

EVALUATING CHINA'S IMPACT: A STRATEGIC IMPERATIVE

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What you can't avoid, welcome. (Chinese proverb)

Mieux vaut accueillir ce que l'on ne peut éviter.

Elements of a speech:

1. Thank CB and CME for inviting me to be the keynote speaker; actually, I think that it will be more useful and interesting for this audience if I can be allowed to be the **keynote talker**; I have less of a speech in mind, but rather want to lay out a few ideas for you to consider over the course of this conference; I'd rather give a talk than a speech;
2. I also very much welcome the theme, '**Developing your China Strategy**' as this is what I have been promoting since assuming my responsibilities in China;
3. **Neil Tait** spoke on opportunities and challenges for Canadian business. Specific issues arising from both of these will be addressed in the course of the next two days;
4. consistent with these themes, I want to focus, as the program indicates, on the '**strategic impact**' of **China**; this is being felt throughout the planet, the developed as well as developing worlds; it applies to Canada, and it applies to every institution, businesses large or small, government, educational establishments, even to the performing arts and ultimately to the way we live and the way we conceive and understand the world;
5. **change is the only constant**: that's the fundamental meaning of the message on the screen, and it doesn't only apply to such recent developments as the rise of China as a significant economic factor;

6. I am ready to bet that every business represented in this room has faced - faces, on a daily basis - **basic challenges to its growth**; key questions on technology development; concerns about what the competition that you know is up to; and what the competition that you don't know, that you are not yet aware of, is up to;
7. in the **last 50 years, the rules governing trade** have evolved; for example, those arising from the creation of GATT and subsequently the WTO; those arising from eight international trade negotiations, such as the Dillon, Kennedy, Tokyo, Uruguay Rounds; some from sectoral agreements such as those on textiles, clothing and footwear, or the 1965 Auto Pact between the United States and Canada;
8. The **terms of trade** are also constantly changing: oil and energy prices have moved from \$14.39 in 1998 to \$55.67 at the end of October. The Canadian dollar has ranged from 61 cents to just under 82 cents over the last two years;
9. big changes were brought about by the rise of **Japan** as the world's second economy, a process that took less than 30 years;
10. so **dealing with constant change**, understanding its dynamic and direction, assessing its impact on you and your business, adjusting your strategies, indeed inventing brand new ones, is something that you have been doing since you got into business;
11. **good Canadian companies overcome these kinds of challenges; great Canadian companies turn them to their advantage, and increase their power and wealth;**
12. so I am not setting you up for an argument that says that China is just more of the same, an argument in favour of complacency:
13. in fact the opposite; I am setting you up for an argument that the **China**

- Challenge** is going to be, indeed is already in some respects, one of the most significant, challenging, structural, transformative, comprehensive developments that you will be facing for the next decade;
14. it is a challenge that is both disruptive, and exhilarating, and those who understand it, adapt to it, and learn how to benefit from it, will survive and prosper; those who don't, won't;
 15. Neil has provided you with a great deal of economic information; I am also distributing a **deck and some statistical tables** to add to the weight of your return baggage;
 16. but let me just point out and repeat some important **realities**: China is the sixth economy in the world, and the second on a Purchasing Power Parity basis; it is the fourth largest trading nation; it has accumulated about \$550 billion in foreign exchange holdings, and become the second largest holder of US Treasuries; it is the world's largest recipient of Foreign Direct Investment;
 17. China last year absorbed 31% of the world's iron ore, 21% of its platinum, 15% of aluminum; it has become the world's second biggest oil importer. It is the largest importer of fertilizer, nickel and copper. Morgan Stanley estimates that China currently consumes about 20% of most of the world's commodities.
 18. on the production side, China produced more steel in 2003 than the United States and Japan combined. China produces 75% of the world's clocks and watches, 55% of the world's dvd players, 50% of the world's cameras, electric fans, and telephone sets, 30% of airconditioners and televisions. Et cetera.
 19. all of this was **achieved within one generation**;
 20. these numbers have reached their current size and importance because of **four sets of reasons: continuity of performance, welcoming international environment; continuity of policies; management of crises**;

21. at a **macro-economic level**, China has been growing by over 9% per year for over a quarter of a century; everyone knows that compounding a number by 9% per year means that you double that number every 8 years; China has thus had time to triple its size in much less time than it has taken to destroy the National Hockey League;
22. So continuity of performance over the long term is one reason that China is where it is today;
23. The second set of reasons explaining this success relates to the welcoming **international environment** upon which China has capitalized.
24. China's entry into this globalizing world benefited from the demonstrated success of Asian models of growth.
25. Japan from the 60s to the early 90s, Korea, Taiwan and the Tigers from the 70s to the late 90s were demonstrations of what well-lead Asian economies could achieve.
26. At least until 1997, **confidence in the potential for growth in Asia** was widespread, so that investors were waiting in line as China progressively opened sector after sector of its economy to foreign participation. Among many investors, little attention was paid in the short or even medium term to return on investment, as the costs of inevitable cyclical downturns would be obviated by long-term prospects that come from involvement in a market of such great potential.
27. Accordingly, even **before** China joined the **WTO**, FDI poured into China. From 1992 to 2001, FDI grew from a low of US\$ \$11 billion in one year, to a high of \$47 billion in 2001, for a total of \$369 billion over those pre-WTO years, involving perhaps over 100 000 projects in all. The result was economic growth of 9.9% per year during this period, on average, raising GDP to 1 trillion US dollars by the turn of the century.
28. Furthermore, despite the absence of WTO disciplines on China, the world

- economy welcomed China to the trading family, and not only through FDI. **Chinese exports** rose from \$84 billion in 1992 to \$266 billion 2001, which was the year China joined the WTO. The US, China's biggest market during the decade, imported \$610 billion, and sustained a total trade deficit of \$486 billion dollars.
29. Canada's numbers are not so dramatic, but nevertheless, our cumulative trade deficit for the decade was CDN \$ 38 billion.
 30. China's total trade surplus during this period amounted to \$186 billion.
 31. Without getting into a debate about the merits or demerits of trade deficits and surpluses, the fact remains that **Canada, the USA and others opened their economies** and allowed massive investment flows to what was then still largely a closed economy. There were many reasons for this, but they were certainly lead by visions of getting a firm foothold in what was expected to become a large economy indeed. And indeed, that is what happened.
 32. A similar openness can be discerned in the **flow of science and technology** and copyrighted knowledge such as computer software. It is hard to imagine China today without Chinese language Windows applications, however they were obtained - and we know that most were obtained without authorization or compensation for Microsoft.
 33. All of these factors favoured China's growth and rapid integration into the international economy.
 34. The third set of reasons relates to the **continuity of policies**.
 35. As I said, China's emergence has benefited immensely from the largely welcoming international economic environment, based on open markets, and the rule of international trade law.
 36. But the credit also goes to the great common sense of China's Leaders, since 1978, in their effort to reform the economy domestically, and force it's doors

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- open to the full impact of the international trade and investment system.
37. ‘**Gaige Kaifang**’ ‘Reform and Opening’ have been and continue to be the most significant, real world set of guiding principles of the Chinese Communist Party and, by extension, the Government of China. It means not only the continuing process of forcing economic reform through increased **privatization and marketization** of the Chinese economy.
 38. It also anchors a growth model, different from that of Japan for example, one that relies on **foreign direct investment, heavy domestic investment in infrastructure and education** and, most importantly, **open markets**;
 39. At 12.4%, for all goods, and 19.2% for agricultural goods, average Chinese **import tariffs** are lower than the average for most OECD countries; they compare to those of India at 29% for all goods and 36.9% for agricultural goods. For purposes of reference, Canada’s averages are 4.1% for all goods, and 3.1% for agricultural products.
 40. For the last 20 years, China has also provided an **investment environment** and the tools that lead to the transfer of vast swaths of global manufacturing capacity to China, initially for export to global markets, and in the last decade, to supply as well the domestic market.
 41. In the process, China has inserted itself in the **supply chains** of a growing number of sub-components and manufactured goods - furniture, home electronics, building materials, textiles, clothing and footwear for example, at present, and soon, coming to a store near you, the full range of home appliances, after-market auto parts, branded upmarket fashion and accessories, even apples and other fruit and vegetables.
 42. **This growth model, by the way, offers some of the reasons that China is part of the world economy, and India is not.**
 43. China did not get here from there in a straight line: it’s important to have at least some awareness of recent history, and the Chinese experience in the **management of crises**.

44. You can make an argument that reform and opening began in 1978, but it had a **slow and contentious start** in the first half of the 1980s, and broad growth policies were not really in place until the latter part of the decade.
45. The **Tiananmen Massacre** in June 1989 had many consequences, some highly tragic, and it also seriously shook investors' confidence, and caused a significant slow-down in FDI, tourism and bond issues.
46. In 1992, policy initiatives put the **economy in hyper mode**; bank loans were out of control, inflation had hit almost 22%, the PBOC leadership was sacked, and then Vice Premier Zhu Rongji tasked to reign-in a runaway economy, putting in place the famous 16 Measures to slow down the economy and reign-in inflation; even then, it took 4 years to bring inflation down to the negative; but Zhu built the policy framework for the China of today.
47. So the possibility of serious shocks to the system cannot be discounted.
48. But as Wendy Dobson put it, in her recent study for the C.D. Howe Institute: **what if the Chinese keep getting it right?**
49. That's what I am betting on, that China will largely get it right.
50. We can debate the risks to China's continuing and rapid growth, and I'll touch on these risks in a minute; I don't think that anyone can argue that somehow China's achievements will be reversed, and that China's strategic challenge will go away; nor would we want it to.
51. Let's look at some of the **strategic dimensions** of China's accomplishments.
52. Actually, there are, for the moment, **three basic strategic dimensions** of importance: **economic influence, geopolitical influence and military power**.
53. **Size matters in matters of trade and economics**; you get more attention if

your are 5.85% of global trade - which is China's share - than 3.64%, which is Canada's or 0.75%, which is India's.

54. And size shows up in various, sometimes unexpected ways.
55. On October 29, the People's Bank of China increased its **benchmark one year lending rate** by 0.27%, to 5.58%, for the first time in 9 years. Some of the press reports that began to appear within one hour of this announcement included:

Bloomberg: crude oil futures may fall on speculation that China's rate increase will slow demand growth;

Korea Times: China's rate hike could slow demand for Korean goods and hurt export growth, and thus the Korean economy;

Japanese press: shares closed lower in Tokyo for the first time in four sessions on concern over declining demand from China for Japanese exports;

USA media: minor interest rate machinations in China were being blamed for causing a direct drop in spot soybean prices at the Louisiana Gulf Friday;

Canada: the TSE ended lower on Thursday, as a move by the Chinese government to hike interest rates...slammed base metals and mining stocks;

And so forth.

56. To give you another example, October also saw the confirmation of a major shift in negotiating power in **iron ore**. Australia's ore producers have traditionally been subject to price and volume decisions made, in concert, by Japan's steel producers. Not any more. The muscle of the Chinese steel makers last year brought competitive price increases of 18.6%, the highest in 10 years. This year's price increases, now under negotiation, could add, according the Wall Street Journal, another 20% to base prices.
57. Look at the situation with respect to **scrap metal** in Canada. Scrap metal is one of the basic inputs for many of Canada's small and medium sized auto parts manufacturers. Chinese buyers have swept into this market, just in the

- last 2 years, and both forced prices upward and, in some markets, bought up the entire available supply.
58. Some of these changes in the structure of global demand have significant geopolitical dimensions. Sinopec (?) just signed a US\$70 billion deal with **Iran for natural gas and access to new oil fields.**
 59. But **economic power alone is not enough** to allow countries to shape the environment to their advantage. Look at Japan, the world's second economy. When was the last time you were worried about Japan's foreign policies?
 60. But we **pay attention to China's foreign policies** because they are increasingly meant to shape the international environment.
 61. Canadian interests will be seriously affected if there is dangerous tensions arise, for example, on the **Korean peninsula.** China has the lead on the Six Party Talks that are trying to defuse that situation.
 62. Our interests will be damaged if there is tension as well in the **Taiwan Straights.** That is why the US/China relationship as it currently stands is so important to Canada.
 63. Let's look at that **Iranian oil and gas deal.** Part of the price? Chinese veto of any United Nations Security Council involvement in the International Atomic Energy Agency's condemnation of Iran's nuclear program. This will seriously complicate US and European efforts to reign in that program and the threat of nuclear proliferation. China has also taken a hard line on UN involvement in the **Sudan.**
 64. Who will lead **geopolitics in Asia** in the future? I won't speculate on US President Bush's Asia strategy, but unless there is more engagement, the lead will **progressively be taken by China,** because of its size, because of its activist economic diplomacy and the sense of historical inevitability that one senses throughout China and throughout the region.
 65. China's impact is increasingly on the **global environment.** Already,

- Canada's northern regions are affected by excessive mercury in the atmosphere, allegedly originating in large part from China's dependence on coal.
66. Does this all of this mean that **China is already a super-power**? However impressive are its accomplishments, I don't think China is a super-power, yet.
 67. **China's importance is, at the moment, economic and diplomatic.**
 68. Imagine a world where China underpins global security, as the US does today or whose views guide international institutions such as the UN or the IMF. Imagine the distance we are from a world where the Chinese navy provides security in, say, the Straits of Malacca; where the Shanghai stock exchange sets the trends in global securities markets every morning; where the global audience for the Golden Rooster awards is greater than that for the Oscars; where the yuan becomes the world's fourth reserve currency; or the public declarations of NGOs and human rights groups hail China as a model for democratic development and human rights, and we can see what a distance China has to traverse before becoming a real competitor to the US or the EU or even, in matters of good governance, Canada.
 69. All of these examples point to reasons why China is **not yet a super-power**. Take the military dimension.
 70. Until the 18th century, challenges to China's security came from the nomads of the North and West. In the last 200 years, they have come primarily from the surrounding seas, from the British Navy, from Japan, from the former Soviet Union. Today, the US dominates the oceans on China's coasts, yet China still does not possess a strong **blue-water navy**, perhaps the most important attribute for a super-power China. It is working to build a strong military, but it is far from achieving that goal.
 71. China faces tremendous problems arising from the growth model that it has adopted. **Income distribution** is so skewed that China now has a Gini coefficient - the standard indicator of inequality of 44.7% and climbing. In

- 1990, its Gini coefficient was only 0.18.
72. One result of this situation is **growing dissatisfaction among the have-nots**, sometimes expressed in demonstrations or worse. Some of you will have read about serious demonstrations, even riots, in Western and Central China just in the last few weeks.
 73. The macro economic numbers are impressive, but our newspapers are filled with articles about the **immaturity of the economic institutional frameworks** in China: weak financial intermediation, Non-Performing Loans, stock markets that are overwhelmingly dominated by State Owned Enterprises - 70% of the shares on the Shanghai exchange are owned by government entities, difficulty of access to credit for SMEs, inadequate legal protection of contracts or intellectual property etc.
 74. So, **being intimidated by China is not the starting point for developing your China strategies.**
 75. Our **starting points** are in fact **two-fold**: firstly, **understanding today's China**, understanding what China's actual and potential impact is and will become in your business sectors; and secondly, understanding as well that **Canadian business history** has demonstrated that, as a country, **we have met and continue to meet all of the basic challenges that the world has thrown at us.**
 76. **We possess** - you possess - in competition with China, better products, stronger R&D capacity, better marketing skills, better corporate and management cultures, better knowledge of what customers want, more sophisticated understanding of the roles of inventory management and distribution greater access to capital, and a reliable legal framework.
 77. **These are the strengths** that, strategically harnessed, will provide the wherewithal to compete with China, as we do in all of the world's markets. We are not any less smart today than were those who faced the challenges of trade rounds, or Japanese market penetration or NAFTA.

78. While Prime minister Martin and Foreign Minister Pettigrew have primary responsibility for **providing the strategic direction** to our bilateral relationship with China, the task is not limited to government.
79. **We all have to be smart.** It is what we do as governments federal and provincial, as businesses, as universities, as performing art groups, as media, as drivers of people to people linkages, **it is what we have and implement as strategies that will matter** in meeting the Chinese strategic challenge. We are all actors on this newed stage of the global commons. Our success in turning China's growth to our advantage depends on whether we are active or passive, lead actors or, like Rosencrantz and Guildenstern, minor characters who get killed before Act V.
80. I don't think that that will happen, and it especially will not happen if we take the lessons of this Conference to heart and develop our China strategies.
81. Finally, a plug. You and Canada's tax payers are covering the costs of XXX Canadian diplomats and YYY local employees in our 6 missions in Greater China. **Become familiar with our services, check our web sites**, let us help you develop your strategies. That part, you have already paid for.
82. Secondly, take advantage of opportunities. International Trade Minister Jim Peterson will be leading a **trade delegation to China in January**. Find out about that delegation, and decide whether it can help you deepen your understanding of China and help you make connections. That is why the Mission is taking place.
83. Thank you very much. Merci.