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China in the World Economy

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Abstract. After several decades of widely admired success in raising its gross national product (GNP) and becoming the world's second largest economy behind the United States, doubts have recently emerged about the sustainability of China's impressive economic success unless it undertakes major reforms and changes its growth model. Opinions vary, however, about China ever attaining the same level of growth that had been achieved in past decades, particularly since the 1978-79 reforms. Sometimes, expressing the present realities and forecasting the future is affected by the measures used, the observer's expectations, and perceptions of what can or cannot be done to deal with current issues and problems. Often, it is a matter of perceiving the glass as half full or half empty. For some observers, the growth model, adopted since 1978-79, has been extremely successful in gaining the objectives sought. To others, that model resulted in many unintended consequences such as a wide disparity in incomes and excessive emphasis and reliance on manufacturing and exports at the expense of the service sector and domestic consumption. What cannot be disputed, nevertheless, is the fact that millions of Chinese have been lifted out of poverty, and incomes per capita have substantially increased. Instead of depending on foreign assistance, China is now an aid-giver and a major player in world economic affairs. This paper examines the current economic status of China, its transition from one of the poorest countries in the world, to become a middle income country despite the fact that it has a huge population of 1.3 billion people, and the imbalances that have emerged and have to be corrected to ensure sustained economic growth.

Keywords. State-owned enterprises (SOEs), Balance of trade, Asian Infrastructure Investment Bank (AIIB), Renminbi (RMB), Special Drawing Rights (SDRs), WTO.

JEL. F10, F40, J51, P33.

1. Introduction

In an article in Time magazine, Rana Foroohar (2016), comments on the recent slowing down of the Chinese economy to about 7 percent growth in GNP, compared to the double-digit annual rate of growth achieved in the previous few decades. She wonders, as a result of this slowdown, if the next global recession (if it happens in the near future) would be "made in China", like many of the Chinese-made products that we buy today. Of course, she is not the only observer that is concerned about the state of the Chinese economy and the impact of a slowdown on the rest of the world. The broad concern about what might happen beyond China itself is a result of the high degree of interdependence and integration in the world economy today due to globalization. Problems in one major country are likely to travel fast and affect other economies, particularly its

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small trading partners. As Mui & Marte (2016) point out, “the slowdown in China is spilling over to several key emerging markets, which have ridden Beijing’s coattails to prosperity during the boom... but as they slow down, countries such as the United States and those in Europe lack the momentum to pick up the slack”.

Other observers and scholars do not go as far as Forooher (2016) in linking what China is currently experiencing with the possibility of a soon to come world recession. One can argue that, after all, it is just an economic slowdown, not a collapse with enormous proportions. Some also argue that China’s previous double-digit growth rate could not have been forever sustainable, considering that the world’s average growth is slightly above 3.0 percent (IMF, 2015). Dorrucci, Pula, & Santabarbara (2013), for example, state, in a report for the European Central Bank, that “there is a widespread consensus...that the producer-based model which still prevails in the country is unsustainable.... While the period of double-digit growth is over....China’s potential growth is set to decelerate gradually (but) we do not expect a sharp downward adjustment to occur”.

2. How the 78-79 Reforms Triggered China’s Economic Transformation

China’s economy was largely agrarian until the 1978-79 reform measures were introduced in a bold move to transform its Marxist-Leninist economic model to a market and a manufacturing-oriented one. As Lin (2011) points out, prior to these reforms, China was seen as a “poor, inward looking country”. Moreover, Zhu indicates that it was, not only poor but “one of the poorest countries in the world. The real per capita GNP in China was only one-fortieth of the U.S. level and one-tenth the Brazilian level”. Adding to this description of China’s poor economic condition before the reforms, Will (2016) points out that until 1978, fifty percent of the Chinese people earned only \$1.4 per day.

Since the adoption of this new economic model and the resulting economic and business transformation, the perception of China has changed. Due to the expansion of its manufacturing capacity, and technological and international marketing capabilities, Hu & Haba (1997) wrote in a report published by the International Monetary Fund (IMF) that the rise of China was like the awakening of a dormant giant. In a relatively short time, it has become a manufacturing powerhouse with modernized infrastructure and a much higher standard of living, and has even been described as the world’s manufacturing platform. As the World Bank (2015) indicates, China’s GNP, after these reforms and the resulting fast pace of its industrialization, grew impressively fast for several decades, averaging about 10 percent a year. This helped its income per capita by 2014 to reach \$7,400.00. Table 1 shows the relative position of China among the world’s five largest economies.

Table 1. *The World’s Largest Economies*

| Country | GDP in 2014 In millions of US Dollars |
|--------------------|---------------------------------------|
| United States | \$17,419,000 |
| China | 10,354,832 |
| Japan | 4,601,461 |
| Germany | 3,868,291 |
| The United Kingdom | 2,988,892 |

Source: World Bank Indicators, Database, December 29, 2015.

3. What the 1978-79 Reforms Required China to do

China’s 1978-79 reforms were composed of a series of new laws and regulations, which reflected a major change in the country’s economic philosophy

and attitude towards private enterprises and individual incentives. Those measures were a product of Deng Xiaoping's vision for China to achieve growth by deviating from the Marxist- Leninist state-controlled model that left the country far behind others in achieving its economic aspirations. Specifically, those measures and subsequent liberalization laws have resulted in:

1. Allowing foreign investors to enter the Chinese market provided that they establish joint ventures with Chinese enterprises.
2. Increasing investment, private and public, in manufacturing in order to transform the country into a major exporter of manufactured goods.
3. Moving away from collective marketing.
4. Allowing farmers to market their produce in the local market.
5. Moving away from the collective farming system.
6. Easing price controls.
7. Allowing some profit retention.
8. Allowing more imports even of some luxury items ([World Economic Forum, 2015](#)).

With these reforms, China entered a new phase in its economic history, which can be described as kind of managed capitalism because the government continued to broadly guide the economy and support its state- owned enterprises (SOEs), but the Chinese economy became less and less of a command economy. China also re-opened the Shanghai Stock Market in 1990 after 41 year-absence, and eventually joined the World Trade Organization (WTO). The incentives that the government instituted led to the re-emergence of vibrant, though capital short, small and medium-size enterprises that began to operate alongside the large state-owned enterprises (SOEs). Some small and medium-size private businesses and entrepreneurial firms have attracted foreign partners and contracted with foreign-based businesses that have been motivated to invest in China to take advantage of its huge domestic market. Some have also been attracted by China's lower wages, workers' productivity, attention to details, and high operating efficiencies ([Hu & Khan, 1997](#)). Other by-products of the success of this economic model include a sharp reduction in the country's poverty rate ([Huang, Yang, & Rozelle, 2009](#)), a sharp increase in foreign exchange reserves, and an impressive rise in the inflow of foreign investment by multinational firms. Also Chinese foreign direct investment in Africa and many Western and non-Western countries grew despite the political obstacles and restrictions imposed by some host governments.

As exports continued to exceed imports year after year, China has consistently maintained a favorable balance of trade, which has been helpful in the accumulation of its large amounts of foreign exchange reserves and increase its investment in other countries. Table 2 indicates the merchandize trade balance in 2014, which is reflective the position of imports relative to exports in previous years as well. According to WTO ([2014](#)), the country's share in world merchandize trade (exports and imports) reached 11 percent in 2013, while the U'S' share in that year stood at 10.4 percent (Press Release, 2014). However, China still lags behind the United States in service exports ([WTO, 2014](#)).

Table 2. *China's Merchandize Trade in 2014*

| | Value in Trillion US\$ | %Increase over Last Year |
|--|------------------------|--------------------------|
| Exports | 23,427.5 | 6.1 |
| Imports | 19,602.9 | 0.4 |
| Total Imports and Exports | 43,030.4 | 3.4 |
| Difference between exports and imports | 3824.6 | |

Source: Ministry of Commerce on the People's Republic of China, Jan. 19, 2015.

In a report to the U.S. Congress, published by the Congressional Research Service, Morrison & Labonte (2013) indicate that in 2012, thanks to its substantial reserves, “China was the second largest holder of U.S treasury securities”, and some lawmakers and others have become concerned about the growing size of those holdings that stand at about \$1.3 trillion in June 2013. Those in the U.S., who see China as a strategic competitor on the global arena, or even a potential adversary, are concerned and “argue that China could use its large holdings of U.S. debt as a bargaining chip in its dealings with the United States” (Morrison & Labonte, 2013). Other observers, however, argue that China could hurt its long term interest if this ever happens.

As a major player in the game of nations, China has used its influence and prestige to gain broad acceptance for the establishment of the Asian Infrastructure Investment Bank (AIIB) with a \$100 billion capital as a multilateral development bank. The mission of AIIB is to help other Asian countries to improve their infrastructure. Over 65 countries in Asia and beyond, including the United Kingdom, have subscribed to become founding members. This bank, which started to operate in 2016, is expected to offer low interest infrastructure development loans as a supplement or as an alternative to the World Bank and the Asian Development Bank concessionary loans. Another impressive development for a country, that a few decades ago was described as one of the world’s poorest countries, is the decision by the IMF governing board to include China’s currency, the Renminbi (RMB), in its basket of currencies that determine the value of the Special Drawing Rights (SDRs). The other currencies in the basket are the U.S. Dollar, the Euro, the British Pound and the Japanese Yen (IMF, 2015). This decision by the IMF amounts to a recognition of the RMB as a major world currency along with just four other currencies that are in that league.

4. Imbalances that Threaten Sustainability of China’s Growth and Social Order

Several economic and social imbalances have emerged as a result of China’s choice of a business model that puts most emphasis on fast rise in manufacturing and exports of the imbalances created over the years have been: (1) A rise of a wide income disparity that the government neglected to put under control, (2) stagnation in productivity and efficiency, (3) large-scale environmental damage and pollution, (3) a lagging and weak service sector, and (4) over emphasis on exporting and lower attention to domestic consumption. Commenting on what lies ahead due to current imbalances, Dorrucci, Pula, & Santabarbara (2013) state that “growth fuelled by the accumulation of inputs, sectorial re-allocation and low unit labour costs (extensive growth) will progressively erode and, therefore, China’s upgrading to the high-income status will depend increasingly on greater efficiency in the use of production factors (intensive growth)....China must succeed in shifting from extensive to intensive growth by overhauling its currently model or risks eventually getting stuck in sub-optimal , low growth equilibrium”.

Dorrucci, Pula, & Santabarbara (2013), further comment on the importance of increasing domestic consumption. They observe that “private consumption as a share of China’s GDP declined from one half to one third between 1990 and 2011”.

According to the U.S.-China Business Council, easing import regulations by the Chinese authorities, and reducing its custom duties and consumption taxes can help, not only in increasing domestic consumption, but would also increase competition that can help in increasing productivity and efficiency of China’s manufacturers, particularly those that produce high-end consumer products. That Council report suggests that a re-examination of government regulations in general,

including those that aim at improving quality and food safety standards would also help in boosting domestic consumption (USCBC, 2013).

The World Bank's China Overview of September 18, 2015 attributes some of China's internal and external imbalances to deficiencies in the reforms introduced since 1978. Although there is a clear recognition of the achievements realized since 1978, including reaching the UN Millennium Development Goals of 2001-2015 to reduce poverty and hunger by lifting 500 million Chinese out of poverty, the Banks Overview states that the "market reforms are incomplete". Highlights of the 12th Five-Year Plan, which the Bank praises for moving China in the right direction, include addressing environmental imbalances and pollution problems, increasing energy efficiency, and emphasizing quality of life issues.

5. Conclusion

After going through decades of fast economic growth since its adoption of policies that aimed at fast expansion of manufacturing capability, flooding world markets with cheaper but highly demanded products, saving and overinvesting in manufacturing and housing capacities, and overcoming its economic backwardness and military weakness, the world started to have some anxiety and fear about China's economy slowing down, particularly since 2014. Despite the constant complaints about its under-valued currency that has allowed it to increase its exports, and the complaints raised by some nations about alleged dumping of various products in their markets to raise its market share, the world is concerned about the consequences of any long term slowdown in China's trade and under-utilization of its manufacturing capacity. Some governments and economists are urging adopting new reforms that would deal with social and economic imbalances in order to revitalize the Chinese economy, raise its innovative capacity, and make it less export-dependent. Often repeated imbalances that reforms should also address include a growing rate of income inequality, a weak service sector, low domestic demand and consumption, a small private sector, and inadequate expenditure on R&D. These imbalances that need taking corrective steps can become major obstacles to sustained long term growth.

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