

# China: The Impact of Domestic Policy on the Future of Global Trade

In its push for industrial expansion, China has released a flood of cheap manufactured goods onto the world market and thereby challenged the global economic order. We test the sustainability of China's business model and what effect it will have on the country's economy.

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## About the Author

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Securities (Asia) Ltd., and Senior China/Hong Kong Economist of The Economist Intelligence Unit Ltd. Mr. Chan received his M.Sc. degree in Economic Forecasting from Leeds University and B.Sc. (Hons) in Applied Economics from East London University. In 1998-2000, he was appointed by the HKSAR Government as an Adviser to the Central Policy Unit (CPU). Location: Hong Kong.

# China: The Impact of Domestic Policy on the Future of Global Trade

Over the past decade, China's rapid industrialization has had a profound impact on world trade. In its drive to supply the world, China has helped push down the price of finished goods, while its enormous appetite for raw materials has helped push up and sustain the prices of energy and commodities.

This double threat—"downstream deflation" combined with "upstream inflation"—has squeezed the operating margins of foreign manufacturers, forcing many of them to either relocate or outsource production to China in order to remain competitive. It has also helped build profits for corporations and others that have invested in China. Will the next 10 years be anything like the past 10 years? Is China likely to continue its current economic strategy?

## When It Started: Deng Xiaoping's Economic Reforms

When Deng Xiaoping launched China's Open Door Policy in 1979, his aim was simple: to raise China's standard of living in the aftermath of the Cultural Revolution by making the economy more attractive to foreign investors. Deng probably never dreamt that in little more than two decades it would help make his country the factory to the world.

Foreign companies saw Deng's economic reforms as an opportunity to profit from a consumer market that was not only totally new to them, but also huge—China's population crossed the one billion threshold during the 1980s—and growing fast. China appeared to be an El Dorado, a golden opportunity for massively expanding their global sales. According to popular lore, shoe manufacturers aimed to sell an additional two billion shoes simply by selling one pair to each person in China.

In reality, the policy played out very differently from what anyone had anticipated. While Deng's reforms opened the economy to foreign capital, they

also liberated China's homegrown capitalist talent. Chinese-made home appliances and other electronic products—likely to be followed in the not-too-distant future by Chinese cars—are building market share not only in the developed world but, increasingly, in developing markets as well. And today China's textile and garment exports are the targets of a protectionist backlash within the US and European markets.

Statistics illustrate the scale of China's impact. In 1997, Chinese finished-goods exports averaged about US\$10 billion a month. In 2007, the figure was close to US\$80 billion—an eightfold increase. Imports of raw materials have grown nearly sevenfold during the same period, from US\$3 billion a month to US\$20 billion (*Display 1*).

Display 1

## Exports of Finished Goods and Imports of Commodities Have Risen Together



Source: CEIC Data and AllianceBernstein

### High Consumption, Low Prices

For everyone—from the consumers and commodity producers benefiting from China’s emergence, to the foreign manufacturing firms without access to its production base—the critical question is: how sustainable is China’s business model? In our view, China’s economic fundamentals are such that, in the absence of external pressure to change, its current business model will be maintained.

China’s model, in essence, consists of high energy and commodity consumption and low-priced goods. For example, today the country consumes about 25% of global commodities (such as steel, copper, and iron ore), but accounts for only about 6% of global nominal GDP, as shown in *Display 2*. In the absence of exogenous shocks, there appear to be few incentives for China to consume energy and commodities more efficiently and increase production value-added more quickly. If China continues on this path, its impact on the world economy could become even more dramatic over the next 10 to 20 years.

Indeed, China has powerful incentives to maintain its current model, as we shall see. The main risk, in our view, is a potential economic backlash that could even escalate to a trade war between China and major Western economies.

### KEY CONCEPTS

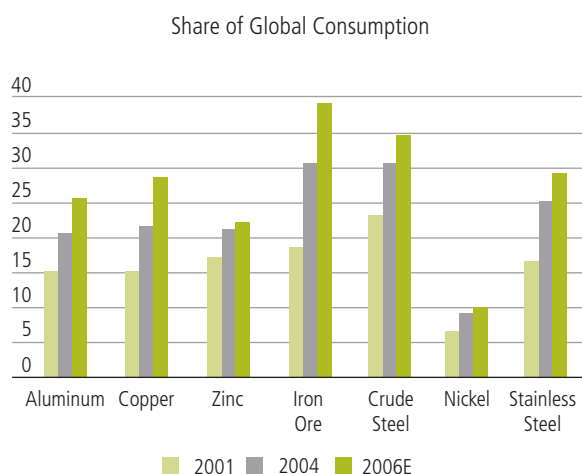
- China is experiencing a massive population migration from rural areas to urban centres with higher-paying jobs
- China will continue to push down the prices of finished goods, while sustaining the high prices of energy and commodities
- Despite the threat of a protectionist backlash from the rest of the world, China is likely to continue to expand its industrial capacity
- We expect the decline in world prices and manufacturers’ operating margins to persist for another decade at least. ■

### The Long March to Urbanization

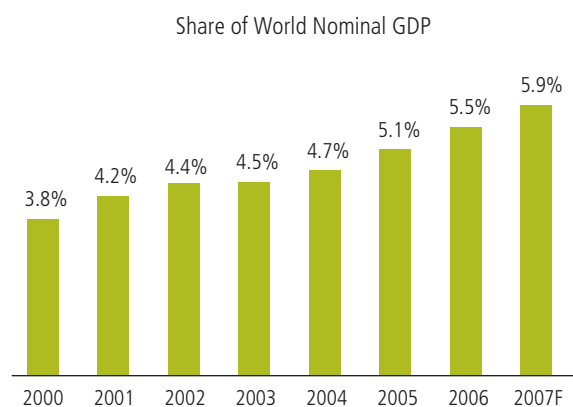
After thousands of years as a predominantly agrarian society, China is rapidly becoming more urbanized. The combination of low agrarian wages and the lure of better-paying jobs in the cities is causing a massive redistribution of China’s population of 1.3 billion. From 1996 to 2006, 122 million rural inhabitants—an average of 11 million a year—moved to the cities. Indeed, no other country in history has witnessed migration from the country to the city on such a scale.

Display 2

#### China Consumes About a Quarter of Global Commodities...



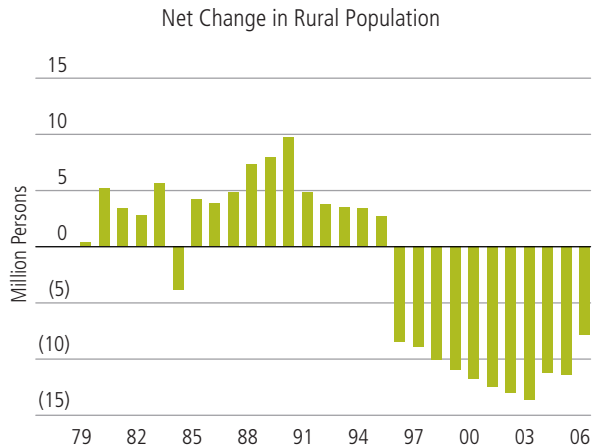
#### ...yet Produces Only 6% of Global GDP



Source: Deutsche Bank Global Commodity Research, International Monetary Fund (IMF), and AllianceBernstein

Display 3

**Although Rural Migration Is Unprecedented...**



Source: CEIC Data and AllianceBernstein

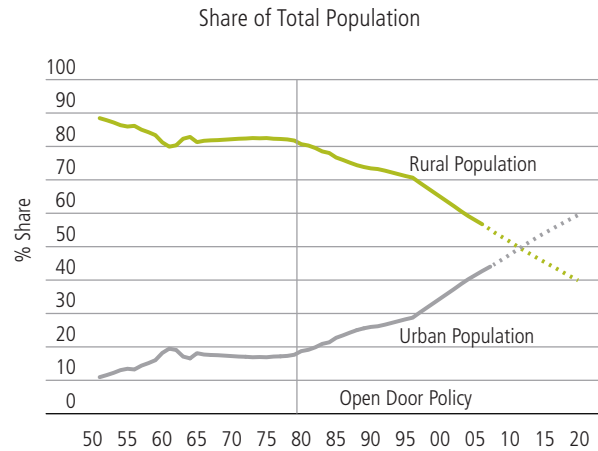
But the rural population still accounts for 55% of the total—a far higher proportion than in such neighbouring countries as South Korea, Taiwan, and Japan, where less than 10% live on the land. This relative imbalance is unlikely to change soon: even if the country’s rural exodus were to accelerate to 15 million a year, 40% of the people would remain on the land in 2020 (*Display 3*).

The urban migration has led to great income disparities between farm and city families. The average household income in the industrialized east is three times that of the more rural west—and the gap is widening, further encouraging the urban migration. China’s leaders must create enough jobs in urban areas to absorb this continuing influx—or risk social and political instability. In the next 10 years, in fact, China needs to create 69 million new jobs just to support its working-age population. Therefore, China must—and will—expand its industrial capacity rapidly at all costs.

**China Lags the World in Energy Efficiency**

China’s expansion will doubtless keep its appetite for energy and commodities enormous. Its energy use has accelerated sharply, with its share of world consumption jumping to about 15.5%, far higher

**...40% of the Population Will Still Be Rural in 12 Years**



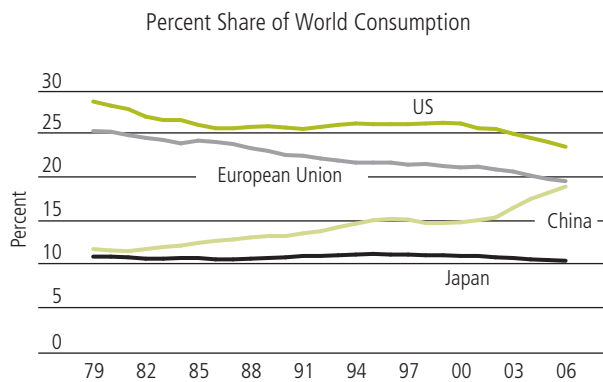
than Japan’s and close to that of the European Union (*Display 4, following page*). Unfortunately, China isn’t using the energy it consumes very efficiently. Although the country made solid energy-efficiency improvements during the 1990s, the investment boom has eroded them. According to our estimates, China brought up the rear in terms of world energy efficiency in 2006, being 3.5 times less efficient than the US. Even if it managed to improve efficiency dramatically, it would still rank near the bottom.

**Corporate Strategy: Expansion, Not Profit, Is the Key**

The sharp increase in investment and industrial growth in China highlights the country’s unique perspective on corporate profitability: growing the business and increasing market share are the highest priorities; profits come second. This stands in marked contrast to a market economy, where fiscal prudence eventually dictates that business lending to companies with low profits be scaled back. However, China’s business model is unlikely to change for one simple reason: its future under that model is promising. China’s potential for industrial development is enormous. In fact, the recent surge in wages and land prices in a few highly developed eastern regions is sending just the right market signals to Chinese factories: to

Display 4

### China Consumes Almost as Much Energy as the European Union



Source: BP Statistical Review of World Energy 2006, CEIC Data and AllianceBernstein

maintain their competitive edge, they must start to relocate to lower-cost regions, where the labour supply is abundant and the vast rural countryside underdeveloped.

#### Why Banks Won't Pull the Plug

Thus far, China's government-controlled banks have supported the expansion of low-profit companies, with no apparent attempt to scale back expansion in favour of profits. Beyond a certain threshold, of course, this low-margin bubble may burst. But a fully market-oriented banking system has yet to be developed in China: state banks—which account for about 70% of banking system assets—remain heavily influenced by government directives.

If the bank loan market were to run into trouble, China's leadership would face a tough choice between righting banks' balance sheets and preserving or creating jobs. On the whole, we think that job creation and social stability would take precedence and that any shortfall on banks' balance sheets would be remedied by an injection of public funds. The pressure to create 69 million new jobs in the next 10 years will remain intense, and the incentive to reduce production capacity in labour-intensive industries will be small.

#### Policy Choices and the Protectionist Backlash

The main threat to China's ability to maintain its high-growth, low-margin business model is the potential for a protectionist backlash from other countries. The US and other Organisation for Economic Co-operation and Development countries have seen their jobs and manufacturing plants move to China—and they've seen their domestic markets flooded with cheaper-priced Chinese goods. As China's industrial revolution continues, this situation will likely become more pronounced. If China maintains its current policy, it risks a trade war, a deceleration of the globalization process, and a decline in world trade, all of which could pose a serious threat to China's export-led economy.

To confront this threat, China could decide to bow to external pressure and "revalue" its currency—the renminbi—more quickly, strengthening it versus other currencies. In theory, if this were to happen rapidly, it would increase China's purchasing power overseas, thereby encouraging domestic consumption, decreasing a massive balance-of-trade surplus, and boosting GDP. A stronger currency would also encourage Chinese manufacturers to start focusing on producing higher-quality, high-end goods, and would help enlarge the growing services sector.

#### Obstacles to Revaluation

Although speeding up the pace of currency revaluation and creating a consumption-driven economy makes sense for China in theory, a number of huge obstacles remain—making this course of action unlikely. While China's nominal GDP (estimated at US\$3.3 trillion in 2007 prices) ranks among the world's highest, the country's per capita GDP remains among the lowest—about US\$2,500 at current prices. This is 17 times lower than the per capita GDP of the US, 14 times lower than that of Germany and Japan, and six to seven times lower than that of South Korea and Taiwan. Even if a currency revaluation made the renminbi twice as valuable in relation to the US dollar, the Chinese consumer's purchasing power would still remain small. Further, not only are the Chinese low wage earners, they are low spenders. China's

consumption-to-GDP ratio, which was about 36% in 2006, is low by international standards.

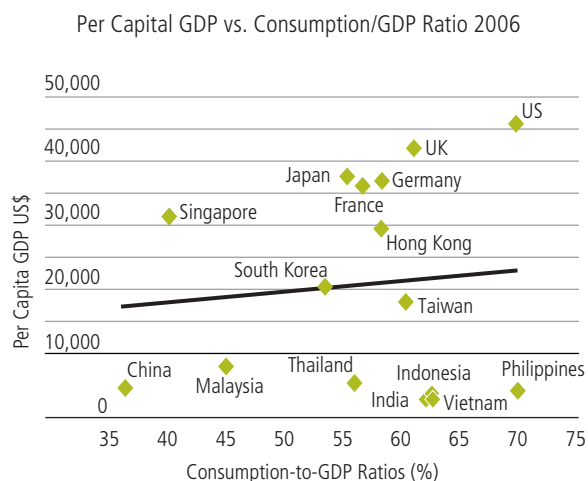
Low income and high savings are seen in few other countries, and the fact that they coincide in China helps explain the country's low consumption-to-GDP ratio. In industrialized countries such as the US, the UK, Germany, France, and Japan, as well as in certain advanced Asian economies like Hong Kong, South Korea, and Taiwan, the correlation between per capita GDP and consumption to GDP tends to be high and positive—that is, the more people earn, the more they tend to spend (*Display 5, top*). The correlation between consumption-to-GDP ratios and savings rates tends to be inverse—that is, the more people spend, the less they tend to save (*Display 5, bottom*). The high consumption-to-GDP ratio (70%) in the US, for example, is the result not only of its superior income per capita, but also its extremely low savings rate (about 13.5%). In order to boost consumption, China needs to both reduce the savings rate and boost income. The real challenge will be to lower the savings rate while accepting the harsh reality that raising the income-per-capita levels of China's huge population will take several years.

A stronger Chinese currency would also make China's goods more expensive in foreign markets, which would pose a huge threat to the country's low-profit manufacturing businesses. While the price of the energy and commodities that these businesses import from abroad would drop, that would not be enough to make up the difference. On balance, we think it unlikely that China will opt for aggressive revaluation of the renminbi. Instead, we expect it to continue to pursue its high energy consumption, low-margin business development model, even at the risk of retaliatory action from other countries.

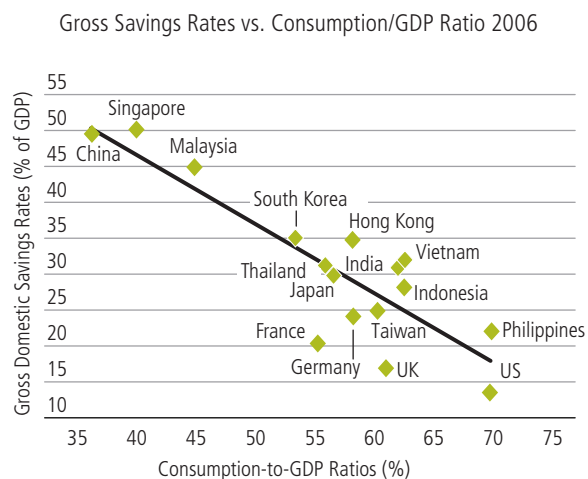
**Our View:  
China Will Continue to Push Down Prices**

China's role as factory to the world is unlikely to diminish—in fact, it will become more pronounced as the country's economy develops, and its far-reaching effects on the world economy will become more entrenched. China will continue to push up

Display 5  
**China's Consumption is Constrained by its Low Per Capital Income...**



**...and Exceptionally High Savings Rate**



Source: Asian Development Bank, CEIC Data, IMF, and AllianceBernstein

energy prices—and push down prices across a wider range of manufactured goods. As a result of the model's success, however, a number of developments will follow. For example, the push now being seen across the industrial base toward the manufacture of higher-margin goods is likely to raise China's per capita income, helping to create a consumer class large enough for multinationals to seek to target. This would be an important driver for the expansion of the services sector, although

such growth would probably be concentrated in the major cities, not evenly distributed nationwide.

The development of the country's interior will increase. Some domestic Chinese companies are already leading the production shift inland, and a small but growing number of foreign firms are following them. In our view, China's industrial sector will become more diverse as a result. The developing hinterland will become the focus of the country's low-margin, volume-oriented manufacturing base, allowing production capabilities in the industrialized east—where skilled labour and quality infrastructure and logistics are readily available—to be upgraded.

The transformation will resemble that of Japan and Southeast Asia during the 1980s. It will also have similar consequences. For example, whereas China's growth as a global production centre over the past two decades has been achieved entirely through borrowed technology, the emergence of higher-margin businesses will serve as a catalyst for research and development, as well as for original product design. As a result, the quality and sophistication of the goods exported will rise. China is ramping up its production capacity, and we expect the decline in world prices and manufacturers' operating margins will persist for another decade at least. ■

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