

Demystifying China's Mega Trends

The Driving Forces That Will Shake Up China and the World

To Margaret, Edwyn and Arthur

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The Driving Forces That Will Shake Up
China and the World

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When Asia Meets China in the New Millennium – China's Role in Shaping Asia's Post-Crisis Economic Transformation, Pearson Prentice Hall, 2003

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China's Impossible Trinity: The Structural Challenges to the 'Chinese Dream', Palgrave Macmillan, July 2015

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List of Abbreviations

| | |
|------------------|--|
| AIIB | Asian Infrastructure and Investment Bank |
| AREAER | Annual Report on Exchange Arrangements and Exchange Restrictions |
| BAR | Belt and Road Strategy |
| BoP | Balance of Payments |
| BIS | Bank for International Settlements |
| CDB | China Development Bank |
| CFIUS | Committee on Foreign Investment in the United States |
| CIC | China Investment Corporation |
| CNH | Offshore Renminbi (Chinese yuan) in Hong Kong |
| CNPC | China National Petroleum Corporation |
| CNY | Onshore Renminbi (Chinese yuan) |
| CPI | Consumer Price Index |
| EPMI | Emerging PMI for seven new industries with strategic importance |
| EU | European Union |
| EXIM Bank | Export Import Bank of China |
| FDI | Foreign Direct Investment |
| FTZ | Free Trade Zone |
| G3 | Group of Three Countries – Japan, Europe and the United States |
| GDP | Gross Domestic Product |
| GFC | Global Financial Crisis |
| LGFV | Local Government Financing Vehicle |
| M&A | Mergers and Acquisitions |
| MNCs | Multinational Corporations |

| | |
|--------|--|
| MoF | Ministry of Finance |
| MPC | Marginal Propensity to Consume |
| NDB | New Development Bank |
| NDFI | Non-depository Financial Institutions |
| NDRC | National Development and Reform Commission |
| NPL | Non-performing Loans |
| ODI | Overseas Direct Investment |
| PBoC | People's Bank of China |
| PMI | Purchasing Manager Index |
| PPI | Producer Price Index |
| PPP | Public-Private Partnership Scheme |
| QDII | Qualified Domestic Institutional Investor |
| QFII | Qualified Foreign Institutional Investor |
| R&D | Research and Development |
| RQFII | Renminbi Qualified Foreign Institutional Investor |
| SAFE | State Administration of Foreign Exchange |
| SASAC | State-owned Assets Supervision and Administration Commission |
| SDR | Special Drawing Rights |
| SOE | State-owned Enterprises |
| SEZ | Special Economic Zone |
| TSF | Total Social Financing |
| UNCTAD | United Nations Conference on Trade and Development |
| UNESCO | United Nations Educational, Scientific and Cultural Organization |

Preface

Some mega trends have developed since 1990s that have propelled China to become the ‘world’s factory’ and the second largest economy in the world after the United States. Initially, these trends are simple and have been widely discussed by businesses and China watchers in the forms of books and business research reports. They focus on the production and income sides of these China mega trends and draw straight-line projections for Chinese demand growth, painting a rosy long-term outlook for the Middle Kingdom and translating them into optimistic business opportunity forecasts in China. The prevailing work predominately focuses on the microeconomic and business aspects.

These books and reports share some common characteristics. They are descriptive of the trends and simplistic on the assumptions that government policies are static (and correct) so that these business trends will unfold as projected. They are microeconomic orientated, based on business data, interviews, surveys and even anecdotes from travel experience. They capture the prevailing market sentiment, and hype, on China’s economic liberalisation. These analyses predominately assume that by opening up to the world, China would be changed by the global forces and move towards the global norms. This approach has been proven naive as China has become so assertive that it wants the world to play by its rules too.

Academic research on China’s mega trends is lacking. There are some papers on individual topics on the changing dynamics of the Chinese economy, but the ivory tower economists have offered no integrated themes on the driving forces behind these changing dynamics. This is not a shortcoming but the nature of academic research. However, there is clearly a need for a general equilibrium approach to piece together the individual developments for understanding the secular forces behind China’s structural changes and their impact on the world over the long term.

The biggest dissatisfaction of the analysis on China's mega trends by market practitioners is the lack of serious research effort. This has resulted in confusion and misunderstanding about the development and direction of the mega trends. Blind acceptance of these trends or reading them through distorted lenses only lead to erroneous business and policy decisions and reactions to the emergence of China.

China and the world are dynamic, not static. New mega trends have emerged in China over time, especially on the financial and policy sides, and they have not been covered by the earlier studies. There have also been changes to the prevailing trends due to changes in the structural forces in China and the world economy. Meanwhile, there are hidden issues, problems and trends that many observers have missed. Here are some of the examples.

- Who would imagine a new trend of reverse migration from cities back to rural areas has emerged in China recently when everyone is still expecting urbanisation to drive China's growth and when most global businesses are still forming their China business strategy based on urbanisation?
- Everyone talks about China's shrinking labour force. But there has been almost no discussion on China's early retirement problem (it has the world's earliest effective retirement age) and its profound implications on economic growth which is already threatened by an ageing population.
- Many observers still talk profusely about the brisk progress in renminbi internationalisation, capital account opening, Belt and Road (BAR) strategy, Chinese urbanisation, consumption etc., but without knowing (or just ignoring them intentionally for the sake of self-interest) that changes have crept in to alter the trajectory of the trends.
- Others project a gloomy future for China based on its structural woes as if they will only get worse and eventually drag China into secular doldrums like Japan. But they do not bother to understand the evolving secular forces that make their predictions of a Chinese Armageddon wrong for more than 30 years.
- Consensus has it that China suffers from a secular problem of excess capacity, but seldom noticed is the fact that it also suffers from under-investment at the same time. How can these conflicting trends coexist, and what are the implications on future growth, systemic risk and economic policy?

Another problem with most market analyses to-date is that they have focused too much on how the outside world will change China as the mega trends unfold, but not on how China will change the world. This is clearly a serious shortfall, as China's influence has become so big that even without an open capital account, a slight change in its policy move or development path has the power to send significant shock waves across the world. Witness the global market rout between late 2015 and early 2016, which was caused by a very small change in China's foreign exchange policy that move the renminbi by only 3% against the US dollar in six months and then stabilised (compared to the steady decline of more than 20% in the major currencies against the US dollar in 2015).

In general, studies on China's mega trends are thin on the ground, both inside and outside of the country. Westerners often do not truly understand China as they are preoccupied by their own values which are not appropriate for examining the structural dynamics in China. Meanwhile, Chinese/Asian analysts are often too stubbornly constrained by their oriental values that blind them from the global perspectives of reading China. Aggravating the problem is the proliferation of casual analysis on, and misrepresentation of, China by the western media, although the mainland Chinese media suffers from tight ideological control which also taints our ability to distil facts from narratives promoted by the Chinese Communist Party.

This book differs from all these aspects and aims at bridging the gaps between the East and West perspectives, and academic and market studies of China. It examines China's macroeconomic mega trends, backed by vigorous research and evidence. It is not descriptive and does not take the trends for granted. Rather it takes a critical approach to question and to assess the evolution of the mega trends through theoretical and empirical analyses.

It captures the new mega trends and reassesses the prevailing trends by examining the structural forces behind them, refuting conventional wisdom and demystifying media and market hypes. This is a significant departure from the existing work, which focuses on the business and microeconomic aspects and adds hype to conventional wisdom to generate exaggerated and erroneous analysis. Crucially, the discussions here cover both the impact of the world on China and China's impact on the world in its process of opening up.

Coverage of China's mega trends in this book is not meant to be exhaustive as new trends will emerge over time and the

existing trends will keep on evolving. Thus, the discussions and views here may be controversial and even incomplete from a research perspective. But the purpose of this book is to dig deep into the hidden issues and uncover the changing dynamics of China in order to stimulate educated debates and further research to correct those distorted assessments that are clouding the understanding of the mega trends of the Middle Kingdom.

The plan of the book is as follows. As an introduction, Chapter 1 gives a bird's-eye view on some of the macroeconomic mega trends that are unfolding in China, while the rest of the book takes a deep dive into these and the new trends that have either been misunderstood or clouded by bad analyses.

Chapter 2 starts our in-depth analysis by exploring the trends of China's long-term growth and reform strategy from a risk perspective that most discussions have missed, namely the possibility of secular stagnation and the risk of an economic identity crisis in the reform process. While no one can pin down China's growth trajectory, there is evidence showing that it is moving towards a sustainable growth path without catching much attention, and that stagnant is a low-odds outcome but needs to be monitored.

Chapter 3 looks at China's demographic challenges through the emerging and hidden trends and problems, including the little-known reverse-migration from cities back to the farmlands, 'early retirement' and its related policy and incentive problems, the structural implications on Chinese consumption (especially the demand for financial assets) of an ageing population and the obstacles for transiting towards a consumption-led growth model.

While China's excess capacity problem is well known, it is seldom noticed that it also has an under-investment problem simultaneously. This bifurcated insight is quite non-consensus and is the focus of Chapter 4, which also reassesses critically the views that Beijing has the power to cut excess capacity at will and that its supply-side reform could yield significant efficiency enhancement. The discussion also highlights the inherent problem of incentive incompatibility in China's structural reform process that Beijing will have to resolve to make reforms successful.

Deleveraging is a key part of China's structural reform and a policy mega trend that unfolds gradually. Behind deleveraging lies the worry about China's 'debt bomb', which has led to pessimistic prediction of an imminent debt crisis sending shock

waves across the global economy. Chapter 5 demystifies the debt-currency crisis by examining the structural factors behind China's debt and assesses the measures that Beijing may take to diffuse the debt bomb. Privatisation is a crucial solution, but there is also a conundrum that this book highlights but many China analysts have ignored.

Opening up the capital account is another mega trend unfolding in China. Although still at its early stage, this trend is already creating significant impact on the global policy and investment landscape and causing confusion, fears and hype among the international community. Chapter 6 discusses the 'controlled way' which China is using to open its capital account and seeks to debunk many of the myths behind Beijing's policy moves, notably the setting up of the two-way channels for capital flows between China and Hong Kong and the free trade zones since 2014. Many observers have mistaken the capital flow channels as a big step towards opening the capital account, while no one seems to be aware of an incentive incompatibility problem behind the free trade zones.

As China opens its capital account gradually, capital outflows have emerged as a related secular trend since 2013. Chapter 7 explores the dynamics of these outflows by examining the worries about capital flight from China, the evolving forces behind China's overseas direct investments, their global impact on the political and financial environment, and the effect of the emerging financial prowess of China on the world's development financing. All these shifts argue that there is a need for a change in the way that the world looks at China's investment and capital flows.

Chapter 8 zooms in to examine one particular aspect of China's capital outflows, the BAR strategy that underpins China's long-term strategic expansion on the global stage. The BAR initiative has been under-appreciated by the international community, which has either little knowledge about its strategic importance or distorted views on its impact on the Chinese and global economic development. This chapter assesses whether the BAR strategy has actually gained traction (as the optimists believe), identifies its development path and examines its impact on China's economic rebalancing (which has been misunderstood) and the concerns about whether China is using its BAR plan to 'conquer the world'.

Closely related to China's capital outflows and the BAR initiative is the internationalisation of the renminbi, which is one of

the major emerging mega trends that is catching international attention and causing jitters. Chapter 9 focuses on the development, risks and challenges of renminbi internationalisation that China and the world are facing and seek to debunk some of the myths and hypes about this process. It is particularly disconcerting to see casual analysis on pushing the view that the renminbi has been developed into an investment currency while its internationalisation process is still stuck in the first gear of being trade driven. Worst of all, no one seems to acknowledge that even the momentum of this first-gear development is hitting a limit.

Renminbi internationalisation will potentially re-write the global monetary order in the coming decades. But it is not a smooth-sailing process, and Beijing is already having second thoughts about its policy priority for promoting the global role of the yuan even at this early stage of its efforts. Chapter 9 also highlights Beijing's change of mind regarding renminbi internationalisation policy that most market analysts have ignored.

Our discussion on China's macroeconomic mega trends argues that it is not a matter of whether but when these forces will eventually elevate China's influence to the top of the world economic league. The eventual realisation of President Xi Jinping's 'Chinese Dream' will mean a global currency status for the renminbi challenging or even displacing the dominance of the current global reserve currencies. Chapter 10 wraps up our discussion by examining the future of the renminbi by identifying the necessary and sufficient conditions of a global currency and understanding China's incentives to acquire those conditions.

A reassessment of the global status of the world's three major currencies (the US dollar, the euro and the Japanese yen) is indeed timely at this point because structural changes behind them are starting to erode their basic currency functions. This argues that their global influence should fade over the long term. The global impact of these structural shifts will certainly be substantial, and even confusing and worrying in the short- to medium-term, because the geopolitical reality behind the future monetary order is that China's global influence is rising at a time when that of the United States and Europe are fading.

Nevertheless, this does not mean that China will dominate the world anytime soon because it still lacks many of the economic, political and cultural attributes that are essential for making it a global power. Our discussion on the renminbi's global status in Chapter 10 highlights the challenges for China to instil global confidence in its currency when it does not have

most of those characteristics that create the necessary and sufficient conditions for the renminbi to serve, on a global basis, as a store of value, a medium of exchange and a unit of account.

I hope that this book will help demystify and clarify some of the important issues stemming from China's mega trends and open up new angles for further debates and research on the driving forces that will affect the Middle Kingdom and the global economy in the coming decades. It is not my purpose to jump into conclusions for the issues that we discuss here, as they are moving targets with no defined paths yet. Rather, by challenging consensus and conventional wisdom, and by correcting the crooked views and distorted analyses, I hope we can have a better reading on China by keeping an open mind and basing our understanding on proper research and evidence instead of sentimental judgement, partial analysis and distorted concepts.