The Dragon’s Dilemmas
Moderation: Maximilian G. Burkhart and Martin Thurau

When will China overtake the West? Economist Dalia Marin and sinologist Hans van Ess discuss the limits to growth in a country with 1.3 billion inhabitants and the serious problems China now faces.

Solar energy was once hailed as perhaps Germany’s most future-proof industry, but this dream has now been shattered. A whole series of firms are now in difficulty, while Chinese producers control the market for solar cells. Is this a harbinger of the coming dominance of China in the global economy?

**Marin:** When a country as large as China becomes a leading player in the world economy virtually overnight, drastic dislocations and painful adaptations in world markets are unavoidable, as the solar energy industry is now discovering, to its cost. This sort of thing is quite normal, it happens all the time. However, in the case of China, the scale is different – simply because the country and its economic potential are both so big.

EU trade commissioner Karel De Gucht has accused Chinese companies of distorting the market by selling solar cells at giveaway prices. That is surely rather more than the usual pressure to adapt.

**van Ess:** The German solar industry has long been highly subsidized. It may have become complacent because governments have done so much for it, and thus failed to anticipate that it might have to face serious competition. Its pricing of the products of a technology that it not terribly complicated was easy to undercut. Competitors other than the Chinese would certainly have been able to do the same.

The EU threatened to slap punitive tariffs on solar panels produced by Chinese firms. Is that a reasonable reaction – or just a last-ditch effort to shore up an industry that cannot be saved?

**Marin:** I was an advisor to Peter Mandelson, Mr. de Gucht’s predecessor but one, so I have personal experience in this area. At that time China was also the target and the problem was light-bulbs. The European firms involved actually adopted conflicting stances on the question. Philips, a global concern, had already moved its production capacity to China, and was therefore interested in being able to reimport the goods without having to pay extra duties. Osram, on the other hand, which was then part of Siemens, favored increased tariffs because it feared Chinese competition. But one must remember that, where protectionism is concerned, the Chinese are no angels either.

However, in China itself, it is quite obvious that the value of the renminbi is rising, though nothing like as fast as it would without state intervention.

**Marin:** Nevertheless, dismissing all appeals for moderation as “interference” is not a good recipe for success in today’s globalized economy. China shouldn’t be surprised when other countries try to take the same tack. After all, Europe is China’s most important economic partner.

**van Ess:** But the Chinese are also well aware that there are widely diverging views on economic issues in Europe. The solar industry is fighting for its life, but the carmakers are wary of anything that would annoy the Chinese – that would be very bad for (their) business. And in Germany, the auto industry has far more clout than the relatively modest solar industry.

**Marin:** And China is now the most important market for Daimler, BMW, Audi and VW.

What is the secret of China’s success? What makes the Chinese economic model so effective?

**Marin:** China had been economically
backward for decades. In other words, they started from a very low base. So it’s no great wonder that their growth rates have been exorbitantly high. The second point is that, with its state-controlled system, China was able to give its economy a huge push simply by transplanting large sections of the population from the countryside into the cities, and from agriculture into industry. Some studies by the International Monetary Fund and other institutions predict that China will overtake the US as the world’s largest economy within the next 12 years, but that assumes the Chinese economy will continue to grow as fast as it has so far. – But I have my doubts on that point.

van Ess: One major factor in the Chinese take-off has been the level of foreign investment. Over the last 20 years, no other country has received so much direct investment from abroad. Much of China’s success as an exporter has been fuelled by foreign capital. But, at some stage, this is bound to reach saturation point. Indeed, many Western firms have already become more cautious. Even the auto industry, which is still investing on a large scale, is beginning to realize that there are difficulties in repatriating profits.

Marin: Two other things have contributed to China’s economic growth. First, they have invested huge sums in education and research. Secondly, there is the accumulation of domestic capital, not just foreign investment. China has one of the highest savings rates in the world. Households save to an excessive degree because China is not a welfare state and has no social security system. Families must be able to finance their children’s education, so that they in turn can look after their parents when they are old. Such a pattern of capital accumulation generates a very traditional form of growth, which is characterized by diminishing marginal returns. It cannot sustain stable long-term growth.

van Ess: China has indeed invested a bundle in education, but whether this primarily quantitative expansion can dislodge the old ideological ballast is an open question. I have many contacts with Chinese students, and I have discovered that flexible thinking does not come easily to them. But the Chinese government recognizes this problem, and provides generous funding to send students to Western schools for further education. The old Chinese fear of a brain drain has obviously been replaced by the conviction that the country cannot achieve its ambitions without input from Western universities.

Marin: The most important question is whether the new government under Li Keqiang and Xi Jinping has the political will to introduce reforms that will really stimulate innovation. If you make extraordinary demands on people, you have to make it worth their while to fulfill them.

Capitalism’s flexibility and the broad scope of the state’s directive power – it looks as if China manages to achieve an optimal balance between these two forces. By combining them, has China not created a more stable system than Western laissez-faire capitalism?

van Ess: The Chinese state is not as tightly structured as we tend to think. The state issues its directives but, at the local level, reality rules, and the end-result is often out very different from the one envisaged in the plan. The foreigners are the losers, because they must follow the instructions from the top.

Marin: China’s strength is easily overestimated. The Communist Party and state officials are terrified by the thought of an extreme polarization of society. The income gap between rich and poor is about 60 times wider than in the US. So far, rapid growth has made it possible for most people to improve their lot so much that they haven’t begun to ask awkward questions. But individual success depends more on links to people in power than to innovative ideas or creativity – and that is a perverse incentive. Assuming that the economy loses momentum, what then? People will inevitably become more dissatisfied, and the State will not be able to counteract this by repression alone.

There have been reports of unprecedented levels of suicide provoked by intolerable working conditions among employees of one of the major suppliers for Apple and other IT giants. Is this the inevitable price to be paid for rapid growth and economic success? And is it also the price that we accept to keep our high-tech gadgets affordable?

van Ess: That a company like Apple should make headlines in this context is very interesting. German firms are often taken aback by the conditions imposed on how they conduct their business in China. Nowadays, foreign firms cannot produce whatever they want and however they wish. These times are long gone. When State enterprises were first privatized, rapaciousness and money-grabbing was not uncommon. But the government has since become pretty sensitive to that sort of thing. Ministers know that it is an explosive issue – in the larger cities at least. China is no longer a place where labor is cheap; the economy has advanced beyond that stage. Many of the classical low-wage sectors, such as textile manufacture, moved to Bangladesh or Vietnam years ago.

Marin: China did try to promote industrialization by adopting a low-wage policy, but, after many strikes, wage levels – and productivity – have risen sharply. Nevertheless, with regard to unit labor costs, which take account of both wage levels and productivity, China remains attractive. But what really
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excites outside investors is the sheer size of the domestic market.

van Ess: Entrepreneurs have repeatedly told me that low production costs are not what attracts them. These are no longer all that low, especially not where manufacturing processes are relatively complex, as is the case in most German firms. For that one needs well educated workers, of which there is a great shortage in China. What really motivates businessmen is the prospect of 1.3 billion consumers.

Marin: Future developments will critically depend on whether or not the new government has the political will to introduce reforms that really allow those who generate the new prosperity to partake of its fruits.

van Ess: The slogan adopted by the new leadership is “the Chinese dream”. That evokes “the American dream”, but it is pretty clear what it means: the mass of the people must benefit, the rewards of economic success must be distributed more broadly.

Marin: A second issue is at least as urgent. Industrial production, the entire manufacturing sector, is facing a period of fundamental change. Technologies such as 3D printing are set to revolutionize manufacturing in the not-too-distant future. That means that labor costs will play a far smaller role in determining overall production costs. Capital and technological know-how will be the decisive factors that define competitiveness. This is bad news for China, because it continues to base its industrialization strategy on its vast reserves of cheap labor. In the long term, the leading industries will leave low-wage areas and return to their bases in the rich-world countries that develop the new technologies.

What would be the most appropriate term for China’s economic and social model?

van Ess: The term used in the Chinese Constitution since 1994 is “socialist market economy”.

That sounds like a contradiction.

van Ess: Indeed, and many in the West were highly amused at the time – and very surprised to find that it apparently works. But that socialism is totally incompatible with elements of the market economy is a purely Western view. The crucial point is that the Party retains its leadership prerogatives and policymaking role. In this sense, socialism remains the overarching idea.

Marin: The Soviet variant was far more centralized. China is comparatively decentralized, which makes the system much more fault-tolerant. In the 1990s the problem in the socialist sphere was how to implement the switch from a planned to a market economy. Eastern Europe adopted a big-bang strategy and introduced the new system overnight, while the Chinese chose a more gradual, incremental approach.

One has this image of China as a kind of gigantic technology sponge. What strategies do Chinese firms employ when they make acquisitions in the West and, conversely, how do Western companies go about setting up shop in China?

Marin: The Chinese are always on the look-out for investment opportunities. They have lots of money and, naturally, they want to diversify – not only in the American market, but also in other currencies and countries. That has been China’s explicit strategy since the onset of the financial crisis. And a significant fraction of this investment ends up in Germany.

As part of a sustainable, long-term development strategy?

Marin: Exactly. The Chinese are also...
interested in gaining access to technological know-how, which it would take them much longer to develop at home. van Ess: Their preferred targets are global market leaders that are going through a bad patch. But they are often reluctant to intervene in the management of firms that they take over in Germany, France or elsewhere in Europe. They are obviously restrained by the fear that they will make a mess of things because of their relative ignorance of how the European business world works.

A whole series of German middle-market enterprises has had very positive experiences with Chinese investors who have taken a careful and low-key approach. But there are examples of the opposite, such as the coking plant in the Ruhr Valley that was snapped up by Chinese financiers and immediately dismantled. The two million components were then shipped to China and the whole plant was rebuilt. Does this combination of extremes make sense? van Ess: Certainly. When economic expansion began in the 1980s Chinese entrepreneurs bought whole factories and reassembled them in China. However, that only works if the technology involved is not too complex. One has to keep the plant in operation afterwards. With things like Kreidler mopeds or automatic beer bottling systems that’s not too hard, but the highly specialized technologies used by many medium-sized firms in Germany are a different story. The problem there is the lack of skilled workers and, in middle management, the dearth of well-educated specialists – in spite of the surplus of engineers. Marin: And anyway, the Germans are known to be world champions in organization, in the administration of existing structures and processes. So not interfering much in the everyday management of newly acquired firms would appear to be the optimal strategy.

If China so wished, it could take over practically the whole of Germany industry, certainly all of the firms on the German Stock Exchange Index DAX. Is China likely to take this step? Marin: Why should these companies agree to be taken over? They are awash in money. Shortage of capital is not the problem in Germany at the moment. van Ess: And apart from that – what do you mean by “German” companies? The DAX firms are in large part already owned by foreign investors.

Perhaps China will soon need all the money it has amassed to tackle its internal problems – such as the huge income gap between rich and poor. How has this developed? van Ess: The various sections of Chinese society have diverged massively over the past 20 to 30 years. In the 1990s the government allowed State enterprises that employed large numbers of people to go bankrupt. It abandoned the so-called “iron rice-bowl” policy – a system of job guarantees that made nobody rich but ensured that no one starved. In 1992, in Shenzhen, Deng Xiaoping famously proclaimed: “Letting individuals get rich is good for society.” The decade from 1992 to 2002 was marked by the calculated dismantling of local safeguards. It was argued that only the desire for riches could stimulate real innovation. That Hu Jintao propagated the notion of “the harmonious society” in 2003 was no accident: Income inequality had grown at a frantic pace, as had the age-old contrast between the Eastern provinces and the rest of the country. Internal tensions are now considerable, and could become explosive, at least on a regional scale.

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Does this contrast between rich and poor mirror the divide between urban centers and the countryside? van Ess: To a large extent, although the boundary between urban and rural in China is very fluid. The cities have encroached on the surrounding countryside, and rural industry now finds itself in the middle of the commuter belt. Internal migration is a significant factor in China’s social structure, but not all migrants are victims of exploitation, and not all are doing badly. The rich make up a very small fraction of the population. Even if one assigns 300 million people – more than half the population of the EU – to the comparatively prosperous urban middle class, that leaves one billion people in relative poverty. This is why China still sees itself as a developing country. Marin: Most of the money has accrued to the so-called “princelings”. Many of those who have always had close links with politics and were an integral part of the political class have become enormously rich – a clear sign of a thoroughly corrupt system. van Ess: That’s true. Nevertheless, there are also many examples of rags-to-riches careers. I have met such individuals. Marin: And how did they manage to succeed? van Ess: The construction sector, for instance, offered favorable conditions. There are huge amounts of money in the system, not all of which is allocated by corrupt agencies. Marin: As long as the size of the cake continues to grow, extreme inequality is not much of a problem. The new middle class can travel abroad and has the freedom to consume. China now has to manage the transition from export-based growth to growth generated by the domestic market. The Chinese realize that if growth falters, the social problems will get out of hand.
The question that interests us in the West most, a quarter of a century after the Tiananmen massacre, is whether economic progress will lead to something akin to real democracy?

van Ess: Political scientists in the US have argued that economic expansion inevitably leads to a democratic political system. I for one am not convinced. The Chinese leadership will make every effort to co-opt the elites that are not already among the 80 million members of the Communist Party – to share the risk and responsibility, not the power – and then assert that Chinese democracy simply doesn’t function like Western parliamentary models.

Marin: I too see no necessary connection between prosperity and democracy. But I regard it as a hopeful sign that Xi Jinping has been in Washington for talks with Barack Obama, and apparently has little interest in confrontation. And there are encouraging indications that the excesses of the pricelings will be curbed.

China has followed a rigorous one-child policy for decades, and the demographic consequences are becoming apparent. Will China get old before it gets rich?

Marin: A standard theory in economics states that average income rises faster when rates of population growth fall. From that standpoint, the thinking behind the policy was reasonable. But if future economic growth is to be driven by technological innovation, the absolute number of creative minds available becomes the limiting factor.

van Ess: Chinese society is aging rapidly. This is a big problem, because they have only begun to set up a comprehensive pension system. So they face a severe demographic crisis. There will not be enough young people available when the older cohorts leave the workforce. The ratio of workers to dependents is now 2.1; the forecast for 2050 is just over 1. The West fears future Chinese dominance. But the world economy is already so closely integrated that the West cannot prosper if the Chinese economy is in the doldrums. That may be a more realistic reason for worry.

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Prof. Dr. Hans van Ess
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