China's March to Geo-political Ascendancy: Time for a Reality Check

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In the introductory chapter of his recent book, *Eclipse: Living in the Shadow of China's Dominance*, Arvind Subramaniam of the Peterson Institute, Washington, has this fictional narrative to underscore the compelling implications of his thesis:

> *February 2011:* It is a cold blustery morning in Washington. The newly inaugurated president of the United States is on his way to the office of the Chinese managing director of the International Monetary Fund (IMF) to sign the agreement under which the IMF will provide $ 3 trillion in emergency financing (about 12 percent of GDP) to the United States and the conditionality to which the United States will have to adhere.

The conditionality to which the US has agreed is the removal of US naval bases from the Western Pacific.

> *November 2011:* The European Financial Stability Facility has announced an augmented war chest of US $ 1.4 trillion, to bail out Eurozone countries threatened by sovereign default. Klaus Regling, the head of the Facility has rushed to Beijing to supplicate Chinese leaders for a sizeable contribution to the facility through the purchase of its bonds. The Chinese reaction is opaque and ambiguous. The conditionality China may be insisting upon, is not clear. There are reports that

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China could invest $100-200 billion, but wants the EU to recognise China as a "market economy" which would eliminate the anti-dumping action Chinese exports are exposed to in Europe.

As if to dramatise the reversal of fortunes between the West and China, it was widely reported that French President Nicholas Sarkozy, was kept waiting for his scheduled audience with Chinese President Hu Jintao for a full quarter of an hour. Could there be any doubt about the eclipse of the West and the irresistible dominance of China? And that, too, a decade before Subramanian's prediction, even though the supplicant is Europe, not yet the US?

When the global financial and economic crisis erupted in 2008, its epicentre was the United States. The Europeans were congratulating themselves on their more prudent policies even if their economies, particularly of the peripheral countries, were badly hit. Fast forward to 2011 and the epicentre has moved to Eurozone, including its larger and key members, Spain, Italy and possibly France.

And through all this, China appears to be relatively unscathed, maintaining an enviable, though somewhat slower Gross Domestic Product (GDP) growth rate of over 9 percent. While conceding that the Chinese economy may slow down even further to, say, 6 percent to 7 percent annual growth over the next decade, several reputed economists and business analysts are convinced that China will, in the next decade, if not earlier, boast of an economy at least 50 percent larger than that of the US The geo-political implications of the shift in relative economic power is encapsulated in Subramaniam's opening narrative.

India and China are both continental-size economies with large populations and steadily growing military capabilities. But on current trends, the power gap between them is increasing. Is it not prudent for India to acquiesce in an emerging Asian and international order which will be dominated by China? Should we not reconcile ourselves to the role of a junior partner in the Asian regional order?

In order to answer this question, it is necessary that India does its own sums and makes critical judgments based on an independent and objective scrutiny of the assumptions that underlie the forecasts of Chinese ascendancy. China has sustained high rates of GDP growth over the past three decades by pursuing the same strategy as the other Asian success stories, that is, Japan, Korea, Taiwan and Singapore. The drivers of growth have been consistently high rates of fixed investment and rapidly rising exports. Among these countries, only Japan could be said to have a critical mass of population and a size of economy which could rival the United States. In fact, in the late 1980s, there was a series of predictions that Japan was destined to become No. 1 in the global pecking order and its own peculiar brand of "managed" development was superior to the Anglo-Saxon capitalism typified by the US and the UK. And yet in 1990, the Japanese property bubble burst, its banking system was crippled and its public debt soared. Since then, the stagnation of the Japanese economy has diminished its relative weight in the global order, through it remains the world's third largest economic power.

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It is true that China has sustained a higher GDP growth rate much longer than the other Asian economies that have traversed a comparable stage in their growth trajectories. However, this is because China has, as a matter of policy, persisted with high rates of fixed investment and rising exports far longer than witnessed among the Asian tigers. From 1979 to 2009, China's fixed investment grew from 35 percent of GDP to 45 percent, while export turnover grew from 5 percent of GDP to 30 percent. Consumption on the other hand, declined from 60 percent of GDP to less than 40 percent. According to the latest *Chinese Year Book*, it was even lower, at 33.8 percent in 2010. China was enabled to deliver a rapidly growing export turnover because consumption grew both in the US and Europe beyond what could be sustained by their rising productivity. Chinese surpluses, both fiscal and in foreign trade, were the mirror image of deficits in the US and Europe. If Chinese surpluses were financing Western deficits, Western deficits made it possible for China to register and grow its surpluses. It is this umbilical cord that ties interdependent economies together in an interconnected global marketplace, which is not being factored into our analyses of China's likely economic trajectory. What needs to be recognised is that while negative imbalances imperil Western economies, positive imbalances make China equally vulnerable. If Western economies are compelled to undergo massive and painful rebalancing, deleveraging their over-extended economies, China, too, must undertake rebalancing by reducing its surpluses. As the US and Europe begin to export more than they import and run fiscal surpluses, China will find the source of its own surpluses shrinking. In the global marketplace, not everyone can be a creditor or a debtor and certainly not the largest economies in the world.

What does this imply for China? If China has to significantly reduce its trade and fiscal surpluses, it must export less and import more. This requires a significant revaluation of its currency. It would also imply a change in the product mix of Chinese industry away from export commodities to those that cater to domestic demand. The share of investment in the economy must go down, while the share of consumption must increase. These shifts cannot take place overnight nor will they be painless. China's 12th Five-Year Plan has adopted a strategy of rebalancing the economy by reducing the overall growth rate, increasing the share of consumption, extending social benefits to a larger number of people and expanding the social safety set beyond the government sector. However, as would be obvious from the latest investment and consumption figures, the imbalance is being intensified rather than being diminished.

One should not forget that despite their recent troubles, the US, Europe and Japan together account for approximately $ 20 trillion of consumption expenditure. China and India together account for about $ 2.5 trillion. Or to put it in a somewhat different context, the advanced economies of the world together account for 69 percent of world consumption, China for 6.2 percent, India for 2.3 percent and other emerging and developing economies for 22.5 percent (FT 02.11.2001). Therefore, even if China were to significantly increase the share of consumption in its GDP, or increase its exports to other emerging and developing countries, it would be unable to compensate for a significant fall in imports by the advanced economies in the course of their deleveraging.

If exports cannot be increased and domestic consumption remains stagnant, the only way in which high GDP growth rates could be delivered would be through the continuance, even intensification of the current investment-oriented strategy. But this would further exacerbate the already serious problem of over-capacity, particularly in the critical sector of real estate construction. Housing investment in China is about 25 percent of all fixed investment and, therefore, a key determinant of growth. Any retrenchment in this sector would drag the economy down. There would be collateral impact on sectors serving construction such as steel and cement.

In 2008, Chinese injected a massive stimulus into its economy to maintain high rates of growth and prevent employment reductions. The announced stimulus was over $ 600 billion, but taking into account subsequent credit growth, the stimulus may have been closer to US$ 1 trillion. Virtually all of this additional funding was channeled through the state controlled banking system and the beneficiaries were mostly state-owned enterprises and local government bodies. They, in turn, used the funds to invest even more in the infrastructure and construction sectors, exacerbating the problem of over-capacity.

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According to a report in a trade journal, total apartment house floor area in Chinese cities is 43 billion square metres, with another 3 billion square metres under construction. It is estimated that roughly 20-25 percent of this total area is lying vacant. With the government trying to dampen the property bubble, by putting limits on the price of built-up property and imposing restrictions on lending for real estate, there is likelihood of a downward spiral in property prices, as happened in Japan 20 years ago, leading to losses in personal wealth and exposing banks to heavy losses. There are reports that in Shanghai and Guangdong, real estate prices are declining by as much as 15 percent to 20 percent. In some cities, discounts of 50 percent are being offered on sale. This needs to be monitored closely as a property bubble unravelling can have a major impact on the economy as a whole and for a considerable period of time.

There is another disturbing development which has surfaced. China has a vast shadow banking system which has been the chief source of funds for private entrepreneurs. Since saving deposit rates have been pegged at about 3 percent to 3.5 percent and inflation is currently estimated at 6.5 percent, the people's savings are consistently being eroded. They find it more advantageous to lend their savings to an agent or one of the numerous "trusts", to earn interest typically at the rate of 8-10 percent. A private firm or entrepreneur may pay 20 percent or more for an informal loan from these shadow lenders to invest in his business. This may work while business is expanding and large profits are being generated. However, when business stalls, either because of loss of export markets or lack of government support, loans are not repaid and the depositor loses his savings. This is precisely what is happening in Tier-2 cities like Wenzhou and Guangdong and is spreading. It is estimated that shadow banks may have lent $ 32.6 billion to real estate companies so far or as much as the formal banking sector ($ 33.1 billion).

The more than 10,000 local bodies, municipalities and townships in China also draw an overwhelming part of their income from sale of land and real-estate transactions. When the central government put restrictions on credit for real estate development, a large number of local governments set up financial vehicles, in 2008 and 2009, in order to raise money for continued investment in property and infrastructure development. This money comes from the shadow banking sector, mobilising the savings of ordinary depositors. As the property market cools down in response to strict government restrictions, local governments may find themselves in deep trouble since over 70 percent of their income comes from land transactions and fees from property developers.

It is not clear what the precise scale of exposure is for these local governments, but there are estimates that both on this account and on account of lending to small and medium enterprises, the total size of underground lending by the shadow banking sector may be anywhere from $ 627 billion to $ 1.3 trillion. Even while these figures have to be treated with caution, taken, together they do point to serious imbalances and distortions in the economy. The Chinese government is aware of them and appears to be taking steps to remedy them. Chinese Vice Premier Li Keqiang recently stated:

> If growth rates slow significantly but China genuinely rebalances, we could still see incomes continue to grow at 5 percent to 6 percent a year, which is much better for China than 10 percent to 11percent growth rates but with continued misallocation of investment and continued imbalances.

If these steps succeed, the Chinese economy will go through a period of painful correction which will at least temporarily drag down the economy and may have serious political and social consequences. For example, in Wenzhou, it is reported that over 90 percent of the families have been involved with the shadow banking sector and its activities. If their assets are eroded or worse, evaporate, the social and human consequences could be very serious. If, on the other hand, the Chinese state no longer has the instruments at hand to bring the situation under control, then the imbalances in the economy will only become more exacerbated. The eventual adjustment may come as a matter of compulsion and not by deliberate and measured choice. In either case, there will be economic and social consequences.

One should keep a close watch on these potentially destabilising developments and see how they may interplay with a sensitive political period of leadership transition. Over the last 30 years, China has never witnessed serious economic deceleration or prolonged economic distress. Coping with a period of painful economic adjustment and slower growth may be an unfamiliar challenge for a transitioning political leadership.

The real test for China will be its ability to cope with the demands of an advanced and sophisticated economy. These demands may begin to impinge upon the nature of political leadership, the quality of governance and the role of creativity and intellectual freedom in society.

China has impressive achievements to its credit and its management of a rapidly developing economy in a challenging globalised environment has been far-sighted and skilful. While pointing to the possible pitfalls that China may have to contend with in the coming weeks and months, the intention is not to predict an end to China's growth story, but to argue that a significant slow-down in its growth is more than likely. Exaggerated projections of overwhelming Chinese power fail to take account of the serious imbalances which have built up precisely due to accelerated growth which can no longer be sustained. China may follow the general trajectory of other emergent Asian countries, where periods of high growth have been followed by more modest and slower growth. There could also be a prolonged stagnation of the Japanese kind if the Chinese leadership is unable to institute reforms that are required in a maturing economy. The catch-up phase is always easier than the phase when growth must be led by innovation, by technological upgradation and advanced management skills. The real test for China will be its ability to cope with the demands of an advanced and sophisticated economy. These demands may begin to impinge upon the nature of political leadership, the quality of governance and the role of creativity and intellectual freedom in society. Watching China navigate this transition should be fascinating and hold lessons for India and provide a template for our own economic strategies for the future.

I still believe that India has certain unique advantages that will help it through the transition to a modern economy and provide greater confidence in the sustainability of the growth process. India's strength lies in its relatively balanced economy which continues to be much more domestic demand driven than China's. We have a high savings rate given our favourable demographics as a relatively young country. This has allowed an investment rate of about 35 percent of GDP which is what one should expect at this phase of our development process. Our consumption levels are also close to the Asian norm of about 60 percent of GDP. There are imbalances. For example, the contribution of the service sector to our GDP is unusually high at 58 percent, while China's is unusually low at only 40 percent. There is an urgent need to promote manufacturing in our country and create opportunities for mass employment. We need to upgrade our skills at every level of economy activity. This is being done but not on the scale required. If the right policies are put in place, the resilience of the Indian economy will prove to be a far greater asset than the ability to deliver double digit growth. We must reject the tyranny of GDP growth and look at the process of development within a more comprehensive frame. I also believe that India's open and liberal society is far more likely to deliver technological innovation and creative entrepreneurship than China's highly regulated and controlled political system. If the successful societies of the future are likely to be knowledge societies and societies which can handle plurality and diversity and which welcome dissent and discourse, India has every opportunity to emerge as a front rank power. Rather than playing catch-up with China in every respect, let us leverage our strengths and neutralise, as far as possible, our weaknesses. But being a democracy is not one of those weaknesses.