

China 2.0 – perspectives on China after the 19th Congress of the Communist Party

Key points

The recent National People's Congress showcased how President Xi Jinping has cemented his leadership position.

China is too big and growing too fast to ignore.

The rules of the business game are different.

The way the business game is played is different.

China's new market economy is not like a western market economy.

The more I know the less I understand.

19th Congress of the Communist Party was a significant milestone

The 19th National Congress of the Communist Party of China featured President Xi Jinping outlining his vision of “socialism with Chinese characteristics”. This vision included China moving to the centre of the world stage based on expanding soft and hard power and the growth of the new economy. The emphasis in the new economy (dubbed China 2.0)¹ is a digital and smart society which harnesses big data and emphasises ecommerce and high tech products like robotics, electric cars and artificial intelligence. So why should Kiwis be concerned about a party event so far away from our waters? The short answer is that China is now too important for New Zealand to ignore.

I recently had the privilege of joining the Asia New Zealand Foundation's Delegation that visited China in August 2017. The focus was think tank to think tank dialogue – so-called Track II diplomacy – rather than Government to Government discussions.² This note sets out the five big takeaways from my recent visit to China.

China is too big and growing too fast to ignore

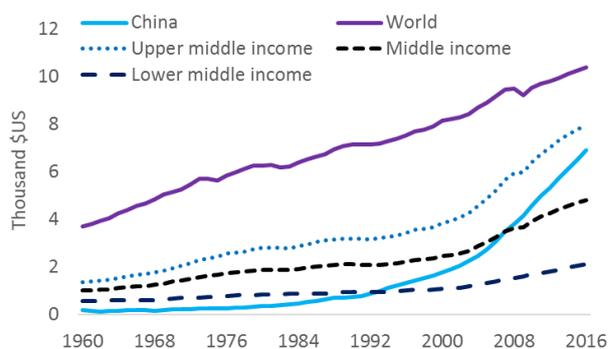
The last 30 years have witnessed one of the greatest economic transformations in human history (shown in Figure 1 below) as around a billion Chinese were lifted from a basic standard of living (GDP per capita of USD 132 in 1962) to upper middle-income status (USD 6,894.50 per capita in 2016). In contrast to earlier economic transformations, such as the Industrial Revolution in Britain, where the increase was barely perceptible to those involved, the transformation in China has been readily observable and has occurred within a generation. This generation have witnessed the growth of a new middle class with whole new cities springing up, new housing being built and they now have access to a basket of goods and services including overseas travel, that had never been available to them before.

This gives rise to some big fricking numbers (BFN). With the growth of urbanisation, in addition to the primary cities (Beijing, Shanghai, Chongqing, Tianjin, Guangzhou, Shenzhen), there are around a hundred second and third tier cities with populations of over 1 million people.

¹ www.aljazeera.com/.../china-20-xi-jinping-prc-economic-future-171021121245905.

² <https://www.asiamediacentre.org.nz/all?ArticleTag=track-ii>

Figure 1 GDP per capita



Source: World Bank Databank

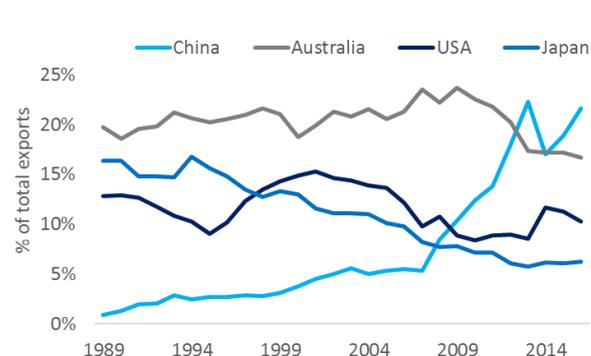
There are three transmission mechanisms – direct, indirect and induced – that make this economic development important to New Zealand.³

The obvious direct channel is through trade – what we buy from and sell to China. China is now the world’s largest exporter and is expected to be the world largest economy by around 2020. As a result, Figure 2 shows that China is now New Zealand’s largest export market overall and the largest single market for a range of products including dairy, wool, and forest products. A similar story can be told for imports and exports of services, where Tourism and Education Services are particularly important. This is all standard stuff.

Less well understood is the rate of change – China took 1% of New Zealand’s goods exports in 1990; it now takes 17% (as at 2016). The change accelerated after the GFC and the signing of the New Zealand-China FTA (in 2008) when goods exports quadrupled and China accounted for two-thirds of New Zealand’s export growth.

China became the locomotive for the world economy while the OECD grappled with

Figure 2 Shares of total exports



Source: Statistics NZ

recession after the GFC and the sluggish recovery that followed. Chinese demand for raw material sustained the Australian economy which in turn benefited New Zealand, as Australia remains New Zealand’s biggest trading partner. This role as the world’s economic locomotive is one of a number of indirect channels through which China’s economy has shaped New Zealand’s recent economic development.

The third significant channel is the change in the geo-political balance of power associated with the emergence of China as an economic superpower. The failure to adapt to this new reality was reflected in agreements not being reached in Doha on multilateral trade and in Copenhagen on global warming. Instead China is trying to develop new rules of the game including through the One Belt and Road Initiative (OBOR). This latter construct is still a work in progress: it currently seems to be more aspirational rhetoric than a well developed policy framework but the rhetoric is real and OBOR will be fleshed out and developed as it is rolled out.

In a world where the US has retreated from its traditional world economic leadership role to

³ I am grateful to my colleague John Ballingall for this framework which I have drawn on here. For a more detailed exploration see

<https://nzier.org.nz/publication/chinas-economic-rise-direct-indirect-and-induced-impacts-on-the-new-zealand-economy>

‘government by tweet’,⁴ China now sees an opportunity to fill the vacuum. And once the genie is out of the bottle, it won’t go back. Whatever framework emerges from OBOR, it will be different to those that we were used to under Pax Americana.

The rules of the game are different

The impact of the rise of China isn’t limited to the way the economic diplomacy game is played. It also means that New Zealand businesses need to understand that the rules of the game are different in what is soon to be the world largest economy. And the rules of the business game in China are very different. In New Zealand – like other Anglo jurisdictions – everything is legal unless it is illegal. In China, the rules are somewhat different. There are laws, which often suggest a number of things may be illegal, but what is important is what is officially sanctioned by the Party.

The trick as Jack Ma founder of Alibaba put it – ‘is to make friends with the state but don’t marry it’. One contact described how there was an operating window which provides a safe harbour for private business. Within those boundaries, private business can operate with a high degree of autonomy and no direct interference. But if that business wants to push out beyond the boundaries then it is important to seek official (read Party) sanction before doing so. Similarly, the boundaries can morph over time so it is important to ensure from time to time that they are still operating within the agreed window.

The private businesses in the new economy (such as ecommerce) operate within the fluid framework set by the state, with the ongoing risk that the political licence can be withdrawn. Hence the importance of investing and sustaining relationships with senior party officials. For some companies (including privatised companies), the Party Secretary conveniently has an office in the executive row

along with the Company Secretary and the CFO.

The way the business game is played is different

In China, as in a number of countries where the formal institutions are weak, long term relationships are critical to building connections (*guanxi*⁵). Business in China is relational rather than contractual. These relationships take years of investment to build up and sustain. And it takes more than a good relationship for relationship’s sake – there must be a clear win-win value proposition.

The striking example from the visit was recognising that China is now the fastest growing market for New Zealand sheep meat. In part that reflects the effort that Alliance has invested in building a business partnership with Grand Farms – a local Chinese firm. It reflects over a decade of effort to build and develop the relationship. The gain comes from being able to move up the value chain closer to the consumer – as one source observed ‘rather than taking part in auctions at the border, we take part in auctions for supermarket display space.’

China’s new economy is unlike a western market economy

By accident more than by design China has developed a unique set of institutional arrangements that have enabled transformational economic development. For example, the capital account is underpinned by a set of controls on particular sectors and approvals for specific overseas transactions. By contrast, the conventional approach to capital controls is based on the type of capital instrument (direct investment, portfolio investment, short term flows etc.).

The underlying metaphor for the economic management regime is that of an engineer

⁴ See NZIER Insight 71 for a topical update on the US and Government by tweet. <https://nzier.org.nz/publication/perspectives-on-the-us-economy-after-8-months-of-trump-nzier-insight-71>

⁵ <https://www.businessinsider.com.au/the-most-misunderstood-business-concept-in-china-2011-2?r=US&IR=T>

operating a hydraulic system rather than the market model found in OECD countries. Economic growth in this hydraulic model is a direct target rather than the outcome of how policy settings influence private decision-making. Planning and targets are particularly important in the smokestack SOEs sector (the old economy). The state dominated banking system provides the liquidity required to sustain the growth through the shadow banking system. Time will tell how well these arrangements stand up in the transition from extensive to intensive growth as the private sector driven new economy (ecommerce, services etc.) increasingly dominate the state dominated old economy based on manufacturing.

The more I know the less I understand

This is my fourth visit to China and my first in around a decade. The change that has occurred in the time since my last visit is dramatic. Each visit only served to remind me how little I really understood the country I was in. The observations in this note are provided from a perspective of 'conscious incompetence' rather than genuine expertise. A wag once commented that based on one week in China one could write a book, a month and one could write an article, a year and one could write a page. Accordingly, I'll limit myself to a couple of pages.

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