Bertelsmann Stiftung

China's Confidence Issue: Hard or Smart Landing – What Can We Expect?

Bernhard Bartsch*

Germany and Asia
Building Bridges – Promoting Progress

November 2015 **Asia Policy Brief** 2015 | 03

A China whose economy is growing at a slower pace is something the world can cope with. But a China with doubts about whether the government can maintain control and implement reform – that would be a serious problem. The signals currently coming from the economic and political spheres are cause for concern. China is in danger of falling into a downward spiral of declining confidence. What are the consequences for Germany?

Recently at a major German corporation: A delegation of Chinese business leaders is visiting to learn more about high tech, Industry 4.0, automobiles and soccer. It's an illustrious group. Each of the guests has a "dishwasher-to-billionaire" biography that could easily be made into a feature film. One participant founded a fashion empire, another a bank. One launched a chain of grocery stores, another builds electricity grids and railways in Africa. A number made their fortunes with construction companies, others with technology firms or Internet portals. All have won big during China's "economic miracle" and are now standard bearers for it.

Yet when asked about China's economy, the entrepreneurs do not hide the fact that miracles are not what they are currently concerned with. China's stalled growth, its jittery stock markets and the restructuring of its state apparatus (a diplomatic circumlocution for the current anti-corruption campaign) are all causing uncertainty, they say, especially for the business community. "These are difficult times," one explains, concisely describing the general mood. "The situation is very volatile and we can only hope that at some point it will improve." It is not the type of assessment likely to attract foreign investors, yet this group has not come all this way looking for money, more to find opportunities for investing their own wealth in Germany.

Even China's traditionally optimistic business elite is now voicing skepticism, something which confirms a sentiment that has been apparent for quite some time in conversations with international managers, diplomats and China analysts: The People's Republic is undergoing far-reaching economic and political change, and how it will all play out – for China and for the world – is anything but clear. That doesn't mean everything will grind to a halt in China. It means many things are not going as well as they should. Neither are they going as well as many people think they could, nor as well as they undoubtedly must if China is to overcome the challenges it faces.

Some experts are calling it a crisis. The Chinese government is talking about a transition to a "new nor-

* Bernhard Bartsch is Senior Expert in the Bertelsmann Stiftung's Germany and Asia program.

mal" with growth that, while slower, is also healthier and more equitably distributed. "New normal" makes it sound as if everything was normal and will remain so – just in a different way. Yet what is normal in China these days tends to be a concern about whether the transition to a more sustainable economic model will succeed, or if China will get stuck in a "middle income trap" as did the once booming economies of Brazil, Argentina, Thailand and Malaysia.

There are numerous disturbing symptoms. In recent months the business community has been unsettled by lower growth, the stock market crash, the country's currency policy, falling real estate prices and rising debt. A number of political factors have added to the uncertainty, including the opaque anti-corruption campaign, the conflict over the islands in the South China Sea, ethnic unrest, Beijing's response to the explosion in Tianjin and the nationalistically laden personality cult surrounding President Xi Jinping.

Uncertainty, of course, is hardly the same as collapse. And some of the news is undeniably good. At 6.9 percent, China's growth rate remains impressive (and would still be so, even if China's statisticians did not massage the numbers, as many analysts suspect). The shift from one-child-policy to a two-child policy has demonstrated Beijing's resolve to make important decisions. Chinese companies, such as telecom equipment provider Huawei and construction machine manufacturer Sany, are increasingly being seen as serious competitors on the global market. When they travel abroad, China's politicians are getting the red-carpet treatment more than ever before. The meeting of President Xi with Taiwan's President Ma Ying-jeou has been a major diplomatic success for Beijing.

Yet the era when China guaranteed global stability (a role largely ascribed to the country in light of its immunity to the Asia crisis of 1997/98 and the financial crisis of 2008/2009) is now over. China has lost its aura of relentless success, a development that is undoubtedly dangerous, since how the country makes it through the transition phase of the coming years depends not only on actual policy decisions and their implementation, but on something far more ethereal: confidence and trust. A China whose economy is growing more slowly is something the world can cope with. But a China with doubts about whether the government can maintain control and implement reform – that would be a serious problem.

Hard landing or smart landing?

The fact that uncertainty in China can roil the waters worldwide shows how important the People's Republic is for the global economy, especially for export-driven Germany (see box and graphic). China is the fourth largest buyer of German goods. Exports to the People's Republic account for about 2 percent of Germany's gross domestic product. Yet China plays a far greater role for many individual companies. In 2014, DAX members made over 13 percent of their global sales in China, or 132 billion in total. The largest share went to the automotive sector. The People's Republic accounts for one-third of Volkswagen's sales; at BMW it's almost 20 percent, at Daimler 10 percent. A slowing Chinese economy will therefore make itself felt on their balance sheets, and on those of hundreds of other German companies.

It's not a surprise that China's economy is now weakening after some three decades of two-digit growth; rather, it's a development that many have been predicting for years – first and foremost, the Chinese government. Less growth is even desirable if unhealthy growth disappears, leaving its healthy counterpart. After all, the development model used in China until now – one based on exports and massive investment in factories, infrastructure and urban development – has not only brought the country prosperity unlike any it has previously seen, it has also been the cause of disastrous pollution, rampant corruption, massive overcapacity and greater inequality. To prevent China from "becoming poor again before it's able to become rich," as many Chinese fear, the country must, in the future, do business in a way that is more environmentally friendly, more innovative and more socially responsible.

China, however, has been waiting for that future for a long time. Xi Jinping's predecessor Hu Jintao called China's course "unbalanced and unsustainable" – thereby paraphrasing his own predecessor. Yet no one to date has made such a mission of restructuring the country's development model as Xi. When he presented his plans for reform in November 2013, he was widely praised, both at home and abroad. Many felt that in economic terms Xi was guiding the country in the right direction: toward a more self-regulating market, more competition, increased innovation and greater integration into the global economy. The hope was that instead of a hard landing, China would manage a smart landing.

Unsettling signals

That optimism was based on confidence in the Communist Party, in keeping with the oft-quoted maxim that whatever China sets out to achieve, it will (although sometimes only by using extreme means). Xi's reform agenda is, however, an ambitious undertaking, even under the best of conditions. Transitioning to a new development model in which prosperity is more equally distributed and emerging technologies spur more sustainable growth is only possible within a stable framework.

Yet given China's current level of development, stability means something different today than it did in past decades. The discussion of whether communist rule will progress in China as it did in the former Eastern-bloc nations has long ended (at least in the West; in Beijing the Soviet Union's demise is still held up as a cautionary tale). The question is no longer ascent or collapse, but good governance or bad governance. To implement a new growth model, businesses need to be sure that political conditions are stable, their own investments safe, their markets open, their innovations protected and competitive conditions fair.

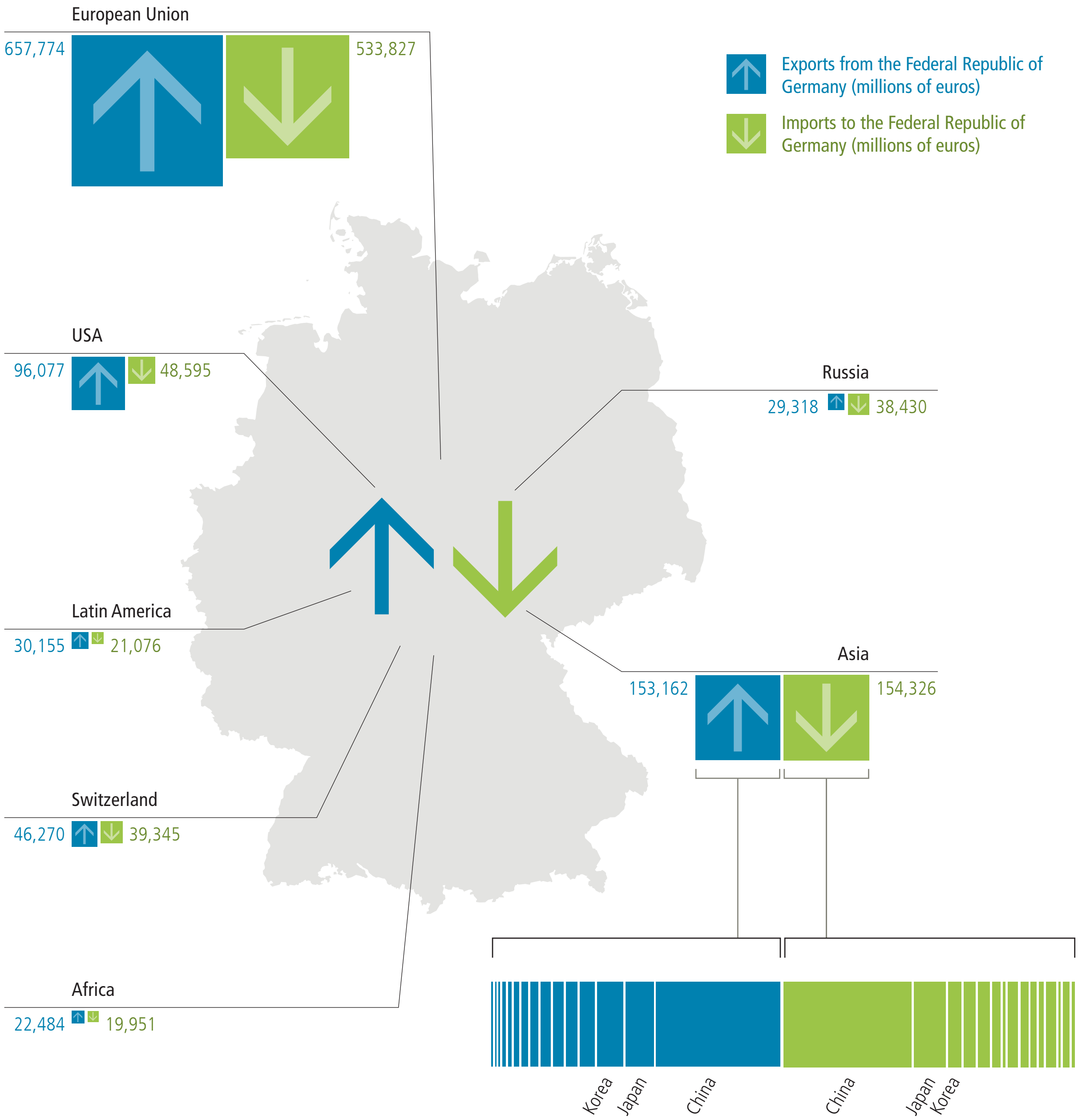
Now, however, two years after Xi's reform initiative was launched, people are much less optimistic. Whether the topic is the anti-corruption campaign or management of financial markets, whether it is relations with international firms or neighboring countries, China is currently sending signals that are generating more uncertainty than trust.

The anti-corruption campaign has been Xi's flagship issue since he took office. At the latest since June, when Zhou Yongkang, China's former security chief, was sentenced to life in prison, no one in China can rely on their status or connections to protect them from anti-corruption investigators. The battle against abuses of power has given President Xi more standing within the party and greater popularity among the public than any Chinese ruler has had since Deng Xiaoping. Whether Xi has improved governance structures in addition to his own position is questionable at best, since the fight against corruption is clearly following the script for a political campaign whose goal is the elimination of internal opponents.

Until now, there has been no attendant increase in rule of law or transparency. On the contrary, in a concerted effort last summer the authorities arrested 280 civil rights lawyers who had represented victims of corruption. Controls on the media and Internet were also increased. Presumably very few Chinese are aware of these events in their daily lives (if such an assertion can even be made about a country in which independent opinion polls do not exist). At the same time, crises such as the Tianjin explosion and the regularly occurring food scandals show that, when it comes down to it, many Chinese have little confidence in the system.

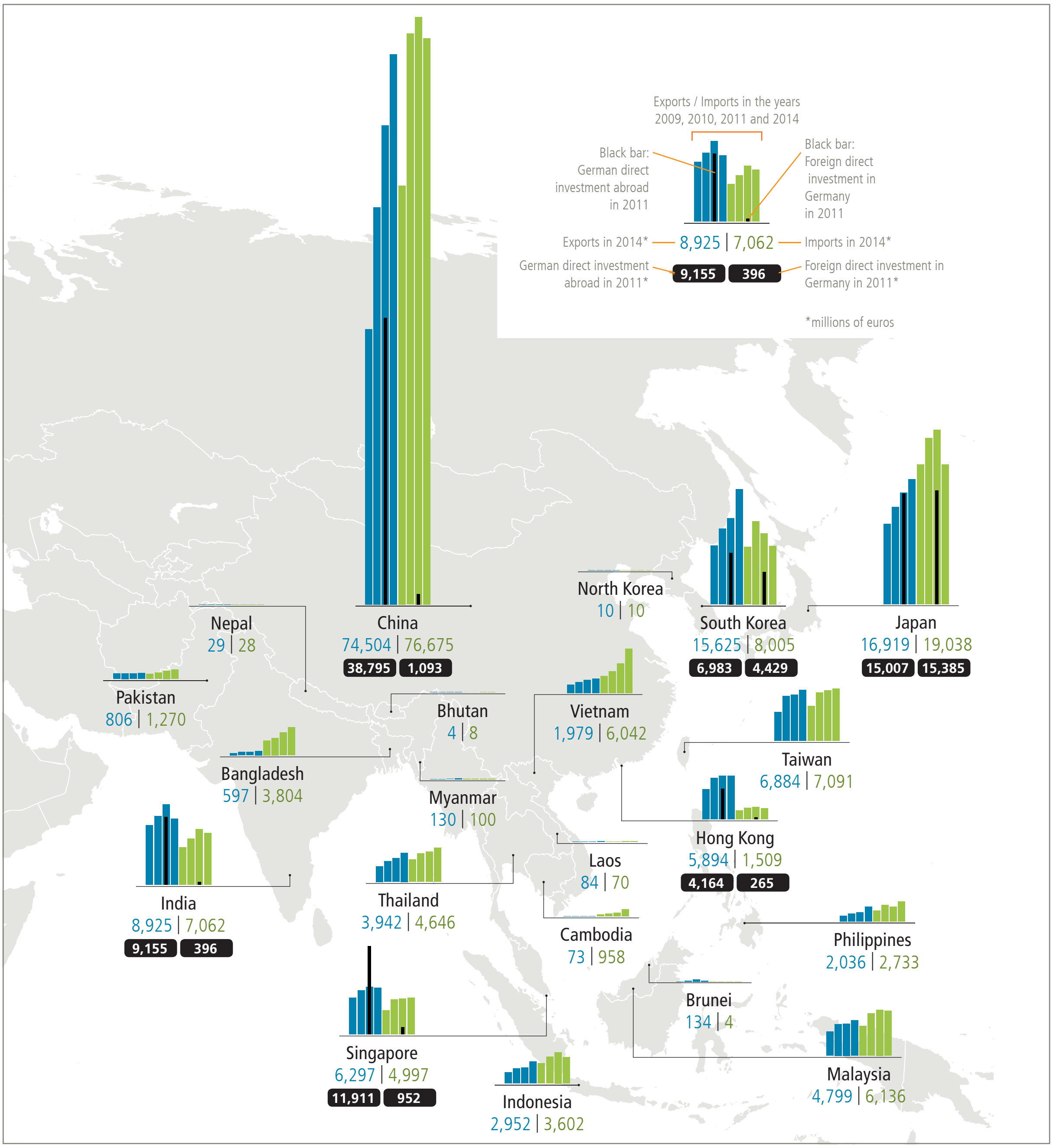
The state suffered its most apparent loss of confidence last summer when share prices collapsed. The Shanghai stock exchange lost 40 percent of its value within a few days. Some $5 trillion in wealth was obliterated, according to financial news agency Bloomberg. What also was obliterated was the expectation, endorsed at the highest levels, that the regulatory authorities had the stock markets under control and could prevent volatility of the kind found on western markets. That was the implicit promise used by the state for years to attract small investors to

Figure 1: Exports from and imports to the Federal Republic of Germany, 2014



Source: German Federal Statistical Office (DEStatis)
https://www.destatis.de/EN/FactsFigures/NationalEconomyEnvironment/ForeignTrade/TradingPartners/Tables/OrderRankGermanyTradingPartners.pdf?__blob=publicationFile

Figure 2: German exports to and imports from Asia



Source: German Federal Statistical Office (DEStatis)
https://www.destatis.de/EN/FactsFigures/NationalEconomyEnvironment/ForeignTrade/TradingPartners/Tables/OrderRankGermanyTradingPartners.pdf?__blob=publicationFile

the stock market. Some 90 million Chinese put their savings in shares, driving prices to new heights. When the bubble burst, it took the state days to prevent a second crash, which it succeeded in doing only by spending huge amounts of money. The damage to the real economy was moderate, since stock markets play only a limited role in corporate finance. The political fallout was, however, all the greater. The government had long postponed a fundamental reform of the financial system, a delay that was now coming back to haunt it. When growth rates are falling there is less leeway for experimenting than in boom times – something that also applies to investors' patience and their ability to tolerate losses.

Foreign companies are also viewing their activities in China with increased skepticism. According to the most recent Business Confidence Survey conducted by the European Chamber of Commerce, just over half of the European businesses present in China say they are still optimistic. In the prior year's survey, the figure was 10 percent higher. The majority of the companies say they are unhappy about unfair competitive conditions and disappointed that Xi's promises to open markets and increase competition have not had any impact on them. According to European business leaders, the most effective lever Beijing has for improving business development is making the legal system more reliable, since the lack of transparent structures is what prevents many firms from carrying out more research and development in China. Yet promoting innovation and an international transfer of know-how is a key prerequisite if a more sustainable growth model is to be achieved.

Beijing's behavior on the international stage is also causing concern. By adding land to islands in the South China Sea, the country has reversed the strategy it pursued for many years, namely doing as little as possible to stir up controversy when it comes to territorial rights, in order to maintain good relations with its neighbors. Beijing's bet that neither the countries bordering the islands nor the United States would interfere with this show of strength have paid off for now. Yet China's attempts to assert itself as a "great power" are causing anxiety. In addition to Japan, South Korea and India, the countries of Southeast Asia are trying to form alliances that can contain Beijing's influence in the region. The US is a welcome protector as they do so. China's fear of being encircled threatens to become a self-fulfilling prophecy and give rise to new confrontations.

The confidence issue

China and the world are currently undergoing a process of disillusionment. The Chinese reforms are stalled or are progressing more slowly than many in and outside of China had hoped. Such a reality check can certainly be healthy. There is little doubt of China's potential as a world power, both economically and politically. Doubts do exist, however, about whether the country can make full use of that potential.

China's leaders will try to give the reforms new momentum in coming months. The framework for this will be the consultations taking place prior to the next five-year plan, which is supposed to be approved in the spring. In terms of content, however, the plan will adhere to Xi's reform agenda of 2013. Whether or not people continue to have confidence in the government will depend, in turn, on how the agenda is implemented.

Beijing will lower expectations regarding growth rates, even below the magical 7 percent that was previously considered the minimum needed to create jobs and maintain social stability. China's slower growth will be felt throughout the global economy. For Germany and European countries in general, however, the growth rate itself is not as decisive as the question of which course China takes.

The signals are contradictory. The reform agenda's success currently seems just as likely as its failure or its stagnation in the current state of uncertainty. Germans should take each of the possibilities seriously and consider the implications, since there is one thing all the scenarios have in common: The framework for economic and political cooperation will become more difficult.

Until now Germany has benefitted from a special relationship with China. There is no other major developed country with which Beijing works as closely and trustingly. The German government is also the only one that holds joint cabinet meetings with its Chinese counterpart. This special relationship is extremely valuable and should continue to be promoted, since the German business community can use any diplomatic backing it gets, and the relationship offers German policymakers the opportunity to include China in the international community to a greater degree.

At the same time, Germany should not rely too heavily on the singular access it enjoys. Should China continue to develop successfully, it could give Germany less attention politically than in the past and the countries' economic relations would be subject to greater competition. As Beijing's economic plans make plain, China wants to become a serious competitor in all major technology sectors. Should China fall into crisis, however, then the German-Sino relationship would also suffer. Companies and politicians should therefore take advantage of the current period of transformation to re-examine their engagement in China and diversify their activities in Asia.

Planning according to different scenarios requires policymakers and the business community to do one thing without disregarding another. It also draws attention to a fundamental truth: Germany's role in global politics stands and falls with the power of Europe, just as Germany's role as an economic power hinges on the ability of its businesses and research institutes to innovate and remain competitive. As always, the most important tasks are waiting at home.

China's significance for the world economy

China now has the second largest economy in the world, measured in current US dollars. The International Monetary Fund (IMF) estimates China's GDP in 2015 to be $11.2 trillion (US: $18.1 trillion; European Union: $16.4 trillion).

According to the IMF, the Chinese economy has been the world's largest since 2014 when measured in terms of purchasing power. In 2014, Chinese GDP was $17.6 trillion valued at purchasing power parity (US: $17.4 trillion, EU: $18.5 trillion).

China is one of the world's most important export markets. In 2014, it imported goods worth $1.96 trillion (US: $2.41 trillion, Germany: $1.22 trillion).

In 2014, China exported $2.34 trillion in goods. That means the country has an enormous trade surplus, which has resulted in significant foreign currency reserves. In July 2015, they amounted to $3.65 trillion.

Germany and Asia

Building Bridges – Promoting Progress

Further reading:

Bartsch, Bernhard. "China im Jahr 2030," IP Country Report on China, No. 2, July – October 2015, 56 – 59.

European Chamber of Commerce in China. "European Business in China2015 – Business Confidence Survey," Beijing 2015, www.europeanchamber.com.cn/en/publications-business-confidence-survey.

Osnos, Evan. Age of Ambition: Chasing Fortune, Truth and Faith in the New China, New York 2014.

Latest editions:

Asia Policy Brief 2015 | 02
The Coup One Year on: Thailand's "Ugly German" Constitution
Serhat Ünaldi

Asia Policy Brief 2015 | 01
Japan Again under Abe – Fresh Start or More of the (not so Great) Same?
Axel Berkofsky

Asia Policy Brief 2014 | 06
Asian Middle Classes – Drivers of Political Change?
Serhat Ünaldi, Clemens Spiess, Cora Jungbluth, Bernhard Bartsch

---

If you have any questions or if you wish to subscribe to the "Asia Policy Brief" please write to **asien@bertelsmann-stiftung.de**.

All "Asia Policy Brief" editions can be downloaded from **www.bertelsmann-stiftung.de/asien**.

ISSN 2364-8562

Responsible according to German press law

Bertelsmann Stiftung
Carl-Bertelsmann-Straße 256
D-33311 Gütersloh

Stephan Vopel
stephan.vopel@bertelsmann-stiftung.de

Dr. Peter Walkenhorst
peter.walkenhorst@bertelsmann-stiftung.de