## 1. End of Easy Growth

### China’s Growth caused by:

1. More efficient allocation of resources (shifted resources to more productive industries not a huge contribution)
2. Competitive pressures (opening of markets; resources *used* more efficiently even when not *allocated* so)
3. Savings and investment (High savings rate 50% allowed for high investment which has accounted for 90% of growth)
   1. Loose monetary policy encouraging high levels of credit/ investment

**China’s growth is slowing:**

* GDP growth decreased from 8-9% to 6-7%

### 3 Growth Models that explain growth

***Solow-Swan Growth***

* Y=f(k) , with decreasing marginal returns
  + Eventually rate of new investment will equal the rate of depreciation
* Economies use Capital/Labour to produce output
* Output tends towards “steady-state” (malthusian trap) where further growth can only be achieved through “manna from heaven”

***Endogenous Growth***

* “Endogenisations” of technological growth - making it dependent on other “stuff” in the economy
* Market failures (spillovers, economies of scale, market power) generate growth by cancelling out DMR

***Evolutionary Growth***

* Economies evolve by individuals responding to incentives

Competition provides following pressures:

* 1. *Pressure to reallocate resources within existing technologies*
  2. *Get better at using resources within existing technologies*: “X-Inefficiency”, resources are allocated OK, but people aren’t using them as well as they can within existing technologies and so they face pressure to use them better
  3. *Get a better technology*: if no further productivity increases can be made with current technology must adopt new tech to survive

“Long waves” of growth occur that spike when a new technology is introduced, continues to increase as more and more people adopt the technology, slows down as it becomes hard to get better at using tech and then spike as new tech introduced (cycle continues)

### Why is China’s Growth Slowing?

* Typical Swan-Solow growth trajectory; running out of good investment opportunities
  + DMR of capital investment
  + Exhausted opportunities for infrastructure development
  + Low quality investments depreciate at high rate
* Human capital rapidly reaching “western” levels
* Opportunity to eliminate allocative /x-inefficiency (resource allocation)
  + **X - Inefficiency** is difference between efficient behavior of businesses assumed or implied by economic theory and their observed behavior in practice caused by a lack of competitive pressure
* Increasingly little scope for process innovation within technologies adopted from the “west”; no more gains from imitation

**SOEs** have no incentive to eliminate their own allocative and x-inefficiencies

* + Public v Private response to market demands
* Lack of large scale-diffusion of technological innovations (Also an issue in the west)
* Little ability to invest overseas despite it being shown to have high returns

### 3 Possible Outcomes:

1. **GFC;** that bounces back and then returns to steady growth
2. **“Muddle- through” path**; steady/ controlled deceleration with trend growth easing to 3%
3. **Japan lost-decade path**; bursting of asset bubbles combined with policy mistakes leading to prolonged stagnation (middle income trap)

### How do you solve the issue?

* Reallocation of resources /productivity improvements still required
  + (i.e opening up to the competitive markets/ incentives)
* SOEs are large portion of Chinese economy with low productivity growth rates/ high debt/ high percentage of non-performing loans
  + **Some estimates suggest that over half run at a loss which are funded by loans from state banks**
* Need more reform otherwise innovation/ productivity growth will be constrained
* SOEs unable to compete in free market due to inefficiency therefore there is lobbying for protection
  + CCP comprised of business people benefiting from the current system so no incentive for reform

## 2. Inefficiency and SOEs

**SOEs** are still a significant portion of the Chinese economy

* Low product growth rates of productivity/ high debt/ high percentage of non-performing loans (On estimates 50% run at a loss)
* Still require reallocation of resources/ productivity improvements (eliminate x-inefficiency)

## 3. Bubbles and Bad Investments

* China has a managed floating exchange rate (not fully floating) that is controlled by the Central Chinese Bank
* Pegged to a “basket” of currencies but the composition has not been made public

**Malinvestment**

* Overcapacity in some industries
* High depreciation on low quality capital

**Bubbles**

* Arguably no housing bubble as despite prices doubling since 2009 in major cities is still sustainable
* Asset market may be a bubble > but if sustainable most investments will be profitable

## 4. Banks and Runaway Debt

A lot of debt is held by state/regional banks which the Central Bank implicitly guarantees

* Means no GFC style crash but impacts still may be felt in Asian region

**Banks Unsustainable**

* Emergence of “**shadow banking**” > unregulated markets that are high risk
* Chinese bank assets (loans) have increased 50 percentage points in last 3 years
  + 100 percentage points in 10 years
  + 310% of GDP > above average for advanced economies
  + 20% of Loans are non-performing
* Mismatch between assets/liabilities > banks depend on short term financing

**Debt**

* Most debt is comprised of the Corporate Sector (SOEs and private enterprise)

*Debt is fine when associated with:*

1. Increases in productivity
2. Increases in the loanable supply of funds
3. More productive banking system
4. Growth in the economy

## Credit Crisis

**Credit Surged since the GFC**

* China’s nonfinancial sector/ domestic debt was at 135% of GDP before the GFC
  + In 2011 was 170% of GDP
  + In 2016 was 240% of GDP
* Government maintained loose monetary policy/ pumped a large amount of money into the economy to avoid a crash during the GFC

**Credit is being allocated less efficiently**

* In 2007 $1 of new credit associated with 0.8c in GDP growth
* In 2016 $1 of new credit is associated with 0.25c in GDP growth

**Most Chinese debt is in the Corporate Sector (SOEs/ Private Business)**

* **Service Sector** twice as efficient as Industrial Sector but receive the same share
* **Private** **business** are twice as efficient as **SOEs** but **SOEs get 50% more credit**
* Provinces (North-East) with falling productivity/ share of GDP/ deposit growth are still receiving high amounts of credit - suggests political motivations
  + Less productive debt = compounding issue
* Government is “picking winners” by deciding which business/industries receive credit
  + Cf **Market system**- money flows to most profitable business plans

*High/Growing levels of debt only sustainable in the context of continued high economic growth*

China’s growth has been the result of loose monetary policy

### Causes of Credit Growth

**Results over 2008-16**

* *Credit growth due to loose monetary policy*
* Both supply (deposit growth) and demand (economic outlook) for loanable funds decreased from 2008-16
  + The expected slowdown was offset by change in monetary policy stance
* **Credit growth isn’t a sign of an expanding economy if is only caused by govt pumping money into the economy**

### Cause for Concern?

|  |  |
| --- | --- |
| **IMF View** | **Optimistic View** |
| Most Credit booms end badly   * In most cases (43) where there had been dramatic increases in credit it ended in a crisis/ growth slowdown   Normal Booms last 2-3 Years China’s has lasted 15 (GDP growth would have been 2% less without the credit boom)   * Few credit “corrections” in the past 30 years * Underlying problems are real and some adjustment will occur whether *policy* or *financial crisis* | **Low Foreign Debt**   * Not exposed to risk of foreign capital flight   **High Savings Rate** 40-55%  **Debt implicitly guaranteed by the Central Bank**  **High Asset Prices** (if sustainable = profits) |

**Potential Outcomes**

1. **Deep sharp crisis;**that bounces back and then returns to steady growth
2. **“Muddle- through” path**; steady/ controlled deceleration with trend growth easing to 3%
3. **Japan lost-decade path**; bursting of asset bubbles combined with policy mistakes leading to prolonged stagnation (middle income trap)

### Comparison to the GFC

|  |  |
| --- | --- |
| **Same** | **Different** |
| **Increase in debt**   * USA (2000) 180% of GDP - (2009) 250% of GDP * China (2007) 160% of GDP- (2016) 240% of GDP   **Housing Boom**   * **USA -** debt went into housing/ creating a bubble * **China-** debt has gone into housing, creating a bubble, with average prices doubling since 2009 in major cities   **Shadow Banking system** | Corporate (SOEs) not private debt   * Consumer debt levels are low (44% of GDP) * Private businesses are generally profitable * Credit crisis will disproportionately affect non-profitable business (SOEs) * Debt owned by State Banks - US style GFC not likely   Housing boom not so boom-y; levels while high still sustainable   * Asset bubbles may exist elsewhere within the economy |

## 

## 5. Public Finances

**Ageing Population**

* By 2030 over a third
* World Wide issue compounded by One Child Policy > Child will grow old before they get rich

**Decline in Working population**

* Chinese workforce is no longer growing (2015)
* Significant decline in the ratio of working age people
  + In 1979 ratio was 7:1, 2018 is 5:1, 2035 expected to be 2:1

Pensions

* Only ⅓ of Urban residents and 5% of rural residents have a pension plan
* Increasing demand for public services with increasing ageing population but a declining workforce means less people paying taxes to support the system

**Social Services**

* Previous structures dismantled in 80s/90s
* People demanding better/more health/education/welfare services

## 6. Political Challenges

* Perception people are getting richer through political connections under the current system= creating resentment

**China Domestic Policies**

* CCP has 89 Million members

Party Congress > Central Committee > Politburo (22) > Standing Committee (7) > Xi Jingping

* National People’s Congress is democratically elected

**Evolution of Political System**

* Lack of democracy means that ideas/opinions are not being heard by politicians; Increasing middle class usually demands more freedoms and tends towards democracy
  + May not be case in China’s system as CCP will be unwilling to adopt any system that reduces their power
* China has **vested interest** in maintaining g**lobal political stability** while they manage domestic affairs (maintaining growth/ controlling debt)
  + **China analysis**= China is slowly improving its political system, but it’s crucial to maintain political stability during a time of rapid social, economic and geopolitical change
* Need for more democratic input but can prevent good policy (See India) due to rational ignorance/ median voter theorem/bureaucratic monopoly

***Guided Democracy***

* Similar to Iran
* Representatives would be democratically elected but the CCP would have veto power as to the candidates
* The National People's’ Congress would become a fully-fledged “lower house” and the CCP would function as a senate with the final control over decisions

***Hybrid Democracy***

* CCP maintain control of the executive (state council) which could be separate entirely from the NCP (Democratically elected Lower House)

***Vertical Democracity***

* Transparent meritocracy where political power is earned by previous success; good ideas from the “bottom” filter up the power hierarchy
* Leaders are expected to respond to the bottom-up ideas
* China does not possess the systems required to retain this system (term limits/free media)

**Pros/Cons of Democracy**

|  |  |
| --- | --- |
| **Benefits of Democracy** | **Costs of Democracy** |
| **Consider opinions of general public**   * Downwards pressure on corruption   **Peaceful contest of Power**   * Smooth transfer of power from one leader to the next * Political disagreements played out in public debate/ democratic elections | Government is made up of people, who respond to incentives and so we can consider the “economics of growth” by looking at those **incentives** = public choice theory   * **Politicians:** Median Voter theory (50%+1); don’t need to determine what works just what is popular * **Bureaucrats:** Monopolistic Behaviour. Own interests > Customer’s Interests * **Voters:** Rational Ignorance/ vote on preferences over beliefs > shaped by Biases |

* **Make Work Bias**= tendency to underestimate the benefits from conserving labour, and opposing labour saving devices
* **Anti-foreign Bias**= tendency to underestimate the benefits from interacting with foreigners; anti-trade, anti-immigration, anti-FDI
* **Pessimistic Bias**= tendency to overestimate the severity of problems, and underestimate recent performance/ development; according to most metrics the world is becoming better and better
* **Anti-Market Bias**= tendency to underestimate the benefits of the market system: Belief in the benevolence of planners, and fear of spontaneous order

## 7. Geopolitical Conflict/ Challenges

**Conflict Areas**

* **Eastern Border** = Japan, Taiwan
* **Southern Border** = Vietnam, Philippines, South China Sea
* **Northern Border** = Russia (currently good relations, historically animosity)

**Competition with USA**

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| --- | --- |
| **1. Economic** | **3. Diplomatic** |
| China leading in trade/ global savings/ catching up in terms of GDP  USA currently retains lead in innovation   * **Growing risk of trade war (YEET)** | Potential for a new cold war   * Growing Chinese assertiveness in Asia |
| **2. Philosophical & Cultural** | **4. Military** |
| An alternative to the “western democracy” model and an alternative set of values | USA has a large advantage  China is rapidly developing and may catch up in the next 20 years |

**Thucydides Trap**

* The rise of any great power that threatens to displace another always ends in war

*Avoiding the Thucydides Trap*

* UK/ US became allies
* USA/Soviet Russia had an extended “cold war”
* Current rise of China seems inevitable’ but economic stagnation/ financial crisis could prevent genuine challenge
  + May “evolve with” competitors i.e a more liberal China

**Areas of Conflict**

* Now China is a rising strategic threat other countries accusing China of neo-imperialism, neo-colonialism and attempts at regional hegemony
  + In cold war claimed a stand against said things

**China 2025**

* China has plans to develop key high tech (and strategic) industries:
  + AI/ Robotics/ Self-Driving Vehicles/ Advanced Medical devices

**Monroe Doctrine with Chinese Characteristics**

* US president declared that foreign military powers were not welcome in the Americas as that was a US sphere of influence
* **South China Sea**
  + Considers the area inside the “first island chain” within the West Pacific Ocean to be crucial for their long-term self interest and wants to remove US military influences

**Taiwan (One China Policy)**

* China/CCP maintains its One China Policy that Taiwan is part of one, unified China and that no foreign powers should be involved
* USA recognises the One China Policy but has been supplying Taiwan with weapons despite wanting the conflict to end “peacefully”
  + The “Grand Bargain” where US stops supporting Taiwan in exchange of China relinquishing its territorial claims in the West Pacific Ocean

**Trade War**

US RAGED WAR FIRST $50mill in tariffs YEW BOI

**Trumponomics**

* (Peter Navarro) Claims China is a currency manipulator/trade cheat/ flooding US with cheap imports driving US business bankrupt/sending jobs overseas
  + Uses Y = C+I+G+NX to argue trade deficits (-NX) are inherently damaging to Y
  + This does not explain how GDP is created
  + To understand GDP creation, need the production function Y= A.f(K,L), which GDP/Capital depends on Capital investment (K) and knowledge (A)
    - Artificial manipulation of NX will likely reduce competition (Lower A) and less investment (lower K)

**CA/KA effect on NX**

* Trump forgets that total balance of payments must =0
  + CA+KA=0 ∴ CA= -KA (CAD=KAS)
* **Current Account** is Exports- Imports (NX)
* **Capital Account** net change in physical or financial asset ownership for a nation (Including foreign investment) largely determines the balance
* To increase NX (return to Surplus) must decrease the CA deficit which decreases the capital account inflows therefore decreases total investment (higher NX, lower I, not change in GDP)
* Further:
  + May not be able to increase NX (See secondary effects of tariff )
  + May actually decrease GDP, since lower investment l

### Trade

As long as voluntary and players have sufficient information= trade by definition creates mutual benefit (Ricardo’s theory of comparative advantage)

* Only cost of trade is not engaging in the trade

Trade policy is ultimately depends on political consideration (use trade as a weapon/ social/ environmental Goals)

**Bilateral Trade Deficits** are irrelevant > normal to have a deficit with another party

**Total Trade Deficits**

* Trade balance determined by capital flows that depend on level of domestic savings/ investment opportunities

### Tariffs

**Effects of Tariffs**

Welfare Change

* Welfare = consumer surplus + producer surplus + government tariff revenue
* Both consumer surplus and producer surplus reduced under tariff

**Deadweight loss from Tariffs**

* Large cost to consumers/business > Small benefit to government/ producers
* Appreciation of the currency consequent reduction in exports

**Link between exports and imports**

* A reduction in imports will cause a decrease in demand for foreign currency, and therefore an appreciation of the home currency
* If there are no changes to the capital account, then trade protectionism will decrease imports and exports by the same amount, having no impact on NX (more likely to be the case where both the capital account and current account change slightly

**Secondary Effects**

* Burden on household incomes created by tariffs is felt the greatest by the poorest 10%

**Negative protection:** If tariff is placed on a input that domestic producers use this will reduce the domestic value of the output and negatively protect the producer

**Effective protection**= percentage change in the value-added of the domestic industry once both input and output tariffs are considered

Output Price - Input price = Domestic Value

**ERP = (New DV - Old DV)**

**Old DV**

**Global Impact of 45% reciprocal tariffs**

* Global GDP -0.2% and global trade -0.7%
* Mexico with GNP +1.2% due to increased trade: also ASEAN +0.3%

**Foreign reserves as a “Financial Weapon”**

* China has 3.1 Trillion in foreign reserves; 1.2 trillion are in US Bonds > 10% of total US Bonds
* A sudden sell off would push down the prices of US Bonds, increasing their yield and therefore increasing their implicit interest rate
  + **But** any changes to US securities price (and implicit interest rate) likely to be short-term
    - Fed would step in/ Investors would capitalise on cheap assets
  + China would also suffer loss on value of assets/ Currency would appreciate against the US hurting exports

## 8. Social Pressures

**Social Unrest**

* Government introduced a new “social credit’ system to monitor and control citizens
  + People with low scores will face various sorts of sanctions

**Inequality**

* Gini Coefficient has increased from 0.3 - 0.42
  + Richest 1% own 1/3 ; Poorest 25% own 1%
  + Inequality has increased since opening up to economic reform

***Causes***

**Success Premium:** “Super Star” effect in some jobs (sports/entertainment, CEOs) that bids up the price of the top performers

**Public Policy:** Chinese government plays an active role in the economy, they do not have a western-style welfare state

|  |  |
| --- | --- |
| **Jealousy/ “Relative Poverty”** can make people feel worse off/ breds resentment   * May depend on the perceived causes and whether high incomes re due to productivity, theft, corruption or inheritance   **Social Stability**: “income inequality is the single biggest threat to social stability around the world” Kenneth Rogoff   * Regional differences can create resentment and distrust between different areas, undermining the sense of national unity   **Positional externalities**   * Market for normal goods leads to positive-sum trade (both sums win) * Market for status goods such as being “fastest”, “richest”, “best” etc is zero sum (where the gain of one person comes at the expense of others) * this can lead to inefficient over-investment in status goods | **Economic motivation:** additional ability, effort /education are increased creating more productive incentives  More unequal countries have higher levels of charity and community engagement |

Caplan: Single biggest threat to social stability is inequality

*Rural v Urban Gap*

* Investment has been focused on major urban centres
* Urban wages 2.7 times higher

**Social Services**

* Aging Population = increased demand for social services

**Hukou System**

* Limited movement and access to social services based on where you were born within the country (rural or urban)
* Favoured urban residents and rural residents were left to fend for themselves
* Lead to Relative labour shortage in urban areas compared to rural (OCP reversed)

## 9. Cultural Barriers

**Nationalism & Racism**

* Nationalist sentiment source of communal pride but extends into bigotry (direct and Indirect Costs)/ Conflict between different ethnic groups (Tibet, Xinjiang)

**Censorship, conformity & innovation**

* Free speech= exchange of ideas which fosters evolution of ideas/ new innovations/ exposes bad ideas
  + Low tolerance for diversity makes innovation less likely
* Control of information in China limits benefits of free speech
* Respect for authority & traditionalism (order biased towards tradition)/ innovation & change (chaos wary post Cultural revolution)

**Rule of Authority**

* Lack of the “rule of law” makes it difficult for small-medium enterprises to do business in China
  + Inconsistent /obscure regulations
  + Difficulty enforcing contract
  + IP theft decreases competition (less efficient market)

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## 10. Environmental Problems

**Air Pollution**

* 1 Million die every year from air pollution (Sulfur dioxide, nitrogen dioxide, carbon monoxide and particulate matter)
* 440 People die everyday from air pollution
* ⅓ of the country breathes unhealthy air
  + Primarily caused by factories/ power plants/ vehicles
  + Recent improvements as the government has required business (mostly SOEs) to reduce emissions

**Water Quality/ Shortages**

* ⅓ of Chinese lakes are unfit for use
* 20% of world’s population but only 7% of fresh water
  + Dramatic shortages expected by 2035
  + 11/31 chinese provinces do not meet World Bank Criteria
* 60% of underground water is contaminated
* 85% of water pollution comes from run offs from Agricultural/ Industry
* Cancer rates more than doubled near heavily polluted Haui River
* 8 other countries are dependent on Chinese rivers (cant make dams)

**South-North Water Diversion Project**

* + $62 billion water diversion plan
* Water usage caps introduced/ stricter pollution regulations
* Could implement a fixed price as is currently artificially low price for water has encouraged inefficient use (agriculture /industry) (85% of water usage)

**Climate Change**

* Largest Emitter of greenhouse gases in the world (followed by US/EU/India)
* UAE/ US/Aus largest per capita (China relatively small)
* No binding targets on alternative energy

**Pollution Policy** **Options**

* **Internalise through Property Rights** Remove the “common resource” by allocating clear property rights; not always possible (coordination costs)
* **Internalise through Tax/ Subsidy:** Compensate for the negative externality with an offsetting cost; externality taxes are relatively efficient taxes, if the tax is set close to the level of the negative externality
* **Control through regulation:** mandate the correct level of pollution
  + Difficult todo properly due to insufficient information about specific benefits/costs
* **Private institutions:** not public policy; when faced with common resources, many groups/cultures develop internal rules and cultural norms to allow for the efficient sharing of common resources

**Inaction=** if there are weak/missing property rights and private institutions, then government inaction will lead to excessive pollution

**Overreaction=**  pollution policy should only be pursued if the benefits (less pollution) exceed the costs

**Deforestation & Desertification**

* Protected areas under pressure from expanding population
* **Deserts growing by 67km2 every year (Western China)**

**Pollution is not a market failure if the benefits of polluting > costs**

* **Market failure if firms dodge costs**

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| --- | --- | --- |
|  | Excludable | Non-Excludable |
| Rivalrous | **Private Goods**  (Cars, phones, most things) | **Common Good**  (public park, rain water) |
| Non-Rivalrous | **Club Goods**  (Pay TV, copyright material) | **Public Goods**  (Military, lighthouse) |

**Rivalrous Good:** If I use it you cannot

**Excludable Good:** some barrier (i.e payment) to use

## China & World Economy (Int. Trade)

* Country will export g/s that utilise their resources
  + China = labour rich therefore export labour intensive goods
  + Labour scare = capital intensive goods

**Export sophistication**- movement from labour intensive low tech to capital intensive high-tech/sophisticated exports

* China joined WTO and achieved MFN (Most Favoured Nation) Status meaning other countries cannot impose trade barriers on Chinese goods
  + Substantially more competitive/ absorbed large portion global goods market

Trade Liberalisation transformed China into world power:

**Largest Merchandise exporter/ Second Largest Importer**

* Chinese merchandise exports = $14 billion (1979) to $2.3 trillion (2014)
  + Share of global exports tripled between 2000-14 (3.8%-12.4%); exceeded Germany 2009
  + 20% by 2030

Trade Balance (Export-Imports) increased:

* 2000 negligence difference; 2014 significant increases

### China’s Major Trading Partners

* **Export** to EU28, the US and Hong Kong (electrical machinery, machinery (including computers), knit apparel, plastics and furniture/ bedding)
* **Imports from** EU28, ASEAN and South Korea (electrical machinery, mineral fuel, machinery and ores)

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| --- | --- |
| **Maintained Trade Surplus** | **Maintained Trade Deficit** |
| * + Hong Kong ($350 billion)   + US ($243 Billion)   + The EU28 ($127 Billion) | * + Taiwan (-$106 billion)   + South Korea (-$93 billion) |

* 2007 China was largest exporter of high-and-low technology-products, accounting for 15% and 19% of total exports in the world, respectively.
  + Strongest export growth has been high-technology products (data processing/ telecommunication equipment)

**China’s Growing Appetite For Energy**

* Economic growth has fuelled a growing demand for energy, such as petroleum and coal
  + Net oil imports 632,00 bpd (1997) to **5.8 million bpd (2013)**; 2nd largest after US

**Export Oriented Policies:**

* Policies that reverse discrimination against exporters and allow more balanced incentives
  + Smaller/fewer departures from free trade
  + Leads to more Liberal economy

**Import Substitution Strategies**

* Tariffs / taxes that favour domestic producers
* Restrictions on imports so they cannot compete with local products

**China’s Trade Strategy 2 Pronged Strategy (Mixed)**

1. Capitalising on abundant labour through job-creating labour-intensive manufacturing
2. Also upgrading economy through exporting higher-technology products

* **Ensuring to invest in tech sector and move to the higher end of the supply-value-chain**
  + Moving along the chain, your return on investment increases as you reach the top of the chain
  + China consciously trying to upgrade their economy through tech investment

**China FTAs**

* Chinese government in support of FTAs as a way of “opening up to the outside world” and “speeding up domestic reforms”

Regional Comprehensive Economic Partnership (RCEP)

* + ASEAN (10) + China
  + Would constitute world’s largest free trade bloc (in terms of combined population and GDP)
* “Economic Cooperation framework agreement” with Taiwan
* Negotiating FTAs with Cooperation Council for the Arab States of the Gulf, Norway and the Southern African Customs Union, Sri Lanka, Japan and South Korea

## China & World Economy- Foreign Investment

**Twin Surpluses**

* 2008 aggregate savings rate in China > 53% of GDP whereas the Current Account surplus exceeded 9% of GDP
* Foreign exchange reserves of China reached USD $3 trillion in March 2011 as a result of the Current Account surplus and net inflow of capital
* 1985-2000 net Current Account fluctuated, never exceeding 4% of GDP (before joined WTO)
  + Increased to 10.1% of GDP in 2007
  + Decreased slightly during GFC to 5.2% of GDP in 2010

S - I = X - M means that the national product not consumed or invested at home must be equal to the net purchase of the rest of the world, which is the current account balance

* Derived from the national accounting equation
* Implies if S > I = X > M (Where X >M is the Current Account Surplus)
  + The gap between savings and investment is the net flow of national savings into investment abroad

**Net Foreign Asset** position = the value of a country’s foreign assets - value of domestic assets owned by foreigners

* A current account surplus will increase the **NFA** position of a country
* China’s NFA position swung from net debtor of ~6.2% of GDP to net creditor of ~30.5% in 2010
  + Previously China’s savings was less than investment but as their net foreign assets increased they became a creditor

**Foreign Direct Investment**

* Objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is a resident in another economy (i.e 10% of voting rights)

**FDI policies Evolution**

* 1980s setup regulations allowing for regulations to permit joint ventures in SEZs
* China’s trade /investment reforms / incentives led to a surge in FDI beginning in the early 1990 (to boost development of domestic firms)
  + 1990s began to allow **Wholly Foreign Owned Enterprises** 
    - Now 2/3s of China’s total FDI
  + 2000s “Go Global” campaign encouraged SOEs to invest overseas
* Have been a major source of China’s productivity gains / rapid economic /trade growth

**China Annual Data on FDI Inflows**

* According to the United Nation, annual FDI flows into China grew from $2Billion in 1985 to $128 Billion in 2014
* World’s largest destination for FDI inflows in 2014 (Followed by HK/US)

|  |  |
| --- | --- |
| **Sources of FDI in China** | **China FDI outflows** |
| * 1979-2014 HongKong (48.9%), the British Virgin Islands, Japan, USA and Taiwan   **Comprised of:**   * Horizontal FDI involving the transfer of production from abroad to China to services the Chinese internal market (Western/ European Markets) * Vertical FDI which seeks to take advantage of low cost production (and especially low wage rates) for export of products abroad | China’s annual FDI outflows   * $12.3 billion in 2005 * $116 billion in 2014 (843% increase) * 3rd largest source of global FDI in 2014 up from 6th in 2011   Outflows > Inflows as of 2014 (**net capital exporter)**  **Destinations-** HongKong (57.5% of Total) the BVI, the Cayman Islands, USA and Australia |

**Share of China’s Export and Imports attributed to FIEs In China**

**Foreign Invested Enterprises** are responsible for a significant portion of China’s foreign trade

* 2013 FIEs in China accounted for 47.3% of China’s exports and 44.8% of its imports, although this level was down from its peak in 2006 when FIEs share of Chinese exports was 58.2% and 59.7% respectively.
* FIEs in China also dominate China’s high technology exports

**ODI Impact of Domestic Firms**

* ODI has a positive effect on value added, employment, productivity, export intensity, R&D intensity and the propensity to innovate new products