Private consumption will rise, although it can reach its potential level only in the long run. Commodity structure of private consumption will keep transforming, with changing nutrition pattern, an advance demand for agricultural products, services, and network commodities.

[17] *Mendonça, HL, Macedo-Soares, TDL van de A, TDL & Fonseca, MV de A, 2018, 'Working towards a Framework Based on Mission-Oriented Practices for Assessing Renewable Energy Innovation Policies', Journal of Cleaner Production, vol. 193, p. 709–719.*

[18] *'China National Development and Reform Commission. Renewable Energy Development', 2016, 13th Five-Year Plan, vol. 12: Development and Reform Energy, Beijing, China.*

2. The structure of national output will change in favour of high-tech capital-intensive products with higher added value and services (including aftersales service of high-tech innovative equipment).

3. Rising consumption and transformation of the production pattern will enhance the gap between demand and supply on the domestic market, which will be filled with rising import. The excessive import demand for the following three types of products can be expected:
    - **Lower-tech goods**, which China used to produce (textile, consumer electronics, some types of primary goods). This opens new niches for some developing Asian countries, such as Vietnam, Cambodia, Laos, India to some extent, etc. The expected trend is upward.
    - **High-tech equipment**. Advanced European and some Asian countries (such as Republic of Korea) may become short- and medium-run winners. The expected long-term trend is stagnating or downward.
    - **Agricultural products** (especially, livestock products). The potential winners are land abundant countries with high agricultural potential, such as Indonesia, Cambodia, Russia and some other post-Soviet countries, as well as some African countries. The expected trend is upward.

4. Reduction of China's households' saving rate together with rising import will lower the country's current account surplus.

5. Declining current account surplus, accompanied with scaled investments into multilateral infrastructural megaprojects (such as BRI), will result in lowering pace of international reserves accumulation or even their gradual depletion.

6. China tends to become the main supplier of medium-level technologies to the developing countries in the near future (mainly lower-income Asian, as well as African and Latin American countries to a lesser extent). Moreover, in the long run, the gradual progress in high-tech development will make these innovations more affordable to these groups of countries.

7. Depreciation of national currency, which will follow rapid capital spending, may provide new opportunities for Chinese exporters, but at a new level. Its relatively cheaper production of higher-tech segment will in the long term invade developing markets (mainly, African and Latin American to a lesser extent).

Nevertheless, whipping up this spiral and speed of structural transformation will depend on answers on several questions:

? How long will the government conduct an expansionary fiscal policy, taking into account the rising budget deficit and national debt?

? Will monetary policy be able to provide sustainability of financial sector? The monetary easing can be curbed with accumulation of bad debts and risks of equity market bubbles.

? Will the authorities be able to solve the rising controversies of the 'impossible trinity' (or trilemma) of monetary policy? What are the chances for cancellation of capital control and/or shift towards free floating of national currency?

? Will the government be able to overcome the problem of labour markets imbalances and rising social tensions, which became a result of rapid urbanization and shift from labour-intensive to capital-intensive innovation-driven industries, i.e. the abundance of lower-skilled labour, on the one hand, and shortage of high-skilled professionals for innovation sectors, on the other?

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