Understanding China's New Export Ambitions

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Abstract. *The world is expecting China to rebalance its growth from investment and export to more domestic consumption. That shift would not only stabilize the Chinese economy; it would also create more opportunities for other countries. Yet, this paper finds that the new leadership does not have concrete plans to do so. Moreover, a review of important policy documents reveals that it is set to make another major push for industrialization through export. This is mostly because the government considers that the large investments in the industrial sector are not exceptional and because of geoeconomic objectives, that is, the attempt to establish competitive national industrial champions and to change the global order to China's benefit. As a result, more sophisticated export promotion policies are put in place. Yet, China might increasingly find its export ambitions incompatible with the promise to build so-called win-win relations*. **Key words:** China, strategic trade, industrial policy.

Introduction

Geoeconomics has often been presented as the assault of states on markets and free trade, as an attempt to protect national industries and to exclude others.[1] China's rise, however, shows again that geoeconomics is more sophisticated. China does not try to *resist* globalization; it tries to *bend* the flows of trade, capital and knowhow into its advantage. It does not want to cripple the market; it wants to use the market to make its own firms more competitive. It does not oppose investments of multinationals; it seeks to use them to expedite the transfer of technology. If geoeconomics is about the art of using political means to gain economic power and to use economic power as effectively as possible in pursuit of political objectives, China is clearly accepting many of the liberal economic standards, being it gradually, to advance its national interests.[2] This instantly explains the spate of concepts being used to capture this hybrid situation: embedded liberalism, embedded mercantilism, economic security, neomercantilism, state capitalism, etc.[3]

With regard to China, the debate has largely revolved around either its internal reforms – its industrial policy and state capitalism – or the repercussions of its growing trade power on the political interests and security of other countries.[4] This paper seeks to offer more clarity on the trade strategy that follows from China's industrial ambitions, in other words: how is China using its economic resources help its industries thrive through exports? Its objective is not so much to test all the relevant concepts and assumptions in the rich literature about geoeconomics, but to present China's industrial and trade policies as an important example of the growing refinement of today's geoeconomics. Its first main argument is that China is determined to make yet another push for industrial power and that it will only rebalance its economy more significantly towards consumption if it feels confident about the strength of its industrial sector. It needs to be remarked, though, that China, as most other countries, expects its future industries to be closely integrated with different commercial services. As such, this paper comes as a corrective to the common view that China is set for a quick rebalancing. China itself has also cultivated that expectation.

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Since a new leadership was installed in 2012, it appeared to confirm the arrival of a great turning point in China's economic transition. The first Politburo's Standing Committee meeting in April pledged to focus on domestic demand and the promotion of consumption.[5] This was affirmed during a Strategic and Economic Dialogue meeting with the United States, where Vice-Premier Wang Yang announced a number of additional steps to boost household incomes and purchasing power.[6] Moreover, Wang promised to rein in cheap credit. Earlier, Xi Jinping had already signalled that he would take new steps to reform the currency exchange rate policy. In 2013, the Yuan continued to appreciate despite widespread criticism that exporters were hurt. Meanwhile, the Ministry of Industry and Information Technology issued a long list of factories in 19 different sectors that were forced to close some of their idle production lines.[7] Officials announced, proudly almost, that China's traditional current account surplus continued to shrink.

Yet, this paper posits that for all the promises, the much anticipated rebalancing is not considered a policy option for the short term. What the leadership most urgently wants to achieve, was not a shift from exports and investments to domestic consumption, but from resource-intensive industries to labour-, capital- and technology-intensive industries. In fact, decision-makers are firmly committed to making another major push to expand exports and especially to allow Chinese manufacturers to profit. In general, the political elite assumes that the country will go on to rely on exports for another decade or so. The fundamental rebalancing towards consumption would only take place if the country during that period managed to join the ranks of advanced industrialized countries. While this geoeconomic strategy makes sense from a Chinese viewpoint, it comes as an important challenge to other economies and is almost incompatible with the presumed harmonious world.

Industrial policy

Despite the promises about rebalancing and stimulating consumption, it is evident that industrial modernization remains key. In the Government Work Report's proposals for 2013, it was stated that domestic consumption would be encouraged, but also that this would be difficult and that "the importance of investments to keep growth on track cannot be underestimated". The key for economic stability, it continued, "lies in finding the right targets for these investments, to optimize their structure, quality and efficiency."[8] The most elaborate objective, consequently, concerned the upgrading of the industrial sector. That entailed the development of labour- and capital-intensive manufacturing, boosting innovation, strengthening strategic emerging industries (战略性新兴产业), and cutting overcapacity.[9] This largely confirmed the objectives of the Industrial Upgrading and Restructuring Plan for 2011-2015 and the Plan for Strategic Emerging Industries.[10] The first economic session of the Standing Committee chaired by Xi Jinping, in April 2013, firmly called for "focusing on releasing domestic demand" and "strictly controlling the reckless expansion".[11] Yet, a subsequent economic session of the Politburo was already more vague and spoke of "promoting consumption upgrading and maintaining reasonable investment growth".[12] Most decision-makers seemed to agree that industrial investment was to continue to play an important role for at least another decade. Liu He, an influential reform-minded official, who was promoted to deputy-director of the NDRC and into the Leading Group, asserted that China would "accelerate the transformation from an economy based on export and manufacturing to consumption and services", but he also insisted that even if the share of manufacturing in China's output might decline, the main task remained to increase the competitiveness of the manufacturing sector.[13] Xu Shaoshi, the chairman of the NDRC, affirmed that industrial investment would retain its "key role" in China's economy and that what mattered the most was to increase the effectiveness of these investments.[14]

An interesting window on the internal policy debate is offered by the influential Development Research Center (DRC) of the State Council, where officials can publicize their personal assessments. Across the different departments and institutions, four important arguments in defence of sustained investments in the Chinese industrial sector come to the fore. To begin with, China's high investment rate is only exceptionally high because China is an exceptionally large and populous country. That requires a much greater effort to build the industrial fundaments. Moreover, throughout history it has been observed that the later countries started to industrialize, the higher their investment rates tend to be.[15] Indeed, if the United Kingdom experienced the peak of its industrial revolution at a fixed capital formation rate of 10 percent, this was 18 percent in the United States, 35 percent in Japan, 40 percent in South Korea. India and most Southeast Asian countries are all hovering around 35 percent, without even having started to build a strong industrial base. China's manufacturing sector contributes 30 percent to its GDP, which puts it in tenth place out of 257 countries.[16] Yet, its manufacturing output per capita puts it in sixtieth place out of 256 countries. Goods and services exports represent 31 percent of its GDP, which is still much less than in South Korea (56 percent), Germany (49 percent), and most other Western European countries. Second, investments in the industrial sector are reckoned to be vital to get China over the so-called middle-income trap.[17] Third, a new wave of investments in advanced industries is deemed essential to lift China out of its inferior position in the global economic order and "to get a better position in the global division of labour."[18] Fourth, it increases China's "national comprehensive power" (综合国力).[19] . As Minister of Industry and Information Technology Miao Wei put it: "If China wants be a world power, it must be an industrial powerhouse first."[20] As I argued elsewhere, China is buying into internationally accepted norms to change the international order, i.e. the distribution of power.[21] In other words, China is still very much a revisionist power, but it aspires to be a smart and efficient revisionist, "to win the competition for primacy and prosperity without having to fight".[22]

Hence, the economic rebalancing that the new leadership promised mostly entailed a shift from backward industries to competitive industries. Only if that transformation is accomplished, a more fundamental shift to consumption can be possible. This new stage in China's industrial policy is not possible without exports. The 2012 Government Work Report affirmed: "While expanding domestic demand is crucial, we can never overlook the importance of external demand in China's economic development."[23] The 2013 Government Work Report proposed as one of the priorities to consolidate exports and imports, to improve their quality, to shift from competition based on price-advantage to competition based on technology, branding, and quality.[24] Along the same lines, the first economic session of the Politburo under the new leadership vowed to "stabilize trade, to improve policy support, to expand export channels, and to increase imports".[25] Both President Xi Jinping and Premier Li Keqiang have endorsed this in separate statements.[26] Liu He confirmed: "For quite a long time China will have to rely on exports, but during that period [we have to] to position ourselves more favourably in the global market".[27] Officials suspect that it would not be so exceptional if China were to continue to run a trade surplus for another ten years.[28] They recognize that increasing labour costs, the uncertain global economic outlook, and growing protectionism could complicate the new push for exports, yet remain defiant and convinced that China is still well positioned to be a key exporter of labour-, capital-, and technology-intensive goods in comparison to other Asian economies. Two interesting cases concern the solar industry and the shipbuilding sector. Both have been caught between overcapacity and pressure from other economies to refrain from dumping the glut on the global market. Yet, in both cases, the State Council vowed "to actively expand new space for foreign sales", "to maintain the international market share" and "to expand the international market share".[29]

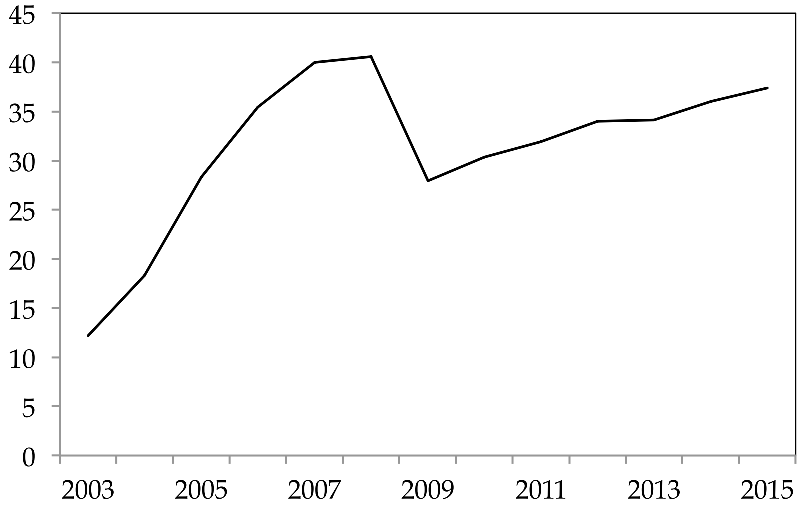

Chart 1. China's manufacturing sector export dependency (%). Net-exports of manufactured goods as a share of manufacturing value added. *Source:* calculations based on UN Comtrade and World Development Indicators.

It is important to underline at this point that the dependence of China's manufacturing sector on exports has not declined. Net-exports, as chart 1 shows, still account for 38 per cent of China's manufacturing added value. This is very high even compared to other major exporters like Germany and South Korea. The consequent strategy has become to upgrade the trade structure, to diversify exports of industrial goods away from the West towards developing countries, and to balance these out by increasing imports of raw materials, high-tech capital goods, and tourism services.[30] These goals were formally sketched out in a joint note of the Ministry of Commerce, the NDRC, the Ministry of Finance, the People's Bank of China, and several other departments.[31] Its main point of departure was that China had arrived at a point where it was required to "consolidate its position as a trading nation and advance its trade power".[32] That brought an effort to "maintain the market share in developed countries and to make new efforts to unlock developing countries".[33] Important in this document was also the emphasis on accelerating the development of key export sectors, like agricultural products, light industry, textile, pharmaceutical, steel building materials, new materials, chemicals, cars, machinery, construction machinery, railway locomotives, power equipment, telecommunication equipment, and ICT products.[34] Considering the vertical integration of the global manufacturing market, the paper also proposed to make a special effort to position Chinese national enterprises strategically along the industrial and supply chain.[35] In 2013, the Ministry of Commerce, together with six other departments, selected 30 emerging economies that would become priorities in the promotion of exports, especially in light industries, machinery, electronics, and pharmaceutical goods.[36]

Chinese policy makers do understand the challenges that this brings. Many of them argue that has to prepare itself for competition on two major fronts. On the one hand, developing countries challenge its low-end industries; on the other hand there are the developed countries with which China has to vie for high-tech exports.[37] Beijing also expects more political tensions and protectionism.[38] "With the fraying of the Doha Round, the major powers re-focus on regional trade arrangements, countries tend to look more after their own interests, and international frictions increase." [39] "China's labour-intensive products face more intense competition from developing countries, and that is natural," explained the Director-General of the DRC's Research Department, "Developed countries will try to pre-empt the upgrading of China's export structure by means of protectionism, opening new markets, labour and environmental rules, new standards, and so forth… Seeing the rapid rise of China's comprehensive national power and fearing that it will challenge the existing rules [They] are spreading the China threat theory."[40] "The United States, Japan, France and other developed countries started to implement reindustrialization strategies," added the DRC's director, Li Wei.[41]

Should we consider China exceptional in all these pursuits? I believe it is not the case. China in essence just wants to become a prosperous, high-income country. It wants to achieve that more efficiently than many other developing countries that got stuck in the so-called middle-income trap, which essentially implies that it has to make long-term sacrifices on domestic consumption to invest into assets that make China more productive and competitive. But this endeavour also departs from important geoeconomic considerations. After started to praise getting rich to be "glorious", the Communist Party has to continue to deliver growth to maintain its own legitimacy and social stability. Wealth is also crucial to enhance China's security: to get the financial resources to build a strong defence and to get the technological leadership to lead the next revolutions in military affairs. These goals are, again, quite reasonable. But there also remains a more nationalist narrative, which prescribes China to gain wealth to change the international order, to restore its status, and to take revenge on the alleged injustices imposed upon China in the US-Japan-led regional order that emerged after World War II – not the least the challenges this created to China's goal to "reunify lost territory", including Taiwan, most of the islands in the South China Sea, etc. One can discuss about whether or not these kind of nationalist aspirations are consciously driving Chinese policy, but even if one looks at the consequences of what China wants, to be a high-income country of 1.3 billion citizens, one looks at a country that will have huge clout to shape the rules, to turn economic exchanges into its advantage, to influence political preferences, and to coerce. Deliberate or not, from a geoeconomic viewpoint, China's industrial and trade strategies all contribute to what could lead to a profound revision of the regional and global order.

Tools

Given the increasingly tense global economic climate and the growing suspicion of China's rise, officials know that they have to tread carefully. This is especially so because trade is still seen as an important instrument to maintain peaceful relations with neighbouring countries. As a result, China has to choose its tools for export promotion cleverly. It was already mentioned that one of the approaches became to balance exports of manufactured goods out with imports of raw material, high-tech, and services. This has to reduce the widespread frustration with trade deficits with China. Besides this selective rebalancing of trade, five important tools for export promotion stand out. What makes China particular is not the tools themselves, but their size compared to other countries.

To begin with, the Chinese government is committed to continue to exempt exporters from taxes. The most important tool in this regard remains the VAT tax rebate, which entitles exporters to get a complete or partial refund of the standard 17 percent rate if the goods that they produce are shipped abroad.[42] Whereas in 2003, the government spent US$ 24 billion on such refunds, this had increased to US$ 183 billion in 2015 (chart 2). As a result, there has been criticism of the cost of this facility and the government did take some of the polluting industrial goods off the list. Yet, the new government assured manufacturers that there were no plans to lower the refund. Quite the contrary, as a measure to support smaller exporters, whose profits often depend on such refunds, the Ministry of Commerce promised to simplify the procedure and to expedite payments.[43] Often, local governments elevate the rebate to the full 17 percent for products like furniture, toys, and shoes.[44]

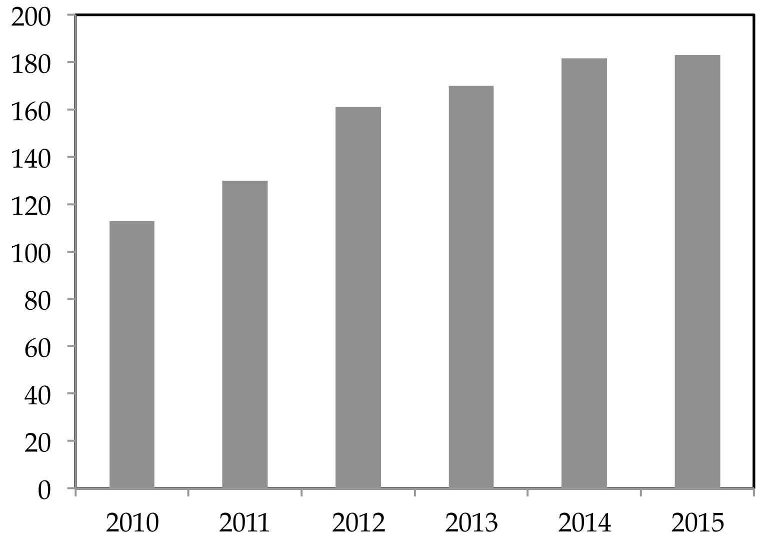

Chart 2. Export VAT tax rebate (US$ billion). *Source:* Ministry of Finance China.

A second tool concerns trade credit—including both export credit and concessional loans.[45] These forms of credit, as chart 3 shows, had increased from US$ 12 billion in 2003 to US$ 183 billion in 2015.[46] By 2015, China's total volume of export credit and concessional loans amounted to US$ 989 billion.[47] The joint policy paper of the Ministry of Commerce and other departments of 2012 pledged to expand export financing, increase export credit support for small- and medium-sized companies, and to increase export insurance as a tool for the government to influence the structure and direction of exports.[48] At a State Council meeting, trade credit was identified as "an innovative way to use foreign exchange reserves" and an important instrument to support "advanced manufacturing, strategic emerging industries, labour-intensive industries, and general industrial upgrading".[49] At a conference on financial services, chaired by Vice-Premier Ma Kai, it was stated that export credit and export credit insurance was to play an even greater role in times of uncertainty and that the government would attempt to broaden the coverage of credit, to help companies to assess the risks, and to assist them in solving repayment problems.[50] The Central Bank considers it an absolute priority to encourage financial support for foreign customers by means of traditional export credit, but also by supporting "large-scale equipment" exports by means of favourable leasing contracts.[51] Since 2012, the national and local governments have become active in providing export credit and insurance facilities to their firms.[52] The People's Insurance Company of China (PICC) also started to provide special short-term export credit insurances to small companies.[53] But that could lead China of course into trouble with other countries that consider export credit trade distorting.

These concerns could be mitigated by involving foreign banks in trade financing and inviting them to provide the credit, on the condition of Chinese sovereign credit insurance. An interesting case was a deal between Huawei and Algeria in 2004. Huawei called in the French Bank BNP Paribas to offer the export credit to its customer; Sinosure offered the export credit insurance to BNP Paribas.[54] Since, Sinosure has especially increased its cooperation with European banks. In 2004, it signed an agreement with Société Générale, in 2006 with KBC, in 2007 with Fortis, in 2009 with Deutsche Bank, and in 2010 with Credit Agricole. These banks have mostly financed Chinese exports of ships, telecom equipment, and machinery.

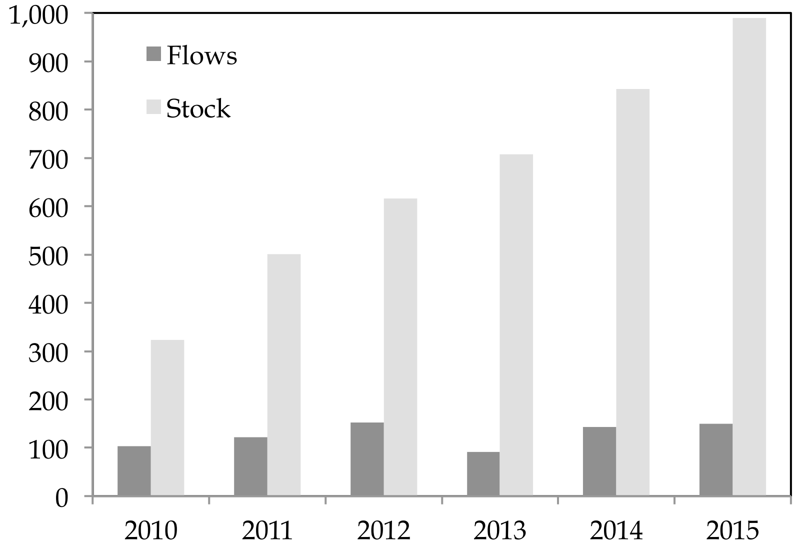

Chart 3. Flows and stock of Chinese export credit and concessional loans (US$ billion). *Source:* State Administration of Foreign Exchange Balance of Payments and Investment Position Databases.

Third come free trade agreements.[55] China has shown itself increasingly worried about being marginalized in a world of bilateral trade agreements revolving around the interests of the developed countries. A task force of the DRC, for instance, stated that the developed countries adopted trade agreements as a means to strive to consolidate their position in rule-making and that if FTAs are supposed to accelerate the facilitation of global trade and investment liberalization, they are increasingly an instrument of exclusion.[56] China has pledged to work towards more bilateral FTAs, which, "compared to an open multilateral trading system allow for a selective opening, control, and safeguards".[57] The focus here is on neighbouring countries, on developing countries, and on a number of markets on the fringes of the United States and the European Union.[58]

A forth lever to promote exports used to be the exchange rate.[59] In 2013, a survey by the Ministry of Commerce reportedly showed that 85 percent of companies wanted a stable exchange rate.[60] Another study showed that each appreciation of one percent led profits to decrease by 6.2 percent in the garments sector.[61] Yet, the foremost concern of currency rate control nowadays, appears to be the control of financial speculation, not the promotion of exports. The Chinese government restated its wish for a reasonable appreciation of the Yuan and currency rate stability. While this would affect low-end exporters, the negative impact could be diminished thanks to lower prices for imported raw materials, components, and knowhow. It is also stated that exporters can insure themselves against the risk of currency fluctuations and that it challenges firms to be more competitive.[62]

A fifth approach is to support foreign market penetration. This starts with higher quality standards and branding, for which numerous funds, subsidies, and tax rebates continue to be available.[63] Different government documents also hinted at a more important role of outward investments, which could permit exporters to benefit from cheap labour and to "circumvent trade barriers".[64] This especially targets the light industry, textile, home appliances, steel, and "other industries with an excess capacity". The Ministry of Industry and Information Technology announced its support for establishing export channels via foreign investments through chain integration, the backing of emerging Chinese multinationals, and the encouragement of "strategic alliances" between Chinese producers.[65] The Exim Bank promised to provide more support for Chinese companies that seek to process abroad with Chinese components, to set up research activities in order to better serve their export markets, and to establish sales and services centres.[66] Interpreting a 2014 State Council Opinion, the People's Bank of China, called for aggressive financial support for helping Chinese companies to gain ground overseas, including the support for these firms in foreign acquisitions, to settle trade in RMB, to speed up the expansion of export channels, to develop more tailor-made export credit, to help leading companies to strengthen their position along the industrial supply chain by doing strategic acquisitions, aiding them use Chinese equipment, in short, "everything necessary to make them true competitive multinationals".[67]

As was the case with China's industrial aspirations, many of these instruments are not exceptional. Most industrial powers have resorted to trade credit, tax rebates, and free trade agreements to support their industries. But what often does make China exceptional is its scale. Obviously, one can expect the industrialization of a country of 1.3 billion to take longer than, say, Japan or Turkey. There is also a huge scope for different industrial clusters inside China, so that it often emerges as a catch-all economy to producers outside China. At the same time that coastal provinces shift to high-end manufacturing, some provinces in the hinterland have just started to develop basic industries. Scale also matters in terms of the policy instruments. The sheer volumes of export credits, for example, are unequalled. The net transfer of capital from Chinese households to the Chinese corporate sector, a transfer that is largely the result of so-called financial repression, amounts to about US$ 3.5 trillion. Does this make China a more dangerous economic manipulator than other economies? That is hard to say. Consider the United States, which, thanks to its consumer market and powerful financial sector, continues to draw in US$ hundreds of billions of foreign portfolio investments. Some of that flows to highly competitive service providers; an even larger part helps to sustain deficits. The fact remains, though, that China's industrial and trade policies to come as a huge challenge to countries that seek to preserve their own industries and to avoid being drawn into trade and public budget deficits. This goes for both developing and developed countries. The consequences of that, the frictions and trade disputes, will be a formidable test to China's diplomacy.

Impact

A rising power that seeks to penetrate foreign markets can try to do so either by throwing its full weight at doors that remained closed or by getting itself invited. China has opted for the second approach. With the government set to pilot China into the league of industrial powers and consequently into the even more selective club of high-income countries, the new export policy is expected to strike a balance between the needs of its modernizing domestic industries and the growing expectations of export markets. It will continue to lower the costs for exporters, but also makes it more attractive for other countries to purchase Chinese goods by means of generous trade credit, imports of other goods and services, and investing more in new outlets. In an optimistic scenario, this policy would not entirely avoid new economic tensions, but at least mitigate them and keep resistance divided by promising more benefits to countries that keep their markets open, to the point, after a decade or so, that China feels confident enough about its industrial prowess, can start to relocate more of its production abroad, and possesses a competitive division of Chinese multinationals that turn this next stage of "going-out" into an efficient source of investment income.

It might not come to that point, though. First, the new policy-induced wave of investments in high-end manufacturing also risks moving the problem of overcapacity up from basic industries to advance industries. Second, China might underestimate the frustration among its partners in the developed world. Third, the shift of exports to emerging markets is not so obvious. It is unlikely that developing countries will take satisfaction in Beijing's strategy to match exports of manufactured goods with imports of raw materials. Almost all developing countries have signalled to China that they want more jobs in manufacturing too. In short, China is taking a huge gamble that could end badly. If more household savings are transferred to the industrial sector and these companies depend more on unreliable export markets, the risk of both economic and diplomatic setbacks will increase. The Chinese government could then find itself in an impossible position with regard to striking a balance between the expectations of its own citizens and the wishes of its partners abroad

China's geoeconomic strategies, we have seen, are largely an attempt to limit economic vulnerability. But they also create new weaknesses, not the least the exposure to external markets, in terms of export dependence and, increasingly, in terms of credit risks and political sensitivities. It will be difficult and politically unattractive for China to backtrack. Terminating export support will terminate many export-dependent companies, and, because of the vast loans, destabilize major banks and, because of the large transfer of savings from families, the Party itself could lose a great deal of legitimacy. This also explains why the government seeks to shift investments to more advanced industries, and not yet to shift from investment and export to consumption. The next salient question then becomes how China will manage the economic tensions with other countries. Answering it goes beyond the scope of this paper, but in another study I found at least four common policy responses: keeping opposition divided by playing of countries against countries, regions against regions, and cities against cities; raising trade expectations and turning them into an opportunity to enhance market access for both Chinese exporters and investors; offering more credit to governments as a way to promote cooperation in services; and, finally, to gradually prepare Chinese companies to relocate resource and labour intensive production to poorer countries, but to let them continue production with Chinese components and brands. This will most likely lead to new vulnerabilities, but that probably remains the most important benchmark of effective geoeconomics and statecraft, that is to manage vulnerability, to reduce it, or to create situations in which partners remain more vulnerable.

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