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DOES CHINA SWITCH FROM ITS "INVITE-IN-GO-OUT" STRATEGY TOWARD A "BLOCK-AND-ATTACK" STRATEGY"? IMPLICATIONS FOR EUROPE

Abstract: Over the last 30 years, China's growth has been considerably based on its opening-up strategy that firstly "invited" foreign investors and secondly fostered trade. The current economic crisis has put pressure and doubts on the future success of this strategy. China's government fears that the politically propagated growth rate of 8% is in danger. Furthermore, the extensive public investment in infrastructure and state-owned companies combined with private investment in real estate has created signs of a bubble economy that could burst in times of declining growth. China's new growth strategy seems to focus firstly on increasing private consumption and secondly on hampering foreign inflows of goods and capital, while at the same time supporting aggressive international market entry strategies of Chinese companies.

Key words: open economy, policy-oriented outwards, emerging markets, China.

1. Introduction

At first glance, China is the only country among the leading trade nations that seems to come out of the current economic/financial crisis without dramatic setbacks in GDP growth (from 11.4% in 2007 to 8.7% in 2009). In 2009 China's fourth quarter growth surged to 10.7% on an annualized basis. Like other leading trade countries China experienced negative growth rates in its current account as well as in its capital/financial account. The current account surplus dropped 35% in 2009; the capital/financial account surplus also recorded a significant cutback. Despite the decreasing surplus in the current account as well as in the capital/financial account (2009 compared with 2008) in absolute figures, China is the largest exporter of goods and importer of capital. As a result, China's foreign reserves moved in 2009 from 1.913 trillion US dollar to 2.399 trillion US dollar. The loss in export business had been partly compensated by increasing domestic demand. Retail sales grew by 16.9% fuelled by a 586 billion US dollar stimulus package. China's economy seems to be the first one that emerges from the current crisis. Governments of the world's leading economies expect that only China has the power to help the world economy get back on the growth track. It is an open question whether a short-term push forward has sustainable effects on mitigating the global economic imbalances not to mention the political consequences that might accompany the shift of economic power to China.

The apparently positive performance of China's economy in the years of the current crisis is getting somewhat dark-stained when observing the effects from different angles. Main concerns of the countries that are economically closely interconnected with China are firstly the undervalued renminbi and resulting from that the increase of their trade deficits with China in the era of recovery. The USA and the EU recently raised the barriers to imports from China in some industries. Secondly, the huge accumulation of currency reserves in US dollars – to a considerable part held in US treasury securities – makes China the top US debtor. This raises concerns inside and outside the USA, e.g. from the dependence of the US government's deficit spending from China's willingness to buy the US Treasury securities up to the "danger" of takeovers of strategic assets, firms, natural resources.

Last but not least, even prominent economists and politicians inside China warn against expecting solely positive effects of China's relative positive economic situation. The main argument centres on the emerging "China bubble" resulting from the permanently increasing currency reserves and capital inflows combined with the exploding public debt which equals over 70% of 2009 GDP. The top-tier aim of achieving the minimum GDP growth of 8% results from the central governments calculation that this rate keeps the employment at an economically and politically reasonable level. The extremely high expansion of capital and loan growth – especially in 2009 – has firstly inflated property and stock prices and secondly increased the credit risk significantly – especially in industries facing overcapacities. The growing debt of private and public actors increases China's vulnerability to shocks. Without squeezing the bubble successfully, the development path after the bang might look like the Japan-style deflation, the Russian-style hyperinflation or the American-style stagnation. Beginning 2010, the central bank's move toward mopping up the excess liquidity might thwart other macroeconomic aims such as the aforementioned GDP growth, the high employment, the efforts in balancing the current and capital account, and even the recovery programs in other, primarily less developed countries. There are factually justified concerns that curbing bank lending will cause noticeably decreasing prices on the world markets of commodities where China is the top buyer.

At the beginning of 2010, the basis for starting a clear defined strategy was still fragile. The danger of tightening protectionism, further inflating of the China bubble, loss of credibility of the political decision makers, hidden risks in China's banks loans is still not eliminated.

But there are also signs that China might emerge out of the crisis even stronger:

– China's trade could benefit from the 2010 launched China-ASEAN Free Trade Area (CAFTA).

– China’s banks seem to survive the crisis better than banks in other countries. Risks result primarily from extensive lending to local governments, especially in 2009.
– In the first two months of 2010 the trade surplus decreased by 50% compared with the same period last year. This results obviously to a large extent from the government’s policy to encourage imports and to stabilize exports. As long as exports are the primary driving force of China’s growth, the export-related measures might cause a slowdown of GDP growth, but opens China more flexibility and policy options *vis-à-vis* its main trade partners.
– There are signals from the People’s Bank of China that somewhere in the near future the RMB will be revaluated. This might reduce the trade tensions with the USA. The fast growing capital-/technology-intensive exports that are less price-sensitive will probably not be hurt from the revaluation. Therefore, total exports will still grow. The revaluation allows China to import at a cheaper price (in RMB) those goods/commodities which are payable in US dollar only (e.g. oil). But it should be kept in mind that China’s central bank is not as independent of the government as central banks in Europe and the USA. Voices from the government – communicated at the end of the People’s Congress in March 2010 – sound slightly different, especially with respect to the time horizon of the revaluation.
– Other signals point to a certain distant thinking of the “growth is all we need-strategy”. This opens opportunities for a move toward a complex social welfare strategy which might reduce internal and external pressure (e.g. mitigating regional and/or income disparities; paying more attention to environmental protection), at least in the long run.

Even China’s cursory sketched economic situation points to the “magic quadruple” that the government will face in the future:

– finding a fast, but sustainable new growth strategy,
– avoiding a sudden burst of the China bubble,
– avoiding a sharp and long upward trend of regional disparities,
– avoiding trade disputes with the USA and the EU.

An additional difficulty results from the still ongoing process of the gradual transformation of the Chinese economy.

In the last decade, China’s growth has been to a large extent the result of an opening-up policy that could be considered one of the main pillars of the transition from a planned to a market economy. The main feature of this policy is a gradual, cautious change of the economic institutional system without changes in the political system. The macroeconomic result is an average GDP growth of around 9.5% per year since the beginning of the 1980s that puts China on top of the contributors to the world’s GDP growth. Even if the “gains from transition” are still creating growth, China’s development path seems to follow more and more patterns similar to the early stages of development of countries like Japan and Korea. Besides cross-country comparisons, the acceptance of a "general model of growth patterns" might support this argument. This model is focusing on the crucial role of trade and investment that drive the domestic (and even international) structural change, the catching-up and the dynamics of allocating competitive advantages between industries, countries, and regions. China's trade is rapidly climbing up in the ranking of the leading exporters and importers in world merchandise trade. It is currently ranked first in trade and fourth in GDP. Independent from the data set and methodology, most pre-crisis studies on China's growth predict a catching-up with the US between 2015 and 2020. This result is based on the extrapolation of the three pre-crisis trends. Firstly, there is evidence that GDP growth is positively correlated with the increase in (total) labour productivity in years with high decline of the work force in the agricultural sector. Secondly, the observation of a slow decline of the growth rate of labour productivity might be interpreted as a gradual phasing out of the catching-up process. But China's overall low development level gives enough room to keep its competitive advantages in low-tech and medium-tech products, even if the renminbi will appreciate. Thirdly, a comparison with early stages of Japan's and Korea's development show that China's wage rates are extremely low relative to investment prices which might allow an economic growth resulting from low labour costs for the next 20-30 years.

All present findings are based on the assumption that the favourable global and regional economic environment will not change dramatically. According to high ranking political leaders China needs a minimum GDP growth rate of 8% to keep the migrant workers on the job and to guarantee social stability. Suddenly voices critical of the trade depending development can be heard. This is related both to exports – especially China's role as the world's manufacturer of parts and components – and imports. The latter refers to China's fast growing middle class that prefers international brands instead of local products. China's leaders now start calling for increasing the consumption of domestic products. There seems to be enough potential in view of the extraordinary high savings rate of approximately 25%.

We argue that the current crisis will be a turning point in China's general transformation and development strategy: The gradual transformation toward a moderate *laissez-faire* economy will be changing toward a more state-intervening approach. The development strategy based on competitive opening-up measures and entrepreneurial investments will be replaced by a measured opening-up similar to the Japanese-Korean strategy, and switching from investment- toward consumption-based growth.

The following section will briefly highlight the history and characteristics of China's opening-up during the 20 years after Deng Xiaoping started the economic reform.

2. China's "invite-in-go-out" strategy

More than 30 years ago, Deng Xiaoping decided to embark on one of the world's most breathtaking economic endeavours: to integrate more than one billion Chinese into the world economy. To start with, there was the collective trauma consecutive to an episode of mayhem and economic exasperation. Mao Zedong had brought his country to the verge of ruin. After his death in 1976, even the State Bureau for Statistics admitted that: "The economic progress got stuck between the fifties and the sixties as a consequence of political turmoil, notably the Great Leap Forward and afterwards the Cultural Revolution. When the Cultural Revolution ended, the national economy was in state of collapse."[1] The Great Leap Forward (1958-1962), an attempt to consolidate collective farming and to industrialize the countryside by means of small-scale commune-based factories, resulted in total failure and a famine that demanded between 10 and 30 million lives. Industrial development as well as technological progress were hampered due to the emphasis on self-reliance: the Chinese economy had to be able to rely on its own capacity, and as a result of several periods of political isolation it was obliged indeed to resort to *self-reliance.*[2] This seclusion became even more apparent after the Third Line operation (1965-1970); a massive, costly removal of all strategic factories from China's peripheral zone's to the hinterland in order to limit their vulnerability whenever a military offensive by the Soviet Union or the United States should occur.[3]

The Cultural Revolution (1965-1969) brought the fatal stroke.[4] During this period industrial production slowed down to nearly zero. Consequently, between 1960 and 1970, China's gross domestic product (GDP) showed an average annual increase of only 1.8%, whereas Japan and South Korea noted down growth figures of respectively 14.5 and 7.7%. However, it was not only at the socio-economic level that Mao's policy proved to be disastrous. The military too was bitterly aggrieved because of the insults it had to endure. During the turmoil of the Cultural Revolution, compatriots of the Red Guard, Mao's revolutionary militia, even attacked several units of the People's Liberation Army.[5] In addition to the economic jumble, it became also clear that after his death Mao left the Communist Party a huge legitimacy

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[1] R. Weil, *Red Cat, White Cat: China and the Contradictions of Market Socialism*, Review Press, New York 1996, p. 293.

[2] For instance, with the death of Joseph Stalin, Mao lost his most important ally. Due to mounting tensions with his successor, Nikita Khrushchev, the USSR decided in 1969 to suspend all economic and technological support to China.

[3] D. Blasko, The PLA from 1949 to 1989, [in:] D.A. Graff, R. Higham (eds.), *The Military History of China*, Westview, Colorado and Oxford 2002, pp. 254-256.

[4] Mao launched the Cultural Revolution fearing that the revolutionary zeal of his communist movement was in decline. Supported by the newly formed Red Guards, he began a nationwide purge to rid the party of capitalists and revisionists.

[5] W. Wei, Mao and the Red Army, [in:] D.A. Graff, R. Highham (eds.), *op. cit*.; A. Scobell, *China's Use of Military Force*, Cambridge University Press, Cambridge and New York 2003, pp. 94-144.

gap. Since the proclamation of the People's Republic in 1949, the entire political elite relied on the cultivation of Mao's revolutionary leadership: personal cult and ideological indoctrination constituted the glue that kept China together. Hence, the pressing question arose how to fill the gap. On the one hand it appeared that nobody among the senior Party members *could* follow in Mao's track: on the other hand an obvious consensus was manifested that nobody *should* try to emulate Mao's personal dictatorship. His political inheritance nearly brought the entire Party into collapse. Deng Xiaoping for instance stated that China should: "avoid mistakes of the Great Leader in his later years."[6] Deng's personal experiences during latter days of the Cultural Revolution, he was expulsed twice as prime minister, made him resolute to end personal capriciousness and the gravest excesses of political intrigues.[7] A new person-based regime turned out neither to be achievable nor to be desirable. Mao's exit unquestionably triggered a period of political catharsis. The subsequent decision to set off on a comprehensive transition rested on a silent pact between, on the one hand, an elite that was in an existential crisis and struggled to survive, and on the other, the millions of Chinese citizens who were desperate to escape poverty and arbitrariness. In this regard, economic liberalisation and the promise to get rich can be considered as an alternative legitimacy base that had to foster new acknowledgement for the Party as the only guard of the nation's interest. Thus, as Martin Wight stated, China's current political constellation is "a realm of human experience."[8] The political choice for capitalism was based indeed on a common experience shared by both the elite and the entire population.

Besides this social explanation, realistic arguments count as well. Throughout the Cold War period, the People's Republic was sandwiched amid the two superpowers. Its own economic backwardness forced China in an awkward dependence, alternately on the Soviet Union and the United States. It relied on both titans for the import of alimentary, technology, and military equipment. Mao's policy of self-reliance in reality made foreign assistance indispensable. In this perspective, opening-up implied a way out of the predicament, and allowed China to look for more diversity among its partners and "to limit or lessen its dependence."[9] The primary object was to foster autonomy and a stronger national economy by tapping the world market. However, Deng also attached importance to relative gains, as he wanted his country "to become one of the major powers in the world."[10] Moreover, national economic

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[6] R. Weil, *op. cit*., p. 290.

[7] Deng was originally purged during the first years of the Cultural Revolution. In 1973 he was reinstated, but purged again, in 1976, by the Gang of Four.

[8] M. Wight, *International Theory: The Three Traditions*, Leicester University Press, Leicester 1991, p. 1.

[9] K. Waltz, *Theory of International Politics*, Random House, New York 1978, p. 154.

[10] X. Deng, *Be Realistic: Look at the Future*, Main points of a speech on industrial development at the meeting held by the Industrial Decision Drafting Committee, 1961, [in:] J. Holslag, *A New Phase in China's Economic Development*, BICCS Asia Paper, 2006.

strength was also thought to be necessary to: “produce a few more atomic bombs, missiles and other pieces of modern equipment, whether for air, sea or land.”[11]

Although the PRC’s communism largely defeated itself, the opening-up implies at least a partial victory of *liberalism*. By getting in touch with the world market China became able to convert its inferior position in the global division of labour into a stronghold. First, it permitted to turn the huge impoverished population into a vital asset: abundant cheap labour. Deng pointed frequently at this dual character of China’s demography. The untapped and underdeveloped market was also applied as a magnet to lure foreign investors. Deng, for instance, confided to his Japanese counterpart that he “should appreciate it if all enterprises in your country – large, medium-sized and small – strengthened their cooperation with us. […] China is short of funds, so that it has been unable to develop many of its resources. If they are developed, we shall be able to supply more of Japan’s needs.”[12] Thus, by becoming a trading state, foreign trade was applied as a less costly, more efficient means to achieve prominence and prosperity.[13] The cause of the reorientation of China’s political economy is obvious: the collective trauma of Mao’s dictatorship. The substance of the policy, however, can be viewed at from several angles and theoretic perspectives: societal, realist and liberalist arguments contributed all to the final option for a far-reaching liberalization.

The most striking feature of the post-Mao era emerged as a gradual, cautious change from central dirigisme to central guidance: As much dirigisme as necessary to keep the political system stable, and as much guidance as possible to enable an efficient use of China’s rich human resources.

Hitherto, three milestones can be distinguished in the take-off stage of China’s economic transformation, firstly the creation of solid political and economic foundations for further reform, from 1977, secondly the economic take-off generated by means of an “invite-in strategy”, from the early 1980s, and thirdly the attempts to consolidate growth and to foster “trade ownership”, from the late 1990s.

Albeit these phases are not marked by abrupt changes: instead they make clear Beijing’s preference for gradualism and cautious guidance. For instance, China’s opening-up has not come to an end, nonetheless Beijing already kicked off a new phase to consolidate economic growth, and to establish its own ties to overseas markets. The economic and financial crisis that spread over from the USA to other countries in late 2007 has challenged China’s “invite-in-go-out” strategy. There is some evidence for a gradual change towards a strategy that could end up in a “block--and-attack” strategy.

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[11] X. Deng, Excerpt from a speech at a forum held by the Military Commission of the Central Committee of the Communist Party of China, 1 November 1984, www.pdaily.com.

[12] X. Deng, *We Should Take a Longer View in Developing Sino-Japanese Relations*, Excerpt from a talk with Prime Minister Yasuhiro Nakasone of Japan, 25 March 1984, [in:] J. Holslag, *op. cit*.

[13] See for example: H.J. MacKinder, *Democratic Ideals and Reality*, W.W. Norton, New York 1962, p. 242; R. Rosecrance, *The Rise of the Trading State: Commerce and Conquest in the Modern World*, Base, New York 1986.

3. Evidence for the changing openness paradigm

The pre-crisis GDP growth was high enough to afford and absorb the negative effects of the "invite-in-go-out" strategy such as increasing income and regional imbalances, manufacturing-oriented economic structure, real estate bubble. The reduced post-crisis growth expectations forced the central government to impose a minimum GDP growth rate that is almost binding for provincial and local governments. By using the 8%-rule as an object, the information content of the GDP growth rate will be questionable.[14] In order to fulfil the GDP growth target, investment in infrastructure as well as investment in SOEs increased dramatically despite decreasing capacity utilization. It goes without saying that this investment driven growth model is not sustainable because of its negative effects such as misallocation of capital, rising non-performance loans, overcapacities in the state-owned sector, corruption. The pressure of the 8%-rule as well as the worsening macro-economic situation – increasing inflation, overcapacities, declining government debt credibility, rising trade conflicts – call for a change in the government's internationalization strategy.

It is to be expected that in the post-crisis era China cannot continue growing or even maintaining its trade surplus without facing protectionism against its exports to many developed countries. Generating sustainable high growth by reducing the exports' contribution requires firstly a shift from imports to domestic production and secondly an increase in domestic consumption. In order to secure and extent China's position in the global markets, the most appropriate strategy seems to be an aggressive multinationalization of large companies such as SOEs in strategic sectors such as automobiles, consumer electronics, durable consumer goods. This requires capital that is allocated from domestic to foreign markets. Even after the crisis inward FDI might not be high enough to replace the outflow of capital. Furthermore, the structure of inward FDI seems to change from production sectors to the real estate sector. This can speed up the misallocation of capital and therefore expand the real estate bubble. The increasing public debt – caused by the huge stimulus packages – and the increasing allocation of public investment into infrastructure projects prevent access of manufacturing and service companies to the domestic capital market. This holds primarily for private enterprises. They have to cope with distortions of competition that result from the preferences of SOEs having access to cheap capital. Finally, the insufficient growth of the domestic production sector on the one hand and the government's efforts to fuel the domestic consumption on the other might cause inflation pressure. This in turn is threatening China's international competitiveness. The government might be forced to break with the pre-crisis "invite-in-go-out" strategy that was an important pillar of the transformation toward an entrepreneurial

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[14] "Anecdotal evidence suggests that many decisions of local governments, whether to endorse new infrastructure projects or real estate developments, are driven by the necessity of meeting their growth targets". E. Chancellor, China's Red Flag, *GMO White Paper* 2010, p. 5.

capitalism. A new strategy of "blocking-and-attacking" fits into observations that China's government is moving toward a more state-directed capitalism.[15] From a macroeconomic point of view, China's economic policy must focus on"

– reducing public investment in unproductive infrastructure projects, reducing investment in real estate, reducing inefficiency in SOEs and re-allocating investment from the manufacturing sector to the service sector, and
– increasing private consumption.

Without doubt, this requires interventionist instruments to control macroeconomic aggregates, industries and the economic relations to other countries. Effects on regions are unavoidable. Conflicts between economic goals have to be balanced. Therefore, a strategic approach has to be developed.

The opening-up strategy needs to be not only modified, but also more or less reversed.

4. Expected implications for EU-China relations

Since the beginning of China's opening-up strategy, the economy of the EU has been benefiting from China's opening-up strategy:

– Outsourcing parts and components production to China has allowed European MNCs' to maintain global competitiveness.
– Entering the Chinese markets has created considerable growth of sales in industries such as automobile and machinery.
– Importing low-tech products from China has allowed European consumers to switch from high-price to lower price products.

The discussions about the negative effects – rising unemployment because of outsourcing as well as because of dumping – are still controversial.

China's new growth strategy will possibly reduce the benefits and increase the negative effects on Europe's economy:

– The shift from investment-oriented toward consumption-oriented policies might reduce the FDI flows to China.
– The government's support of Chinese companies to go global might threaten European MNCs global market positions.
– The pressure from cheap low-tech imports might not change because Chinese manufacturers will move their production to low labour cost countries in Asia (e.g. Vietnam, Cambodia).

Future research should also give great attention to the handling, effects and development of EU-China trade disputes in the WTO framework.

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[15] Y. Huang, *Capitalism with Chinese Characteristics*, Cambridge University Press, Cambridge 2008.

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CZY CHINY PORZUCĄ STRATEGIĘ "PRZYCIĄGANIA I EKSPANSJI" NA RZECZ STRATEGII "UTRUDNIANIA I ATAKU"? WNIOSKI DLA EUROPY

Streszczenie: W ciągu ostatnich 30 lat rozwój gospodarczy Chin w ogromnej mierze opierał się na strategii otwarcia gospodarki, która po pierwsze zachęcała zagranicznych inwestorów do wchodzenia na ich rynek, a po drugie stawiała na rozwój handlu. Jednak obecny kryzys ekonomiczny budzi wątpliwości co do powodzenia tej strategii w przyszłości. Chiński rząd obawia się, że zagrożone jest propagowane przez niego tempo wzrostu PKB na poziomie 8%. Ponadto, szeroko zakrojone inwestycje publiczne w infrastrukturę i przedsiębiorstwa państwowe w połączeniu z prywatnymi inwestycjami w nieruchomości spowodowały powstanie oznak bańki, która może pęknąć w okresie spadającego tempa wzrostu. Wydaje się, że chiński rząd zaczął wprowadzać nową strategię wzrostu zorientowaną na zwiększenie prywatnej konsumpcji, a następnie ograniczenie napływu zagranicznych towarów i kapitału, przy jednoczesnym utrzymaniu agresywnych strategii wchodzenia przez chińskie przedsiębiorstwa na rynki międzynarodowe.