China in 2018

What It Will Mean for the Global Economy?

China is not only the world's second largest economy, but is a central hub of the global supply, production and value chain. China's dynamics in 2018 are bound to have across-the-board impact on the world's trade and investment flows.

The International Monetary Fund (IMF) has upped its estimate of China's 2017 economic growth from 6.7 to 6.8%. This rate of growth is a far cry from headier days but is still enviable compared to Western economies. "However, fixating on simple growth rates risks missing the wood for the trees. There are three reasons why.

First, the economics of size. China's economy quadrupled between 1990-2010, growing at a rate of some 10% a year. Since then, it has grown much bigger and remains on track to double its 2010 GDP by 2020. In other words, in a few years time, China's economy is likely to be four times bigger than in 1990. As a rule, the world economy grows at much modest rates. So, in terms of impact on the global economy, a smaller percentage of a much larger Chinese economy can compare favorably with a higher percentage of a much smaller Chinese economy.

Second, if you have only ten dollars and asked to make 10% a year, it is not that difficult. But when you have $11.2 tn (size of China's economy in 2016, bigger than the rest of the BRICS countries combined), growing at 6% a year would propel it to overtake the US economy by 2028.

Third, GDP growth is not everything. China has started to switch gear towards a higher-grade, all-inclusive, more balanced growth, embracing domestic consumption and quality of life.

President Xi Jinping has set three strategic goals for his second five-year term—reducing systemic internal risks (social, economic and financial) and external risks (geopolitics), targeting poverty relief and creating a greener China.

For 2018, the emphasis is not on sheer growth, but on deleveraging, growing an innovative economy and responding to an external anti-China backlash.

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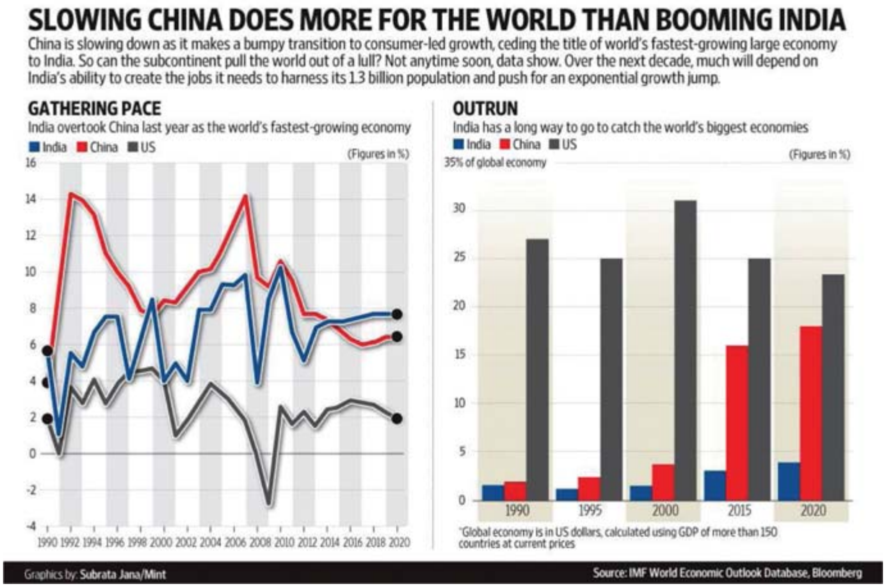


Let us first look into debt. Both the IMF and rating agency Moody raised the alarm bells recently. China's ratio of debt to GDP stands at 258%. It is on track to reach 288% by 2021, compared to the global total of 189% for emerging economies.

However, according to the CIA Annual World Fact Book of June, 2017, Japan tops the list of countries highest in ratio of debt to GDP at 234.7%. The top 23 most-indebted include European countries like Greece, Italy, France, Spain, Belgium and the United Kingdom. China is conspicuous by absence.

Apart from different metrics, the apparent contradiction is largely due to the fact that an overwhelming proportion of China's debt is incurred by local governments and State-Owned Enterprises (SOEs). Even though home mortgage debt has been rising rapidly, gearing is extremely low by international comparison. Householders would be extremely lucky if they get a mortgage loan of more than 50% of the purchase price. Much larger loan portfolios are incurred by local governments and SOEs. These are mainly underwritten by the central government with huge financial reserves and state assets. What is more, China has virtually no external debt. If anything, China is the world's largest external creditor.

Another distinguishing feature is that much of the local government and SOE loans is often recycled back to the largest state-owned banks as deposits. This enables them to earn high interest spreads and acts as a cushion against exigencies.

According to the People's Bank of China, at the end of 2014, total bank deposits amounted to some \$19 tn while total loan book stood at \$14 tn. 45% of the bank deposits represented personal savings, while 50% came from enterprises. Thus, China is in a curious situation where, contrary to most other countries, the total loan book is much smaller than total deposits.

Therefore, while China's debt problem is mounting, it is more a reflection of an immature and distorted financial system. Nevertheless, this spells gross inefficiency of capital utilization. Moreover, it also poses systemic risks and remains a bottleneck to economic growth.

As for deleveraging, since 2015, China has been embarking on what is known as "supply-side reform". This aims at cutting (industrial) overcapacity, de-stocking (property inventory), corporate deleveraging, lowering business costs, and ameliorating "weak links" in the economy. While there has been substantial de-stocking in say, the steel industry, over-capacity still remains an albatross on the economy.

At the 19th Party Congress, President Xi launched a vision of "New Era socialism with Chinese characteristics". This embodies the "Two centenaries" goals for the China dream of national renaissance: by 2020, becoming a "moderately well-off society" just ahead of the China's Community Party's 100th anniversary and by 2050, becoming a world power able to play at the center stage, shortly after the People's Republic of China's 100th anniversary.

With worsening demographics despite revision of the one child policy, these goals are unlikely to be achieved without a quantum leap in technology and innovation.

The following technological developments highlighted in Hong Liu's *Chinese Business – Landscapes and Strategies* (Routledge, 2018) are instructive.

China lags far behind in breakthrough scientific research. Chinese science Nobel laureates are rare. But the nation has made quantum strides in applied R&D, which is what usually matters for business.

According to the World Intellectual Property Organization, in 2014, China filed 2.7 million patents, more than those from the next three sources—US, Japan and Europe – combined. In 2015, Huawei led the world with 3,898 applications under the Patent Cooperation Treaty. These compared with Qualcomm's 2,442 applications in the US. Huawei has maintained the top global slot since 2013.

China's innovation capacity is supported by anecdotal evidence.

China has developed the world's fastest supercomputers—the Sunway and Tianhe—with speeds far exceeding those of competitors, including the US. In 2016, China also overtook the US in installed supercomputing capacity. On August 16, 2016, china launched the world's first quantum satellite. Strategically, the country is working to boost its computing power tenfold within the next couple of years. The plan is for a new generation of exascale supercomputers capable of one billion billion calculations per second.

Although quality and sophistication may not necessarily be comparable, Chinese scholars produced 193,733 Science Index Citation papers in 2012, a five-fold increase in ten years. This output is supported by the world's largest cohort of R&D personnel. In 2012, this numbered 3.247 million, accounting for 29.2% of the world total, compared with Japan's 7.8% and Russia's 7.5%.

This human capital is derived from an annual output of seven million university graduates, including 300,000 doctorates.

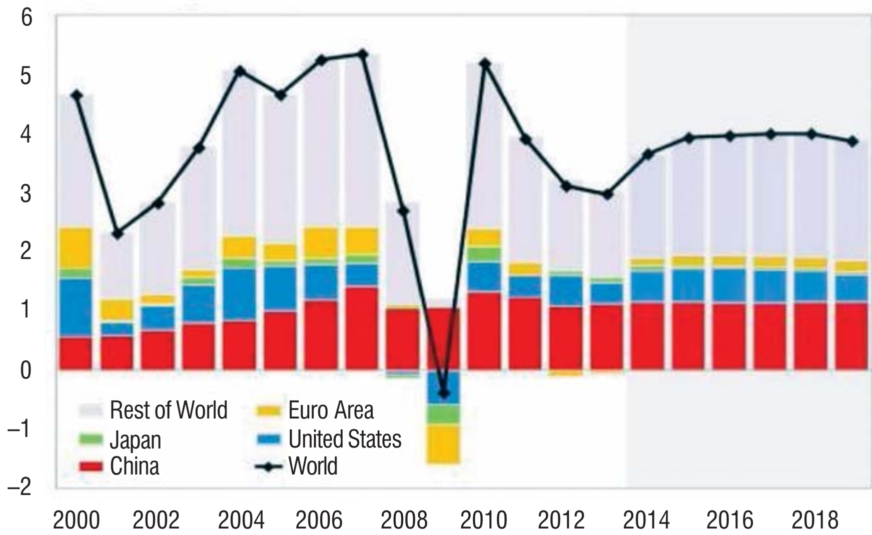
China has 115 university science parks and more than 1,600 technological business incubators, housing some 80,000 enterprises with 1.7 million employees.

What really stands out in Chinese innovation is ubiquitous digitization, manifest in e-commerce, e-payments and e-financing.

A McKinsey Global Institute report of December, 2017—Digital China: Powering the economy to global competitiveness - shows how:

- China accounts for 42% of global e-commerce—more than France, Japan, the UK and the US combined.
- Mobile payments are used by 68% of China's Internet users, totaling $790 bn last year—11 times more than the U.S.
- China's venture capital industry has exploded from $12 bn in 2011–13 to $77 bn, or from 6 to 19% of the worldwide total in 2014-16. China is leading the US in fintech venture investment.
- The BAT companies—Baidu, Alibaba, Tencent—account for 42% of the venture funding in China, compared to 5% provided in the US by the FANG companies—Facebook, Amazon, Netflix and Google.

Contribution to Global Growth (in %)



Source: IMF

Nevertheless, while China leads the world in digitized commerce, the US industry is 3.7 times more digitized than China, although the gap has rapidly narrowed from 4.9 times in 2013.

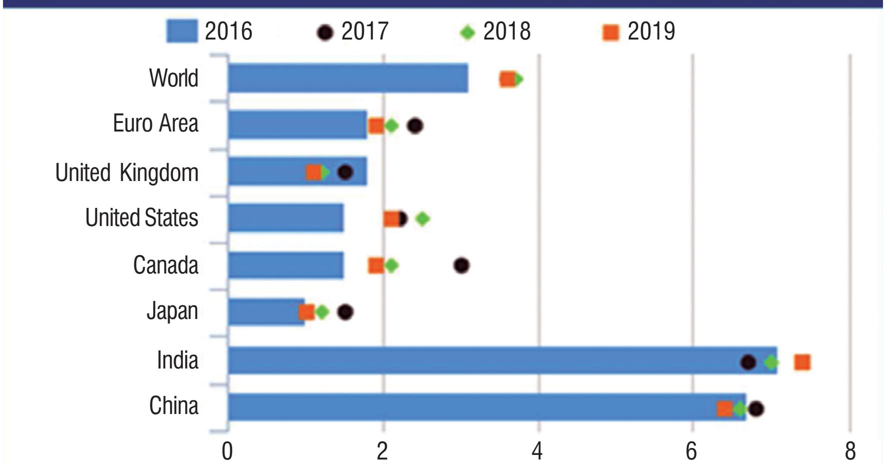
For now, the US still remains far ahead of China in venture investment in areas like Artificial Intelligence (AI), Big Data and robotics. However, it is noteworthy that China's State Council has approved a three-stage national AI development plan that aims at global dominance in the sector by 2030, capitalizing on the country's vast population database and financial incentives to lure talents.

Meanwhile, the BAT companies—the leaders among China's Disrupters— are rewriting the rules of business in China and beyond. Jack Ma, the founder of Alibaba, had President Trump's ear vaulting to help create one million American jobs selling US products and services to China on the Alibaba e-commerce platform.

The above tectonic shifts creating a "Middle Kingdom of Cyber Space" offer a virgin soil for many foreign businesses, both inside and outside China, from consumer brands, lifestyle products and services, pharmaceuticals to healthcare.

China is taking giant steps to become even more global. A massive

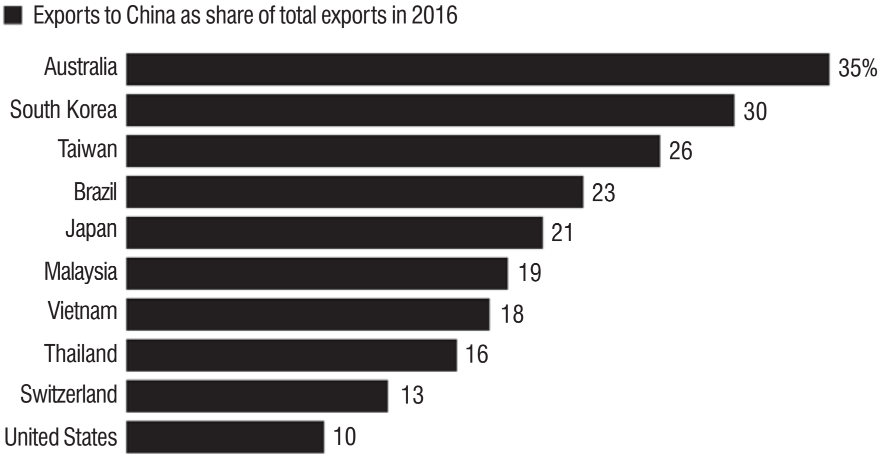
Global Growth Continues
(Real GDP % Change, Year-on-Year)



Source: OECD Economic Outlook, Volume 2017, Issue 2.

Exposed to China

China's import slowdown in 2018 will hurt some more than others



Swiss exports may be distorted by commodities trading, which does not necessarily lead to actual shipments.

Source: Bloomberg

game-changer to connect the world is China's inter-continental Belt and Road Initiative (B&RI), designed to link policy, infrastructure, trade, finance and people-to-people with 64 countries, representing 62% of the global population and 30% of the world's GDP.

Supported by China's financial wherewithal, and partnering with the Asian Infrastructure Investment Bank (AIIB), the New Development Bank, and B&RI countries and enterprises, the grand initiative's potential investment is expected to reach $5 tn, many times the size of the Marshall Plan after the Second World War. Investments of some $900 bn have already been committed.

Connected to the B&RI in Asia is the national strategy to create a fully-connected Greater Bay Area (GBA) comprising the entire Guangdong Province, and the two special administrative regions of Hong Kong and Macao. The GBA has a combined population of 66.72 million and an aggregate GDP of $1.37 tn, analogous to the New York and Tokyo bay areas. A 55-kilometer-long bridge connecting the three areas is expected to become operational later this year.

Apart from economic growth, the environment is becoming an increasingly pressing socio-political imperative. Across the nation, there is a race among party secretaries to build the next best "green" or "smart city". The country is already leading the world in solar, wind, and hydropower energies. As China is now the world's largest car market, vigorous push is also being given to the vision of leading the world in New Energy Vehicles (NEVs). Conventional fuel cars are to be entirely phased out by 2025.

Needless to say, these developments will open up many opportunities for trade and investments as well as related professional and small and medium-sized businesses and services both locally and worldwide.

An important part of China's galloping global economic footprint is Africa, where there are numerous resource, infrastructural and other business projects and businesses across the continent. These are supported by a million Chinese resident immigrants.

The continent is the world's largest untapped food basket and is considered the world's second fastest-growing region by the IMF.

According to a McKinsey Global Institute report of September 2016, Lions on the move II: Realizing the potential of Africa's economies, by 2034, the continent will have the world's largest work force of 1.1 billion, more than China or India. Meanwhile, it is witnessing the world's most rapid urbanization, with 24 million urbanites added each year from 2015-45. Household consumption is expected to grow by 3.8% p.a. to $2.1 tn by 2025.

Manufacturing output is to almost double from $500 bn to $930 bn by 2025. This is mainly to meet domestic demand as Africa currently imports one-third of food, beverages and processed goods consumed.

Technological change is accelerating. Penetration of smart phones is expected to rocket from 18% in 2015 to 50% by 2020. East Africa is now the global leader in mobile payments. E-commerce in Nigeria doubles each year since 2010. E-learning is also taking off, for example, in Mauritius.

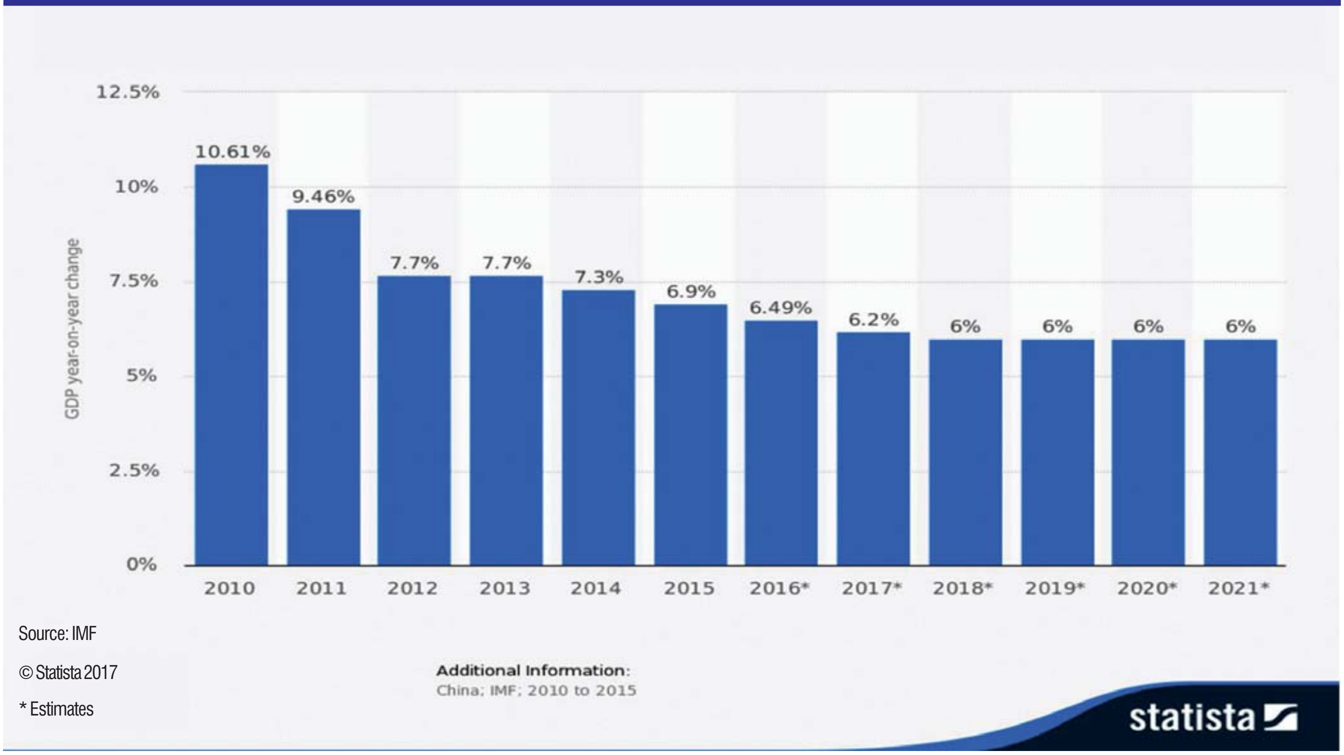
Of all foreign investors, as Africa's largest trading partner, China is perhaps sui generis in capacity-building and influence projection. In exchange for resource extraction, China has been building more schools, hospitals, power plants, railways, highways and bridges. These have served Africa well. The rise of Sub-Sahara Africa in recent decades bears testimony.

However, despite improvements, China's engagement with Africa remains tainted with corporate governance deficits, ecological neglect, decimation of indigenous informal economy, harsh treatment of local employees, and perceived domination. Howard French's China's Second Continent: How a Million Migrants Are Building a New Empire in Africa is instructive.

In coming decades, how China succeeds in promoting international goals, principles, and values in Africa would mean as much for Africa's developmental trajectory as a test of China as a Great Power.

Indeed, an anti-China backlash is becoming more noticeable across the

China: Growth Rate of Real Gross Domestic Product (GDP) from 2010 to 2021



Source: IMF

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* Estimates

globe. Apart from certain African countries, China's main trading partners, particularly the US and the European Union, are starting to take a more assertive stance against what they perceived as China's unfair mercantilism.

On the eve of the first China-US Comprehensive Economic Dialogue in Washington DC in July, 2017, Vice Premier Wang Yang made clear that China had been restructuring its economy, now much less driven by investment and export. The contribution of final consumption to economic growth jumped from 47 % in 2013 to 77% in the first quarter 2017. During the same period, services relative to GDP increased from 46.7 to 56.5%. China's current account surplus relative to GDP dropped from a peak of 10% in 2007 to 0.7%. Policy directives have been issued to promote greater opening of the services sector, leaving only 63 industries under restriction, 117 fewer than in 2011, an improvement of 65%. Limited licenses have been issued for foreign enterprises to conduct underwriting and settlement in China's interbank bond market.

However, the process of liberalization is perceived to be too little, too late. Moreover, perceived "unfair" practices and issues remain, such as insufficient reciprocity, demand for intellectual property sharing, and leakage of technologies critical to national security.

A new report China at the Gates: A new power audit of EU-China Relations complied by the European Union for Foreign Relations suggests a more "realist" and robust approach to relations with China, demanding more reciprocity and tighter screening of Chinese investments. These sentiments are also evident in the US and Australia.

Outlook

In sum, China's astronomic rise during the past decade or so is shaking the world, as presaged by Napoleon.

2018 is the opening year of President Xi's second term. He is acknowledged as the strongest and most strategically-minded leader China has ever had since Chairman Mao. Fresh from consolidation of his powers at the 19th Party Congress, at a time of seismic shifts in global power dynamics, he is unlikely to let slip this "new era" of opportunities by scratching the surface of long-awaited meaningful reforms.

So we are likely to see deepening of China's structural economic transformation, tackling the root causes of internal and external economic, social and political risks, achieving real breakthroughs in poverty relief, significant strides towards a more technology-savvy, innovative and green future, and the continuation of an assertive and perhaps more nuanced foreign policy.

According to Graham Allison, even at a lower growth rate, in 2015 China's economy created a Greece every 16 weeks, and an Israel every 25 weeks. But the China in 2018 will be very different from earlier times. Bountiful business opportunities worldwide are likely to be had not so much by fixating on more of the same trodden paths, but on emerging vistas and changing dynamics. ■

Reference # 20M-2018-01-10-01