CHINA'S ECONOMY: ITS PAST, PRESENT AND FUTURE

8 Experts Weigh in on the Key Trends and Changes in China's Economy

CKGSB
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CHEUNG KONG GRADUATE SCHOOL OF BUSINESS

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About Cheung Kong Graduate School of Business (CKGSB)

Established in Beijing in November 2002, Cheung Kong Graduate School of Business (CKGSB) aims to cultivate transformative business leaders with a global vision, sense of social responsibility, innovative mindset, and ability to lead with empathy and compassion.

Today, CKGSB stands apart for its full-time, world-class faculty, research excellence, China insights and an unparalleled alumni network. More than half of its faculty members previously held tenure or senior professorships at top business schools, such as MIT, Wharton, and Yale. CKGSB is the school of choice for management training for established business leaders and a new generation of disruptors. More than half of its 17,000 alumni are at the CEO or Chairman level and, collectively, they lead one fifth of China's 100 most valuable brands.

The school offers innovative degree and non-degree, full-time and part-time programs--including MBA, Executive MBA, Business Scholars Program and Executive Education programs--in English, Chinese and Korean for professionals and management teams worldwide. Headquartered in Beijing, CKGSB is also located in Shanghai, Shenzhen, New York, Hong Kong and London.

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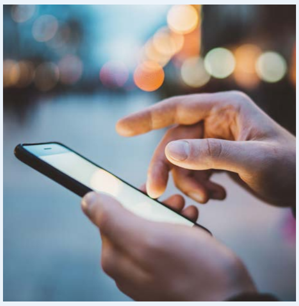
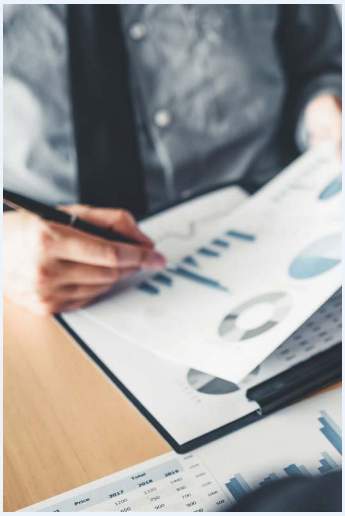


Introduction

In the first half of 2021, China's successful control of the COVID-19 pandemic, investment in infrastructure and real estate, export boom driven by global demand, steady growth of domestic consumption and prudent monetary policy seemed to have led its economy back to pre-pandemic growth. However, the risk of inflation, China's aging population, decreasing birth rate, trade tensions with the US and structural imbalance will pose major challenges. China's new push towards carbon neutrality, technology advancement and financial sector reforms are all seen as key factors in driving growth. What are the risks and challenges to China's economic growth? What can we expect to see in terms of policy and regulation? What are the global implications of China's transformation in the next decade? Cheung Kong Graduate School of Business (CKGSB) professors and industry experts share their opinions and research on China's engine for growth in the future.



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01

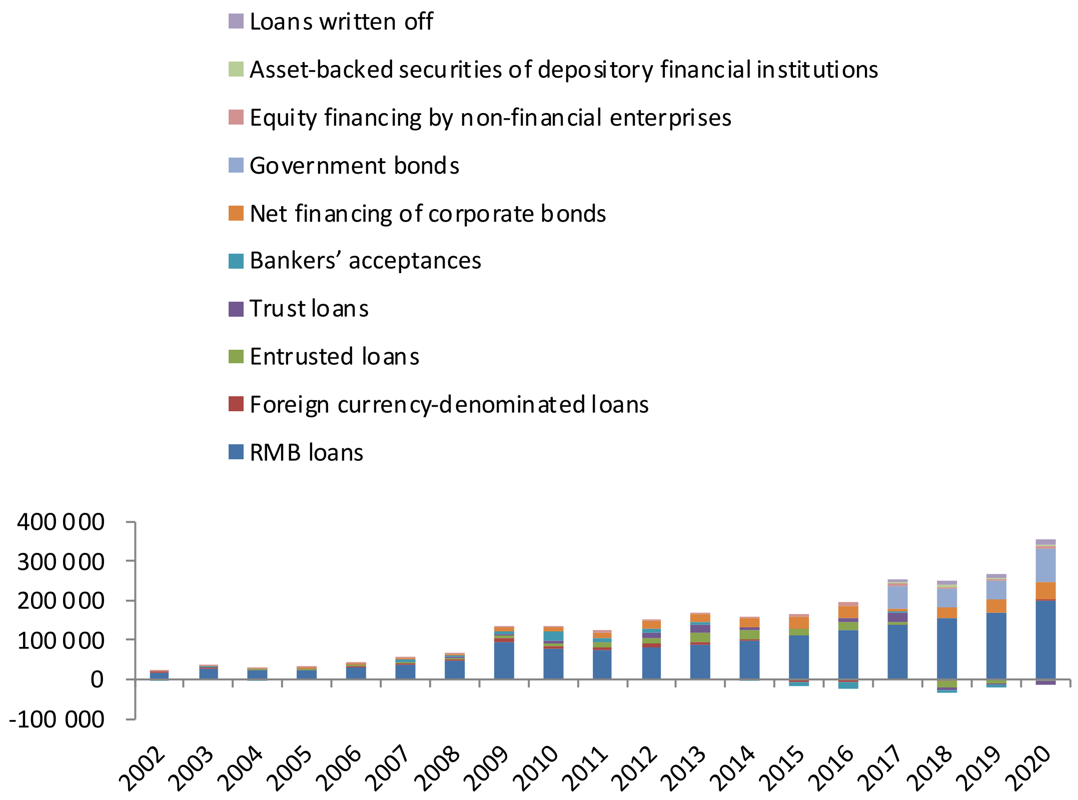
A Great Transition: A Review of China's Financial Development Over the Past Two Decades

Li Wei

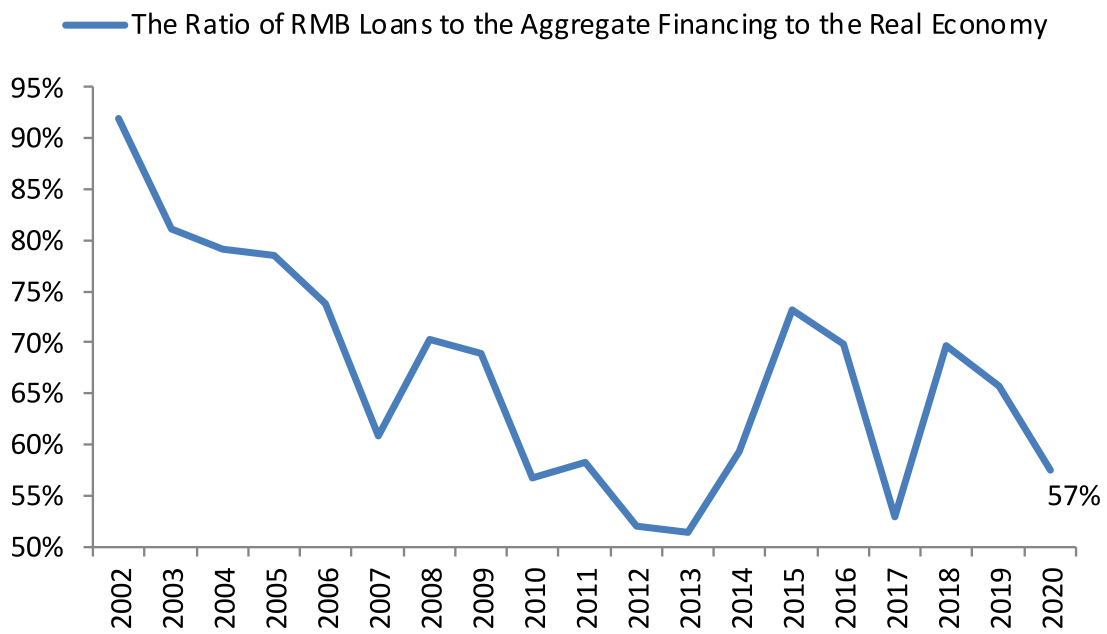
Professor of Economics, CKGSB

Dr Li Wei is a Professor of Economics and Associate Dean for Asia and Europe at Cheung Kong Graduate School of Business. Professor Li has been running the monthly Business Conditions Index (BCI) since 2011, a set of forward-looking, diffusion indices to gauge the business sentiment of executives about the macro-economic environment in China.

Among the multiple transitions that China's economy has undertaken in the past two decades, the rise of shadow banking could be considered as one of the most impactful, which is reflected in the total social financing or aggregate financing to the real economy.



Graph 1. Source: CEIC

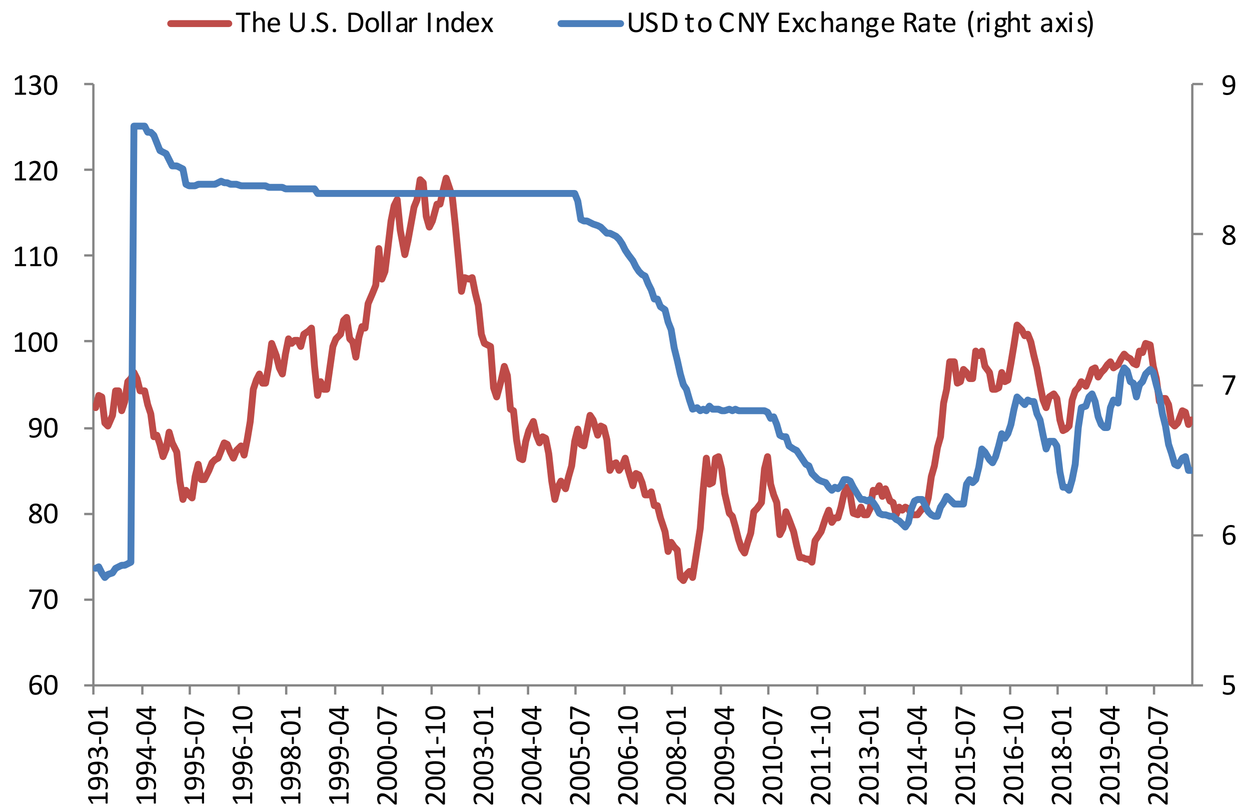


Graph 2. Source: CEIC

From Graph 1 and 2, we can see that the aggregate financing to the real economy has increased as China's economy grew. Secondly, from 2002 to 2020, the ratio of RMB loans overall plummeted, only rebounding a few times over that period.

To understand this phenomenon, it is necessary to look back at China's exchange rate mechanism. Starting in the early 1990s, China went through significant economic reforms. Economic activities started to pick up after Deng Xiaoping took his 'Southern Tour' in 1992. Competition among local governments to boost economic growth through heavy investing led to a credit boom, which soon brought about double-digit inflation.

As one of the countermeasures to reign in inflation, the Chinese government decided to peg its currency, yuan (or RMB), to the U.S. dollar in January 1994 at a significant devalued exchange rate, as shown in Graph 3. The devaluation was meant to make Chinese goods and services more cost competitive in the global market and to make investing in China cheaper for offshore investors. The dollar peg gave the yuan a nominal anchor and constrained China's monetary policy by limiting policy options and committing the government to maintain a stable exchange rate. At the same time, the Chinese government intensified its efforts to woo foreign investors in general, and those based in Hong Kong, Taiwan and Macao in particular.



Graph 3. Source: CEIC

*The U.S. Dollar Index is an index that measures the value of the United States dollar relative to a basket of foreign currencies. The Index goes up when the exchange rate of the U.S. dollar to other currency increases.

The yuan then experienced a mild appreciation until the Asian financial crisis in 1997. Affected by the crisis, most of China's neighbors devalued their currencies against the U.S. dollar, but China maintained a stable yuan-dollar exchange rate, which meant that China's currency appreciated against most Asian and European currencies.

The Chinese government could not have chosen a better time to peg the yuan to the USD. In mid-1995, just over a year after the yuan-USD peg, the USD started to march upward and then sharply appreciated when most Asian currencies were devalued during the Asian financial crisis. The appreciation of the USD didn't run out of steam until 2001. Between 1995 and 2001, by relying on an appreciating currency as a nominal anchor, the Chinese yuan experienced marked appreciation against most Asian and European currencies. Fortunately, the yuan's appreciation was more or less in agreement with China's breakneck economic growth that was fueled by improvements in productivity.

With her ascension into the WTO in 2001, China intensified its transformation from a conglomeration of segmented and highly regulated local economies into a more integrated national market. Chinese and foreign firms took advantage of improved business environments, market scales, and improved mobility of labor within China. As a result, the Chinese economy saw rapid increase in productivity as well as export competitiveness. Standard economic models would forecast continued and perhaps accelerated appreciation of the yuan.

However, new developments external to China were not as accommodative. The USD started to march downward in 2002 and didn't reach the nadir until 2008. During the same period, prices of energy and industrial commodities, which were playing an indispensable role in sustaining China's rapid development, were also increasing quickly and only to reach their peaks in 2008.

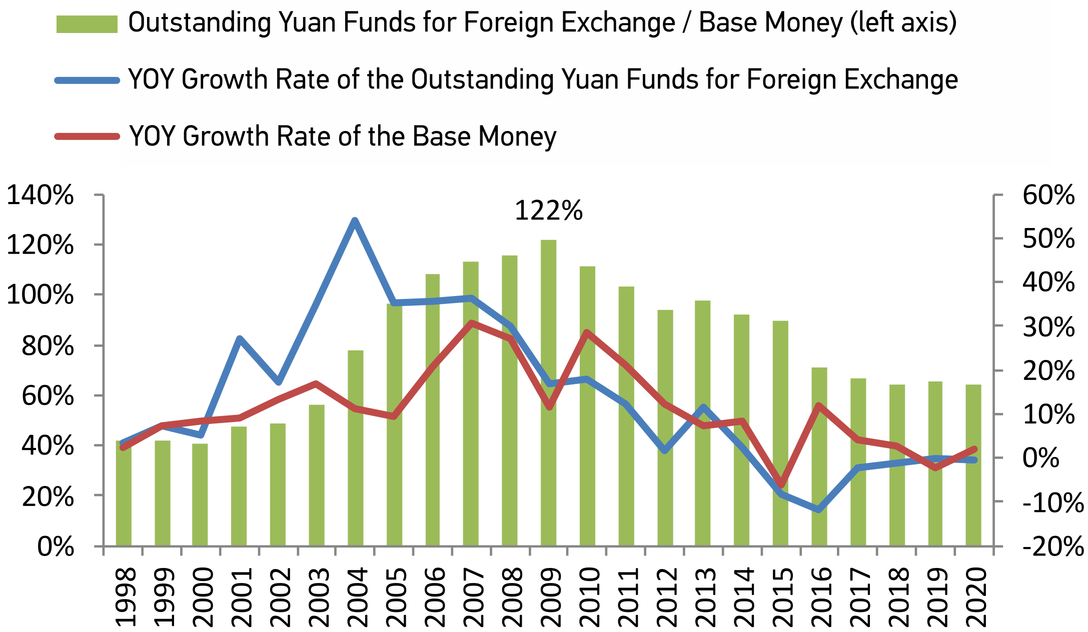
In retrospect, the year 2002 could have been an optimum time for China to unpeg the yuan from the U.S. dollar and to opt for a more market-driven exchange rate regime. But the fixed exchange rate regime had so far been very successful in stabilizing the Chinese economy. So initially, Chinese policy makers were reluctant to change. Facing mounting pressures from the exchange market and from China's major trading partners, China adopted a "managed floating exchange rate system" in 2005 and slowly strengthened the yuan against a depreciated and still depreciating dollar. Although China's yuan was officially unpegged, it was still more managed than floating and the USD was given more weight than all other currencies combined in the currency basket, which the Chinese central bank was tracking for setting the yuan's trading range. In the meantime, the market had developed high expectations for the yuan to appreciate against the USD as China's economy and productivity continued to grow rapidly. Against such a background, China saw large inflows of foreign investment, which, together with its substantive current account surplus, drove China to accumulate her foreign exchange reserve at a rapid rate.

Some of the foreign capital inflows took the form of foreign direct investment that Chinese policy makers preferred as they represented long-term capital commitment. However, increasingly more inflows landed in China to take a one-way bet on the yuan's appreciation and to arbitrage higher interest rates in China. As interest rates in the U.S., Japan and Europe continued to fall, China became a relatively attractive destination for Chinese financial institutions, real estate developers and corporations that could borrow foreign funds at lower interest rates to bring in offshore funds in order to arbitrage the onshore and offshore interest rate differentials.

In general, as more arbitrageurs took on long positions on the yuan and short positions on the USD, the foreign exchange market would react by making the yuan more valued. And such a market driven appreciation could overshoot, making the yuan temporarily overvalued, thereby exposing subsequent arbitrage positions to heightened risk of a downward swing of the yuan and an abrupt reversal of capital flows. The presumed risks naturally limit the size and duration of these "carry trade" arbitrages. But by gradually appreciating the yuan against the USD, the Chinese central bank offered an implicit insurance policy to these arbitrageurs against presumed downside volatility of the yuan. This further increased the risk aptitude of the arbitrageurs.

As more foreign funds came onshore, the People's Bank of China (PBC), which managed the exchange rate, was obligated to purchase the inflows and add to its foreign exchange reserve balance. Typically, the money that the PBC used to purchase foreign fund inflows was newly created base money (mostly in the form of banks' reserve deposits). So with more foreign funds landing in China, the PBC was obligated to expand China's monetary base. In order to neutralize unintended monetary easing caused by foreign fund inflows, the PBC issued a large amount of sterilization bonds (central bank bills) to mop up the unwanted liquidity.

As shown in Graph 4, for a long time, the funds outstanding for foreign exchange have been growing more rapidly than the monetary base. In 2009, the ratio of the funds outstanding for foreign exchange to the monetary base was at a shocking 122%. This fact revealed that China's central bank issued a significant amount of sterilization bonds.



Graph 4. Source: Wind

In general, there are two approaches to neutralize the impact of excess foreign inflows on the quantity of M2, the broad money that the PBC was targeting:

1. Issuing sterilization bonds to control the quantity of monetary base
2. Raising the required reserve ratio (RRR) on bank deposits in order to lower the money multiplier

The PBC adopted the first option initially and had at one point over RMB 4 trillion outstanding sterilization bonds. But this approach was gradually abandoned, since the interest rates that the PBC paid on the sterilization bonds were usually much higher than the interest rates that the PBC received for its holding of foreign exchange reserves, which were primarily comprised of treasury securities issued by the U.S., major European countries and Japan. In other words, sterilizing foreign inflows was quite costly for the PBC.

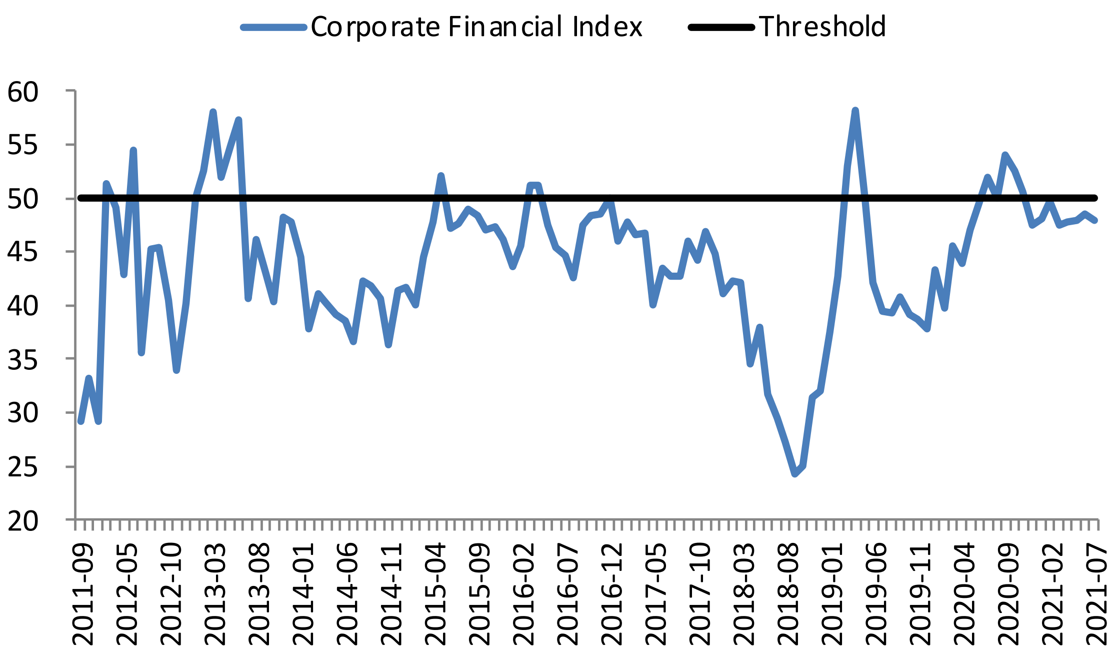
The second approach was preferred by the PBC as one of its advantages was that it enabled the PBC to transfer the consequential financial costs to commercial banks, since the interest rate that PBC paid the banks on the required reserve balances was quite low. The RRR rose to over 20% at a time (for large-scale financial institutions) after PBOC used this tool frequently.

It should not be surprising that the higher RRR brought about shadow banking in China. As the central bank increased the RRR, commercial banks were required to deposit more reserves in the central bank, thereby reducing the money multiplier and the scale of banks' lending business. Commercial banks, even though most of them are state-owned, would have the incentive to move deposits and loans off their balance sheets, by, for example, issuing wealth management products (WMPs) to their depositors and investing the WMP funds raised in trust funds. In doing so, banks no longer earned interest margins, but instead charged commissions, which are recorded as intermediate service income, therefore circumventing regulatory requirements.

The commercial banks also constantly absorbed short-term money to support their long-term investment with the off-balance-sheet assets and liabilities. Although it improved efficiency and drove the marketization of interest rates, such behaviors obscure risks and cause hidden dangers. It is precisely based on this concern that the regulatory authorities have repeatedly warned of related risks. But the market forces were unstoppable, and hence the shadow banking system grew quickly to become, in the eyes of the regulators, a source of systemic risk.

The regulatory authority is, obviously, unwilling to let this situation simmer. That is why, in 2018, the regulators initiated a large-scale rectification of the financial sector, in which many shadow banking activities were shut down almost overnight. Based on statistics, that campaign did achieve the intended effect. For example, the proportion of RMB loans to the aggregate financing to the real economy immediately declined as a result in 2018, when it had increased from 53% in 2017 to 70% in 2018. But the proportion fell again to 57% in 2020.

Although shadow banking has various irregularities and even drawbacks, our data shows that it is an important financing channel for private small-to-medium-sized enterprises. As we can see in Graph 5, with the deepening of the financial rectification in 2018, the Corporate Financing Index — a sub-index of the CKGSB Business Conditions Index (BCI), a set of forward-looking, diffusion indices to gauge the business sentiment of executives about the macro-economic environment in China – also dropped all the way to its lowest point in history at 24.2 in September 2018. After that, with the relaxation of policies, the index recovered nicely.



Graph 5. Source: The Case Center and the Center for Economic Research, Cheung Kong Graduate School of Business (CKGSB)

In the past ten years, regulators decided to crack down on shadow banking. Whether one likes it or not, however, shadow banking came into being and will continue to play a role, likely a less prominent one, in the Chinese financial system. Shadow banking provides diversified financing channels, creating market-determined interest rates in China in its own way. But the risks involved cannot be ignored. Two types of risks are particularly worth mentioning: implicit default-free guarantee on risky wealth management products (WMP) and maturity mismatches on the balance sheets of shadow banking institutions. It will be essential for China's financial sector in the next ten years to figure out ways to take shadow banking out of the shadows where competent regulators are absent and offer sustainable market-based financial services to consumers and firms.

02

Are Chinese Corporations too Big to Fail?

Li Xin

Vice President, Caixin Media

Li Xin is Vice President of Caixin Media and Managing Director of Caixin Global, leading the company's global news and intelligence services, as well as Caixin's international branding and global events. She is an alumna of the Executive MBA program at the Cheung Kong Graduate School of Business.

Are Chinese corporations too big to fail?

The short answer is no.

There are indeed some companies that pose systematic risks, and some have gone under. Then, the government is likely to step in. But bailing out failed big companies is a tricky and delicate task. There have been several such cases over the last few years in which regulators have tried to protect the financial system from massively indebted companies. The rescue efforts were costly and time-consuming.

Anbang Insurance was a case in point. The company went on a dazzling M&A spree at home and abroad until its chairman was jailed in 2017. He was later sentenced to 18 years in prison for fundraising fraud and embezzlement.

The takeover of Anbang began in February 2018 and took two years to complete as regulators and financial experts struggled to untangle its complex and opaque operations. A state-owned industry bailout firm had to inject 60.8 billion yuan ($9.4 billion) into Anbang, and establish a new company, Dajia Insurance, with an end goal of bringing in strategic investors and turning Dajia into a privately owned firm.

Another example is a local bank based in Inner Mongolia, Baoshang Bank. It was taken over by the central bank and the country's banking regulator in May 2019. This was the first high-profile seizure of a bank in two decades. The reason is a 220 billion yuan hole in its books due to misappropriation by its largest shareholder, a conglomerate called Tomorrow Holding.

These high-profile, dramatic rescues sent shockwaves through China's financial sector and capital markets. They exposed risks in the country's financial system, and highlighted the failures to identify and fix problems of those risky institutions early on.

When the government steps in, it's clear that it's only the systematic risks they are tackling. Regulators should keep in mind three important questions each time such an effort is undertaken — the people who intended to make companies too big to fail should face the full consequences of the law, systematic fixes should be put into place to prevent future risky institutions from growing too big, and the rescue effort should be market-oriented.

Regulators should keep in mind three important questions each time such an effort is undertaken:

1. The people who intended to make companies too big to fail should face the full consequences of the law.
2. Systematic fixes should be put into place to prevent future risky institutions from growing too big.
3. The rescue effort should be market-oriented.

There are regulatory measures that serve as right steps in that direction.

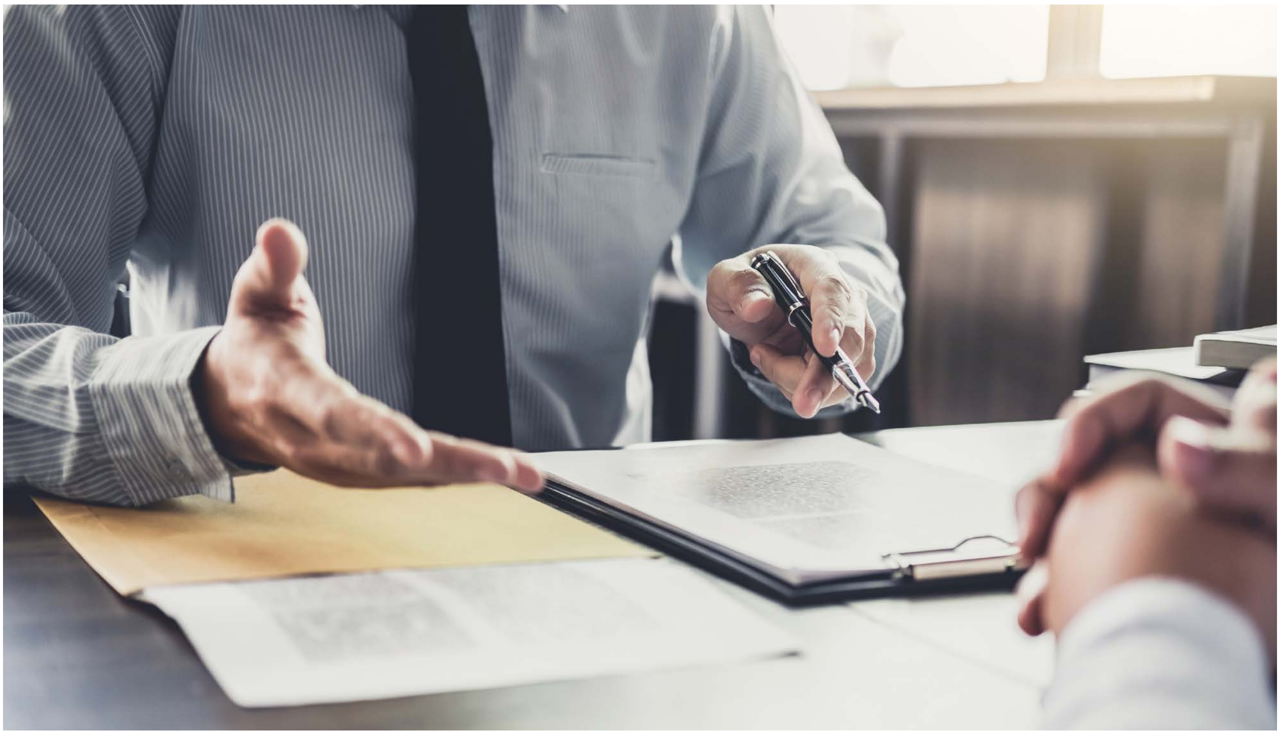
For instance, major banks and insurers are required to make living wills, officially known as recovery and resolution plans, to ensure an orderly next step when they become problematic or insolvent.

And more importantly, the rescue should be market-oriented. When the company going under is state-owned, the government and party discipline officials usually punish the people responsible for the loss, either due to their malfeasance or bad judgment. The real test is how to inject new life into those struggling companies. When it comes to finding new owners and managers, the results are better when those invited come from the private sector.

Over the last few years, a number of state-owned enterprises' (SOEs) restructuring efforts benefited from the involvement of private players. The major ownership of struggling Dongbei Special Steel Group was given to Shagang Group, China's largest private steel company, while control of Bohai Steel Group, a once-struggling steel behemoth based in Tianjin, is now in the hands of privately owned Delong Group. In both cases, the restructuring achieved good results and market recognition.

Last but not least, in restructuring problematic giants, malicious debt evasion is a no-go.

Market confidence takes a long time to build. After a series of debt crises involving government-backed companies in Tianjin, investor confidence was so low that net bond financing of local SOEs was negative 82.4 billion yuan in the first five months of 2021. Worried city officials had to convene a meeting in June with more than 100 financial institutions to publicly pledge that no more local SOEs would default, in an effort to rebuild market confidence. However, investors were not convinced.



Some business leaders are believers in too-big-to-fail, and used their enormous credit to power reckless expansions of their businesses. The tide went out much faster than they had anticipated, and those with massive debts have often been the ones who have managed to leverage financial institutions under their control. When Tomorrow Holding was liquidated, the sprawling empire had a debt hole of at least 500 billion yuan through financial institutions, including Baoshang Bank. By now the regulators are clear that risks multiply when reckless players have financial institutions at their beck and call.

The regulatory storm to reduce financial risk is still ongoing. One can expect that more bad debt will surface in the process. Restructuring is not a license to dodge accountability. With discipline and real enforcement, there shouldn't be any more too-big-to-fail stories.

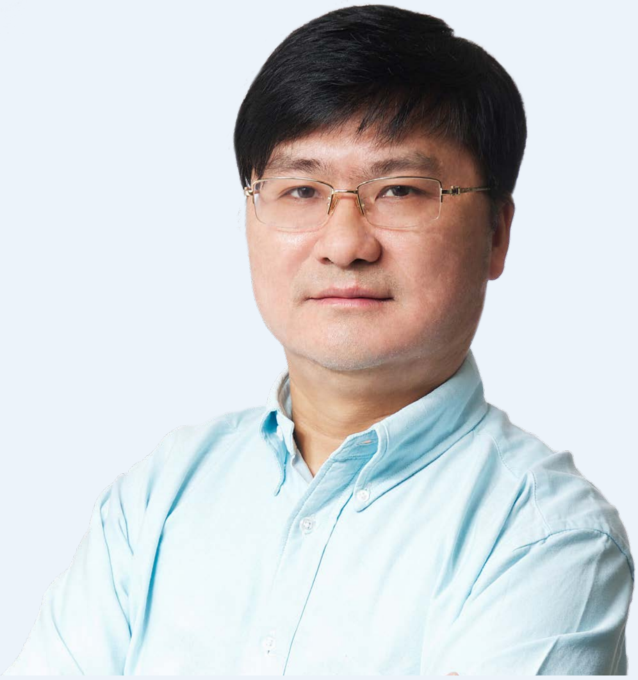
03

China’s Digital Economy and Limitless Supply

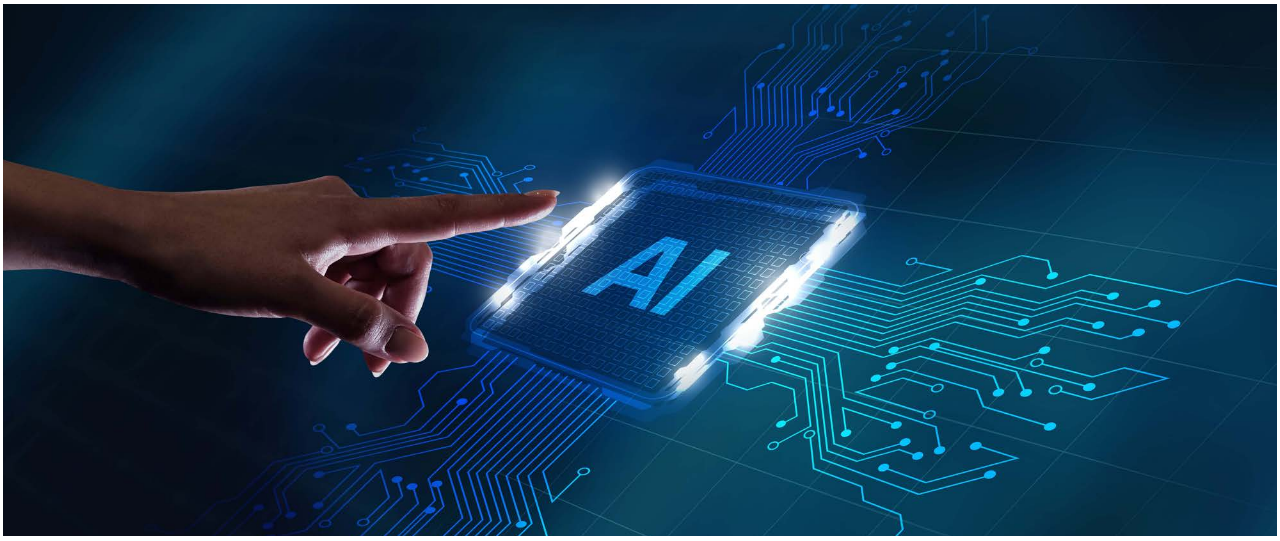
Zhou Chunsheng

Professor of Finance, CKGSB

Dr Zhou Chunsheng is a Professor of Finance at Cheung Kong Graduate School of Business. His theory of “limitless supply” explores China's digital transformation and how it alters its economic landscape.



In 2020, China's digital economy contributed nearly 40% of the country's total gross domestic product (GDP). As the world's fastest growing digital economy, China is seeing its digital transformation altering the way businesses function. People's everyday lives--such as their interactions and consumption habits--are changing with the vast digital ecosystems produced by tech giants like Alibaba, Tencent and ByteDance.



Unlike the traditional economy where resources such as land, labor and capital limit the production capacity, the digital economy offers unlimited supply in which data and technologies are limitless and can be supplied over and over again. Technologies such as Artificial Intelligence (AI), big data and mobile internet have brought forth new industries, products, services and business models, to stimulate new consumer demands and disrupt our traditional consumption concepts. Limitless supply products are products that can be supplied simultaneously or in a short time, without any limit, at no marginal cost to satisfy any market demand. These can include copyrights, scientific and technological achievements, computer software, and digital products, like WeChat, TikTok, Zoom and operating systems.

The new economic system fueled by data and technologies have already changed the way we do business.

In the digital economy, there are roughly two business models:

1. Companies that charge for their digital products, like Microsoft with their Windows applications.
2. Companies that provide products to users at a very low price or even for free and then earn derived revenues from people's usage of its service, such as TikTok or Google.

Both business models require a large user base to dominate the market share.

"The new economic system fueled by data and technologies have already changed the way we do business. In the digital economy, there are roughly two business models – companies that charge for their digital products, like Microsoft with their Windows applications, and companies that provide products to users at a very low price or even for free and then earn derived revenues from people's usage of its service, such as TikTok or Google."

The first business model requires companies to make direct profit earnings for each product sold. The second business model allows companies to use vast amounts of user data to generate revenue through financial services, targeted advertisement, gaming and other commercial services. Companies like WeChat and Google have done very well with the second business model. Since the supply of digital products is not limited by their production capacity, companies with such products can grow exponentially and expand at a staggering speed as long as demand is there. Therefore we are seeing companies with digital products (or limitless supply companies), like Alibaba, Tencent and ByteDance in China and Facebook, Google and Amazon in the US, acquiring as many users as possible and profiting from the traffic, instead of investing in fixed assets.

The decrease in fixed asset investments is contributing to the slowing of GDP growth. The digital economy is disrupting the way we measure GDP in general. Traditionally people believed that technologies would mainly increase productivity but nowadays technologies are being used to improve the quality of the product or to provide new products and new services. With upgraded technologies, a smartphone user doesn't need to buy a camera any more as the functions are integrated into one product. These new technologies also allow users to enjoy services and products for free, like being able to make free video calls.

In this sense, it is natural that GDP seems to be slowing down as these traditional businesses are no longer recorded in the GDP statistics. As the economy becomes dominated by light-asset companies producing limitless supply products, we are seeing a plummeting growth rate of fixed asset investment to slightly above 5% from 25% some 15 years ago. GDP is not as accurate as before to reflect an economy. This is why policymakers are changing the way they gauge economic growth to reflect the new digital and technology-powered world.

Giant tech companies seizing large market share are pushing late-comers to focus on niche markets. These niche companies are inventing new products, thus creating new business models. Business leaders must embrace innovation to maintain their competitive edge. In the era of transformations, everybody needs to keep up with the trends in order to thrive. I believe digitalization holds the key to future successes for business leaders no matter what industry or sector.

04

Reasons to be Bullish on China

Liu Jing

Professor of Accounting and Finance, CKGSB

Dr Liu Jing is a Professor of Accounting and Finance and Associate Dean at Cheung Kong Graduate School of Business. Professor Liu has been leading the Investor Sentiment Survey, a quarterly survey to gauge investor sentiment and expectations in China’s domestic equity market since 2018.

These are very challenging and uncertain times. The global pandemic has disrupted the way we operate and do business and adding to this uncertainty is the deteriorating US-China relationship. But there is another source for uncertainty. The internal Chinese economic structure is now undergoing major changes as the government tries to address the imbalances brought on by the country's meteoric growth.

"The internal Chinese economic structure is now undergoing major changes as the government tries to address the imbalances brought on by the country's meteoric growth."

However, if we look at China's economic fundamentals and what's happening to the investments in China, there are reasons to be bullish. The fundamentals are actually quite strong.

China is the second largest economy and will overtake the United States as the largest economy in a few years. It has the world's largest middle-class population, which is expected to reach 550 million by 2022. China's purchasing power will rise at a faster pace than developed economies.

One thing that is crucial to note is that China's reform and opening up policy has not changed. In fact, the government has tried to intensify the opening up of its markets for global trade and investment. The recent EU-China Comprehensive Agreement on Investment (CAI), although now stalled, and the Regional Comprehensive Economic Partnership (RCEP) are indications of China's intent to engage more with international partners, not less.

The other example of China's intentions to continue opening up economically is Hainan Province, which is shaping up to be one of the largest experimental centers for China's opening up policy. By 2025, the island will be fully integrated into the international system, similar to Hong Kong or Singapore. Hainan will not only have a very low tax rate of 15%, but it will also have free flow of capital, information, and people. Eleven industrial parks are being developed for the construction of the Hainan free trade port.

When compared to Hong Kong or Singapore where companies are restrained by high rent and land costs, Hainan's biggest advantage is that it is a big island and land prices are relatively cheap. Once the tax rates and institutional arrangements are on par with Hong Kong and Singapore, Hainan will be an attractive location for multinationals looking to expand regional headquarters in Asia.

The other area for optimism is China's upgrade from export-oriented low-end manufacturing to more consumption driven growth, which is the central goal for its dual circulation policy. Increasing China's internal consumption can only mean more imports and greater global trade.

It has also realized that in order to compete, it must innovate. The deterioration of US-China relations has further pushed China to accelerate this process. Tech and innovation have been identified in the 14th Five Year Plan as the key strategy for growth in the next decade. The government has been ramping up efforts to encourage faster development in China's technology sector, including more spending on research and development in high-tech manufacturing, IT and robotics. In 2019, China spent $300 billion on R&D, accounting for 20% of the world's total R&D expenditure.

China's digital economy is the world's fastest growing with success stories like Tiktok and Wechat, examples of leading products globally. China's is also leading in renewable energy, lithium-ion batteries and software for the electric vehicle industry. In 2020, China boosted its budget for renewable power subsidies to 92.36 billion yuan ($13 billion USD).

Another point of optimism comes from the results of the Cheung Kong Investor Sentiment Survey (CKISS). In 2018, to better complement our understanding of the financial markets, I started an investor sentiment survey to gauge expectations in China's capital markets. The survey has since expanded its scope to 13 major Chinese cities and is conducted on a quarterly basis with approximately and is conducted 2,500 valid samples, including 1,900 samples from individual investors and 600 from institutional investors. In the first quarter of 2021 as China's economy recovered to pre-pandemic levels, investors showed optimism towards the expectations of the Chinese economy. Approximately 61.1% of the survey respondents believe that China's future GDP growth rate can exceed 5%, an increase of 8% from the previous period.

Even though China's annual GDP growth may never reach 9% again, it is still considered one of the top destinations for investments from multinational corporations. Its rebalancing towards consumption and services, investments in environmental protection and high-tech sector, growing middle class and optimistic investor sentiment all point to strong fundamentals that should not be overlooked.

05

Trends and Analysis into 7 Years of Industrial Sector Data

Gan Jie

Professor of Finance, CKGSB

Dr Gan Jie is a Professor of Finance and Academic Director for MBA programs at Cheung Kong Graduate School of Business. Since 2014, Dr Gan has been leading the Business Sentiment Survey (BSI), a quarterly survey on China's industrial economy surveying more than 2000 Chinese companies from within the sector.

In 2014, China's economy grew at its slowest rate in the past 24 years, falling short of its targets for the first time since the 1990s. It was abundantly clear that if policymakers wanted to achieve China's growth targets, it had to increase both domestic demand and facilitate industrial upgrades with the help of technological innovation. That would require fundamental changes to the economic system and a deepening of reforms, which have significant implications for the corporate sector.

A long-standing challenge facing both government policymaking and corporate development in China is a lack of timely and reliable data. Firms often do not have reliable information when they attempt to assess market opportunities, make investments and decide on financing strategies. We believe the only way to obtain reliable data on the economy is through micro-level company surveys. To this end, starting from the second quarter of 2014, we have conducted a quarterly survey of 2,000 industrial firms on their operating conditions and financing.

The samples are based on a stratified random sampling by industry, region and size from the National Bureau of Statistics' population of 48,800 industrial firms that have sales over twenty million RMB. Therefore, our survey not only reflects the overall situation, but also captures industry and regional trends.

Over the past 7 years, the biggest challenges facing the industrial firms from our surveys have consistently been weak demand and overcapacity. On top of these challenges, profits are being squeezed due to rising costs. The data suggests China is losing its labor cost advantage. Since 2020, raw materials' costs have also been rising, further increasing firms' operating costs. On top of these ongoing challenges, the US-China trade war, which started in 2019, has further exacerbated the restructuring of the Chinese economy and hindered the sustained recovery from the COVID-19 pandemic.

Below I've outlined some overarching trends I've seen in my Business Sentiment Index (BSI) research in the past 7 years.

Neutral Business Sentiment[1] and Sluggish Fixed Asset Investment

Overall business sentiment, which reflects both the current operating conditions and expectations about the future, has been quite neutral, after mild operating conditions in 2015-2016.

A lack of growth opportunities is reflected in sluggish fixed investments. On average, only 2.6% of firms have expansionary investment in fixed assets.

"The CKGSB Business Sentiment Index (BSI) is the simple average of three diffusion indices, including current operating conditions, expected change in operating conditions and investment timing. Compared with other economic indices, our BSI is more forward-looking and is a reflection of the absolute level of economic activities."

Weak Demand

Our diffusion index for oversupply in the domestic market has been stubbornly high, standing above 80 since 2016 and above 90 since the COVID outbreak. Oversupply in the domestic market has been more severe than in the international market, though the gap has narrowed since the trade war and COVID-19 outbreak.

> "The diffusion index ranges between 0 and 100. A larger value indicates better operating conditions, with 50 marking the turning point between expansion and contraction."

Access to Credit and Legal Environment

Perhaps the most surprising finding from our survey is that financing is not a bottleneck for the industrial economy. This result has been highly persistent. In each quarter of 2020, fewer than 1% of firms cited financing as a constraining factor.

Each year, in the Q4 survey, we would ask the firms to rate the country's legal environment. "On a scale of 0-10, what is the likelihood that the legal system will uphold your contract and property rights in business disputes (0 being the worst)?" The rating is 7.6 on average and reached its highest of 8.4 in 2020, probably reflecting greater trust in the government after the COVID pandemic. Overall, contrary to the sceptical opinions of some in the West, the legal institutions in China have provided fairly good protections for business operations.

R&D

A fairly large number of firms do not have any R&D spending, ranging from two thirds to 80% over the years. This proportion has gone up in recent years, in accordance with declining profits due to the trade war and the COVID pandemic.

Overall Confidence in the Industrial Sector

In the 2020 Q4 report, 68% surveyed firms were either "optimistic" (5%) or "cautiously optimistic" (63%) (2019: 9% and 50%) about economic outlook in the next three to five years. Among those who were "not optimistic", 62% cited competition and overcapacity as their top concerns, 14% higher than 2019 (2019: 48%). 37% of firms cited concerns over macroeconomic environment. These numbers are fairly persistent over the years.

Overall, the industrial sector has shown strong resilience in the past seven years. Underlying oversupply is a lack of core competitive advantage, consistent with absence of R&D spending in majority of the firms. Going forward, product innovation is the only path to the long-term growth of the industrial economy.

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06

A Trinity of Growth Drivers for the Post-Pandemic Era

Henry Wang

Founder and President, Center for China and Globalization (CCG)

Dr. Huiyao (Henry) Wang is the Founder and President of Center for China and Globalization (CCG), a leading Chinese think tank. Dr. Wang is also an adviser to the Chinese government, having been appointed as Counselor for China State Council, China's Cabinet by Chinese Premier in 2015.

China’s economic integration, digital economy, and continued talent dividend point to a bright economic outlook.

China’s effective containment of Covid-19 has reinforced the country’s position as the hub of global supply chains and leading engine of global growth. In the first seven months of 2021, China's total imports and exports in dollar terms expanded by 35.1 percent year on year to $3.3 trillion.

The World Bank has predicted that China’s GDP growth will reach 7.9 % in 2021, underlining the positive outlook for its economy. Looking ahead, we can expect this strong performance to continue, underpinned by three key structural drivers that will propel the Chinese economy in the post-pandemic era.

The first is continued economic integration, particularly in the Asia-Pacific region. China has committed to further embrace globalization and is part of the Regional Comprehensive Economic Partnership (RCEP), set to be the world's largest free trade area.

The 15 Asia-Pacific signatory nations have pledged to expedite the enactment of RCEP by the start of 2022. Once effective, RCEP will reduce trade barriers across an area covering a third of the world's population and economic output.

RCEP will catalyze Asia's long-term integration and is a major milestone in the opening up of China. It can also provide a foundation for China's membership in more advanced trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). In November 2020, President Xi said that China will "favorably consider" the idea.

At the same time, China will also work with other countries to strengthen the beleaguered WTO. Twenty years after accession, China is well placed to use its heft in the WTO constructively to help retool the organization and revive the multilateral trade agenda for the post-pandemic era.

It is hoped that these efforts at the regional and global level can stem the tide of protectionism and spur trade growth, so that trade can play a positive role in global recovery such as it played after the Second World War and Global Financial Crisis. In turn, the recovery of external demand will support China's economy and rise as a global supplier of increasingly advanced goods and technologies.

The second growth driver, one that has truly come to the fore during the pandemic, is the digital economy. Data has become as vital to the world economy as oil was in the 20th century, transforming and creating entire industries and giving birth to countless products and services. Technologies such as cloud computing, artificial intelligence, big data, and the internet of things have brought new ways to connect people, things, and places, and their impact is only set to grow.

COVID-19 has been a catalyst for digital transformation worldwide and China is a forerunner in this shift. China's well-developed digital infrastructure made it relatively easy for businesses to adapt and for people to work remotely. Internet industries such as online education, healthcare, and new retail have created new sources of growth. With this development, the value of China's digital economy reached CNY 39.2 trillion (just over $6 trillion) in 2020, accounting for 38.6% of its GDP. In first-tier cities, the share is even greater. There is also an increasing digital component to China's external economic cooperation. A report jointly published by the Center for China and Globalization and the Hinrich Foundation in March 2019 found digital exports to be the second-largest category among Chinese exports.

The third key driver for China's economy is its vast pool of skilled talent. According to the Seventh National Census, the number of people with a university education reached 218 million in 2020. This provides a huge reservoir of workers, innovators, and entrepreneurs with the knowledge foundation and skills to adapt to the rapidly-changing demands of our economy and create new products, technologies, and businesses that will be a source of growth in years to come.

To build on this human resources advantage and boost global competitiveness, China should establish a more open talent system. This will help emerging sectors tap the talent dividend, especially the international talent dividend, bringing more dynamism to the economy.

Building on the benign conditions brought by successful management of the pandemic – in China and hopefully worldwide, before too long – the trinity of growth drivers outlined in this article can fuel continued growth over the coming decade and beyond. Furthermore, economic integration, digitalization, and talent development can reinforce each other.

For example, new digital technologies can facilitate the development of more efficient cross-border value chains that take advantage of liberalization under agreements such as RCEP. This can create new growth markets and opportunities to spur the flow of talent in Asia-Pacific and beyond. In turn, circulation of talent can stimulate innovation and the development of new sectors and solutions, feeding back into trade growth, increased openness, and investment. Such a virtuous circle would surely be a huge boost, not only for China's economy, but for peace and prosperity across the entire world.

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07

U.S. – China Tensions: Debunking Myths about China's Economy

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U.S.-China economic tensions have not diminished under the Biden administration. Trump's punitive tariffs on China and related restrictions on hi-tech exports and investments remain intact. These actions exacerbate uncertainties about China's growth prospects and in part, are a result of misguided views.

The Trump administration's initial mistake in launching a trade war was to assume that trade deficits were inherently bad, and that China was the cause.[1]

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However, trade deficits are not a good indicator of the state of the economy.[2] Booming economies import more, leading to higher deficits. Furthermore, the United States has been running trade deficits for over 40 years, long before China became a major trading nation. U.S. trade balances are largely driven by soaring federal budget deficits, and this has little to do with China. The irony is three years after Trump's punitive tariffs were initiated, China's trade surplus has increased while America's deficit has gotten worse.

Trump also echoed popular but misguided sentiments that U.S. firms have been investing too much in China, resulting in a loss in competitiveness. But over the past two decades, only 1-2 percent of U.S. foreign investment has been going to China.[3] By contrast, the European Union (EU), which is comparable to the United States in economic size, has been investing roughly twice as much. So, the question is actually why the United States invests so little in China rather than so much. The answer is because EU exports to China are dominated by machinery, transport equipment and high-end consumer goods, which need foreign investment for localized production and servicing. U.S. exports to China consist largely of agricultural products and hi-tech components, neither of which lead to much foreign investment.

Recent U.S. decoupling measures to restrict financial flows to China, however, have not deterred potential investors.

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China's rapid recovery from the pandemic has led to a surge in global financial inflows with foreign direct investment likely to reach an all-time high this year.[4]

China's alleged failure to protect intellectual property rights (IPR) is another major U.S. concern. The reality is that developing a sound IPR regime takes generations as was the case for the United States.[5] The building blocks for China's IPR system were laid only two decades ago with reforms that accompanied China's membership in WTO in 2001. In the ensuing years there has been steady progress. The 2020 American Chamber of Commerce in China Business Climate Survey indicated that 69 percent of the U.S. firms felt that China's enforcement of IP rights improved compared with 47 percent in 2015.[6]

Another oft-cited complaint is China's use of subsidies, which is often directed to state-owned enterprises (SOEs) to support strategic objectives. The reality is that all countries provide subsidies, but their forms and purposes vary depending on an economy's structure. China's subsidies are channeled primarily through its banks because of its less developed tax system, whereas U.S. subsidies are usually provided through federal and state budgets to both consumers and producers. While China uses subsidies primarily to promote innovative, strategic industries, U.S. support ranges from grants to farmers to tax write-offs for households and firms to encourage green technologies and tax incentives to lure companies like Amazon to relocate.[7] The U.S. government could choose to pressure China to align its subsidy policies more with Western norms by raising this issue with the WTO, but instead, the Biden administration now seems intent to copy China's playbook with proposals to promote technological advancement and competitiveness.[8]

More recently, western security concerns have been exacerbated by perceptions that the role of China's state is increasing. A decade ago, observers were trumpeting China's market reforms and the rise of private sector investments. China's National Bureau of Statistics data show that the relative shares of fixed asset investment by SOEs and private firms in 2010 were roughly equal at 42.5 percent. But by 2015, the private share had surged to 50 percent and the state's share had plummeted to 32 percent.[9]

In recent years, however, pro-market cheerleaders have turned critics in noting that the state's share of fixed investment has ticked back up. Some western observers now worry about China's state champions dominating the global economy. The story is actually more nuanced.

"In recent years, however, pro-market cheerleaders have turned critics in noting that the state's share of fixed investment has ticked back up. Some western observers now worry about China's state champions dominating the global economy. The story is actually more nuanced."

Most of this increase is accounted for by infrastructure projects not commercial endeavors like expanding export capacity. Furthermore, investment is increasingly being managed by local authorities via "local government financing vehicles," which are classified as SOEs, to raise funds and manage infrastructure investments.

It is hard to imagine such local investments, much of it in poorer interior provinces, having much relevance to U.S. concerns about China becoming technologically more advanced. Beijing's actions to promote a more innovative and self-sufficient economy is an inevitable response to global economic tensions. The key to more harmonious relations lies in recognizing that a more developed China need not be a threat to the well-being of the West. The product mix and comparative advantages of what the United States, Europe and China produce differ considerably. There is space for all sides to prosper through trade and foreign investments. Simmering great power rivalries, however, are driven less by economic realities but the lack of trust in managing strategic intentions. Debunking the myths that have obfuscated the economic issues is part of the process of rebuilding relations.

08

China has Clear Pillars on Which to Build its Global Leadership

Lord Stephen Green

Chairman, Asia House

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Throughout much of the twentieth century, the global economy was dominated by the markets of the G7. However, since the turn of this century, a major shift has emerged. The G7's share of global GDP is in decline – a trend that has been accelerating since 2000 – while China has well and truly arrived. Having started its decades-long reform process in 1979, China achieved an average annual growth rate of nine per cent until 1990, followed by an average 10.2 per cent growth rate each year between 1990 and 2009. The scale of its transformation can be seen in China's foreign exchange reserves, which stood at US$11.1 billion in 1990. Today, they are at an estimated US$3.22 trillion - the largest in the world.[1] Some forecasts have China's economy overtaking the US as soon as 2028.

The COVID-19 crisis has, of course, proven a major disrupter to the global economy, along with predictions for its trajectory. Yet there are strong indications that China's influence in the world is only set to increase.

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These include the evolving nature of China's foreign direct investment (FDI) in line with its own economic development; the inevitable expansion of the Belt and Road Initiative, despite narratives to the counter; and China's role in the most pressing issue of our time: climate change.

FDI: a shift in quality and direction

As the global economy recovers from the COVID-19 pandemic, China seems likely to further assert its presence on the global stage, predominantly through economic and financial means. The quality and breadth of its outward FDI is set to improve, particularly as it succeeds in rebalancing its growth towards consumption. Additionally, if China undertakes reforms to increase its potential long-term growth, it will become a more attractive prospect for inbound FDI. As has been seen of late, this will catalyse FDI into neighbouring economies, leading to regional spillover effects and, in turn, a deepening of Beijing's ties and influence in Asia.[2]

The Belt and Road Initiative – in for the long haul

While rhetoric in some quarters has sought to question the viability of China's Belt and Road Initiative (BRI) – the ambitious network of highways, fast railroads, airports, ports, pipelines, power transmission lines and fiber optic cables across Eurasia – this is not the reality on the ground. The BRI is a flagship item of President Xi Jinping's vision of a more self-confident China, and it has been embraced by infrastructure-hungry markets, particularly in the Middle East. Even after adjusting for inflation, the BRI - estimated to cost of between US$1 trillion and US$8 trillion[3] - has been calculated to amount to 12 Marshall Plans.[4] An initiative of such scale and reach will only increase China's influence and status on the world stage. Despite some risks of debt build-up in both China and in a number of partner economies, the BRI will continue to foster new investment opportunities, promote China's export markets, and boost incomes.

An internationalised RMB

The BRI will also present another opportunity for China to elevate its presence in the global economy through greater usage of the renminbi among recipient countries. Financial leverage, particularly through the renminbi, is likely to be an important aspect of China's global role, and its early progress in RMB digitalisation could spur wider adoption, particularly if the People's Bank of China succeeds in capturing first-mover advantage to meet the world's growing demand for digital currencies. Asia's growing digital ecosystem, and China's deployment of financial assistance to neighbouring central banks, could foster renminbi usage.

Whether these developments will affect China's status within international finance will, of course, depend on a range of geopolitical factors and domestic policy decisions. The renminbi currently accounts for just two per cent of global foreign exchange reserves. If it is to become significant as a store of value, China will need to move significantly further towards capital account liberalisation and see a stabilisation in international relations, particularly with the US. Without these developments, the current dominance of the US dollar in global payment systems, currency swap lines and the provision of global liquidity and reserve assets is unlikely to be diminished by the RMB.

Driving global green growth

Of all the areas where China has the capacity to exert greater influence and leadership in the world, it is surely the green economy that offers the most potential. Green technology is crucial for China's sustainable growth, not to mention its commitment to carbon neutrality by 2060, and it has already enjoyed tremendous success in this space. China is a leading manufacturer of green technologies, including solar panels, electric vehicles and wind turbines. It generates more energy from both solar and wind power than any other country on Earth. This innovation and expertise offers major export opportunities for Chinese businesses, alongside broader global leadership on energy transition. But China also stands to benefit from the demand-to-come for rare earth materials that will drive the green revolution, in which it is richly resourced. This sector in particular could help China develop and move beyond its high-carbon phase of economic development while contributing positively to global efforts to tackle climate change and hit net zero.

Yet China's leadership role on climate change will also require a fair deal of self-reflection. Natural resources have been a key aspect of its export strategy, and China's resource-seeking FDI has typically been greater than its market-seeking FDI. Its investment outflows to BRI economies, for example, have largely been from sectors that have contributed to pollution in China,[5] and BRI economies with low institutional capacity and inadequate governance measures have typically been recipients of this type of environmentally unfriendly investment. China will therefore need to reconsider the nature of its outbound FDI or risk its positive work in green technologies being eclipsed – further impetus, no doubt, for improving the quality and breadth of its FDI.

A foundation for global leadership

Amid the challenges of an increasingly multipolar world, China has some clear pillars upon which to build its global influence. While the BRI, the internationalisation of the RMB, and a shift in its FDI profile will play a role, it is surely as a driver of green global growth where China's real value to the world will lie.

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