CHINA IN THE GLOBAL ECONOMY

MEMO FROM BEIJING AND CHONGQING, JULY 2011

BRIEFING

Will Straw
with Alex Glennie

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An IPPR delegation including Lord Peter Mandelson and Tristram Hunt MP visited Beijing and Chongqing from 27 June 27 to 2 July 2011. Will Straw, IPPR Associate Director for Strategic Development, reports on the experiences and findings of the visit.

The scale of China's economy and its growth are well documented but worth repeating. China has grown at around 10 per cent a year for 32 years and now boasts the world's second-largest economy. In terms of purchasing power parities, it may overtake the United States by 2016. In 2009, China contributed 18 per cent of global growth, compared to 14 per cent from the United States. The country is now the world's largest exporter of goods and the second-largest importer.

But despite these extraordinary figures, China is not complacent about the challenges that it faces. The recently published 12th five-year plan makes clear that China's development is 'unbalanced, uncoordinated and unsustainable' – a point emphasised to us at several points on the trip, not least by Wang Qishan, Vice-Premier in charge of economic, energy and financial affairs, who is tipped to join the nine-person leading Standing Committee in 2013. Key to addressing this is a rebalancing of China's economy towards domestic consumption, which currently stands at 35 per cent of GDP, and away from an over-reliance on net exports and investment.

To some extent this process is already underway. David Li, Director of the Center for China in the World Economy (CCWE) at Tsinghua University, told us that China's trade surplus was likely to be just 1.5 per cent of GDP this year, compared to a record high of 7.5 per cent in 2007. This is partly due to a combination of nominal exchange rate appreciation and higher inflation, which means that the yuan is rising by about 10 per cent per year. Meanwhile, the termination of China's $586 billion stimulus which began in 2008 will reduce investment levels.

Lord Mandelson with Vice Premier Wang Qishan

Addressing China's big issues

But despite this progress, China faces many challenges. Chief among these is inflation. Prices were rising at an annual rate of 6.4 per cent in July (a three-year high) and threaten to erode rises in living standards, which are critical for the regime's legitimacy among its people. To deal with this, interest rates were raised in July for the fifth time since October while the bank reserve requirement is 20 per cent. That said, Liu He, a senior economic advisor to the governing Standing Committee of the Communist Party of China and architect of the five-year plan, told us that the nature of the inflation did have an upside. He pointed out that nearly half the inflation was due to wage increases affecting domestic demand. However, he did acknowledge that there were groups which had not benefitted from this, notably university graduates who, without adequate skills, have not seen an increase in wages in the types of jobs for which they are applying.

David Li said that China's burning issue was its housing bubble. Earlier this year it was reported that 64 million Chinese apartments were lying empty while residential housing investment has trebled in the last decade as a share of GDP. Liu He echoed this point and attributed the bubble to four factors: urbanisation, increases in the money supply, increased wealth at the top of society driving investment into domestic property, and local government reliance on land sales for income. But he added that leverage rates were not nearly as big as in the United States in the run-up to their housing bubble.

In relation to its capital markets, China is cautious about further liberalisation. Yu Hongjun, Vice Minister of the International Department, told us that China's 'prudent' approach had prevented the worst impact of the financial crisis. He said that this prudence would continue in relation to reducing credit restrictions until the financial crisis was over. One impact of this has been that many small businesses have been struggling to get credit and going to private lenders instead. As a result, China's credit market has been described by some experts as 'chaotic'.

Another issue – and one of tension within the Chinese administration – is the future of the country's state-owned enterprises (SOEs). As of 2010, China had approximately 114,500 SOEs, including both centrally and locally administered enterprises. But while this overall number is falling (from 159,000 in 2003) the significance of China's biggest companies are rising. From three in 1995, China now has 46 companies in the Fortune 500, third-most of any country in the world. Of these, 40 are SOEs.

A senior government advisor described these state monopolies to us as 'terrible' and called for more competition in most sectors. He said that the opportunities for small businesses were reduced because SOEs hoovered up capital, and noted that the five-year plan included 36 items to help develop the private sector – including proposals to 'expedite reforms of large SOEs [and] deepen the reforms of monopoly industries' – but that these were proving hard to implement. Joel Ruet, a French Visiting Scholar at the CCWE, described the Chinese economy as a 'competitive oligopoly' and described a power game taking place between those SOEs controlled by central government and those controlled at the local level.

In contrast to these concerns, we were given a rosier view at a meeting with officials from the State-owned Assets Supervision and Administration Commission (SASAC). Bai Ying, the Deputy Director General for Bureaucratic Planning and Development, told us that SOEs would be the backbone of the economy and become world-class enterprises by 2015. She rejected the idea that they were 'privileged' and said that the Chinese market was 'completely open' to the outside world, listing a narrow range of opportunities for EU companies, including in wind and solar power.

Yu Hongjun offered another perspective suggesting that private enterprises were being encouraged in the electricity and energy sectors but that in other 'dominant' areas like aviation and transport the state would retain its role. David Li gave a more prosaic view, suggesting that because SOEs were not currently causing problems they were not being reformed. For example, he suggested that reform of the large state-owned banks would only happen if and when smaller banks in rural China started to eat away at their profitability. Chen Taotao, director of the International MBA programme at Tsinghua University, said that SOEs had some strengths, including the internal discipline to do R&D. This, he said, was resulting in some technological developments, not least in the work that was being done with regard to mining in Australia.

The final concern we discussed was China's reserves. At just over $3 trillion, China has the largest accumulation of foreign exchange reserves in the world and more than the EU27, Japan and Russia combined. Indeed, China accumulates roughly $1 billion per day in reserves. David Li said that China was looking for the world's understanding in its need to invest overseas. He pointed out that China had a need to diversify away from US Treasuries – which make up $1.15 trillion of their reserves, meaning that the country had to acquire foreign shares or make direct investments.

China's social policy

China's five-year plan has a clear set of social objectives. It says:

> **'We will strive to raise the proportion of national income distributed to the general public, and raise the proportion of the primary distribution of income that goes to wages … We will standardise the way income is distributed, strengthen the role of taxes in adjusting the distribution of income, effectively regulate excessively high incomes, and strive to reverse the trend of increasing income disparities between urban and rural residents, between regions, between professions, and between members of society.'**

In reality this may prove harder to achieve. The difference in fortunes between China's rural and urban populations is stark. Almost half (49.7 per cent) of China's population is now in urban areas. This is expected to rise to 75 per cent by 2050. But although over 600 million Chinese have been lifted out of absolute poverty since 1978, 500 million people still live on less than $2 a day. Indeed, the average salary in rural China is just one-sixth of the average in the urban areas of the east coast. But many of China's 220 million migrant workers face a form of social apartheid due to the *hukou* system, which tends to tie social benefits to an individual's original place of residency.

Alongside the issue of income distribution, China is also creating a social safety net. But Professor Haifeng Wang, Director of International Economy at the Institute for International Economic Research, said in our roundtable discussion at Tsinghua University that the government had failed to reform the social sector over the last 20 years, which meant that it would now be expensive to make the necessary reforms in education, pensions, health and social security system at the same time. This suggests that the timeframe required to deliver a universal safety net may be long.

Because of these difficulties, China should be supported in its efforts to increase middle class wages and put in place a proper social safety net, since these measures will have implications for imbalances globally as well as within China. The logic is that these reforms will reduce China's reliance on savings and increase domestic consumption and imports. This in turn will help further reduce China's trade surplus, slow the accumulation of foreign reserves and help to rebalance the global economy.

Another aspect of China's social policy, which we saw particularly in Chongqing, was an increased focus on quality of life. Bo Xilai, the party secretary of the province, was clear that there had to be more to prosperity than material riches. He told us that:

> **'[Y]oung people should have other goals outside of making money. They should be encouraged to contribute to the progress and goals of their country.'**

While he has been criticised by some for appearing to revive old Communist rituals, he defended himself as someone trying merely to improve the wellbeing of those living in his province.

Bo's 'five Chongqings' programme is a key part of this. The city government has spent close to ¥20 billion on improving its roads, railways and light rail to reduce commuting times (Convenient Chongqing), planting hundreds of trees (Forest Chongqing), developing sports and medical facilities (Healthy Chongqing), providing new public rental housing (Liveable Chongqing), and driving an anti-corruption and crime crackdown (Safe Chongqing).

Model of planned developments in Chongqing, Minxin Jiayuan public rental houses

Opportunities for Britain

The second part of our trip – to the fast-growing city of Chongqing – provided us with an opportunity to consider the opportunities in China for British, and indeed European, businesses. An essential element of China's rebalancing strategy is a desire to move China's production from the coastal regions of the east to the centre of the country. Chongqing is critical to this effort. In 1997, Chongqing became China's fourth directly-controlled municipality after Beijing, Shanghai and Tianjin. It is thought to be the fastest-growing city in the world, with 500,000 new arrivals every year by some estimates. Economic growth last year was a staggering 17 per cent. Over the last five-year period, the city met its energy intensity target and reduced its energy use per unit of GDP by 21 per cent.

Chongqing sits on the Yangtze River so has easy, navigable access to the South China Sea. A railway to Europe has recently been completed, passing through Kazakhstan and on to Rotterdam in 13 days (but much longer for cargo, which has to stop at several border check points). The city's airport will be the fourth-largest in China by 2015, handling 60 million passengers per annum.

The party secretary, Bo Xilai, was clear about Chongqing's role in driving Chinese growth. He told us that if the last 30 years had been about the development of coastal China, the next 30 years would be about the development of central and western China, and he described the economic development of Chongqing as his 'priority among priorities'.

Central to this is the Two Rivers New Zone, which is inland China's first national-level development zone after Pudong in Shanghai and Binhai in Tianjin. Weng Jieming, who heads up the project, talked us through the zone's plans and said that there was a 'big space' for cooperation with the UK. Chongqing has been an automobile hub for many years but is developing specialisms in laptop production and cloud computing. Although 40 per cent of the world's notebooks are currently built in Shanghai, it is anticipated that the majority of this production will move to the Chongqing and Chengdu areas over the next three to five years. Perhaps surprisingly, these changes are not being resisted by


Lord Mandelson with Chongqing Party Secretary Bo Xilai

Shanghai's political leaders or business community, who want to move away from low-value manufacturing and towards the provision of services.

The picture is not all rosy, however. Although better than its BRIC-bloc counterparts Brazil, India and Russia, China is 79th on the World Bank's 'Doing Business' rankings, with a number of barriers to business entry. Chief among these is the protection of intellectual property rights: while enforcement has improved, not least because of the concerns raised by Chinese companies concerned about theft of their own IP, concerns remain, particularly around whether the same rules are applied in relation to foreign firms. One European businessman who had been active in China for over 30 years told us that there was a conflict of interest because China needed to own its own technology in order to continue to grow. But earlier at Tsinghua University, David Li had pointed out that German companies were most self-confident about partnering with Chinese companies because they 'keep innovating' and were therefore less concerned about patent infringement.

A young British entrepreneur based in Chongqing told us that the greatest barrier to doing business that he faced was cashflow and difficulties in planning, given that Chinese clients often delayed payments for months. A lack of a skilled local workforce was also noted.

However, despite these concerns, there was a clear message from the businesses that we met that European firms should not hold back. A representative from the British Chambers of Commerce in south west China noted that it is currently much easier to set up a business in China than it was even a few years ago, when foreign companies were only given preferential treatment if they were willing to invest huge sums of money. Now, the government is more accommodating and has more money to spend on attracting and retaining businesses. Hewlett Packard provides an illustrative example (see boxed text over).

Getting into the country and building up relationships and expertise would more than make up for the slow start that businesses would face. British competitive advantages in financial services, business services, market research and creative content were all raised. Britain can also benefit from exports without any goods or services leaving the UK. In 2009/10, there were 95,000 Chinese students in the UK but this is the same proportion as British students studying in China, so there is clear scope for expansion. Meanwhile, 57.4 million Chinese travelled abroad in 2010 – but while Germany is poised to enter the top 10 of foreign destinations for Chinese tourists, Britain languishes in 22nd place.

Case study: Hewlett Packard in Chongqing
Alex Glennie, Research Fellow

Hewlett Packard (HP) has been present in China since the early 1980s and established China Hewlett Packard in 1985. It has seen a massive expansion of its operations in Chongqing since choosing to locate a major laptop manufacturing base there in 2008 – the first of its kind in inland China. The factory makes 1 million notebooks every month and will produce 18 per cent of the world's laptops by 2013. This base, which became operational in 2010, sits in the Xiyong Complex to the west of central Chongqing, and is home to a number of original equipment manufacturers (OEMs) which carry out the labour-intensive manufacturing work for HP and other technology companies. The complex also includes a logistics park, a hi-tech industrial park and an integrated urban area, with housing and entertainment facilities.

Jason Ortega, a senior Commodity/Project Manager for HP, told us about the factors underpinning the company's decision to establish a significant base of operations in Chongqing. The most critical of these is the strong relationship HP enjoys with the local government, which aims to transform Chongqing into the biggest manufacturing and trade centre in western China – or as Ortega put it, 'the Chicago of mid-western China'. As part of this drive, it has established a 'Comprehensive Bonded Zone' (CBZ) in the vicinity: this is a special customs supervision area that provides tax-free facilities and other incentives for enterprises, which HP has taken advantage of.

Factory floor, Hewlett Packard complex, Chongqing

HP has gained other benefits from its close ties to the government, including the establishment of a bonded road for the transport of its products to the railway station and Jiangbei International Airport, the construction of an extra runway in response to a request from HP, the provision of a stable power supply (in a region that suffers from significant electricity shortages) and substantial infrastructure investments. Ortega commented on the irony of US and European complaints about the unfair subsidies China offers to its own companies, while failing to acknowledge the incentives that it also provides for international businesses like HP.

Other benefits of operating in Chongqing include relatively lower wage costs – wages are typically one-third of those in Shanghai – and a greater predictability of labour supply. Companies in coastal cities like Shanghai tend to suffer high rates of turnover, with many workers going home for holidays and failing to return. But the situation in inland cities like Chongqing tends to be better because of the large pool of workers located in surrounding areas who want to work close to their families.

BOXED TEXT CONTINUED

There are a number of challenges associated with working in Chongqing, notably a lack of local employees with a hi-tech background and experience of IT manufacturing. But Ortega thought that these difficulties would be overcome as educational facilities improved, pointing to the creation of the 'Chongqing Education Town' neighbouring the CBZ as evidence of the government's commitment to develop local expertise and skills.

Finally, Ortega observed that Chongqing was a 'greenfield' for IT manufacturers. Because IT is a new industry for the area, there is currently a very open environment for the constellation of industries and businesses that surround it. But he warned that, as the area becomes more developed, these advantages would not last for long, providing a clear message to British businesses interested in developing their China operations.

Attitudes to global institutions

The G20

China's leaders appear positive about the role of the G20, which they regard as a more representative and legitimate grouping than the G8. Yu Hongjun said that coordination had been a 'very good experience' and that China had come to realise its importance.

The official position – as expressed to us by Vice-Premier, Wang Qishan – is that the conditions are not yet right for the G20 to have its own secretariat. Both he and Liu He told us that the G20 had to prioritise strong global growth and that it would need to wait for a global recovery before taking on a wider and more institutionalised role. Wang Qishan also expressed frustration with the French desire to increase the number of agenda items, including the creation of separate G20 agriculture and labour ministers meetings. As a rule, he said that issues discussed at the UN or one of its organisations should not be discussed at the G20.

But at a roundtable discussion organised by the International Department's Research Center for the Contemporary World (RCCW) we heard some ideas about how the G20 could be reformed. One speaker suggested that the G20 needed a secretariat to arrange meetings and summits. She even recommended that the G20 could develop a new, central committee of seven systemically responsible countries: the United States, China, Japan, Germany, France, India and the UK. The rationale would be that any country with a GDP (using PPPs) greater than 5 per cent of global GDP would be included. It should be noted, however, that using IMF figures, only the United States, China, Japan and India (plus the EU as a single economic unit) have more than 5 per cent of global GDP on a PPP basis. The presence of Britain and France might also be disputed, since Russia has a larger economy than either. Another speaker proposed that a secretariat would contribute to the 'institutionalisation' of the G20.

International Monetary Fund (IMF)

Asked why China was not more willing to offer someone to lead the IMF, speakers at the roundtable said that conditions were not yet right for Chinese leadership, but that the IMF head after Lagarde might well be Chinese. This point was reinforced by the appointment days after our trip of Zhu Min as deputy managing director.

Doha

All the Chinese experts we spoke to were positive about the role that trade had played in China's growth and were concerned about rising trade barriers. Nonetheless, they appeared somewhat passive about the failure of the Doha round. Wang Yuan from the Development Bank of China attributed the stalled negotiations to changes in the global economy. David Li from Tsinghua University made the interesting point that China did not have the 'thinking capacity' to take a more prominent stance on the Doha negotiations. He explained that it was this lack of capacity, rather than a lack of willingness, that prevented China from adopting a global leadership role more commensurate with its economic power.

Wang Qishan told us that China felt it could do business with the UK but was concerned about the European Union's attachment to agriculture subsidies and the United States' refusal to open up manufacturing. He did, however, say that China supported World Trade Organisation Director-General Pascal Lamy's proposal for an 'early harvest' while expressing scepticism on whether the United States would support this route.

Development and climate change

In relation to development and climate change, we were told at the RCCW roundtable that developed countries had a responsibility to increase aid, particularly to underdeveloped countries, and to share low-carbon technologies to avoid environmental degradation.

Annex: List of individuals consulted

Yu Hongjun – Vice Minister of the International Department of the CPC

Kong Genhong – Deputy Director General of China Research Centre for the Contemporary World

Xu Yongguan – Director of the General Office for the China Research Centre for the Contemporary World

Shao Zheng – Director of the Translation/Interpretation Unit, International Department

Mou Hong – First Secretary, China Research Centre for the Contemporary World

Zhao Zhenhua – Director General of the Department for Economics, Central Party School

Wang Yuan – Chief Economist of the China Development Bank Corporation

Bi Jiyao – Deputy Director of the Institute of Foreign Economic Policy, Academy of Macroeconomic Research

Chen Fengying – Director of the World Economy Institute of China's Institute of Contemporary International Relations

Liu He – Head of the Office of the Central Leading Group for Finance and Economics

Bai Ying – Deputy Director General, Bureau of Planning and Development

Xu Aibo – Deputy Director General, Bureau of Foreign Affairs

Jia Like – Division Chief, Bureau of Planning and Development

Fang Zhigang – Deputy Division Chief, Bureau of Policies, Laws and Regulations

Shan Wenbing – Deputy Division Chief, Bureau of Research

Zhang Nengzi – Program Coordinator, Bureau of Foreign Affairs

Deng Weiqiong – Program Coordinator, Bureau of Foreign Affairs

David Li – Director of CCWE

Zhao Zhongxiu – Dean to School of International Trade and Economics, University of International Business and Economics

Hu Biliang – Dean to School of Economics and Resource Management, Beijing Normal University

Joel Ruet – Visiting Fellow at CCWE

Wang Haifeng – Research Director of International Economy, Institute of Foreign Economy, National Development and Reform Commission

Zhou Nianli – Associate Professor of WTO Institute, University of International Business and Economics

Song Hong – Research Director of International Economy, Chinese Academy of Social Sciences

Li Yong – Vice-Chairman of China International Trade Association

Weng Jieming – Director General, Two Rivers New Zone

Li Xingming – Deputy Director General, Two Rivers New Zone

Hao Ming – Director General of Chongqing FAO

Bo Xilai – Communist Party Secretary, Chongqing

Jason Ortega – Commodity/Project Manager, Hewlett Packard

Paul Sives – General Manger of Proton Products and Chairman of European Chamber of Commerce in Southwest China

Eric Lin – Public Affairs Director of Lafarge

Ulrich Birch – General Manager of Jiangjin Turbo Systems

Mike Zhang – General Manager of BP

Alistair McMahon – Director of BioRegional

Sam Priestman – Director of Priestman Architects

Wang Yi – Director General of COFTEC

Gao Wen – Director, Foreign Affairs Division, COFTEC

Jin Lei – Director, Business Division – agriculture, light industry, COFTEC

Hu Ji – Director, Business Division – advanced engineering, COFTEC

Li Qian – Director, Business Division, COFTEC

Li Haiming – Director, Business Division, COFTEC

Yan Xiaoqing – Director, Business Division – chemical and medical industry, COFTEC

Tim Hsu – General Manager, Chic Group

Zhang Bulin – General Manager, Qiaoya Electronics

Liu Keija – Assistant President, Carpenter Tan

Wang Nongcheng – Deputy President – Chongqing Machinery and Electric Co. Ltd.

Xu Sheng – Deputy Director, European Division, FAO

Chen Demin – Executive Vice-Chairman of Chongqing University Affairs Council

Zhao Chenping – Dean of International Cooperation and Exchange, Chongqing University

Wang Xu – Dean of College of Trade and Public Administration, Chongqing University

Pu Yongjian – Assistant Dean of Sustainable Development Research Institute, Chongqing University

Long Yong – Assistant Dean of College of Economics and Business Administration, Chongqing University

Liu Yulin – Assistant Dean of College of Trade and Public Administration, Chongqing University

Yin Xinguo – Associate Professor of College of Trade and Public Administration, Chongqing University

Lin Yong – Assistant Dean of Development Research Center, Chongqing University

Lin Jian – Associate Professor of Sustainable Development Research Institute, Chongqing University

Chen Litai – Associate Professor of College of Trade and Public Administration, Chongqing University

Wang Rui – College of Trade and Public Administration, Chongqing University

Fu Quiang – Director of the Export-Import Bank of China, Chongqing