Roundtable by Long Ke, Muneo Kurauchi, Prof. Kazuyuki Motohashi & Prof. Mariko Watanabe

Roundtable Discussion on the Chinese Economy — Opportunities & Challenges

By *Japan SPOTLIGHT*

METI's White Paper on International Economy & Trade 2018 highlighted the Chinese economy as a key to global economic development and Japanese economic prosperity against the background of the growing digital economy in which the Chinese digital industry is playing a pivotal role.

***Japan SPOTLIGHT*, in highlighting this White Paper 2018 in the cover story of the Sept./Oct. 2018 issue, organized a roundtable discussion on the current state and future of the Chinese economy by distinguished experts.**

Prof. Kazuyuki Motohashi, professor at the University of Tokyo's School of Engineering, is an expert on econometrics who is working on an econometric analysis on Chinese innovation capacity. Muneo Kurauchi, advisor to MUFG Bank, Ltd, has been chairman of the Policy Sub-Committee of the Committee on China of Keidanren (Japan Business Federation) for the past five years. Since 1995 he has watched developments in China as a leading banker responsible for business and strategy there. Prof. Mariko Watanabe, professor at the Faculty of Economics, Gakushuin University, has been an expert on the Chinese economy since she started her research on it as a researcher at the Institute of Developing Economies in Japan, focusing on institutional changes, business strategy and industrial organization. She studied at the University of Hong Kong (1996-98) and Peking University (2006-2008), and has conducted research on Chinese firms and industrial organizations to discover the institutional background of China's high economic growth. Long Ke, a senior fellow at the Tokyo Foundation for Policy Research, is one of our editorial committee members and one of the most well-known Chinese economists, and has been working on Chinese political economy for many years.

(Roundtable on Aug. 2, 2018)

Participants

Long Ke

Muneo Kurauchi

Prof. Kazuyuki Motohashi

Prof. Mariko Watanabe

Chinese Macroeconomy in 2018

JS: First of all, we are all interested in the issue of the Chinese economy in 2018. Mr. Ke, could you please present your view on it?

Ke: Yes. What is notable about the Chinese economy in 2018 is how it underwent structural reform. The Chinese business model that took advantage of cheap labor costs does not work anymore, as labor costs keeps rising. While China's digital economy, which is the so-called new economy, has been doing well, one of the key questions about the Chinese economy is how it can restore the old economy suffering from rising labor costs. But as for new economy, looking at the consequences of the US ban on transactions by the government, industry and military for national security reasons involving the products of ZTE, this Chinese high-tech company has been forced to stop production because of this policy, and thus their technological base is not well consolidated. Technology seems to be a bottleneck in enhancing the value-added of the Chinese industrial structure. Another concern is the gap in science capacity between China and developed nations. It would be easier to catch up with the advanced technologies in developed nations, but it will be difficult to fill in the science capacity gap. In China, the ability to create new technology is limited due to this lack of science capacity and the weakness of incentives to develop science.

Looking at the Chinese macroeconomy in 2018, consumption growth is not expected to be high but will not be too disappointing. A key structural problem for Chinese consumption growth will be the widening income inequality and the lack of a well-established social security system, such as insurance for caregiving in a rapidly aging society. This is because Chinese consumption growth is not explosive.

Business firms' investment cannot be expected to be high, since business firms in particular in the old economy are suffering from excess capacity in production facilities. The Chinese government has thus recently announced new business cycle countermeasures to stimulate the economy, consisting mainly of an active fiscal policy oriented towards public infrastructure investment. However, their high-speed railways and highways are already well established, as are their port and airport facilities. So there does not seem to be any significant need for public infrastructures at this moment.

Another growth engine, trade, is to be seen as rather negative. Even before the trade war between the United States and China started, Chinese export growth had been negative in 2015 and 2016 due to rising labor costs. President Donald Trump's protectionist trade policy initiative further accelerated this downtrend in trade. In the light of this negative prospect for trade, China announced an active fiscal policy to avoid a possible recession in the second half of 2018 and 2019. From all this, I have a rather pessimistic view on the Chinese economy in 2018.

Watanabe: The Chinese government clearly recognized the existence of excess production capacity in the following five industrial sectors — steel, cement, aluminum, oil refinery and paper & pulp. In particular, in the steel sector the government has been actively enforcing the reduction of excess capacity as it announced and committed to at the Global Forum on Steel Excess Capacity Ministerial meeting, an international surveillance mechanism for excess capacity. It is also reported that growth of investment by state-owned enterprises shrank drastically in 2018 and investment growth in total is lower than GDP as a whole. This has happened for the first time in the era of reform. It is uncertain whether the supply side reform will definitely lead to an economic slowdown, now that consumption has become a substantial part of the macro economy. The new economy in urban areas is robust and the expanded middle class will support the stable growth of consumption more strongly than one or two decades ago. Thus, the Chinese economy could grow steadily even without investment growth.

JS: Is there any possibility of excess production capacity rising in any other industrial sector?

Watanabe: Yes. The excess production capacity issue could rise in the sectors where a policy framework exists to preserve firms in the business, even though they are losing competitiveness and there is no economic rationale for them to be kept in the market. This could cause a serious impediment to the economy. Another issue is that it is often pointed out today that the semiconductor industry in China has been too greatly subsidized and is thus suffering from excess production capacity. Insofar as the Chinese government invests into state-owned enterprises in the semiconductor industry, that industry's production will be controlled by the government and there would not be excess production, even though part of its production capacity could be wasteful.

On my first point, I think whether fair competition based on a level playing field is to be implemented or not would be an important criterion to judge if this subsidizing can be justified. However, whether there is excess capacity or not will also depend on whether China can beat the international competition. As Chinese companies become more competitive, it will be difficult to define those capacities as excessive.

JS: What about Mr. Ke's view on Chinese exports today? In his view, the US-China trade war could worsen the declining trend in Chinese exports and 2019 will be a year when the Chinese economy falls into serious difficulty. Do you all agree with him?

Kurauchi: Depending on the outcome of the trade war between China and the US, it is certainly true that the Chinese economy could be seriously damaged. I guess Trump will maintain his aggressive policy against China until the US mid-term elections in November to boost the Republicans' chances of winning. But after the elections, I think there will be a change of policy, since neither China nor the US will really want to continue the trade war seriously. I am not so pessimistic about the prospects. On behalf of the Japanese business world, I hope for stable economic policy management in China, as more than 30,000 Japanese business bases are active there now. The business performances of the headquarters in Japan will be seriously affected by their arms in China. I believe that the Chinese government is capable of managing the economy well for its stabilization and thus the trade war will find a way for a soft landing.

Innovation in China

JS: China's political stability must be a key to achieving such good governance of the economy. The capacity for innovation is another important issue in thinking about the long-term prospects for the Chinese economy. Let's talk about Chinese technology.

Ke: It is surprising to see that 67% of Chinese exports of semiconductors in business-to-business (B2B) transactions are from non-Chinese affiliated companies in China, according to trade statistics. In the light of this reality, I guess Chinese firms are not technologically competitive enough, though sales of semiconductors in business-to-customer (B2C) transactions are enormous due to the fact that in China there are 800 million Internet users.

JS: Prof. Watanabe, what do you think are the main characteristics of Chinese innovation? In what sector is innovation rising? What do you think are the advantages and disadvantages of the Chinese economic and industrial system in starting innovation compared with other nations? How do you think Chinese innovation will evolve in the future?

Watanabe: Wherever you may be, today you will find that data is a key asset for innovation. The firms with affluent data are overwhelmingly competitive and can lead innovation. In this regard, Google and Facebook are the frontrunners but Alibaba and Tencent, both Chinese companies, are competing with them and have overwhelmed them in some particular fields. For example, Tencent is very successful in operating Internet banking for consumers. It has controlled bad or irrecoverable debt at surprisingly low levels and made profits due to this efficiency. It computed the risks of borrowers more accurately based on rich data from QQ or WeChat. Thus, it is so important to manage data well to achieve innovation today, not only in China but anywhere else.

Open networks of transaction, product and innovation are the key organizational characteristics of China. This openness offers extensive access to the new disruptive technology. The more open, the more users and suppliers are coming in, and this has accelerated new encounters and innovation. This is a good environment for "disruptive innovation" as defined by Clayton Christensen. This organizational competence has accelerated innovation in Shenzhen and elsewhere. The openness means the rapid spread of technology and homogenous competition; the players are forced to innovate new benefits so as to survive.

In the future, China must get into a stage to implement another type of innovation also mentioned by Christensen: "sustainable innovation" where it is accumulating competencies and raising the level of its technologies by itself. It has already appeared in China. For example, Huawei, an information technology company which has already started to design and produce semiconductor chips, has already reached this stage. The quality of its chips is already next to the top runner in the US.

In the domain of AI, Chinese researchers are literally the frontrunners. Their papers outnumber Japanese researchers' ones. Meanwhile, open innovation-based industrial organization in China survives and by taking advantage of it China will have good potential to begin further innovations. Shenzhen and Hangzhou are the places where you can find such open innovations.

China certainly seems to be rather behind Japan in the domain of fine-tuning technology in which the Japanese excel. However, I think China will catch up with Japan soon in this domain as well. There will be very little the Japanese do that the Chinese will be unable to do. As the Chinese population outnumbers the Japanese, their competitiveness is expanding in every domain.

JS: What do you think about science in China? Do you agree with Mr. Ke?

Watanabe: It depends on the domain. AI, for example, I believe is the domain of science where researchers and business are collaborating, and in this domain Chinese scientists have a strong presence in the world. I am not quite sure, in this light, whether you can say that Chinese science is not competent.

Kurauchi: They may be weak in science but they are very competent in turning the seeds of technology into business and winning money. Chinese Internet facilities like Tencent or WeChat have achieved great business success by using Big Data. Such Chinese companies are also facing serious competition in the market, but this may enhance their competitiveness further.

Motohashi: I have a different view on Chinese science from Mr. Ke. Chinese universities' science research papers not only outnumber Japanese ones but are also higher in quality, in that they outnumber Japanese papers among the top 1% of the Highly Cited Papers worldwide. The background of this outstanding academic performance by Chinese scientists is, in my view, their internationalization at a significant speed. In Chinese universities, many Chinese-speaking American researchers are visiting their Chinese colleagues and talking with them in Chinese. The Chinese government also encourages Chinese academics educated overseas to mediate between American or European academics and Chinese academics. The Chinese Education Ministry is also spending a large amount of its budget on raising the academic level of science.

On technology, although 10 years ago many Chinese patent applications were not necessarily well qualified, their scale of business and human resources has been instrumental in raising the quality. With the significant internationalization of business as well, their performance is outstanding and clearly Chinese technology is catching up with Japanese and others. In sectors like telecommunications equipment or electronics, their research costs are rather high and non-Chinese firms' subsidiaries in China are the main exporters of these products to the overseas market, but today the percentage of those non-Chinese exporters is decreasing. In contrast to this, in the automobiles sector, this percentage is still high. Thus I see the Chinese auto industry's competitiveness as not so strong, and probably not so strong either in sectors like materials and robots.

It is certainly true that Chinese Internet business companies like Baidu, Alibaba and Tencent are showing outstanding performances. For example, Google and Baidu are the only companies in the world with the Level 4 technology for driverless cars which would enable a driverless car to work perfectly in some specific places. You would need a map in order to enable it. Baidu owns a map of the whole Chinese continent and so Google cannot do the business of a driverless car in China. Such a map is devised by data that is the product of engineering rather than science. However, the data can be used only in China. This is true of other business transactions including finance for consumers.

JS: Prof. Motohashi, could you please elaborate on the cultural and business background to the emergence of those creative digital technology companies in China, such as Alibaba and Tencent, compared with Japan?

Motohashi: One striking difference from Japan is that in China there has been no credit card use for payments. Therefore, for e-commerce there is no way of paying without using cash but Fintech. Another thing is that those digital platforms have created financial instruments for the management of their clients' savings. Their offered interest rate was much higher than the market interest rate. So they have been successful in attracting large sums of money. Another thing to have pushed this platform business is that they adopted a method to identify individuals by just reading QR codes without using a specific PC with high security. Now wherever you go, you can use a QR code as your identity. The digital platform companies like Alibaba have been successful in creating trust on a nationwide scale, having expanded trust among relatives and family members in their traditional culture to a much wider scope of human relations through this easy way of personal identification.

Another Chinese tradition that has helped promote the digital platform business is one that allows people to be generous about experimentation. They do not mind so much about details in the business. For example, a QR code is good enough for identifying individuals and very few worry about the other means to ensure security, which is significantly different from Japanese culture. I guess those are the reasons why the digital platform business is prosperous in China.

JS: Mr. Kurauchi, could you please tell us how our Japanese companies can become involved in this Chinese digital business or in the digital market overall?

Kurauchi: The key question on our bankers' side would be how much information must be protected. In the case of China, even in buying an express train ticket, personal data would be revealed. Can we Japanese accept such a disclosure of private information? I am afraid we cannot.

Another concern is that payment by Fintech is almost monopolized by the two digital payment services, WeChat and Alipay, in China and so there are much fewer alternatives for payment than in Japan. I am afraid this may prevent Chinese society from being an authentic affluent society where people can enjoy many alternatives. I do not think Japanese society would go in the same direction as Chinese society, though the latter may be more efficient.

On the other hand, Japanese banks are now studying a variety of Fintech payment and settlement frameworks in order to ride this global trend.

Motohashi: IT and financial services are today interacting with each other closely. Financial institutes employ many AI experts. Digital financial services are also employing financial experts from the banks and thus they are pursuing a mixed industry of IT and finance. This is a supply-side story.

On the demand side of this business, it is necessary to make a distinction between business in Japan and business in China. In order to do business in China, you would have to be a Chinese company by acquiring capital in a Chinese company. You would have to observe a Chinese law prohibiting people from bringing out their acquired data from China. Meanwhile in Japan, Japanese banks are not adopting the

services provided by Alipay or WeChat.

Kurauchi: Payment and settlement are core and legacy businesses for Japanese banks. I think there must be a risk in leaving those businesses with Chinese financial IT services. As such, there are obstacles for Japanese banks in introducing a cashless financial system like in China. However, we would need to transform our financial system to catch up with the innovation in the digital market.

Ke: On the issue of driverless cars that Prof. Motohashi mentioned, Baidu bought a map from the Chinese military forces that would be crucial to national security. It is impossible for any non-Chinese company to get this map and they cannot get into the Chinese market for driverless cars.

On the question of the business and cultural background of Japan behind its lack of capacity to create a competitive digital platform business model like those created by Alibaba and Tencent, I guess there are three reasons for this. First, there are so many system engineers in Japan who know about technology but have no business mentality. Second, whenever Japanese try to do anything new, they start thinking about rules first. However, this digital world is a new economy and there have never been any rules in it. Whereas Alibaba and Tencent propose possible rules while they are actually engaged in the business, Japanese wait for rules to be adopted by the government. Third, Japanese firms have a strong sense of business territory. So there is no single Japanese company owning the data of 80 million inhabitants out of the total Japanese population of 127 million people. Meanwhile, digital platform companies like Alibaba and Tencent in China are creating only business models and not unique technology. The technology is provided by other nations.

In China, they can introduce a driverless car, but they cannot fully introduce electric cars. In 2017, 2.9 million cars were produced in China and the percentage of electric cars to total auto production was only 2-3%. Even those produced electric cars were for taxis or buses rather than vehicles for individual use. Why won't Chinese consumers buy electric cars for their households? Because the batteries in the cars are weak in terms of durability and safety. This is how, I believe, Chinese science capacity is truly limited.

If we define science as learning derived from a university's Department of Science or Department of Medical Science, such as studies in biochemistry or cells, there are very few Chinese students studying these things in US universities among the 300,000 Chinese studying in US universities in total. We have the largest number of Chinese students in business schools and the second largest in computer science schools. This is because they believe that studying science would not be helpful in earning money. So I think it would be a misunderstanding to exaggerate Chinese economic supremacy. They clearly have a weakness in innovation capacity.

Electric cars produced by BYD, a Chinese automobile company, cannot run longer than 100 kilometers unless they are equipped with so many batteries. With many batteries, their fuel consumption efficiency would be significantly worsened. This means in the old economy like the auto sector, Chinese innovation has not achieved a good performance. There is still a large technology gap between Chinese automakers and German, Japanese and American ones. Their labor force with technology skills is not well developed yet.

In the steel sector, there is the largest generator producer, Dongfang Electric, in China. Though their generators are of high quality, their important materials, such as special steel, are all imported from Japan, since all special steel made in China is not qualified. In shipbuilding, its core part, engines are also all imported from overseas.

It is certainly true that in the new economy where no legacy is necessary in promoting business, China has strength. This is because it has 800 million data users controlled by the government with all of their IDs. But this strength remains all inside the Chinese border.

Trade & Investment Issues

JS: Let's move to the questions of trade and investment. Mr. Ke, could you please give us your view on the prospects for the US-China trade war?

Ke: Trump has started a trade war with the US mid-term elections in November 2018 in mind. I have heard from US sources that he wanted to fight against China exhaustively, bearing in mind that President Ronald Reagan brought about the collapse of the Soviet Union in the 1990s. He wants to leave a legacy in history like Reagan by causing Chinese socialism, the last surviving such regime in the world, to collapse.

On the other hand, in spite of the trade war, there have been no riots attempting to attack American symbols in China such as Walmart, Starbucks or GM so far, though in past international conflicts with Japan or European nations their supermarkets or coffee shops or automobiles were destroyed by Chinese mobs. It can be understood that the Chinese government is preventing riots, being afraid of further US reaction. In this light, I think China will seek a solution for a soft landing from this trade war. Deputy Chairman of the Chinese Communist Party Wang Qishan will be a key person in achieving this. He may propose to the US government a menu of Chinese economic reforms including opening markets or reduction of excess production facilities. A compromise between the two would depend on how Trump values the menu. I think there would be a further negative impact upon the Chinese economy at this stage if China sticks to aggressive retaliation against the US protectionist policy. Of course, this trade war could work in favor of the Chinese economy, if China starts reforming seriously by taking advantage of this pressure from the US as a possible positive development. The Chinese economy could enjoy higher growth with this, while structural economic reform in China has been slowing down.

Kurauchi: After the US mid-term elections, if the Americans find that they have to buy more expensive goods from China due to higher tariffs imposed by the US government and that their benefits from tax cuts would be offset by paying for those higher tariffs, they could have a negative reaction to Trump's protectionism. This might be another possibility for a soft landing.

China-Japan Business Relations

JS: Mr. Kurauchi, could you give us your thoughts on the possible opportunities for Japanese businesses in China and also the challenges for them in the Chinese market, including the issue of investment climate? What market do you in particular believe has high potential in China?

Kurauchi: The Chinese economy is now as important as the US for Japanese business in terms of scale, growth potential and global business strategy. In 2017, Japanese exports to China reached around 15 trillion yen, nearly equal to those to the US. Recently, as Chinese tourists in Japan are increasing, e-commerce beyond borders is also increasing to reflect the growth in demand for Japanese consumer goods. The Chinese government is also working on import promotion today and Japanese companies are trying to take advantage of this initiative.

On FDI, according to annual surveys by the Japan Bank for International Cooperation (JBIC), the top-ranked destination for FDI by Japanese companies within the next two to three years had been India since 2012, though it used to be China before that. However, China became the top-ranked destination again according to their most recent survey published in November 2017. This means that Japanese companies have acknowledged again that the size and growth potential of the Chinese market is still attractive and important in the medium run. A JETRO review also clarified that half of their surveyed Japanese companies were planning to expand their business in China in one or two years by reinforcing sales functions or increasing production of high-value added goods.

METI's White Paper 2018 mentioned that the sales figure of personal services-related companies from Japan to China was lower than those of US or European nations. Western big names like Starbucks, IKEA and ZARA have subsidiaries in China and they are enjoying their business. In contrast, Japanese service industries' presence is still limited in China. We understand that there exists enough space for Japanese companies to go into expanding service/consumer-related business in China. Of course we know that it is not that easy to win the competition there.

On the question of Chinese firms to invest in, healthcare, caregiving and medical services were mentioned as a potentially high growth sector on the occasion of Chinese Prime Minister Li Keqiang's visit to Japan in May 2018. Those services are the core of the Chinese government's policy to promote national health. Those services are also ones where Japanese business can be fairly competitive against US and European firms in terms of providing safety, soundness and trust. This area could be a potential opportunity for Japanese business, I believe.

As for the business climate, rising labor costs, tough competition, non-transparency in implementation of laws, insufficient protection of intellectual property rights, and regulations on foreign exchanges and remittances are expected to remain the issues as before. The Chinese government is strengthening its regulations on the environment and it will be a challenge for Japanese business. The Japanese Chamber of Commerce in China in its annual white paper published in June 2018 made three requests to the Chinese government for economic reforms. The first is to correct a commercial system that prevents fair competition and achieve equality between Chinese and non-Chinese companies. The second is further elaboration of administrative reforms such as simplification and speeding up of government procedures, achieving a common interpretation in implementing laws and providing private businesses with sufficient time for adjustment to changed rules and regulations. The third is further modification of entry regulations for non-Chinese companies into the manufacturing and service sectors in China.

I believe we should keep requesting the Chinese government and they may continue to respond to our requests in our favor, such as lowering social insurance fees and revising the list of non-Chinese companies for market entry under administrative surveillance.

JS: A prolonged trade war between the US and China will seriously harm supply chain networks. Would this be Japanese business people's biggest concern?

Kurauchi: Yes, it is one of our concerns. Stable management of the Chinese economy will be most important for Japanese businesses to work in China. The US-China trade war could also affect Japanese intermediary goods production through supply chains by way of exports from China to the US. In this regard, we hope trade friction will find a way for a soft landing soon.

JS: What do you think about the possibility of collaboration between Chinese firms and Japanese firms in third countries, such as Central Asian countries or African nations?

Kurauchi: While China promotes its "One Belt, One Road" initiative, Japan is promoting a free and open Indo-Pacific strategy and there must be some duplication between these two. We will need to pursue collaboration with transparency, openness, economic efficiency and the fiscal health of the third country as the basic principles of cooperation. Based on these principles, two platforms were established as well for collaboration on the occasion of Premier Li's visit to Japan in May. One is the committee for the promotion of business cooperation between Japan and China in third countries, to be led by the governments with participation from the private sector, and the other is the Japan-China Forum on Third Country Business Cooperation, to be attended by a wide range of companies and relevant ministers.

Japanese companies are interested in cooperation with Chinese companies in Africa, the Middle East and the Commonwealth of Independent States (CIS). I believe that Japan's participation in deals will increase the transparency of the project and it must be welcomed by all concerned parties. However, there are various types of risks which might challenge business viability. Another issue is finance. For collaboration, we need to adjust and build the framework quickly as there is a difference in the lending policies between the JBIC and Chinese policy banks, such as the China Development Bank and the Export-Import Bank of China. I hope we find solutions to these issues in the intergovernmental discussions with the private sector's cooperation.

Final Remarks

Watanabe: The key message from Japan to the world must be commitment to maintaining a free and fair world trade system. The White Paper 2018 clearly declares this point. I think the Japanese government needs to keep on communicating this message. The government must carry out two tasks. First, it is important to take advantage of the existing rules and policy measures to achieve a free and fair world trade system. For example, we should work on elaborating a policy recommendation on the competitive neutrality problem and subsidy issues under the WTO framework. Active implementation and utilization of institutions under the current WTO/FTA framework is desirable. Particularly in East Asia, although the investment agreement clearly provides a scheme of intergovernmental communication, it is very rare for the member governments to use this clause for communication, even if any of the member governments' actions allegedly violate the interests of foreign investors, due to diplomatic reasons. For example, the Lotte group of South Korea was forced to close its supermarket business in China in 2017. The incident was allegedly related to the placement of the THAAD anti-missile defense system by the South Korea government, as the group agreed to sell its real estate for the site in South Korea. Consequently, it was reported that the Chinese government ordered the closure of 112 supermarket stores in China due to inadequate fire protection facilities. This issue should have been addressed by the existing investment treaty among Japan, China and South Korea. In this treaty, private business can require the government to look into possible cases where competition between domestic firms and foreign subsidiaries in the host country could be distorted by politics. But no action was taken by either South Korea or Japan.

The other task is building new institutions for adapting to this new environment — new issues like data protection or the implementation of competition law in which we have not yet had any harmonized rules. We will need to work on international harmonization of rules for those issues.

Motohashi: I agree with Prof. Watanabe. Japan should make clear its stance of fully supporting the WTO system, and strongly oppose Trump's protectionist policies. JS

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