Going Global

The risks and rewards of China's new international expansion.

BY CHI LO

China has been expanding its economic power through overseas investment in recent years in order to secure supply of raw materials, energy, and other commodities for its economic development. Others are beginning to grasp how China is shaping the world with its huge appetite for energy and natural resources. However, what is less understood is the way China is itself being shaped by the world as it integrates with the global system.

The recent Middle East-North Africa turmoil shows that China's "going global" policy does not come at a low cost, as Beijing might have thought. In other words, the time for China to quietly reap economic benefits with limited risk exposure to the global markets is past. Even the need to ensure the welfare of Chinese citizens, whose outflow follows the overseas investment expansion, means that China cannot stay away from geopolitical risk anymore. As China becomes more involved in world affairs, the United States will need to rethink its China engagement strategy because America's superpower leverage has diminished significantly after the subprime crisis. And China knows that.

CHINA'S GREAT INVESTMENT OUTFLOW

China's rapid economic growth has raised its confidence in looking outside its boundaries for investment opportunities. Increased competition and the drive to maximize profits have raised Chinese awareness of for-

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eign market potentials. There is also a growing need to acquire raw materials from external sources. Hence, Chinese foreign investments have grown rapidly in recent years, though they are still small in absolute size, accounting for just about 1.5 percent of GDP. The subprime crisis will help speed up China's investment outflow trend in the coming years by lowering the cost of acquisition by Chinese companies, since global asset prices have dropped.

China's overseas direct investment is concentrated mainly in the developing countries, especially in Africa. In the 1980s, China's overseas direct investment was quite small and driven primarily by political rather than economic considerations. Before 1985, only state-owned and local government-owned enterprises were allowed to invest overseas. Private enterprises were allowed to apply for overseas direct investment projects after 1985, when Chinese authorities started designing and developing the necessary procedures and policies. Under the investment liberalization program, there was a flow of investment to Hong Kong in the 1990s. But most of the projects went bad due to lack of investment know-how, ignorance about the rule of law in overseas markets, and corruption among Chinese officials and corporates.

The Asian financial crisis in 1997 prompted Chinese authorities to rethink their overseas direct investment strategy. The regional crisis changed the global economic landscape by highlighting the strength of the overseas markets. These markets were growing strongly at that time and acted as an "economic savior" for the Asian economies by absorbing Asia's excess capacity via imports. Seeing the great opportunity in foreign demand growth, China issued a directive in 1999 to develop direct investment abroad that would promote Chinese exports via processing trade investment. This directive signified a crucial shift of China's policy from promoting overseas investment to directing it.

In 2002, Chinese authorities started pushing the "going global" or "stepping out" strategy as part of the economic reform process and to promote global industry champions in the wake of its accession to the World Trade Organization. Then in 2004, the Chinese authorities made another change in their overseas direct investment policy. In addition to just approving overseas direct investment applications, they further defined explicitly their roles in supervising the projects and providing facilitation services. This prompted Chinese enterprises to go global aggressively. China has invested in over 170 countries and engaged in an extensive range of economic activities, including information technology, finance, retail, fish processing, and forestry. The bulk of these overseas investments are concentrated in a few areas, including Australia, Hong Kong, Macau, southeast Asia, Russia, and the United States.

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China's overseas investment expansion in recent years, especially after the subprime crisis, has been seen as politically driven to secure raw materials and strategic resources to feed its industrialization process. Indeed, China's direct investment in geographically and politically sensitive regions such as Africa and increasingly South America for the purpose of acquiring natural resources has raised international concerns about its aggressive procurement policy upsetting global economic and political balances. However, academic studies show that seeking markets and resources are not the only motives driving China's investment overseas. Other crucial motives include cost of production, agglomeration or herding behavior, and pressure to seek higher investment returns for the huge US$2.8 trillion (and growing) foreign exchange reserves.

What all this means is that China has been integrating into the global system deeper by the year as it expands its economic influence beyond its borders. While this "going global" strategy has delivered economic benefits, it also means that, due to the complex structure of China's investments, their full exposure to global risks is not readily visible until events eventually unfold. The Middle East-North Africa turmoil is a good example of the flip side of China's push for overseas investment.

RISK OF INFLATION OR DEFLATION, OR BOTH

The economic disruption stemming from the Middle East-North Africa trouble comes mainly from the risks of both a sustained rise in oil prices pushing up global inflation, and geopolitical contagion to unaffected regions (including Asia) leading to a sharp rise in risk aversion.

The former may lead to stagflation—a combination of stagnant growth and inflation—while the latter would have a negative impact on risk-taking.

Oil price hikes are inflationary due to the role of oil as the cost base for almost all production, directly or indirectly. Oil price hikes also affect inflationary expectations, which could feed wage inflation that adds to general price inflation. On the other hand, oil price hikes are also deflationary, as they erode buying power in other sectors. Econometric models suggest that a sustained US$10 per barrel rise in crude oil prices would cut global economic growth by 0.2 to 0.5 percentage points. This may not be a huge effect. But if the US$30 or greater price hike that we have seen so far were sustained for a year or longer, the impact on the developed world's growth would be significant.

However, history has also shown that the world economy could continue to grow even though oil prices soared. For example, in 2004–08 prices went from under US$30 per barrel to over US$100 due to a positive demand shock stemming from buoyant oil demand from Asia (notably China). The current situation is not as benign. The most recent oil price hikes come from a negative supply shock due to geopolitical crises in the Middle East-North Africa region, while the developed world is stuck with high unemployment and weak demand in its post-bubble adjustment process. Rising oil prices will eventually feed through to the consumer price index, albeit slowly, while pricing power will remain weak in the post-bubble adjustment process so that firms will not be able to pass on the full cost of oil price hikes to the consumers. Margins will be squeezed, and workers will not be able to secure higher wages on a sustained basis. As far as stagnant demand growth in the developed world is concerned, it would hurt Chinese exports as Europe and the United States together account for over 42 percent of China's total export market share.

However, the odds for this stagflation outcome are still low, as the Middle East-North Africa turmoil is expected to be a temporary event so that the oil supply disruption is also temporary. Recent events should keep the major central banks from tightening too early (or aggressively in the case of the ECB and possibly the Bank of England); even policy hawks would agree that tightening in the face of a geopolitical oil shock would only cause more damage to the fragile developed-world economy.

THE RELEVANCE RISK TO CHINA

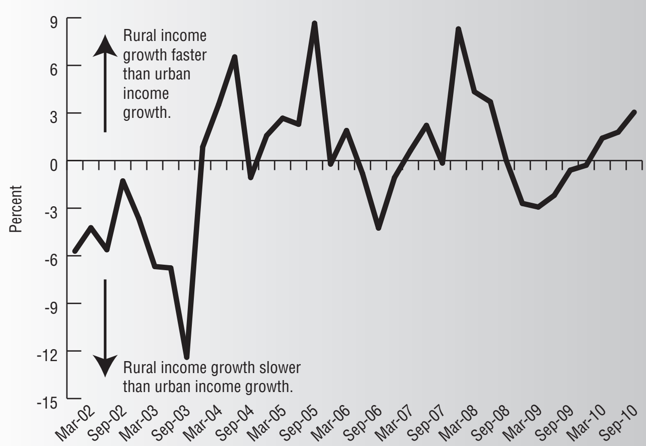
The situation is different in Asia, where growth and the financial system have not been damaged much by the subprime crisis. Inflation is a real risk here. China is a prime example, with both headline inflation and inflationary expectations rising. The oil price hikes may put further upward pressure on China's consumer price index. Increases in oil prices will also have an indirect impact on other costs, including fertilizer, petrochemicals, transport, and other raw materials, feeding into rising inflationary expectations. Workers are demanding higher wages under these circumstances. We have seen double-digit wage increases recently, fueling fears of a wage-price spiral.

All this will lead to more fears of policy tightening and price controls, and hence downside risk for Chinese asset prices in the short term. There is also a chance of more price controls on basic food items, fertilizer, animal feed, and electrical power, as Beijing is worried about the potential social and political implications of surging food prices. A critical reason people in Tunisia, Egypt, and Libya took to the streets was soaring food prices eroding their standards of living.

Income growth for young and rural Chinese workers in recent years suggests that the odds for political contagion from Middle East-North Africa to China are small, though addressing income inequality is still a top policy priority in China. Most participants in the Middle East-North Africa unrest are educated but unemployed youth, who resent poverty and ever-rising income inequality. This means that steady growth will need to remain a priority for China for years to come, as demand growth creates jobs and income.

The double-digit rise in wage growth for migrant workers since 2010 is a move toward narrowing the income gap between lower-class and middle-class workers. This is also reflected by per

China's rural-urban income growth gap



Sources: CEIC, HFT (HK).

capita rural income growth outpacing urban income growth recently (see figure). However, China does have an income inequality problem, driven partly by surging property prices. Beijing is addressing the problem by getting tough on property speculation and increasing housing supply by pushing forward massive social housing programs in the coming years. In a nutshell, all the cyclical and geopolitical risks that China is facing are still manageable.

CHINA CANNOT STAY ALOOF

However, the point remains that as China is sucked more deeply into the affairs of distant lands through its global expansion policy, its ability to stay out of trouble is diminishing. In the Middle East-North Africa troubles, Beijing scrambled to evacuate its 35,000 Chinese workers in the Libyan oil, rail, telecommunications, and construction industries when violence broke out in late February. In addition to twenty civilian aircraft, it also sent four military transport planes to rescue thousands of stranded workers in what the mainland media said was the first deployment of the air force in such an operation. Some political analysts even argue that the Libyan deployment marks a profound shift in China's security policy. It put China on par with the United States, the United Kingdom, and other advanced countries that can protect citizens far from home.

The question of how to protect Chinese citizens abroad goes well beyond Libya. There are 50,000 Chinese workers in Nigeria, 20,000–50,000 in Sudan, 40,000 in Zambia, 30,000 in Angola, 20,000 in Algeria, and tens of thousands more scattered throughout Africa. Chinese companies are now pushing into South America, another resource-rich region far from home. With all these commitments overseas, will Beijing feel compelled to try to shape the economic and political realities of the countries in which its companies operate? This is certainly food for thought for American policymakers.

From China's perspective, its overseas economic expansion comes at a cost of exposing the country to exogenous risks that Beijing might not have expected when the "going global" push began. If the Middle East-North Africa events proved anything, it is that the days of China keeping its head down are probably over, and with expanding clout overseas comes certain burdens.

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FOOD FOR THOUGHT FOR THE UNITED STATES

For the United States, perhaps it is worth rethinking its engagement strategy towards China. America's current economic policy towards China is similar to earlier strategies under Bill Clinton and George W. Bush, when the United States was able to enforce its will effectively in bilateral meetings. This is not working now. During the Clinton/Bush years, U.S. military power was at its height; the country was experiencing its strongest-ever economic expansion; and U.S. information technology was changing the world's economic landscape. China then was still emerging from backwardness.

The U.S. position is now much weakened. Daunting issues on the fiscal, banking, and economic fronts need resolving. At the same time, China's economic ascent has raised eyebrows, with robust GDP growth lifting hundreds of millions out of poverty, its expanding role in global trade, and its growing diplomatic ties in Asia, Latin America, and Africa. Most importantly, it has amassed US$2.8 trillion (and growing) in foreign reserves, becoming a critical creditor to the United States.

China is unlikely to become a superpower anytime soon, but America's superpower leverage has diminished significantly, and China knows it. New times need new policies. A plausible way to make China play by the international rules would be to weave a web of multilateral arrangements into which China could fit and by which China would be bound. This is food for thought for the United States. ◆