China in the 21st Century: The birth of a new trade empire

For the rest of the planet, China is at once a symbol of menace, opportunity and danger

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It’s a well-known secret: the world has undergone tremendous changes over the past decade. International economic and political circles have been considerably shaken up. The end of communist regimes, the opening of borders and the foundation of new supranational institutions are all good examples.

The new phenomenon of globalization has scarcely begun as many developments and advances will only become apparent in the context of another fifty years. This is particularly true of numerous emerging economies, such as China.

“Let China sleep. For when she wakes, she will shake the world.”

Napoleon Bonaparte, 1816

The world’s “factory”

The development of China is unprecedented. Economic growth has been, on average, 9% per year since the beginning of the 90s. After Japan, Hong Kong, Singapore, Taiwan and South Korea, China has got into step with Asia’s economic catch-up, but at a pace and on a scale never seen before.

China is already the world’s largest consumer and producer of raw materials and, after the United States, its economy attracts the largest number of capital investments. In December 2001, it became the 143rd Member State in the World Trade Organization (WTO). With a population of 1.3 billion inhabitants, two-thirds of whom still live outside urban centres, China and its neighbour India (1 billion inhabitants) are by far the planet’s most populous countries.

China embarked on capitalism at the beginning of the 80s. Under the rule of Deng Xiaoping, it developed trade and industry mainly by attracting foreign investments in order to broaden its technological base. Xiaoqing and his allies implemented a pragmatic policy of economic reforms and gradual opening to the outside world, while still maintaining a political dictatorship. But it was only in 1992 that China officially launched itself into a market economy. Then, in 1997, with the reintegration of Hong Kong, came new economic reforms: privatization of State businesses, establishment of mixed national/foreign corporations and new measures designed to contend with international competition.

Today, by its size and the advances in its trade, China is among the world’s big economies and, given the pace things are moving at, the Chinese economy will outstrip that of the United States, currently Number 1, in less than
40 years. Nonetheless, considering per capita GDP, China is way far behind, in 138th place worldwide, with an annual average income of only US$900 per inhabitant. Furthermore, income distribution is still sharply unbalanced while the human rights situation continues to be regularly denounced by international organizations.

The Eldorado of the 21st Century?

China’s economic and, especially, trade importance has increased greatly over the last 20 years. In fact, China’s advances in world trade are highly impressive. Chinese exports in 2003 already represented more than 6% of world exports. The increased role of China in world trade comes from dizzying economic growth, huge investment efforts, production capacities that are still largely untapped, gains in market share due to low production costs and high productivity, and a vast need to catch up.

Economic growth and direct investments by foreigners are obviously stimulated by very low wage costs. China’s average hourly wage is about 50 cents US, or 3% of American manufacturing wage. The huge pool of workers outside urban areas, nearly 400 million people, will keep wages very low in the Chinese manufacturing industry, which is concentrated mainly in the large centres, for many years to come—if not several decades. Additionally, the absence of other expenses (linked to regulation, the environment, security, etc.) for Chinese businesses compared with businesses in the industrialized countries allows China to produce for much lower production costs.

The low costs and cheap labour will allow China to win even more market shares in most manufacturing sectors, to the disadvantage of other emerging countries, particularly Mexico and Brazil, and, most of all, of the industrialized countries, where costs are distinctly higher.

The yuan is undervalued

For several months, the Chinese currency, the yuan, also often called renminbi, has regularly made the headlines. The renminbi, which means literally “people’s money,” has been the object of international pressure for re-evaluation, i.e. a par value or a higher level for the currency relative to other currencies. Due to China’s low costs of production and the vast reservoir of labour, many fear that it may cause even more deflation for the rest of the world, while gaining larger and larger shares of the market on the international game board.

The maintenance of a fixed parity between the yuan and the US dollar for several years, in spite of the divergence of rhythm between the Chinese and US economies, has been brought back into question. On the one hand, the growth cycles between China and the United States are far from being synchronized, which disadvantages many countries dealing with weak economic progress. On the other hand, given the strong growth of the Chinese economy, the yuan, which has already become the main currency in developing Asia, is seemingly kept at a rate that is too low for its true value. The yuan’s current resistance to movement seems in some ways to be limiting the international monetary adjustments that several economic regions desperately need.

Since the middle of the 90s, the Chinese currency has been tied to the US dollar at the fixed rate of 8.27 yuan to 1 US dollar, with a daily fluctuation range of more or less 3 one-thousandths. Many industrialized countries, mainly the United States and the countries on the European continent, claim that China’s considerable trade surpluses with the industrialized nations and the large direct foreign investments in the country since the end of the Asian crisis, are very visible signs that the yuan is currently undervalued.

The United States trade deficit with China recently exceeded 100 billion US dollars. At the beginning of the 90s, the deficit was barely 10 billion dollars. China also has large trade surpluses with most other industrialized countries, and even recently moved Japan into second place among the importing countries in Canada.
The United States will have a trade deficit of more than $US150B with China in 2004

So a change in the exchange system is probably unlikely in the short term. On the other hand, a considerable widening of the yuan’s fluctuation range currently appears to be the most likely quick-fix solution, while a re-evaluation of the exchange rate (the interim solution) appears less probable for the time being.

The broad widening of the fluctuation range, even if it were to lead investors to speculate on the rise of the yuan, would give companies and banks the time to adapt to the change and allow development of an exchange market as well as a regulatory framework. Together with the widening, the Chinese government could also reduce certain tariffs and barriers to importing foreign products into China and decrease assistance to Chinese exporters.

Little change in the short term

For the Americans particularly, China does not play according to the game rules of international trade. The low level of the yuan gives it too great a competitive advantage. Even more so in that, for the majority of industrialized countries, the average depreciation of the American dollar of about 15% over two years against a basket of currencies makes Chinese products even cheaper in those countries. Moreover, the production of increasingly sophisticated products by the Chinese is worrying manufacturers in the industrialized countries. From that perspective, many are calling for a sharp re-evaluation (between 30% and 50%) of the yuan as soon as possible or even the introduction of floating system based on market forces.

The Chinese economy is in overdrive mode. In this respect, the risks of excess liquidity and over-investment are increasingly present in many sectors—the real estate industry especially. The economic boom that the 2008 Olympic Games in Beijing and the 2010 Universal Exposition in Shanghai will bring about will only amplify the phenomena. A decrease in the trade surplus brought about by a change in parity would be harmful to many of China’s present and future needs. For the Chinese authorities, internal priorities will probably win out in the short term over international pressures. Stability and social calm remain the greatest challenge for the world’s most populous country. Remember that the unemployment rate is still high at more than 11%. Moreover, it could even rise under the effect of structural reforms required to free up the economy.

It must also be remembered that the fixed parity between the yuan and the greenback has encourage the Chinese to invest in assets written in American dollars, especially in bonds and Treasury bills. Chinese companies that export to the United States receive greenbacks that they convert in their commercial banks, through their central bank. The large reserves of the People’s Bank of China, the Chinese central bank, are then used mainly to purchase American financial equities, which are issued to finance the federal government’s deficit. By force of events, China has rapidly become the world’s third largest owner of American bonds. These massive purchases contribute to keeping interest rates low in the United States and, by ricochet, are aiding the economic recovery south of our border. In the short run, a much higher value for the yuan would reduce the purchase of US financial equities by the Chinese and, likely, be harmful to the US economic recovery.
Another solution might also come to light, which would be to determine the value of the yuan according to a basket of major currencies such as the euro, the yen and the American dollar. Determining value in this way would reduce the pressures associated with inverse fluctuation as is currently the case for the currencies selected to be in the basket and allow a broader diversification of currency reserves for China. There again, however, such a system will not spring up overnight.

Even with large international reserves of foreign currencies, China’s economic awakening will soon lead investors, speculators and the financial markets to indirectly put the yuan under heavy... positive... pressure! Sooner or later, there will have to be a re-evaluation of the yuan, but everything points to this not occurring in 2004.

Second, there still exist too many inefficient State businesses, too closely controlled by political managers. Lack of transparency as well as corruption are still largely omnipresent in the Middle Kingdom.

Third, there is the large risk of a backslide in economic growth. This slipping might come from the fact that the level of life in China is increasing too rapidly the demands for democratization and could lead to political instability. The unbalanced distribution of wealth and the near absence of social programs are large problems, particularly in the context where public debt is sharply accelerated due to the costs related to structural reforms and by the existence of deficiencies in the tax system. The authoritarian Chinese regime could be shaken up by a rapid move toward democratization and by a resurgence of social tension. Contrary to the Russian experience of the 90s, Chinese authorities opted for rapid development, but with prudent and gradual policies. An economic backslide and political destabilization might risk instigating a retreat to the classic Chinese policies, as has often been seen in the past.

Conclusion

Without pursuing modernization of its economic and political systems as well as greater democratization, China will not be able to rise to the rank of a great industrial world power. Don’t forget that the one-child policy will brutally reduce the working population around 2020 at the same time as a rapid ageing of the population begins. Strong economic growth will slow abruptly and it will then
be its neighbour, India, that will take its place as the most promising emerging country.

For foreign investors, China represents an investment opportunity, but also a considerable risk due to its government’s lack of transparency. The current small size of the financial markets in China is also a risk that investors must take into account. Between now and the full freeing up of the economy and financial markets as well as greater openness on the part of the Chinese authorities, foreign investors must stay on guard and remain wary of the Chinese miracle.

All in all, in spite of its recent economic and trade successes, this new economic empire still has a long way to go. So China remains a great power that is weak… for the moment. Many questions about how it will evolve in the future will go unanswered for a long time to come.

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Footnote:

1 For the time being, India seems to be seriously behind. On the average, its inhabitants have lower incomes and are less well educated than China’s. The opening up to trade and foreign investment is less strong in India, while it has a less sophisticated industrial base, is smaller and is experiencing moderate growth. India is developing through a service-based strategy, including exportable services. On the other hand, for many, over time India might just turn out to be the tortoise in the old fable, and China, the hare. Thanks to its spirit of entrepreneurship, the quality of its higher education system and its democratic tradition, India might become the most promising emerging country within little more than a dozen years.