

Corporate Network

China: the business outlook

Part one:

International and domestic strategic Issues

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China and global strategic issues (1)

- The world is interconnected and China is part of it
- Consider the following two points:
 1. Zhu Rongji was asked in 2001 what is the biggest international threat to China? He replied, “Any economic downturn in the US”.
 2. In January 2007, Iran became the number 1 oil supplier to China
- The following scenario presents itself:

If the US wanted to launch an attack on Iran, China could oblige the US to desist by saying, “If you launch an attack on Iran, this will disrupt our oil supply. We command you not to do this. If you do so, we will announce that we plan to pull out some/all of our \$900bn assets in the US and your dollar and economy will crash”.

China and global strategic issues (2)

- That is fine and accurate: China does hold the whip hand
- But equally any major collapse in the US would badly damage the Chinese economy and create economic and social turmoil
- Hence the power that China holds over the US is qualified
- Equally talk of US and China going to war over Taiwan is pure reverie
- Future tensions over Taiwan or elsewhere will be resolved diplomatically
- China and US economies are so tied together that neither can nor will damage the other
- In fact though, when the US economy falls 1.0%, China's GDP falls only 0.3%

China and global strategic issues (3)

- Which is not a big chunk out of 10% annual average growth
- So perhaps China can do without the US more than the US can do without China
- Intergalactic, geo-political threats, military scenarios and war games take a back seat to economics and business
- And there lies a tale
- Lee Kwon Yew, former Singapore prime minister, summed it up well:
 - “I believe the Chinese leadership has learned the lesson that if you compete with American armaments, then you lose. You will bankrupt yourselves. So, avoid it, keep your head down, and smile for 40-50 years”.
- Excellent words of wisdom and he could have gone on to say, “smile for 40-50 years... all the way to the bank”.

China and global strategic issues (4)

- Russia would do well to follow this advice too
- Power in the 21st century will not be through military might and nuclear weapons
- Power will come from energy and pipelines (Russia) and trade/financial dominance (China)
- These countries and the Arab world will also use their strategic Sovereign Wealth Funds...
- ...to buy more assets in the West which will further link the major markets together
- The current China success story was built on the premise of low military spending
- In 1978-79 Deng Xiaoping initiated reforms with liberalisation in agriculture

China and global strategic issues (5)

- But it is less well known that the major facilitator behind this reform through the 1980s was the slashing of defence spending
- Deng saved on defence to divert funds into agriculture and then industrial manufacturing
- China's booming economy today is based on that policy
- Deng though had the political authority and personal prestige to bully the generals into line
- While he did this in 1980s, the US was throwing billions at Star Wars and the USSR was crippling itself with armaments expenditure
- Deng was the architect of reform and improved the conditions for hundreds of millions of Chinese—he deserves credit for this visionary thinking

China and global strategic issues (6)

- He was also the first Chinese CP leader to encourage trade with Taiwan in 1979
- The current Chinese leadership does not belong to the revolutionary generation and has less sway over the military
- Hence why military spending is picking up - but still at moderate, bearable levels
- The military needs some toys to play with, such as to raise the stakes over Taiwan, in order to boost the defence budget
- A very strong Taiwan lobby in Washington also stirs things up
- But US and China will not resort to military conflict over this
- Ties between China and Taiwan also proliferate
- Already in 2005 Taiwanese exports to China exceeded those to US, Japan and Europe combined

China and global strategic issues (7)

- One million out of a total 23mn Taiwanese now live, work, go to school or get married in China
- Appears that economic/social links get closer, while Taiwanese internal politics drift away from closer political links
- But this “circle will be squared”
- The good news is that there is a strong consensus within the Chinese leadership
- After Tiananmen Square in 1989 regime used increased nationalism as a tool for validation
- But since 2000, it is trying to back-track on this
- To act as a good neighbour in Asia and to defuse relations with Japan

China and global strategic issues (8)

- Again business links supersede political ones
- Intra-China-Asian trade has grown twice as fast as world trade in the last 5 years
- China is the number one trading partner for Taiwan, Japan, south Korea and Vietnam and usually number two for others
- Tranquil foreign relations is epitomised in the 2002 policy of “Peaceful Rise”
- This was wittily summed up by the Chinese State Information Office Head, Zhao Qizheng, who said:
 - “The “Peaceful” bit is for foreigners; the “Rise” is for us”.
- China acts as a “responsible power”, a “status quo” power

China and global strategic issues (9)

- China's key foreign policy goals in summary:
 1. Officially—to make Japan apologise for war atrocities (while maintaining good trade and political relations)
 2. Bringing Taiwan back into the fold (but without resorting to military activity. The Straits crisis in the 1990s did not serve China well and they learned a lesson)
 3. Make the US treat China as an equal partner (after the century of humiliation from the West 1850-1950)

China and global strategic issues (10)

- None of these is a breaking point issue
- Foreign affairs takes a back seat to domestic policy or is indeed a tool of domestic policy
- Managing China's evolution is the biggest challenge for the West in the 21st century
- At a time when adverse economic and international trends make US more protectionist
- Competition for resources especially oil and in Africa will prevail
- But China is often cooperating with India to share oil acquisitions
- US more insecure as China searches for more Asian region allies and global influence

China and the global economy (1)

- China is crucially important in the global economy
- Holding almost one trillion dollars of US assets, China has kept the dollar afloat for last 5 years
- Curiously China started to buy big into US assets after the 9/11 attack on the US
- Since 9/11 the US has been distracted in Middle East and Iraq, and has kept its eye off China
- Thus China sought to gain financial influence over US while it was distracted
- Osama Bin Laden saved China from closer US scrutiny!

China and the global economy (2)

- China was the major contributor to weak global inflation in 2000-07 by selling products at cheap prices into developed markets - this was the so-called “China price”
- Allowing western central banks to keep interest rates low
- Western consumers then had more money to spend on consumer goods rather than on mortgages
- The re-invested savings of Chinese peasants on \$5 per day allowed the nouveaux riches in Milan and New York to buy more flat screen TVs at \$18,000
- All western manufacturing companies saw their profits rise by
 - selling to China
 - sourcing from China
 - or selling to western consumers who had more discretionary income

China and the global economy (3)

- Rising inflation in China combined with lower productivity is one of biggest global threats today
- Because it means China would become a significant net exporter of inflation
- In 2007 for first time Chinese export prices to US rose by 2-3%—this is not much, yet
- But if this rose and was sustained, it would be a dangerous stimulant to global inflation
- China already accounts for much inflation thanks to surging commodity prices on the back of Chinese consumption

China and the global economy (4)

- China is also the major explanation for the decoupling of emerging markets from a weaker US economy in 2007-08
- Emerging market/Chinese exports to the US slowed in 2007 and will do so again in 2008
- But China and other emerging markets are selling more to each other
- And also seeing domestic demand take up some of the slack from weaker exports
- In 2007 for first time China exported more to other emerging markets than to the US
- But the converse is that in 2007 for the first time emerging markets bought over 50% of US exports

China and the global economy (5)

- The weaker dollar has made US products more competitive and the emerging markets are buying them
- The trade links between the US and emerging markets are still critical to global business
- These recent trends show that emerging markets are taking up the slack from developed markets

Free trade and the West (1)

- Free trade was an excellent idea in Western eyes from 1776 until about 2000
- But this was bogus: in fact markets such as the US, the UK, Japan and South Korea have been some of the most protectionist in history
- Since 2000 when developed markets have been more on the back foot, free trade and open markets are still good...
- ...but only when foreigners don't want to get in on the act
- When the Chinese and Indians are come along expecting a level playing field and open markets ...
- ... the West has virtually said, "Don't be so bloody naïve. Open markets are for us, not for you".

Free trade and the West (2)

- From 1776 the West wanted to get into the Chinese market and didn't care about the Chinese coming out because they were so weak
- From 2000 the West still wants into China but the Chinese can only come out on our terms
- If the Chinese want to buy low-yielding US treasury bills to support the dollar, they are very welcome
- If they want to export their capital and buy into western companies, then they are not welcome
- The Chinese minister of commerce has a point when he complains of "EU non-tariff barriers on Chinese textiles from a poor country with per capita income of 4% of the EU".
- By the way, what the hell is the EU doing producing textiles in the 21st century anyway!

Free trade and the West (3)

- The Chinese are moving up the value curve as well in response to barriers
- This happens in IT, but also in ladies' bras
- In 2002-03 China was the largest supplier to the US of bras with a market share of around 43%
- Tariffs were imposed by the US on low-quality Chinese bras
- In response China started university courses in bra manufacturing and introduced higher quality bras...
- ...and took over the high-priced US bra market instead

Strategic domestic issues (1)

- China is not a communist society; the term communist is a fig-leaf for the communist party
- Social and income inequality is now one of highest in the world
- The Chinese state laid off 25mn workers after the 1997 Asian crisis—the state knows how to be as brutal as any capitalist corporation
- China is a successful corporate statist model (like Russia but with even less democracy)
- The only social democratic part of the world left is in areas of western Europe
- China is a success story, a successful model (so far)

Strategic domestic issues (2)

- There are three fundamental and interlinked regime goals:
 - generate rapid economic growth
 - ensure political stability at home
 - ensure peace abroad
- Economic growth buys off political dissent and keeps the middle class and peasants happy
- The authorities fear a coalition of dissatisfied urban middle class, peasants and students, which threatened in 1988-89,
- Strong growth keeps unemployment at bay and raises wages
- Regime is happy to bang nationalist drum at home when it suits them for regime legitimacy
- But tranquil foreign relations helps economy and domestic stability in China

Strategic domestic issues (3)

- The party has bought off the rising middle class
- The message from the Chinese communist party is straightforward: **stick with us and we will make you rich in a strong China**
- Economic growth and control of army and police keep party in power
- If party falters with growth then a more nationalist assertive regime could result
- China has a tiger by the tail and the tiger is itself

Strategic domestic issues (5)

- On one hand, the current system has major pluses:
 - this corporate statism serves many hundreds of millions well
 - not easy to envisage other model which could provide so much growth and relative stability
 - would a Western democratic system work in China or threaten chaos and regionalism?
 - turmoil of unfettered markets and currency could plunge tens of millions back into abject poverty
 - western ignorance and self-interest is reflected in the argument over revaluing the renminbi
 - revaluation would suit US but could possibly plunge China into banking or agricultural crisis

Strategic domestic issues (6)

- On the other hand, this Chinese attempt to marry party-state with the market brings problems in its wake:
 - rampant corruption
 - weak R&D and absence of global Chinese players
 - waste of resources
 - environment degradation
 - soaring inequality
- A bankrupt communist party is inconsistent with:
 - pluralism of opinion
 - security of property
- The party is looking to find a new role in the future, but for now it is buying time
- Is it a dysfunctional hybrid? How sustainable is this model?

Strategic domestic issues (7)

- What may sustain it all is the huge drive of the Chinese people
- Much of their entrepreneurship of the past is now unfettered
- Huge advances have been made by hundreds of millions of people and they will not relinquish them
- They will accept the “guidance” of the communist party and accept some limitations, but there is no going back
- Likelihood is that neo-liberalism will take further hold in the cities in the next decade and party will see its authority erode
- This potential vacuum in the system is when political risk could peak
- For now domestic politics have been taken out of the equation as the huge majority want to be left in peace to make money
- Global surveys indicate that the Chinese are the most optimistic people in the world about their future

Strategic domestic issues (8)

- The CP leadership stays in power and buys time with:
 1. Buying off the middle class
 2. Co-opting the business class into the CP
 3. Buys off internal CP dissent (sadly) via corruption—unhappy officials can make themselves happy by stealing from the state
 4. Ensuring strong economic growth of at least 10% to stave off unemployment
 5. Keeping citizens happy with a modicum of nationalism without being externally aggressive abroad
 6. Retaining threat of big stick and keeping the army onside by increasing defence spending
 7. Allowing some steam off through the press and internet despite some censorship

Strategic domestic issues (9)

- Extreme poverty rate (\$1 per day) has shrunk remarkably: down from 16% of population in 2001 to 5% in 2007
- But that still means 70mn on \$1 per day and about 350mn people on \$2-3 per day
- Inequality is rising sharply; China is one of the most unequal societies in the world now
- The countryside is changing
- Of 500mn rural dwellers, only 100mn are engaged in agriculture!
- The other 400mn rural dwellers are either un/under-employed or artisans or mostly commuters to the towns and cities

Strategic domestic issues (10)

- In the last 10 years, 150mn (half the US population) have migrated to the cities
- But not all is change in the countryside
- 500 women commit suicide every day in China—often because they become the property of their mother-in-laws when they marry
- China accounts for over 55% of all female suicides in the world

Strategic domestic issues (11)

- China becomes the world's largest emitter of greenhouse gases in 2007-08 ahead of the US
- It is the largest emitter of mercury into the atmosphere (600 tonnes—25% of world total)
 - Mercury found in the atmosphere over Boston, Mass, USA, has been traced back to factories in Shanghai !
- China is promoting an automobile policy to satisfy consumers/ the middle class
- In 2006, China added the equivalent of California's entire energy generating capacity, and 90% of this was coal-fired
- China is already the world's largest coal producer. The point is: if the Chinese were to come close to consuming per capita as much as the Americans then all the world would choke to death on smog (just after the oil price peaks at \$463 per barrel)

Strategic domestic issues (12)

- Most over-arching of risks is whether the Chinese CP is able to adapt...
- ...the political super-structure to the economic and social foundations of society
- And in doing so, come to grips with rampant corruption among the elite
- The thing not to throw away is that since the massacre in Tiananmen Square 16 years ago...
- ...this is the longest spell of political, social tranquillity in Chinese history since 1949 or even 1911

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