Dysfunction/Stagnation in Advanced Economies and China: Challenges and Opportunities

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The outbreak of the global financial crisis in 2008 was mainly due to the dysfunction in advanced economies. And the aftermath of the GFC was one of the important reasons for the rise of populism. The direct consequence of the GFC was substantial economic losses. The GFC resulted in a shrink of $ 50 trillion in world assets, of which $12.8 trillion were US assets. The GFC caused bankruptcies, increased unemployment, widening income distribution, weak global demand, and slow economic growth. All these exacerbated the rise of populism.

The advance of globalization has caused some dissatisfaction in people who were experiencing meager profits and widening income gaps, which became economic reasons of the rise of trade protectionism. These conditions had negative impacts on the Chinese economy. Here I will make a detailed elaboration of them.

1. Negative impacts of the global economic slowdown on China's economy

China's economy is under downward pressure from the global economic slowdown. Since the GFC, global economic growth has slowed down, from 4.33% in 2006 to 2.44% in 2016. Besides, global trade growth has also declined, with a negative growth of trade-to-GDP for five consecutive years (see chart 1). Under a global demand downturn, China's export growth also slowed down from 27.18% in 2006 to -2.82% in 2016, then the economic growth slowed from 12.7% in 2006 and 14.2% in 2007 to 6.7% in 2016.

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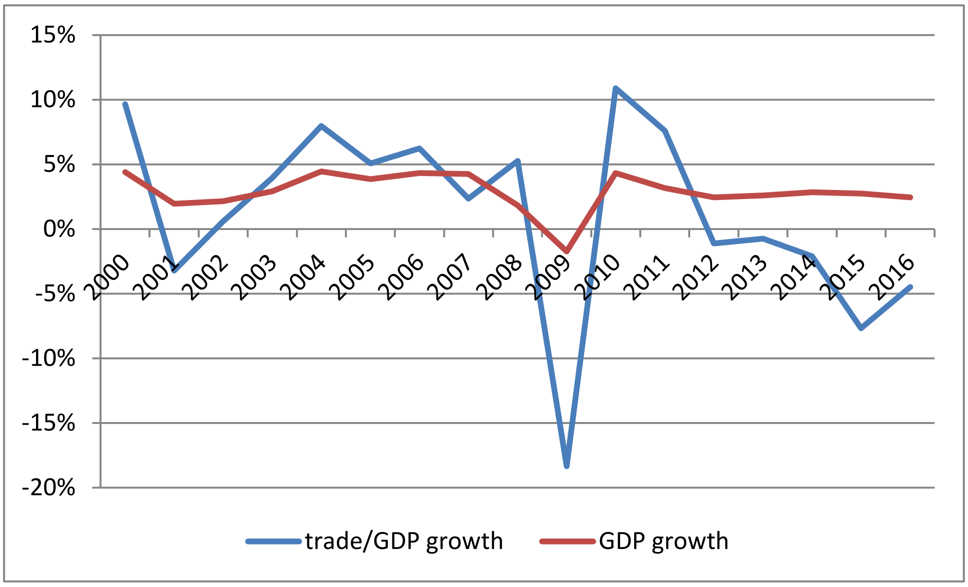
Chart 1: Global GDP Growth and Trade/GDP Growth

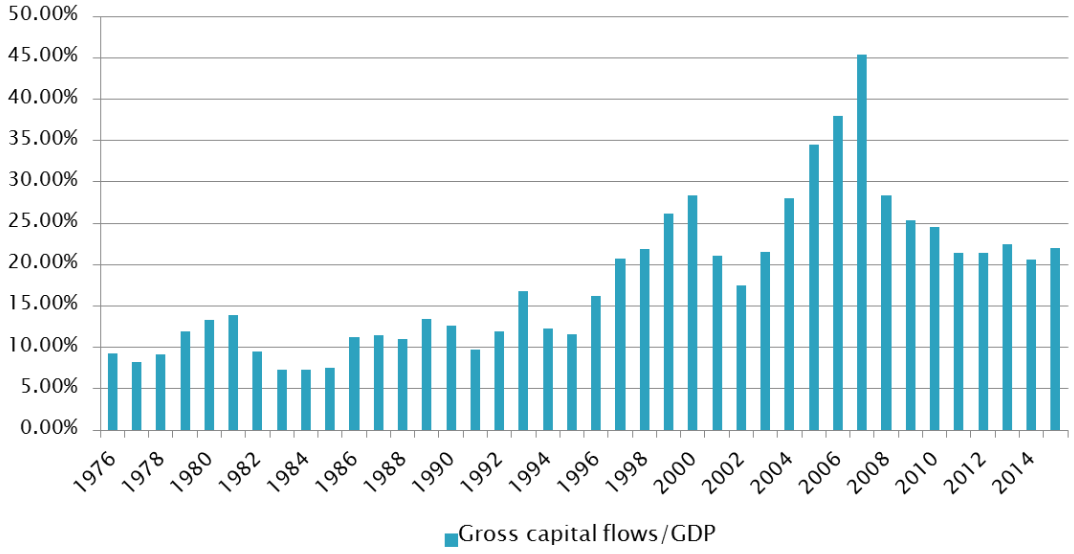


Source: World Bank, WTO, Shanghai Development Research Foundation

Of course, it must be pointed out that the slowdown in China's economy cannot be attributed to external factors completely. China's economy is in transition, many domestic factors are also important reasons for its slowdown. For example, China’s labor force reached a peak in 2013, then labor productivity declined, the benefits of reform gradually diminished, and the urbanization slowed down and so on.

China's economy was also affected by the volatility of cross-border capital flow. Cross-border capital flow was one of the important external causes of the GFC. The percentage of total cross-border capital flow in GDP reached to 45% in 2007, and the ratio fluctuated significantly before and after the crisis. After the crisis, the ratio declined rapidly, and its volatility also shrunk, however the current rate is still above 20% (see chart 2). It is noteworthy that the contraction of global cross-border capital flows was mainly due to the reduction in the cross-border capital flow between developed countries, while the increase of the cross-border capital flow in emerging markets has surpassed the peak of the crisis. Especially when the Fed gradually exited from QE, there were large capital outflows from China. From the second quarter of 2014, China's non-reserve financial account deficits have kept for 11 consecutive quarters, totaling $ 984.8 billion. Foreign exchange reserves also fell from $ 396.88 billion in August 2014 to a current size of $ 3091.5 billion. Of course, the reason for China's capital outflow and reserves decline was multifaceted, but the external environment has also caused a lot of capital outflow.

Chart 2: Gross Cross-border Capital Flow/GDP



Source: IMF, World Bank, Shanghai Development Research Foundation

2. Negative impacts of trade protectionism on China

In recent years, a “close door” tendency in trade and investment has risen, especially in developed countries, which is the embodiment of populism in the economy. Firstly, trade disputes have increased. In the first half of 2017, China has encountered 37 trade remedy investigations from 15 countries and regions (including 28 anti-dumping, 4 countervailing, 5 safeguard measures), totaling 5.3 billion US dollars. It should be particularly noted that Article 15 (a) (ii) of “Protocol on the Accession of the People’s Republic of China” stipulates that “the importing WTO members may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product”. That is, an alternative country may be selected in conducting anti-dumping investigations. However, Article 15 (d) provides that "in any event, the provisions of subparagraph (a) (ii) shall expire 15 years after the date of accession". Now it is the 16th year after China's accession to the WTO, but the United States and Europe has expressed their intention of refusing implementation of this clause. Secondly, there are tighter examinations of China M&A. In the United States, there are more strict review and examination of Chinese enterprises from Committee on Foreign Investment in the U.S (CFIUS), which has postponed some M&A deals in the U.S. According to the data from London investment bank Grisons Peak, from the middle of 2015 to the end of 2016, a total of nearly $ 40 billion of the Chinese M&A plans was denied. A recent case about the application of an Chinese-funded private equity firm(Canyon Bridge Capital Partners) acquiring U.S Lattice Semiconductor（LSCC）was also denied for threatening the national security.

In Europe situations are much alike. Recently, France, Germany and Italy have asked EU to impose greater restrictions on foreign investment. Although it was not particularly targeted at China, China is bound to bear the brunt. As a result of this, China's overseas investment has declined, which totaled $ 57.2 billion in January-July 2017, down 44.3% from the same period of last year.

In addition, China has also facing pressures from external environment. This is caused by the misleading concept of global imbalance. Before and after the GFC, many people simply equated global imbalances to trade imbalances, criticizing countries with large current account surplus including China. But in fact, the global economy not only includes trade, but also investment, financing and immigration. It is unreasonable only talking about trade while neglecting investment and financing. Global finance has not entirely been dependent on trade, but shown its unique rules. When the reserve currency countries are in recession, or the central banks loose its monetary policies, the cross-border capital flows would increase rapidly, causing a large number of capital flows to emerging markets and developing countries; when the reserve currency countries are overheated, or monetary policies are tightened, large number of capital flows from emerging markets and developing countries, cross-border capital flows begin to shrink sharply. In this process, emerging markets, including China, are affected by the sharp fluctuations in cross-border capital flows.

3. Countermeasures and opportunities for China

In such circumstances, what kind of policies should China take or have taken? I think it can be summarized as two "continuations".

First is the continuation of open policy. China has created an economic miracle in the past 40 years because of open policy. This policy has been identified as a national policy which has been and will continue to adhere to. In Davos and G20 Summit, Chinese President Xi Jinping has made important speeches, expressing the main points of Chinese government’s policy, namely, to support globalization, and adhere to open policy.

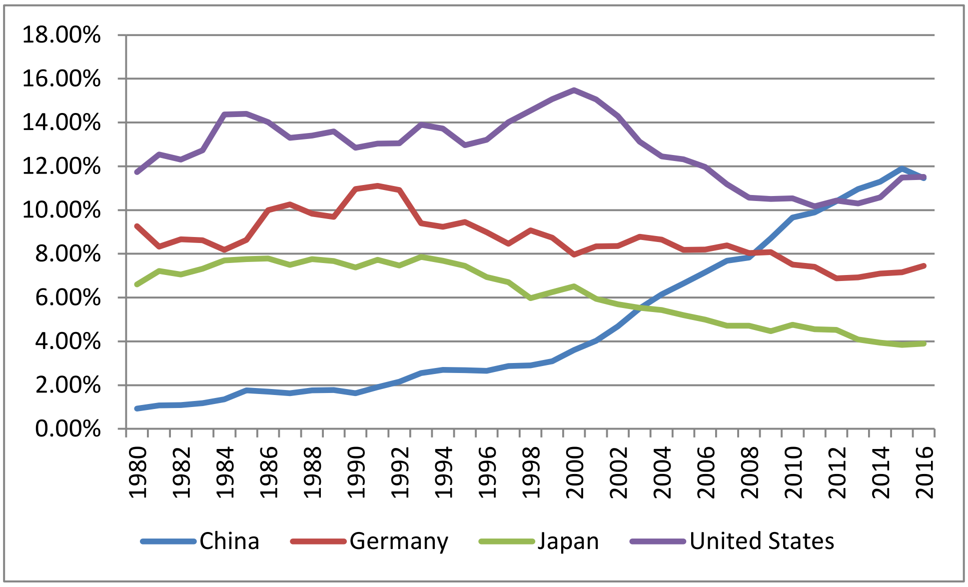
In 2013, Xi Jinping put forward the "Belt & Road" initiative, aiming to create a broader stage, and provide a bigger platform. In May this year, Belt and Road Forum for International Cooperation was held in China. During the forum, China promised to increase financial support for the Belt & Road constructions. The initiative has gained support from over 100 countries and international organizations because of its open, inclusiveness, economic mutual benefit.

Moreover, China is negotiating free trade agreements (FTA) with more countries. What is particularly worth mentioning is that the withdrawn of US from the Trans-Pacific Partnership Agreement (TPP), while China’s continuation in promoting the Asia-Pacific Free Trade Area (FTAAP), the Asia-Pacific Economic Cooperation (APEC) and the Regional Economic Partnership (RCEP). China’s State Council has also released new documents No. 5 and No. 39 to encourage more FDI. Among them, document 39 contains a negative list of foreign investors, encourages M & A, reconfirms that foreign investors' profits, dividends and other investment gains can be freely remitted in the form of RMB or foreign currency. At the same time, China and the US are also engaged in trade negotiations, to promote the signing of bilateral trade agreements (BIS). In addition, in regard to the unwillingness of the US and EU in the implementation of Article 15, China has proposed lawsuit to the WTO on December 12, 2016. Recently, new trade regulations were finally reached in EU: 1) to treat all WTO members equally when deciding whether to conduct an anti-dumping investigation; and 2) to allow an exceptional investigation in case of “serious market distortions” such as government over-intervention. I estimate that China will agree to accept this proposal.

Second is the continuation of domestic economic reform. It can make China's economy more resilient. 1) The reform of the state-owned enterprises (SOE), which will improve its efficiency. 2) The reform of the capital market. Currently, there are too many interventions in the capital market, making the capital market as a policy tool. This brings underestimation or ever distortion of the enterprises’ true values. 3) The land reform. There is dual system of land ownership in China. The land of the city is owned by the state, while the land of the countryside is collective ownership. With the development of urbanization, more and more rural land was bought by the government at a low price and then sold to developers at high prices. The farmer did not get the proper income. Now there has been a rural collective management of land for the development of rental housing, which is a correct step. 4) The reform of Hukou system (population registration). With the progress of urbanization, many farmers went to cities to get a job. They made contributions, but haven’t enjoyed all the benefits because of Hukou limitations. Now, small cities have loosened Hukou restrictions in some respect. I hope medium cities, and even big cities will follow in the near future.

The dysfunction and stagnation in advanced economies also provide an opportunity for China to play a leading role. China has become the world's second largest economy in 2011, and become the world's largest trader of goods in 2013. Chart 3 shows China's global trade accounted for less than 1% in the global trade volume in 1980, and only 3.6% by 2000. However, after 2000, it increased rapidly to 10.95% in 2013, becoming the largest trader over the US. China's share in global trade in 2016 was 11.45%, slightly lower than the US which is 11.52% (see Chart 3). With the improvement of economic strength, now China’s voice in the international community is much louder. In 2015, the BRIC New Development Bank (NDB) and the Asian Infrastructure Investment Bank (AIIB) were established under China’s initiatives. In 2016, the RMB entered the SDR basket. And in 2017, the Belt and Road forum on International Cooperation was held in Beijing. Now the B&R initiative has gained support from more than 100 countries and international institutions.

Chart 3: Main Countries Trade Proportion in Global Trade Volume



Source: WTO

In short, the dysfunction in developed economies and populism pushed each other. At the same time, the economic dysfunction led to the outbreak of the GFC, and the aftermath of the crisis in turn exacerbated populism. These three together led to the stagnation of the developed economies, and economic stagnation boosted the rise of populism. These bring challenges for the emerging markets in three channels. The first is the decline of global economic growth; the second is the volatility of cross-border capital flows; the third is the rise of trade protectionism.

If these challenges can be dealt with by emerging markets correctly, challenges can be turned into opportunities. For example, China can deal with these challenges mainly by two "continuations". One is the continuation of open policy, including attracting more FDI, taking the initiative to participate global industrial chain and gradually integrate into the financial globalization; the second is the continuation of the domestic economic reform, the purpose of which is to let market play decisive role while government play effective role in building up a prosperous, rigorous, and equal society.

In addition, for China, there also have some interesting observations. One is that the complaint about integration of globalization has been dramatically reduced under outside pressure of protectionism/populism. Another is that the complacency has risen since outbreak of GFC, which became barriers for further economic and political reforms. We should pay attention to these phenomena and make efforts to overcome them. Otherwise, it is also hard for China to seek opportunities under the challenges of dysfunction/stagnation in advanced economies.