

Challenges Facing China

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Abstract: This article examines economic and other challenges that China is facing. It has completed its cycle as a high-growth, low-wage country and thus from now on, it should have to concentrate on efficiency of the economy. However, there are other issues like corruption, lack of cheap work force, lack of market liberalization, and political issues which will need to be addressed.

Keywords: China, economy, reform, challenges, debt, corruption, future

1. INTRODUCTION

China, according to most experts in the field, has completed its cycle as a high-growth, low wage country.¹ This means, that until now, China tried to maximize investment (like Japan, South Korea did few decades ago), but from now, it will have to maximize return on investment – the so-called ‘middle income trap’. That is to say, China’s economy will have to be more efficient as it shifts to consumer led growth.² However, to achieve this, it will have to reduce state control, which is widely present in the current Chinese economy. At the same time, because the new phase includes slower growth, the most likely divergent forces will be contained by an increasingly powerful central government. Economists, therefore, forecast that China will continue to be a major economic force in the world but not the dynamic engine of global growth it once was.³ In the following article, the challenges that China is facing, mainly from economic aspects will be examined.

2. ECONOMIC CONSIDERATIONS

The size and huge resources of China means that the Chinese economy has been based on the idea of mobilisation of resources, without any concerns on the efficiency of using these resources. Arthur Kroeber noted that ‘visitors to China observe the waste and inefficiency visible everywhere and often conclude that the economy will soon hit a crisis.’⁴ Realising the ‘middle income trap’; that the economic growth is slowing down, and that domestic demand has become a new growth engine,⁵ it seems that the Chinese leadership tries to postpone the problem by keeping living standards and employment high, instead of

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¹ Stratfor (2015) link 5, Howitz (2016) 4, Prasad (2015) 3.

² Saich (2017) 1.

³ Kroeber (2016) 235.

⁴ Kroeber (2016) 22.

⁵ Maliszewski (2016) 1.

improving quality (efficiency). As a result, unemployment is very low – a merely 4.09% in 2014.⁶ The reason for this might be the leadership's fear of social unrests, what is understandable considering that China has gone from being one of the most equal countries in Asia to one of the most unequal.⁷ Thus, China tries to artificially maintain growth by major investments into infrastructural and housing projects, altering banking supervision, devaluing its currency and changing laws for some industries that can hopefully create larger economic growth.⁸ Investments are typically financed through state-owned banks. However, investing money into infrastructure in China is not generating any more high return and growth.⁹ This is shown by the deterioration of China's GDP growth rate from 10.61% in 2010, to 6.7% in 2016.¹⁰ All this results in a reduction in the asset quality of banks. It might be also a problem that China's credit expansion is very fast compared to other economies.¹¹ The Government has created a long term unsustainable credit expansion and banks lowered the lending standards to increase profits.¹² IMF experts point out that there is a very high 'credit gap' comparable to countries that experienced painful deleveraging, like Spain, Thailand, or Japan. They also draw the attention to the credit-to-GDP ratio is significantly higher than in countries at a similar level of development.¹³ In addition, there is considerable shadow banking activity in the country.¹⁴

At the same time, the structure of the Chinese debt is very interesting with the central Government's debt is low, a mere 4,328.52 billion U.S. dollars in 2015¹⁵ whilst corporate debt is very high. The reason might be that credit is centrally distributed to huge state owned enterprises and not on market bases to productive enterprises, like earlier in South Korea. The "economic officials of the reform era inherited a country virtually without legal or regulatory systems". China therefore found it convenient to regulate via the controlled enterprises, rather than through impotent regulatory agencies.¹⁶ Figure 1 shows the distribution of debt in China and in some other global countries and the ratio of corporate debt is highest in China.

⁶ Statista (2016) link 8.

⁷ Saich (2017) 1. The Guardian (2017) link 6, Kroeber (2016) 22.

⁸ Prasad (2015) 3, Georgievski (2016) 156.

⁹ According to Smith, China's declining growth rate is 'not something cyclical, based on the prolonged aftermath of the 2008 global financial crisis, but something structural that will affect China's growth over the long-term'. Smith (2017) 9.

¹⁰ Statista (2016) link 8.

¹¹ Maliszewski (2016) 1.

¹² Georgievski (2016) 167.

¹³ Maliszewski (2016) 2.

¹⁴ Georgievski (2016) 167.

¹⁵ Statista (2016) link 8.

¹⁶ Kroeber (2016) 13.

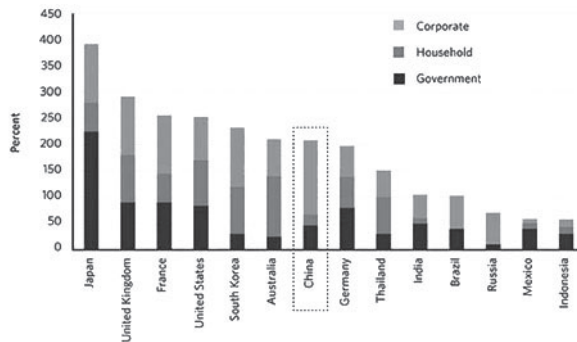


Figure 1. Debt-to-GDP ratios

[source: Carnegie Endowment (Bank for International Settlements, IMF, Goldman Sachs)]

The return on invested capital in these huge state owned enterprises is declining from the last economic crisis and the gap is widening between state owned and privately owned companies (Figure 2). This is happening in despite state owned enterprises having privileges when borrowing money from banks.¹⁷ This process is followed by deteriorating debt servicing capacity of these companies.

This is an alarming sign considering that state owned enterprises are the main tool of the economy, through the state investments programs.¹⁸ The Party promised to reform the system, and make it more market based, however, these enterprises are of prime importance for the Party, both from political and economic aspects¹⁹ and will presumably not be passed over the whims of the market. Experts forecast state-owned enterprise reform with so-called ‘Chinese characteristics’. One direction is merger of central state owned enterprises.²⁰ Another way the government tries to solve the problem is winding up loss making companies and those in non-strategic sectors; to broaden ownership and improve efficiency in state owned companies. However, this strategy used many times done selectively and only in certain sectors.²¹

¹⁷ Maliszewski (2016) 7.

¹⁸ Zhou (2017) 1.

¹⁹ Zhou (2017) 2.

²⁰ Zhou (2017) 5.

²¹ Maliszewski (2016) 8, Saich (2017) 9.

More markets needed: resources must be shifted to the private sector

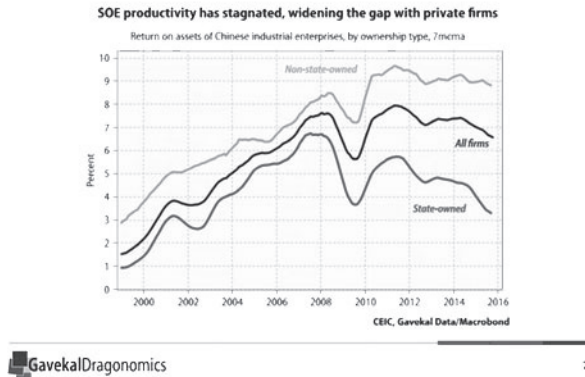


Figure 2. SOE productivity (source: Gavekal Dragonomics)

The mentioned huge investment projects and related problems are well illustrated by the construction boom, which is very much over. There are several ‘ghost cities’ in China. These real estate and infrastructure projects were extremely inefficient and also involved corruption. By investing into such projects, the Government bought additional time, but at the same time, enlarged the problem. These investments are not bringing long term profits.

The Government realized these issues and tried to move the capital to the private sector where the return is higher. It also introduced some reforms in the financial sector, like interest rate liberalisation. Renminbi, the Chinese currency, is also used more in trade settlements.²²

China is gradually moving towards market based currency rate. The majority of experts forecast that in future the Chinese currency will depreciate as it is tied to a basket of currencies, not only to the dollar. However, it should be mentioned that Chinese regulation is still not in accordance with International Financial Reporting Standards, there is serious lack of transparency in the financial sector and a sizeable shadow banking. The calculation method for the loan-deposit ratio, as previously mentioned above, is very flexible, and the Government is constantly lowering reserve requirement ratio and banks can grant more credit.²³ This way the Government is artificially increasing liquidity of Chinese banks.²⁴

General market liberalisation started with the ‘open door policy’ end of 1970s as a transition from state controlled and closed economy to market economy, and economic growth was based on foreign trade and foreign investment, bringing capital, technology, management knowledge, etc.²⁵ It still seems that the Government still broad policies and allocates the majority of resources.²⁶ Kroeber finds this paradoxical as ‘an apparently

²² Saich (2017) 10.

²³ Georgievski (2016) 168.

²⁴ Smith (2017) 13, Georgievski (2016) 168.

²⁵ Conkling (1997) 93. This is a difference between China and other East Asian models. Kroeber (2016) 14.

²⁶ At the same time, Kroeber notes that there is an unusually high level of fiscal decentralisation for an authoritarian country like China. Kroeber (2016) 4.

centralized, one party authoritarian state presiding over a dynamic, decentralized economy.²⁷ Thus, there is still no real information about the market – a serious obstacle for foreign investors.²⁸ President Xi has promised that market forces will be more ‘decisive’, however, it seems that this is not coming true.²⁹

There is another reason for lack of private capital – the majority of domestic investors are taking their money abroad as a result of anti-corruption laws. President Xi launched an anti-corruption campaign under the slogan ‘catching tigers and flies’ resulting in the arrest of several high and low ranking officials.³⁰ A study carried out by Chen and Zhong revealed that it is not only the political elite that profit from corruption, but also wider social-economic classes. Therefore, anti-corruption legislation affects not only bureaucracy but the private sector as well. Paradoxically, these laws increase the cost of entry to the market for the private sector. The study concludes that ‘the negative impact of anti-corruption on business registration suggests corruption may help reduce entry barrier.’³¹ Thus, effective anti-corruption laws slow down economic growth.³² Other sources support this view explaining that local and other officials think it is safer to do nothing rather than approve investments or making decisions which may lead to accusations of misuse of power.³³ The 2016 report of Corruption Perception Index of Transparency International also shows how serious problem is corruption in China, ranking it at the 79th place among 176 countries.³⁴ According to a recent poll corruption is a top concern of the Chinese citizens.³⁵ All in all, corruption is a huge problem in China that affects the economy.³⁶

3. OTHER CONSIDERATIONS

Demographics might be also an issue for the Chinese economy.³⁷ During the last few decades there was a favourable demographic situation in China as the dependency ratio was good, that is to say the ratio of dependent young and old people to productive workers. It was between 40 to 100 productive workers during the peak and in addition, more than 200 million workers have migrated from the countryside to the cities during the last 30 years. These unskilled people were trained in factories and became cheap work force in the cities.³⁸ The urban population percentage changed from 43.87% in 2006 to 56.78% in 2016.³⁹ The dependency ratio is deteriorating, and in some areas of China, there is lack of cheap work force. Some workers are even imported from abroad e.g. Vietnam.⁴⁰ Fertility

²⁷ Kroeber (2016) 5.

²⁸ Smith (2017) 6.

²⁹ Smith (2017) 15.

³⁰ Saich (2017) 6.

³¹ Chen (2017) 4.

³² Chen (2017) 17.

³³ Saich (2017) 5, Chen (2017) 7.

³⁴ Transparency International (2016) link 7.

³⁵ Chen (2017) 4.

³⁶ Lately, Minxin Pei has published a good book on crony capitalism in China.

³⁷ Smith, (2017) 5.

³⁸ Smith (2017) 11.

³⁹ Statista (2016) link 8.

⁴⁰ China Daily (2017) link 1.

rates are also below replacement value, 1.57 children born per woman in 2015.⁴¹ The result is that wages are rising and it has a negative effect on the competitiveness of the Chinese economy. Figure 3 shows the population age pyramid and there is not too much hope for improvement. A related issue is the huge difference in living standard between inland parts of China and the coastal regions of the country and Yangtze River Delta. There are plans to close the gap between these regions but if the economic growth slows in the advanced regions, they will not be able to aid underdeveloped parts of the country. Thus, these differences might cause long term tensions.⁴²

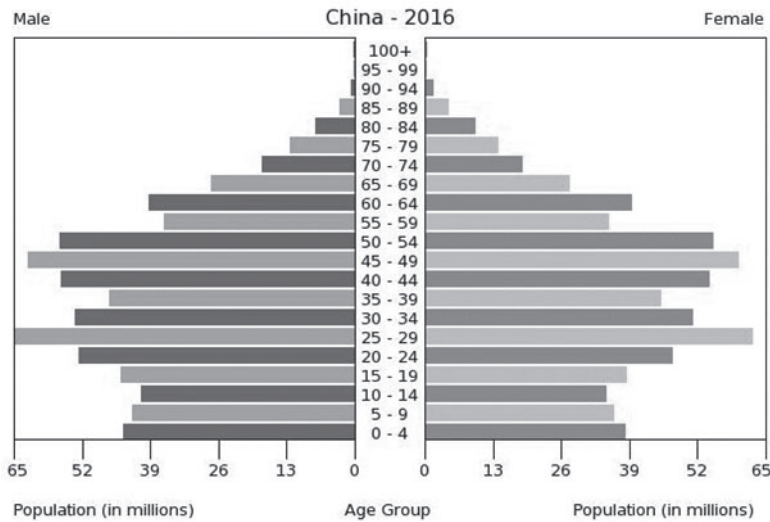


Figure 3. Population age pyramid (source: Index Mundi)

Another issue that has impact on the Chinese economy is environmental pollution. Rapid industrial development without taking into account its consequences to the environment has caused serious ecological issues in China.⁴³ Its Environmental Performance Index score is 65.1 and ranked 109 out of 180 countries.⁴⁴ The condition of major environmental components, air, water and soil has a bleak outlook. China took over from the United States of America the leadership in air pollution in 2007.⁴⁵ The main reasons being the extensive usage of coal in the industry, the growth of traffic, and of course, the emission of factories. There is a related higher number of cardiovascular, lung and other

⁴¹ Statista (2016) link 8.

⁴² Stratfor (2015) link 5.

⁴³ Cantoni (2016) 67-68, Mujačević (2015) 583.

⁴⁴ The Environmental Performance Index (EPI) is constructed through the calculation and aggregation of more than 20 indicators reflecting national-level environmental data. These indicators are combined into nine issue categories, each of which fit under one of two overarching objectives. This section provides an overview of how the EPI is calculated. Complete methodological details and indicator-level metadata are available at: EPI (2014) link 2.

⁴⁵ Albert (2017).

disorders in the population.⁴⁶ All this result in high public health costs. Life expectancy is also stalling as a result, only increasing from 73.77 years in 2005 to 76.00 in 2015 despite the rapid economic growth and significantly increased quality of life.⁴⁷

There is also issues with the quality of waters, soil, desertification, energy efficiency, etc.⁴⁸ It seems that the State still prefers economic growth to environmental protection.⁴⁹ The strong competition and lack of regulation in some fields resulted that the producers sometimes do not respect even basic environmental standards. However, experts hope that China is reaching the peak of the 'Kuznets curve' (Figure 4) and the situation is going to improve during the years that follow (less polluting technology is used, etc.). (At the same time, it should be noted that the theory related to the Kuznets curve has its deficiencies.).

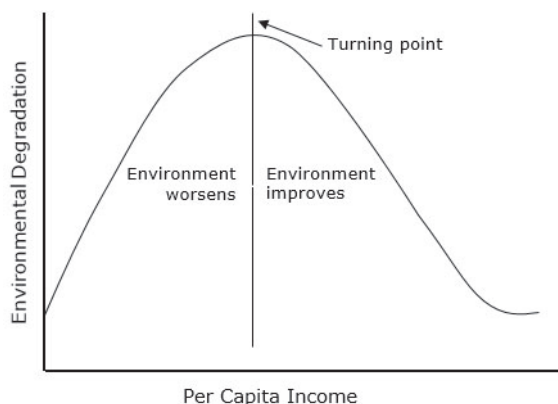


Figure 4. Kuznets curve

At the same time, there are some promising signs, there has recently be fall in the consumption of coal was recorded and a certain improvement in the air quality due to more than hundred most polluting factories being closed down during the last year, and new vehicles were introduced into the traffic, some with electric engine.⁵⁰ China is also investing extensively into renewable energy and is a global leader in wind energy production. The number of environmental activists is constantly rising in the country and also the awareness and conscience of people is also changing. The Government and the Party have to find the balance between economic and environmental interests. However, this will not be an easy task as still the main goal is to maintain economic growth.⁵¹

A few words should be devoted to domestic and foreign policy as well, as they have huge effect on the economy as politics actually determines economic system. The main political issue currently is also related to the economy of the country – how to find the balance between maintaining power and control of the Party and maximizing economic growth in the country. The Chinese leadership has been good at this during the last few

⁴⁶ Kineska ekologija, energetika i ekonomija (2015) link 3.

⁴⁷ Statista (2016) link 8.

⁴⁸ Lallanilla (2013) link 4.

⁴⁹ Amesheva (2017) 427–30.

⁵⁰ Zhang (2016) 1307.

⁵¹ Amesheva (2017) 427–30.

decades. They have even researched the collapse of the Soviet Union. Allegedly, Deng Xiaoping once said that Michail Gorbachev was an idiot for putting political reforms ahead of economic ones.⁵² Until now, the Party has handled the issue relatively flexibly, prioritising the economy, understanding its importance.⁵³ However, currently it seems that political and economic powers are getting more centralised, nationalism is in rise, and all this will certainly have effect on market oriented reforms in the economy.⁵⁴

Foreign policy has also effect on the economy in as much as it seems assertive in its foreign policy e.g. building artificial islands, etc. Currently, China has no interest to be internationally aggressive and having its own sphere of interest might be costly. Besides, China is both a huge importer and exporter in the region and worldwide. For example, the United States of America is China's leading trade partner (\$520 billion of total trade in 2016), and China is the US' third largest.⁵⁵ The large amount of exports by China is also shown by the country having a trade surplus of 593 billion USD in 2015.⁵⁶ In the long run, an exception might be Russia's maritime interests in the East. However, if China has no interest in developing its own sphere of interest, why does it increasingly focused on soft cultural power and indirect influence through international investments? Are these merely signs of China trying to assert its own identity or that China has greater plans for the world?

4. CONCLUSIONS

It can be generally concluded that China should shift to a growth model that emphasizes quantity over quality. Resources should be used more efficiently. However, in a system like the Chinese, such thorough changes can be carried out only centrally.

The 19th Congress of the Chinese Communist Party took place in the autumn of 2017 with a strong focus on internal issues. Xi Jinping has strengthened his positions as the General Secretary's and the Chairman of the Central Military Commission. It is true that his highly centralized approach to economic policymaking is a departure from the usual practice over the prior three decades and that he has built up a powerful bureaucracy.⁵⁷ However, it is still a question how will he react when faced with the problem of choosing between economic reforms and strengthening the party. It also bears mentioning that Mr. Xi is not only strengthening his position but is also increasingly moving towards a more centralized system. Systems, such as these, tend to be dominated by political, and not economic considerations.

Some analysts suggest that

First, the government should act quickly before the problem becomes systemic. Second, the problems of both creditors and debtors should be tackled together. Just cleaning up the banks by moving bad loans off bank balance sheet and recapitalizing the banks, or allowing companies to go bankrupt without recapitalizing banks would not revitalize economic activity. Third, the governance problems in the corporate

⁵² Kroeber (2016) 8.

⁵³ Stratfor (2015) link 5, Smith (2017) 7.

⁵⁴ Stratfor (2015) link 5.

⁵⁵ Smith, (2017) 4.

⁵⁶ Statista (2016) link 8.

⁵⁷ Kroeber (2016) 18. Georgievski (2016) 170.

sector and the banks that gave rise to the problem should be addressed to prevent the re-emergence of a vicious credit cycle.⁵⁸

Saichs' prognosis is that

There would be a dominant executive with a weak legislature and a fragmented civil society overseen by a strong domestic security apparatus and military. The leadership would stress the fear of social chaos to keep the middle class supportive with a stronger nationalism to cement patriotic cohesion.⁵⁹

However, Arthur Kroeber for example, is more cautious and forecasts more scenarios. One of them is that economic reforms will be carried out (bankrupt state enterprises shut down, banks recapitalised) under tight party control and thus growth will settle at 5%, with a limited expansion of rights. Another scenario is that economic reforms will be judged too destabilising, therefore growth will slow sharply and nationalism will be strengthened. The last scenario is entrenched political-economic bargains, which impede reforms, thus resulting in low growth and high debt trap.

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⁵⁸ Maliszewski (2016) 1.

⁵⁹ Saich (2017) 19.

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