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Does China matter? The
global economic issues

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Does China matter? The global economic issues

STUART HARRIS¹

INTRODUCTION

In this paper, I discuss whether Gerald Segal's views on China's economic importance, a key component of his *Foreign Affairs* article 'Does China matter?', are still valid. In his previous writings on China, Segal had largely confined himself to the political and strategic implications of a rising China. The more detailed consideration of economics in his article was therefore something of an exception.

Segal argued that 'China is a small market that matters relatively little to the world, especially outside Asia'.² Although in earlier exchanges with Gerry I had argued against the China threat on the grounds that China would remain relatively unimportant for a considerable time, this was only partly on economic grounds.³ Segal was correct that the public debate had tended to over emphasise China's economic weight. Even so, at the time, his generalisation was unduly dismissive. In part perhaps this reflected the influence of the 1997–98 Asian economic crisis. Some of the pessimism then prevalent, especially in Europe, about the inability of Asia generally and China in particular to weather the crisis has abated. In any case the economic argument now needs to be qualified. We now have a longer experience of China's management of its economy on which to base our evaluations.

- ¹ Department of International Relations, Research School of Pacific and Asian Studies, The Australian National University. This paper will be published in Rosemary Foot and Barry Buzan, eds, *Revisiting Gerry Segal's 'Does China matter?'* (London: Routledge, forthcoming). Comments on an earlier draft from Ross Garnaut, Rosemary Foot and Barry Buzan are gratefully acknowledged. Sadly, Gerry Segal died of cancer in November 1999.
- ² Gerald Segal, 'Does China matter?', *Foreign Affairs* 78(5) September/October 1999, pp. 24–36, at p. 25.
- ³ My arguments were subsequently published in Stuart Harris, 'The People's Republic of China's quest for great power status: A long and winding road', in Tien Hung-mao and Yuh-han Chu, eds, *China under Jiang Zemin* (Boulder: Lynne Rienner, 2000).

Segal's conclusion that judgements of China's economic importance were based on its assumed potential remain largely true today but, while still often exaggerated, that potential is more evidently substantial and is being factored into both expectations and global economic decision-making. So China does now matter. Of course, although China's actual and potential importance is greater than Segal allowed, China's economic importance is still conditional on China continuing its reform process and its economic progress. Failure in those respects will give China an importance in much less welcome ways, creating political and social instability regionally and inevitably globally. I would also note that China's own perceptions of that prospective economic importance reflect a greater recognition of its economic weaknesses than Segal acknowledged.

To answer the Segal question, 'does China matter?', I need to ask what determines whether a country 'matters'? Specifically, how does a country 'matter' in global economic terms? His article advanced a number of measures against which to judge China's importance: the proportion of world gross domestic product (GDP); income per head; inter-province trade within China; the proportion of world trade and of Asian trade; the share of US, European and Asian country exports; and the share of inwards global and regional foreign direct investment (FDI). Segal concluded that Asia as a whole, apart from Japan, has little impact on the global economy, as illustrated by the Asian crisis, and that exaggerating China is part of exaggerating Asia.

Here, I address a number of the Segal criteria directly relevant to assessing China's global significance. There are, of course, other ways to consider China's economic importance—or whether China 'matters'. For example, will China's economy influence the global economy in providing either a locomotive or a drag on global economic activity? It was judged to have behaved responsibly during the Asian crisis by not devaluing its currency; how far will its actions in the future affect global currency movements and how co-operative will it then be? Again, as some argue, does China's industrial development threaten living standards and jobs internationally?

A broader sense of China's economic importance is what it represents in terms of power and influence. Put simply, to what extent does China's economy enable it to influence others in directions it wants them to go, or to

avoid directions it opposes. This influence can be achieved, as with any country, basically by coercion, bribery or persuasion. Coercion is usually thought of in military terms, with economic strength as a critical basis for military strength and this is an issue for some in the US, as I note later.

Economic coercion, however, including withdrawal of economic relationships, is an important potential weapon itself and a factor in Chinese thinking, with examples of its use in practice, as with its purchases of civil aircraft. I will ask how much freedom China has to coerce in an increasingly interdependent global economy. It is also relevant to ask not just about capabilities but about the use China might make of its added power. That, however, is beyond the scope of this paper.

CHINA'S ECONOMY

A country's share of global GDP is a traditional indicator of its overall economic weight. In 2000, on standard GDP measures, China was sixth in global rankings, after France but above Italy. (Adding Hong Kong and Macau puts it closer to, but still below France.) Segal saw the sixth ranking of China in global GDP terms as indicating merely middle power status. He noted that China's GDP was only 3.4 per cent (3.7 per cent in 2001) of global GDP, compared with the 31.2 per cent (32.5 per cent in 2001) of the United States. In a sense he was right. Yet Russia, ranking only seventeenth, is now effectively a member, as is Canada, of the G8, purportedly comprising the major economic powers. And China is larger than both Canada and Russia on standard measures.

But there are analytical problems with the standard comparisons based on market exchange rates that are especially relevant to China's potential role in the global economy. For international comparisons, use is made increasingly of purchasing power parity (PPP) measures of GDP.⁴ Segal acknowledged these measures but negatively, referring to them as the 'now-dubious purchasing-power-parity calculations'.⁵

⁴ The World Bank's PPP measures are obtained by converting gross domestic product using conversion factors provided by the International Comparisons Programme, a joint effort of the World Bank and the UN regional economic commissions.

⁵ Segal, 'Does China matter?', p. 25.

Since PPP measures are analytically important here, not just because of the global comparisons of GDP—I draw on them later in assessing China’s potential—I need to detail what they represent. Standard comparisons of GDPs across countries convert national currency aggregates to a common currency—the US dollar exchange rate. Among the problems with this approach is that individual country exchange rates are affected differentially by various policy and other influences; moreover, major short term swings occur in market based exchange rate values, including that of the US dollar. Thus, such conversions can give an erratic picture, making difficult valid comparisons of real product levels between countries.

Moreover, a large proportion of commercial exchanges which make up a country’s GDP are not traded and their prices may not follow, in the short to medium term, movements in the exchange rate. Thus the US dollar value of what the average Chinese can purchase in their own currency can mislead, especially by undervaluing their benefits from the cheaper labour intensive non-traded sector. Consequently, for comparisons, economists increasingly use PPP measures, based on the cost of a basket of traded and non-traded goods and services across countries. This approach values the number of units of a country’s currency required to buy the same quantity of comparable goods and services in the local market as one US dollar would buy in the US.⁶

In looking at a country’s international purchasing power overall, its ability to service foreign debt or to import foreign military equipment, market or official exchange rates remain the relevant measures. Nevertheless, sufficient analytical work on, and using, PPP estimates has invalidated the Segal reference to them as ‘dubious’ for the comparative purposes to which he referred. PPP rates are generally accepted as superior for comparison purposes, especially where developing countries are involved. They are used extensively by the World Bank, the International

⁶ World Bank, *World Development Report 2003* (New York: World Bank and Oxford University Press, 2003), p. 245; Steve Dowrick, ‘G-20 comparisons of incomes and prices: What can we learn from the international comparison program?’, in David Gruen, Terry O’Brien and Jeremy Lawson, eds, *Globalisation, living standards and inequality: Recent progress and continuing challenges*, Proceedings of a conference held in Sydney, 27–28 May 2002 (Sydney and Canberra: Reserve Bank of Australia and Australian Treasury, 2002), p. 222, <www.rba.gov.au/PublicationsAndResearch/Conferences/2002/index.html>.

Monetary Fund (IMF) and the OECD and are regarded by the UN Statistical Commission as the appropriate basis for international comparisons of the economic size of countries and, on a per head basis, the economic wellbeing of their residents.

In the short to medium term, the differences can be large.⁷ Notably, however, exchange rate measures tend to undervalue systematically the GDPs of developing countries, including China. On a PPP basis, China's economy ranks second in the world after the United States, larger than Japan's economy. Its proportionate share of global GDP amounts to 11.2 per cent compared with the 21.4 per cent for the US.

World Bank PPP data show some over valuation of the exchange rates in some developed countries and considerable under valuation in many developing countries.⁸ In the long run, market exchange and PPP rates are likely to move towards convergence, and relatively fast-growing countries to experience real exchange rate appreciations.⁹ If so this would raise their GDP values relative to those of developed countries beyond their growth rate in national money terms.

Ross Garnaut demonstrated that in the 1980s and 1990s, the GDPs of some rapidly growing Asian countries, converted at US dollar exchange rates, rose more rapidly relative to developed countries than differences in real growth rates would suggest.¹⁰ He notes, for example, that real income per head in Singapore rose from US\$8,000 in 1985 to US\$28,000 in 1996.

⁷ PPP based comparisons are themselves not without problems of data, including an equivalent of the index number problem. Present calculation methods also tend to overstate the differences between market and PPP exchange rate based figures for developing countries, including China, but not enough to invalidate their use and general conclusions drawn from them. See Dowrick, 'G-20 comparisons of incomes and prices'.

⁸ World Bank, *World Development Report 2003*, pp. 234–5. PPP based estimates do reflect differences in developed countries; in the case of Japan, for example, in 2001, GDP on a PPP basis was over 20 per cent less than that based on market exchange rates, presumably reflecting particularly the high price of non-traded goods in Japan.

⁹ Kenneth Froot and Kenneth Rogoff, 'Perspectives on PPP and long run real exchanges rates', in Gene Grossman and Kenneth Rogoff, eds, *Handbook on international economics*, Volume 3 (Amsterdam: Elsevier, 1995), pp. 1648–84, at pp. 1648, 1683.

¹⁰ Ross Garnaut, 'Catching up with America', in Ross Garnaut and Ligang Song, eds, *China 2002: WTO entry and world recession* (Canberra: Asia Pacific Press, 2002), pp. 1–16.

The growth in GDP per head, in exchange rate based international comparisons, was well ahead of the real growth rate measured in national currency terms. The significance is that China may catch up with or surpass the GDPs of developed countries in US dollar terms more rapidly than national growth rate arithmetic would suggest.

Segal noted a disposition to mistrust the accuracy of China's growth rate statistics arguing that official Chinese figures have exaggerated China's growth since the market reforms of 1978. There has been a considerable argument, inside as well as outside China, over what are the correct figures, to which a critical Zhu Rongji contributed. This was largely stimulated by the failure of the official figures to reflect the 1997–98 downturn and the build-up of stocks of unwanted goods.¹¹ Many observers judged that official figures could overestimate real growth by perhaps 1 or 2 per cent.¹²

Thomas Rawski, a major critic of China's official growth data, notes that under-reporting of the service and private sectors probably offsets over-reporting elsewhere, at least until 1997, and that the official figures from 1978 to 1997 may be about right. He had argued, however, that compared with official figures averaging 7.5 per cent for 1998–2001, the real figures are closer to half—or 3.8 per cent.¹³ Other evidence of greater growth than this in those years leads others, such as Nicholas Lardy to doubt this.¹⁴ A growing consensus suggests that the official figures may have a margin of error of a percentage point either way.¹⁵ Overall, therefore, greater credibility now attaches to the official figures of average annual growth of 9.5 per cent from 1979–2001 with little doubt existing about what has clearly been substantial and sustained growth.

¹¹ Thomas Rawski, 'Measuring China's recent GDP growth: Where do we stand?', *China Economic Quarterly* 2(1) October 2002.

¹² Nicholas Lardy, *China's unfinished economic revolution* (Washington, DC: Brookings Institution, 1998), p. 9; Angus Maddison, *China's economic performance in the long run* (Paris: OECD, 1998), p. 155.

¹³ Thomas Rawski, 'Where's the growth?', *Asian Wall Street Journal* 19 April 2002.

¹⁴ Nicholas Lardy, 'Integrating China into the global economy', Address at Rice University, Houston, 29 April 2002, <www.ruf.rice.edu/~tchina/commentary/lardy042902.html>.

¹⁵ 'Truth or consequences: China's GDP numbers', *China Economic Quarterly* 7(1) 2003 Q1, p. 32.

And Segal's other criteria? His dismissal of China's low income per head ranking noted that this was less than that of Papua New Guinea (PNG). This has changed; in 2001, income per head in China was significantly above that of PNG on conventional as well as PPP measures, closer to levels, for example, of the Philippines.¹⁶ In any case, for present purposes, this measure is less significant in China's situation. While China remains a poor country despite its large economy, the size of China's population means that the government could collect taxes on a very much larger tax base if it wished.

China's economy has opened up significantly in the last two decades. It had reduced its trade barriers substantially well before it joined the World Trade Organization (WTO), and its membership is stimulating further liberalisation. China's openness is usually indicated by the growing proportion that trade represents of China's GDP, exports amounting to some 22 per cent in 2002. Yet, these figures exaggerate the openness: on PPP measures of GDP, exports as a proportion of GDP constitute just under 6 per cent. This compares, on the same basis, with around 18 per cent for the UK, and 12 per cent for Japan. Comparable levels would not be expected, however, since this reflects a pattern common to large economies. Thus, on the same basis, trade is only between 7 and 8 per cent of GDP for the US.

Certainly, in the trade and investment field, China's global importance has grown. China is already a major trading nation, ranking sixth in 2002 as a global exporter, just behind the UK. China's trade, not including Hong Kong, in that year represented 4.7 per cent of global trade, compared with 2 per cent only ten years earlier (over 7 per cent if Hong Kong is included). Its trade with Asia exceeds that outside the region but the US is its major export market and the European Union (EU) its third major market; Japan, however, remains its major trading partner. Although still small in services trade, it increased its share of global service trade exports more than threefold in ten years to 2.3 per cent in 2001. Overall in recent years China's exports and imports have grown more rapidly than the global average and are expected to continue to do so.

¹⁶ For 2001, income per head for China was US\$890 (or \$4260 in PPP terms); for Papua New Guinea it was \$580 (or \$2150).

Segal set trade with the major trading countries as one of his criteria. Although growing, China's trade with the major traders is not especially substantial. Imports by China account for less than 3 per cent of US merchandise exports but the US takes about a third of China's exports (as a share of US imports it now accounts for some 9 per cent as against 3 per cent in 1990). If Hong Kong exports, substantially from China, were included, this would add another 5.8 per cent to the share of US imports from China/Hong Kong. China is a smaller trader with the EU. Only 1.2 per cent of EU exports go to China (excluding intra-EU trade it rises to 5.5 per cent). The role of foreign enterprises in generating exports has been significant. Foreign invested firms now account for over 50 per cent of China's exports and, since US firms are major long term investors in China, a significant share of Chinese exports to the US comes from US companies.

The importance of bilateral trading relationships, however, is not just the trade's value but includes the dependency involved or how far other import sources or market outlets can be substituted. For China, the main areas of potential trade dependency include raw materials, such as iron and steel, grains, fibres and energy. In the first three, trade dependency is unlikely to be significant since markets are open and the materials substitutable if at some cost. This is also largely true for energy as well but energy has some special characteristics, as discussed below. China is dependent upon access to markets for its exports of manufactured goods and some vulnerability exists given its substantial dependence on US markets.

China's ability to coerce economically is also limited except on a symbolic 'punishment' basis to demonstrate displeasure. That might be significant for small countries. It is unlikely to be so for major countries. Other markets would be available for most exports from the US or Europe to China and the issue unimportant unless private interests involved are politically influential. With China's substantial dependence on the US market, finding alternative markets for that volume of exports would be difficult and costly. Private interests, however, have in the past worked to protect China's exports to the United States from undue punitive action.

China has become a significant factor in the international capital market. Attention is normally directed to inward FDI movements which in recent years have usually exceeded US\$40 billion annually. In 2002, with inwards FDI around \$50 billion, China became the largest recipient of global FDI,

passing for the first time the US, normally the largest recipient. This, however, was largely because of a major dip in inward investment in the US. In addition, 'round tripping', Chinese domestic firms exporting and then importing investment capital to gain from preferred tax and intellectual property protection treatment for foreign firms, accounts for an element of the Chinese figures, estimates ranging between 5 and 20 per cent. Although FDI is mostly from non-Japan Asian countries, part of Hong Kong's investment is from US and European affiliates in Hong Kong. Overall, however, the increased inflow reflected other factors, including expectations of economic opportunities due to improved regulatory frameworks flowing from China's WTO membership and inflows from Japanese, Hong Kong, Taiwanese and to a degree South Korean firms relocating to China to reduce costs.

Since the 1990s, Chinese entities—state owned enterprises (SOEs), but also Chinese cities, provincial governments, government departments and other state agencies—have become significant fundraisers on overseas capital markets, commonly through international investment banks in Hong Kong. A 2002 estimate suggests that some US\$40 billion was raised in international markets from 1993–2000, around \$21 billion of it in 2000, and much of it in the US. A further US\$20 billion was raised in US dollar denominated international bond holdings.¹⁷ Further sizeable sums have come from governmental sovereign bond raisings and raisings by the remaining international trade and investment corporations (ITICs).

China has also become a substantial foreign direct investor, accounting by 1995, for around 2 per cent of global capital exports.¹⁸ As an outlet for its large foreign exchange reserves, it is the second largest foreign holder of US Treasury Bonds after Japan, and a major purchaser of US government backed mortgage finance bonds. It is also an important purchaser of government securities in London, continental Europe and Tokyo.

¹⁷ China Security Review Commission, *Report to Congress: The national security implications of the economic relationship between the United States and China* (Washington, DC: US Congress, 2002), Chapter 6.

¹⁸ World Bank, *China 2020: Development challenges in the new century* (Washington, DC: World Bank, 1997), p. 26.

In trade, whether China matters is often seen from a different perspective. For major products China may still be largely a price taker rather than a price maker. China's extra supply of consumer goods on international markets does, however, have some downward effect on prices of labour intensive products. Among other things, this helps to counter the expected upward pressure on China's exchange rate.

While adversely affecting competitors, this price effect raises the living standards of those consuming those products. For example, with China now dominant in the global bicycle market (supplying over 60 per cent of the global market), average prices have fallen substantially. This benefits bicycle purchasers but there has been a geographic redistribution of bicycle production. Consequently, there are those, particularly in the US among industry lobbyists and leading politicians, who argue that China matters, but negatively through its adverse effect on employment in developed countries.

As with bicycle producers in Western Europe given protection against Chinese competition but more generally, they reflect widely held fears that its low cost exports threaten living standards and jobs in developed economies. The fear has been reflected, for example, in the abnormal safeguard measures in the US' WTO settlement with China and in US and French arguments pursuing labour standards in international trade negotiations.

Production relocation effects in developed countries have often large local effects but are small at the macroeconomic level. For example, as noted earlier, China's total exports are a small share of total US imports (9 per cent) and imports a small share of total US GDP (7 per cent); imports from China are therefore only some 0.6 per cent of US GDP. In a growing world and domestic US economy, the necessary adjustments are manageable by those able to adjust. In a sluggish world economy, the adjustments required are likely to be more severe and difficult for those slow to adjust. Nevertheless, since like other countries, China exports essentially in order to import, the more it exports the more it can provide markets for imports that create employment in exporting countries.

More generally, as China's productive efficiency moves closer to that of developed economies, it contributes to increased global productivity and global real income, which will translate into greater spending and increased employment. Gains from trading between China and the rest of the world

increase living standards of China and its trading partners, for the former through higher incomes and in the latter case, more substantially through increased consumer purchasing power. It is not that employment elsewhere is not affected by China's exports of labour intensive products, but that the overall magnitude of the effect is small, with larger effects due to other changes, notably technological change.

There could be more substance in principle in the concerns about 'massive' flows of productive capital from developed countries to emerging countries, and China in particular. Capital exported from developed countries is capital not invested in those countries putting downward pressure on their real incomes. Paul Krugman has shown, however, that in practice the domestic impact of shifting productive capital from developed countries to emerging countries is small.¹⁹ Developed country capital exports to China are not quantitatively large relative to capital investments made domestically in capital exporting countries. Moreover, China's substantial purchases of bonds from the US and some other developed countries helps finance their trade and budget deficits.

A second argument doubts the world's capacity to absorb rapid increases in production of goods arising from 'the manic logic of capitalism',²⁰ to which the industrial emergence of the developing world, and notably China, contributes. This is a new variant of an old fear of production outrunning demand or 'global glut'²¹ but, as illustrated by the employment sharing efforts in France under Prime Minister Lionel Jospin in the late 1990s, is present in European politics as in the US.

Yet, compared with the 1930s and Keynesian concerns at over saving and under consumption, many countries, including the US, now worry more about under saving and over consumption. While China's growth adds to global productive capacity in labour intensive products, at present China contributes only a relatively small proportion of the global supply of the

¹⁹ Paul Krugman, 'Does Third World growth hurt First World prosperity', *Harvard Business Review* 72(4) July–August 1994, pp. 113–21.

²⁰ William Greider, *One world, ready or not: The manic logic of global capitalism* (New York: Simon and Schuster, 1997).

²¹ Robin Broad and John Cavanagh, 'No more NICS', *Foreign Policy* 72 Fall 1988, pp. 81–103.

goods it exports. That it will add to that supply more substantively in the future seems probable given its entry into the WTO—helped, for textiles and clothing, by the eventual removal of quotas under the Multifibres Arrangement. With better macroeconomic policies than in the 1930s, however, the confidence that those gaining increased incomes in China from exports will spend them is more justified.

China's export expansion will not be limited to labour intensive products. As well as increasing exports of consumer durables, China is already the third largest exporter of electronic equipment, and is widely expected to become the major exporter of information technology products within a few years. These are commonly dual-use products, however, with strategic implications that some will see as increasingly problematic.

These projected developments depend upon an international willingness to accept growing exports from China. This is particularly relevant for the US where China's direct trade surplus remains substantial, although less so if Hong Kong is included. Moreover, what such a bilateral trade balance means in a globalised world is increasingly unclear since US firms are major participants in exports to the US. Overall, however, China has maintained a reasonable balance between export and import growth. Its trade surplus is gradually diminishing and it provides a substantially growing market for those exporting to it. The UN economic report for 2003 notes that, given a global economy showing only modest growth overall, China's domestic demand provided some stimulus to exports from other countries, but particularly in East Asia.²²

Nevertheless, China is not yet a major engine of global growth in general although in 2002, 15 per cent of global economic growth and 60 per cent of global export growth came from China. Although China's direct economic impact is greater in the Asian region than in the global economy, it does have a global impact in specific areas. Particularly important is its growing demand for energy. China is a major consumer of primary energy, second only to the United States. Although a sizeable producer of oil, not far behind Iran, its growing energy demand has increasingly required oil and gas

²² United Nations Department of Economic and Social Affairs, *World economic situation and prospects 2003* (New York: United Nations, 2003).

imports. It is extending its oil interests overseas investing, not just in the Middle East (notably Iran and Oman) but also in over 20 countries outside the Middle East including in Africa (Sudan), in the Western Hemisphere (Venezuela) and in Central Asia (Kazakhstan) and several developed countries, including the US.

From some 70 million tonnes of net imports in 2002, estimates of future oil import needs range widely from 130 million tonnes to nearly 400 million tonnes by 2020.²³ This could account for between 5 and 15 per cent of world oil trade, from its present 4 per cent. By 2030 China's oil imports, according to the International Energy Agency's Executive Director, '... will equal the imports of the United States today ...',²⁴ and China will become a strategic buyer on world markets. That will make energy sourcing, diversification, and safety of its energy transport links even more influential and constraining on its foreign policy than it is already, given the vulnerability that import dependence implies.

China is a major coal exporter, second after Australia, but more importantly, it is the second largest consumer of coal after the US. Its domestic use of coal makes it central to the global warming debate and negotiations around the Kyoto Protocol processes, since it provides around 10 per cent of global carbon dioxide emissions. World Bank estimates of China's consumption of energy per unit of output (energy intensity) put it at three to ten times that of the major industrial countries.²⁵ Again, the qualifying perspective of the PPP measures is important here: on a PPP basis, Angus Maddison estimated China's energy intensity as higher than that of Germany and Japan but around US and Australian levels and greatly below that of Russia.²⁶

²³ The higher figure is an International Energy Agency estimate; the lower is an official Chinese figure. International Energy Agency, *China's worldwide quest for energy security* (Paris: International Energy Agency, 2000).

²⁴ International Energy Agency, Press Release, Beijing, 26 September 2002.

²⁵ World Bank, *China 2020*.

²⁶ Maddison, *China's economic performance in the long run*, p. 155.

CHINA'S FUTURE GLOBAL IMPACT

How far China will matter in economic terms in the future will depend upon the extent to which China can maintain its economic growth ahead of the major developed economies. Economic and employment growth is also critical to China's internal stability. Officially, China aims to double its GDP over ten years, from 2000 to 2010, implying average annual growth rates of between 7 and 8 per cent. Projections of China's economic growth range around these figures. World Bank estimates have ranged upwards from 6.5 per cent, while others believe higher rates are possible.

In the trade field, the World Bank estimated that by 2020, China would be the second largest world trader, accounting for some 10 per cent of world exports, just behind the US.²⁷ If its recent trade growth is sustained, it will certainly become an important influence on overall world trade growth.

There is widely held optimism that these economic growth and trade rates, or rates near to them, are achievable. Yet others have less confidence, perhaps most notably Gordon Chang.²⁸ The main doubts tend to centre on the sources of China's economic growth; questions about currency reform; China's ability to continue to attract high levels of FDI; the financial management of a banking system with large non-performing loans; loss-making SOEs; and large government debts. Also in question is China's political ability to absorb changes implied in China's reform processes, including SOE reform; its WTO commitments and their consequences; and income imbalances between coastal and inner provinces, to which agriculture reform is a major contributor. How it manages these issues will largely determine how, and how far, China will 'matter' in the future, so I look briefly at each in turn.

Sources of China's growth

I noted earlier the ongoing debate about China's economic growth rate. Economists question whether the sources of China's growth have been simply short-term quantitative factors—more labour and capital—or reflect more sustainable qualitative change—more efficient combinations

²⁷ World Bank, *China 2020*, p. 31.

²⁸ Gordon G. Chang, *The coming collapse of China* (New York: Random House, 2001).

of labour and capital. Some argue that growth came predominantly from quantitative increases in resources—capital and previously under-employed labour, implying that these were largely one-time gains and not a basis for sustained long-term growth. This argument is discussed in Heather Smith's work.²⁹ Like other studies she showed that quality improvements, through market reforms and technological catch-up, were increasing overall productivity. Zulu Hu and Mohsin Khan, for example, argue that productivity growth accounted for nearly half China's growth.³⁰ Scope for further growth through greater efficiency is still large with further reform, a continuing inflow of foreign technology and further opening of the economy to international competition.

One question is whether China will continue to benefit from two financial pluses: the substantial inflow of foreign capital and high domestic personal saving. Much of China's foreign capital inflow comes through FDI, although China has borrowed substantially from international institutions. Its ability to continue to attract large inflows of FDI depends upon domestic political stability and economic policies that attract foreign investors.

FDI was critical to China's past growth in supplying capital, in stimulating exports, and in providing technology transfer and entrepreneurial skills. Yet although the inflow is large it represents, in domestic terms, only some 10 to 15 per cent of gross capital formation. It was central to China's economic growth, however, when labour intensive exports were a major stimulus to growth.

Initially, foreign companies had the advantage of access to funding and protection of intellectual property unavailable to domestic Chinese producers. FDI at that stage, moreover, was largely by small companies, mainly from non-Japan Asia, seeking to benefit from China's cheap labour for export, but not offering transfers of advanced technologies. In that role,

²⁹ Heather Smith, "Western" versus "Asian" capitalism: Is there anything new under the sun?, in Stuart Harris and Andrew Mack, eds, *Asia-Pacific security: The economics-politics nexus* (Sydney: Allen & Unwin, 1997), pp. 260–6.

³⁰ Zulu Hu and Mohsin Khan, *Why is China growing so fast?*, Economic Issues No 8 (IMF) (Washington, DC: International Monetary Fund, June 1997).

FDI will be less critical in the future given the increased competitiveness of China's domestic producers and their growing importance in its exports.

Changes have benefited domestic producers as reforms have developed, and particularly after 1997.³¹ Meanwhile, larger European and Japanese companies have become more important investors, and technology transfer, if still limited, has increased. FDI will remain important to China now, therefore, through its contribution to China's overall productivity growth. The evidence suggests no early diminution in foreign investor interest in China, although one investment motivation noted earlier, WTO entry, has a once-only character.

Like FDI, maintenance of high domestic savings rates, the major source of China's investment capital, depends in part at least on China's domestic policies and reforms.

Currency reform

It reflects China's growing importance in the trade and capital markets that its exchange rate policy is increasingly scrutinised by trading partners and competitors at global as well as regional levels.³² Because of its competitive position in international markets, a belief is emerging that its exchange rate influences significantly currency markets, notably US dollar and Japanese yen rates, disadvantaging those countries.

China's exchange rate is becoming more important in international currency markets. Yet, the Chinese yuan, tied to the US dollar, follows the dollar up and down. Periodically, it will be undervalued against other currencies as it was in 2002–03 following the weaker dollar, and be marginally undervalued against the dollar itself. Yet as recently as the 1997–98 Asian economic crisis it was credited with stabilising the turbulent regional currency situation by not devaluing the yuan.

Arguments abound about the merits of China's maintaining a stable exchange rate. They include suggestions, usually by interested parties, that

³¹ Yasheng Huang, 'Foreign direct investment in China: Why surging levels of FDI may indicate serious economic problems', Presentation to Carnegie Endowment for International Peace, 16 January 2003, <www.ceip.org/files/events/events.asp?EventID=566>.

³² 'US must force China to drop yuan peg: Economist', *Business Times Online* 31 January 2003.

not only is it deflationary but that China deliberately manipulates an undervalued currency for competitive purposes. As noted earlier, some deflationary effect undoubtedly results from the lower prices of China's more competitive exports while its purchase of foreign securities provides some counter to upward exchange rate pressures. In the long run the yuan is likely to appreciate in line with productivity growth. Garnaut's argument that the market and PPP rate will converge will probably hold eventually. In the short and medium run, however, that tendency could be outweighed by other domestic and international influences including further trade liberalisation. While China's exchange rate already matters, for some time it is unlikely to matter sufficiently for any manipulation to be effective.

Meanwhile, the yuan is only fully convertible on current account and is unlikely to be made convertible for capital transactions and to be floated until drastic reform to China's banking system and other financial institutions has been effected.

Domestic financial management and the banking system

While acknowledging China's growth potential, its capacity to sustain sufficient growth for domestic stability depends upon its success in managing effectively its full range of macroeconomic policies. So far, despite occasional missteps, it has been reasonably successful in its economic and financial management. Managing a soft landing after inflation flared in the late 1980s and early 1990s was an important achievement, as were the elimination of the dual exchange rate system in 1994 and the relatively stable exchange rate system maintained since then, and the exclusion of the military from most of its business interests. It has also had some, if incomplete, success in reforming the banking system, in reducing its SOE problem, in dealing with corruption and smuggling, and in reforming the taxation system.

Concerns have been expressed about China's debt problems. As already observed, capital inflow other than FDI has been sizeable but the related debt burden does not represent a particular problem. China's outstanding official international debt amounted to about 11 per cent of GDP in 2000. The debt is basically long-term and China has massive foreign exchange reserves.

Domestically, however, China has problems over the level of domestic government debt and of banking sector non-performing loans (NPLs). The official 16 per cent of GDP figure, if correct, would not raise undue concern. China has sustained domestic growth through deficit financing for a number of years, however, and that is expected to continue to absorb unemployment. Continued use of deficit financing to support China's expansionary fiscal policy could provide future difficulties. Moreover, other estimates of government debt, as in the *Economist*, put it much higher, arguing that debt calculations should include the state-owned banking system's NPLs.³³

Estimates of the banking sector NPLs themselves vary, ranging from the official figure of around 25 per cent to over 50 per cent. Since the major banks are state owned, the NPLs are a contingent government liability. China's central bank accepts that NPLs and government contingent liabilities through state guarantees to banks amount to some 60 per cent of China's GDP. NPLs seem to be diminishing only slowly in the face of government reform efforts. Although an important management problem, given the government's ability to raise funds by selling government assets, including shares in the profitable among its SOEs, however, it is not ultimately a problem that could bring the system down.³⁴

Normally, however, such banking sector uncertainty would be expected to discourage high levels of private saving through the banking system. Expectations of government backing and limited alternatives to the banks as a depository of savings make this improbable in China. The benefit that China gains from its high level of personal savings is likely to continue.

Every new loan to a loss-making enterprise crowds out potential good investments elsewhere. NPLs reflect a non-productive use of the capital involved by banks through lending to unprofitable SOEs, while the profitable and potentially employment absorbing private sector still has difficulty obtaining credit. Gradual entry of foreign banks under China's

³³ *Economist* 13 June 2002.

³⁴ Shuanglin Lin, 'China's government debt: How serious?', *China: An International Journal* 1(1) 2003, p. 91.

WTO commitments will increase the pressure on local banks to compete effectively but also on the government if they cannot do so.

State owned enterprises

The banking sector's problem of loans to non-performing SOEs arose substantially following attempted SOE reforms in the 1980s and early 1990s. Direct government financing of SOEs was replaced by bank loans in a bid to enable them to operate and survive in the competitive environment of an increasingly marketised economy. This proved ineffective for various economic and political reasons. Recent reforms have relieved SOEs of the burden of redundant employees and allowed changes to SOE ownership structures, including privatising the smaller among them, making up about 80 per cent of the total number. These reforms appear to have been more effective.³⁵ The SOEs now account for well under one-third of gross industrial output compared with around three-quarters in 1980. Nevertheless, despite major labour lay-offs, SOE employment remains well above its industrial output share as does the SOE share of total investment, reflecting a continued inefficient use of resources.

SOE profitability has increased due in part to extraneous factors—falling interest rates, rising oil prices for the oil enterprises and bad debt write-offs—but ownership structure and management reforms have also increased efficiency. Despite profit increases, with its high shares of resources and rates of return well below the non-state sector, the state owned sector remains a drag on China's economic growth. The murky ties between the party, state, provincial governments and the SOEs slow reform and help still to channel bank credit to the loss-making among them. Despite significant improvement, therefore, without further structural reform in the state ownership sector, scope for increased productivity and exports will be diminished.

³⁵ Ross Garnaut, Ligang Song, Yang Yao and Xialo Wang, *Private enterprise in China* (Canberra and Beijing: Asia Pacific Press and China Centre for Economic Research, 2001), p. 16; Xialu Wang, 'State-owned enterprise reform: Has it been effective?', in Ross Garnaut and Ligang Song, eds, *China 2002: WTO entry and world recession* (Canberra: Asia Pacific Press, 2002), pp. 29–44.

Political support for reform

China is undergoing a massive industrial revolution and its dynamics create considerable political and social stresses in China as historically such dynamics have in other countries. Many demonstrations have been reported in northern and western provinces in particular, where unemployment due to SOE and other reforms is relatively severe. The reform process and failures of governance associated with corruption, unemployment and falling incomes in rural areas could be politically destabilising unless adequately addressed by China's government. So, too, could accommodating pressures for 'democratisation'.

Income inequality has continued to increase, even though in most years all incomes have risen.³⁶ Several factors contribute to the growing inequality. Essentially, China is condensing its industrial revolution into a historically remarkably short period. Moreover, some inequality is necessary to encourage labour movement from the interior to the coastal economy to meet the latter's long term labour needs and to facilitate productivity growth through modernisation in China's agriculture. Too great an income discrepancy creates social problems, however, particularly if, rather than arising from differential rates of income growth, it reflects absolute falls in real incomes in the interior, as has been the case in some provinces in recent years. Efforts to limit this problem continue. Considerable state infrastructure investment has been directed to the inner provinces; around 20 per cent of China's FDI has been going to the interior regions. This constitutes some 10 per cent of the interior economy, paralleling experience in other countries, notably the US.³⁷

A more comprehensive welfare system is an accepted need. Those receiving social security rose to over 12 million in 2002 but this is still small compared with the urban unemployed estimated at over 40 million.³⁸ Moreover the pension system is in financial difficulties, and with

³⁶ Wang Shaogang, Hu Angang and Ding YuanZhu, 'Behind the China wealth gap', *South China Morning Post* 31 October 2002.

³⁷ Huang, 'Foreign direct investment in China'.

³⁸ Wang, Hu and Ding, 'Behind the China wealth gap'.

subsistence payments to the unemployed, constitute an increasing claim on current budget expenditures

CONCLUSION

Segal's broad conclusion was that China's small market mattered little to the world. That conclusion now needs substantial qualification. China's vast population and size give it the basis for a major global political presence; its geographic spread (fourteen land borders and a number of sea borders) ensures that its economic presence is widely felt globally as well as regionally; in addition, it is a relatively important economic partner of the US and other major powers outside of Asia. Continuation of China's growth at high rates of between 6 and 8 per cent in, say, the next two decades is at least a plausible prognostication.

Consequently, while not yet a major engine of global growth, China does matter not just regionally but globally in economic terms. The more complex question is how much does it matter. There are no readily applicable criteria and judgements differ according to the starting perspective. Certainly, as Segal said, China is still only a middle power. But attitudes towards a middle power that will remain a middle power differ substantially from one likely to become a great power in economic terms. Few doubt China's potential to become a great power, even if it faces 'a long and winding road'. Perhaps as critical in determining how China is perceived and responded to, and despite doubts expressed by some commentators, China's leaders have shown a capacity to deal effectively enough with its internal problems to progress rapidly and at the same time to maintain stability. This gives it an advantage over Japan.

China's population will become substantially better off but for some time to come will remain relatively poor. Consumer income will grow, however, and consumption will grow with it, further enlarging China's market. China's participation in the global capital market, still relatively small, is growing in importance, politically as well as economically; so is its increasing involvement in the global energy market.

Of the economic impacts of China's continuing economic growth, two seem to gain considerable attention: its role vis-à-vis global competitors, and the international market's ability to absorb China's increased production. Even though the former is inevitable, but not quantitatively

large, it may still matter politically and lead to more disputes over China's exports in major markets.

For the latter, while China's development will increase global productive capacity, global incomes will also increase. While demand will increase along with supply, the location of distribution will change, with impacts outside East Asia likely on producers in countries such as India and Mexico. That the quality of China's exports is likely to continue to rise, as China's export structure moves towards dual-use electronic goods and machinery, will give rise at times to strategic issues and concerns.

For some US Congress members and some senior academics,³⁹ fear of China's economic growth potential already warrants counter action by the US. The hurdles activists are likely to succeed in placing in China's way, however, are probably less important than the hurdles China faces domestically to maintain its economic development.

China's growth will require massive infrastructure investments in transport, power, water, urban systems, telecoms, and desertification and environmental controls. Its energy demands, and growing energy import needs, also require major foreign and domestic investments. And its needs to provide enhanced employment opportunities are great.

China has shown a capacity to surmount many of its major domestic challenges while maintaining reasonable budget disciplines. Further challenges, such as the essential reform of the financial system and the reform of SOEs are being addressed, if less effectively. Given the further reforms still needed, major problems of social discontent and control could emerge beyond those already being experienced. More basic requirements include effective management of crises such as AIDS and SARS. They also include no significant internal or external conflict. Conflict for China is more likely with a weak and unstable rather than a strong China.⁴⁰

China's emergence as a major economic power participating fully in the working of international economic institutions already influences the global

³⁹ John Mearsheimer, *The tragedy of great power politics* (New York: W.W. Norton, 2001).

⁴⁰ Philip Bobbitt, *The shield of Achilles: War, peace and the course of history* (New York: Alfred Knopf, 2002), p. 781.

economic system. But China has been participating in the international institutions very much as a status quo country and, while not without qualifications, with a manifest national interest in supporting the fundamentals of the existing economic system. In assessing whether China matters, it is not enough simply to judge it on its activities and performance to date. It is worth also considering how much this contributor to regional stability and global growth could become a major global problem if it behaved in a destabilising fashion.

Ultimately, therefore, while Gerry Segal's injunction not to over emphasise China's importance remains useful, his article's conclusion that, in effect, China could be largely ignored, no longer holds true in economic terms. China is no longer peripheral economically and although far from the dominant giant often argued or feared, it does matter and its concerns and interests do have to be taken into account. Moreover, as a rising power, where it will be in the future rather than where it is today is what influences policy thinking in most countries. For most governments, China is a country that matters not just regionally but also at the global level.

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