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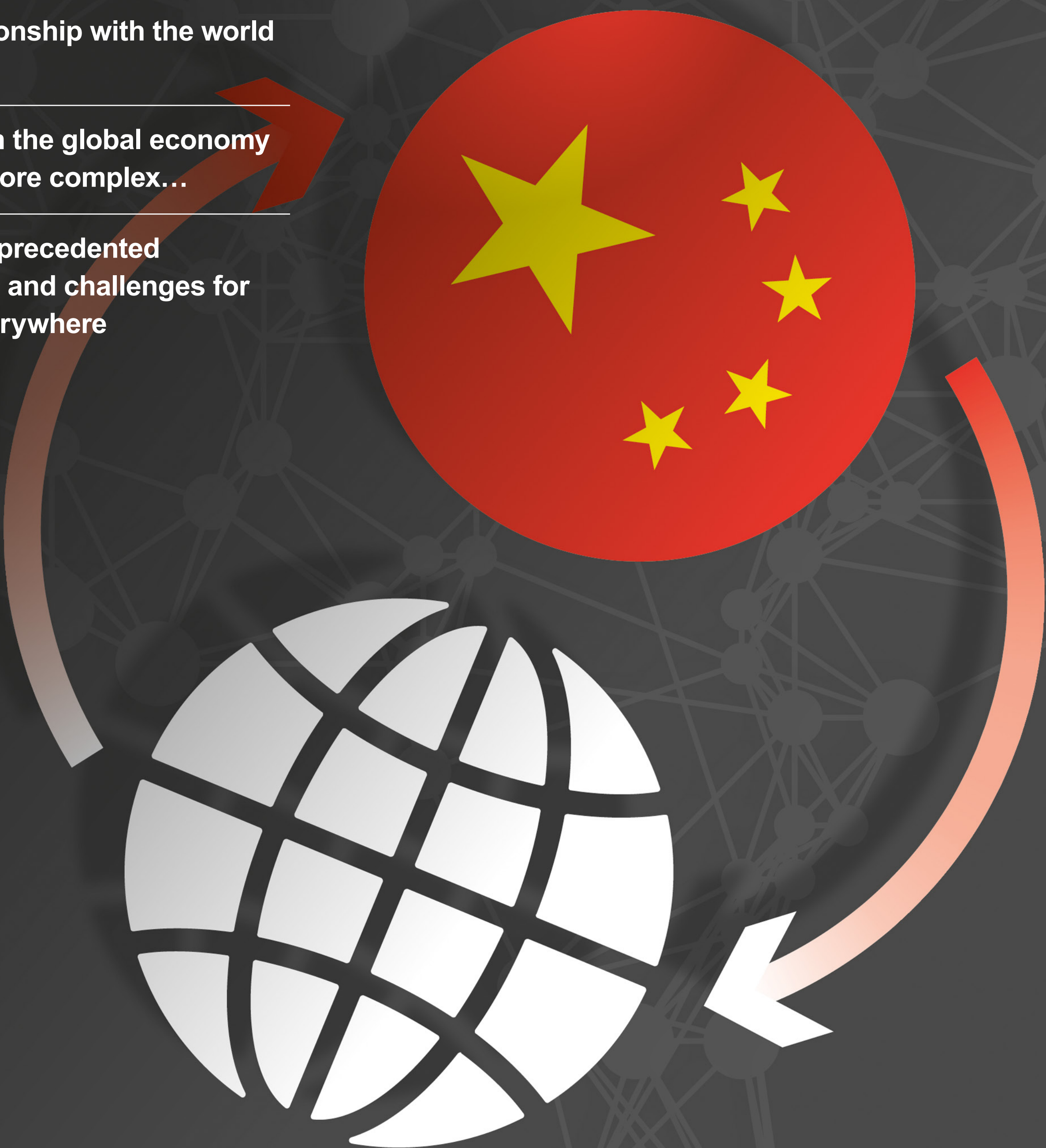
China and the world

New Frontiers, Fresh Connections

China's relationship with the world is changing...

...as its role in the global economy grows ever more complex…

...bringing unprecedented opportunities and challenges for countries everywhere



Executive Summary

An ever-changing story

All roads lead to China

It could be a trip to Sydney's Taronga Zoo, a compelling new Korean drama, an upmarket store in London, a multi-million-dollar footballer, an online payment app, a robot, or an electric car. The common thread is that all roads, wherever they are in the world, eventually lead to China in some way or another. It's just a question of joining the dots.

While the rest of the world may fear a Chinese slowdown, its economy is still contributing more and more to global growth. The US may be the world's biggest economy but China is the most important, with its growth and changing tastes having a far reaching impact all over the globe. These connections are changing, both in terms of size and in shape with countries stretching from Chile to Australia and Ethiopia to Korea seeing the growing influence of China on their own domestic fortunes. With China's developing economy, new countries may be the main beneficiaries of the next leg of China's growth and the increasing demand for higher-end products and services.

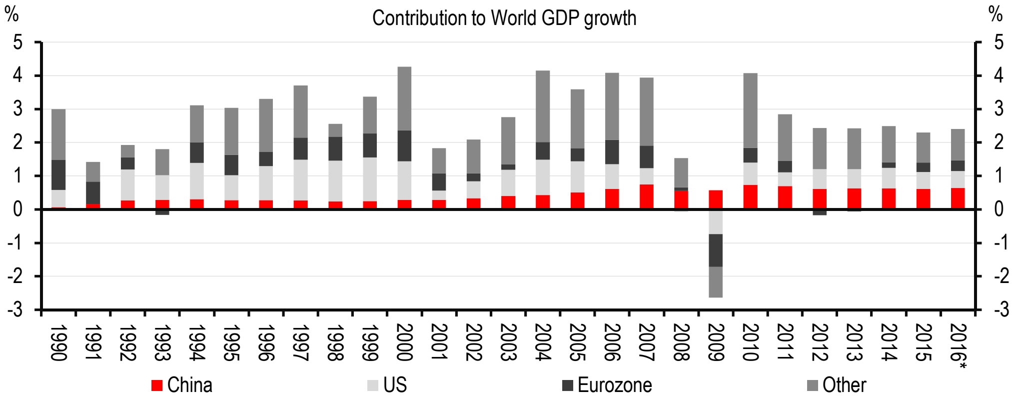
China's role in the world is changing…

These links have become more multi-layered and complex. Whether they concern trade, the flow of capital, technology, the private sector or tourism, it is this deeper relationship with many different countries and industries which now has to be understood, beyond the familiar statistics about copper, chemicals and iron ore. This report sets out to examine these changes and what they mean for China and the rest of the world.

…and its influence is growing

The first chapter looks at how China is now the world's most important economy in terms of growth, now accounting for 12% of global GDP and affecting the health of economies in countries all over the world. The second shows that China is moving up the export value chain and becoming a more influential global consumer of goods and services, both domestically and overseas. Over time, the country will become a greater capital exporter due to more overseas direct investment and portfolio investment. The last chapter looks at a paradox – China is still a poor country despite being the world's second largest economy. This brings large trade and investment opportunities, as well as challenges that require greater opening of both markets and minds.

China's contribution to world GDP growth is holding up as growth slows



Note: Real GDP growth. * HSBC forecast for 2016
Source: World Bank, HSBC

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New drivers for growth

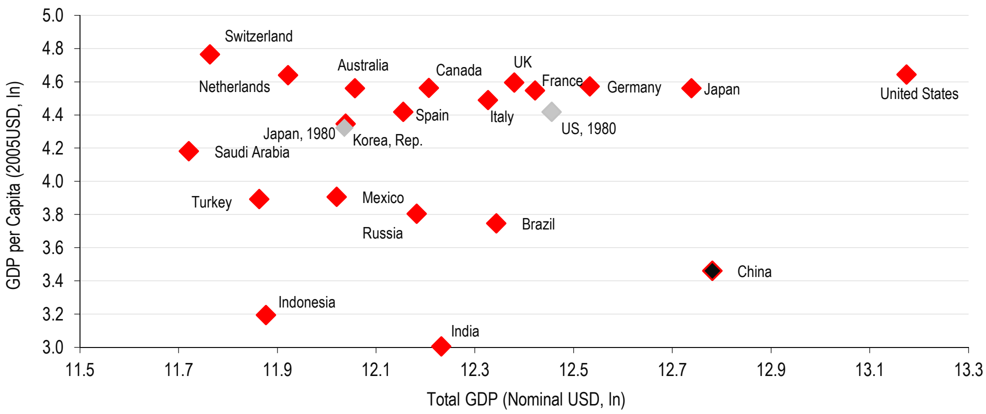
As heavy industry and traditional manufacturing wrestle with slowing demand overseas and overcapacity at home, the new engines of the economy are humming. Social media, cinemas, travel and R&D are driving consumption, services and high-technology sectors. This is where the new links are to be found. As we said, you just have to join the dots. Here are just three examples:

- It's a sunny midweek day in Sydney and Taronga Zoo, scenically positioned on the city's spectacular harbour, would be quiet but for the large numbers of visitors from mainland China. This highlights the rapid increase in Chinese tourists (and students) in Australia and the growth in the number of flights between the two countries. This, in turn, is helping Australia rebalance its own economy away from commodity sales to, yes, China. Look further down the supply chain and we find that in April Airbus and Boeing split an USD10bn order for 35 wide-body aircraft from China Eastern Airlines as the company adds new long-haul routes.
- Chile's ever growing relationship with China is evolving once more. Exports to China accounted for less than 5% of its total at the turn of the century, but that has now grown to more than 25%. With the burgeoning Chinese middle class, these exports are slowly moving from copper to wine, owing to the greater demand from dinner parties, restaurants and bars.
- From soap operas and cosmetics to food and pop music, the Korean cultural wave known as Hallyu is washing over China like never before. The latest smash hit Korean television drama, *Descendants of the Sun*, was streamed more than 2.3 billion times by Chinese fans in April. And now there's another cultural phenomenon to add to the list – cosmetic surgery. These trends have helped the Korean consumer economy recover after the outbreak of Middle East Respiratory Syndrome last year.

From football to investment

Similar micro links can be found in high-end manufacturing, sport, and cinema, in the form of robots, football and corporate hook-ups with Hollywood. Put together with the macro themes of capital flows, investment and trade evident in ambitious projects such as the Asian Infrastructure Investment Bank and the One Belt, One Road initiative to create a New Silk Road by land and sea, the ripples are being felt in almost every corner of the planet.

A big economy, but still a poor one

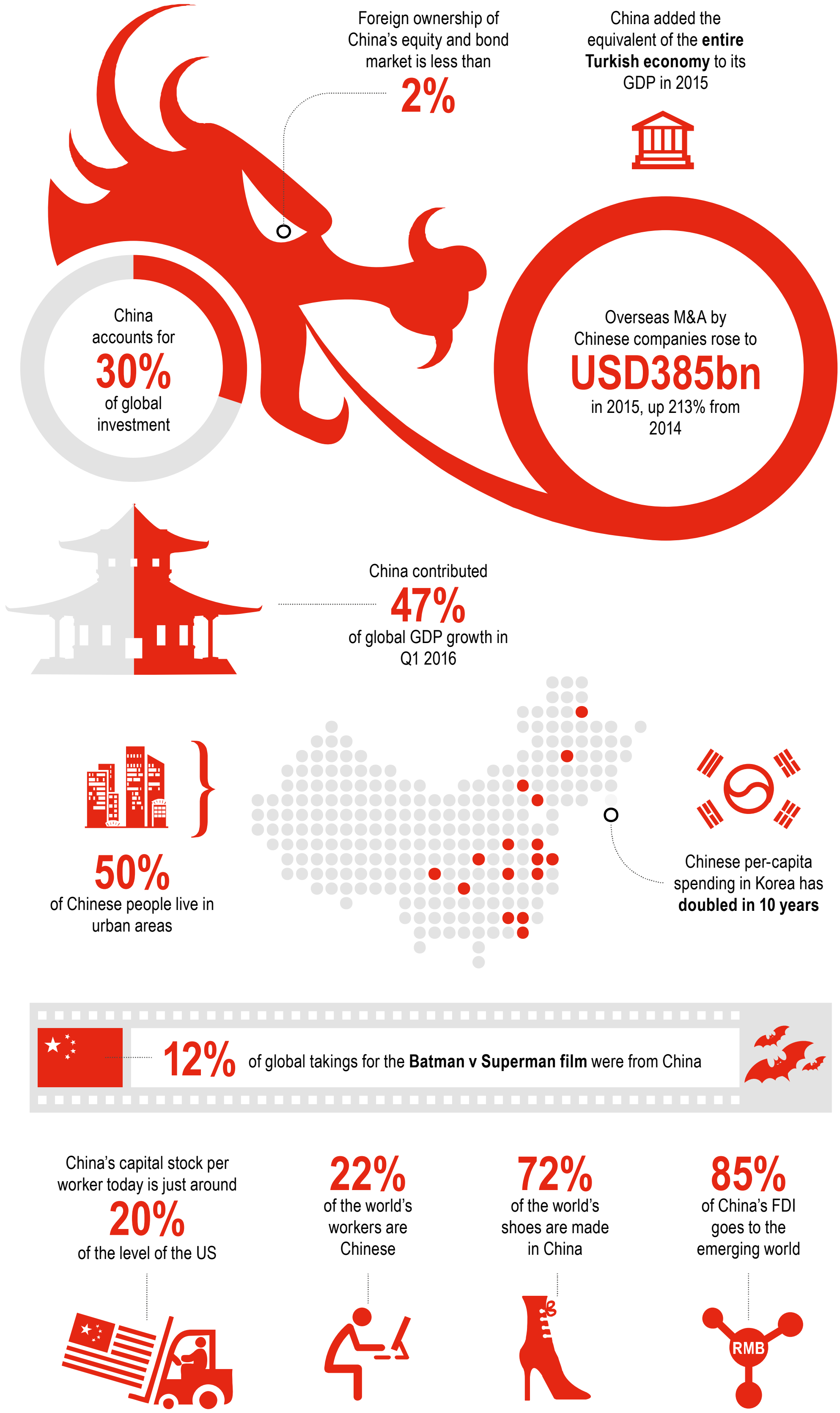


Source: World Bank. Note: ln is natural logarithm of the data

China continues to evolve

The message is clear – China's already formidable commercial power is changing as it finds new markets and creates new channels through which to flow. That is not to understate the importance of the existing links and the near-term challenges facing the country. Beijing is trying to cut capacity in heavy industry without stalling the economy. We believe the leadership will maintain enough policy support to ensure steady growth while pressing ahead with supply-side reforms. But here is the bigger picture - what the new forces at work in the economic, commercial, financial and demographic complexity of today's China mean for the world.

China, trade, and the world



Source: HSBC

Big, bigger, different

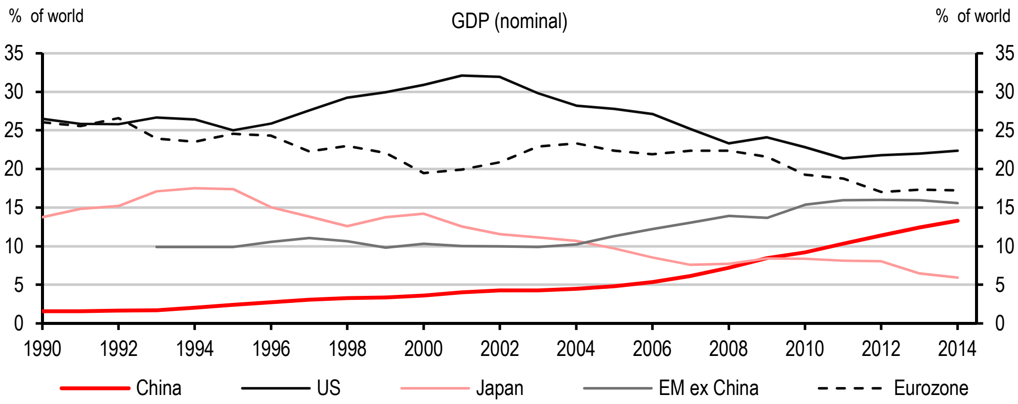
- China is now the world's most important economy in terms of growth
- It accounts for 12% of global GDP and affects growth rates all over the world
- Even as it expands, so the country's economy is changing in ways that have important implications for the rest of the world

Slightly slower does not mean less important

In PPP terms, China is the world's largest economy

China's role in the global economy keeps expanding. Over the past 25 years, it has gone from 11th largest (in nominal USD) to second. The country's economy is now 60% that of the US, up from just 13% in 2000. That means its role in determining global demand is critical. In terms of purchasing power parity (PPP), it is now the world's largest economy. While China's size and pivotal role have long been recognised, an increasingly important part of the story is how its economy is changing and what that means for everyone else.

1. China's role in the world economy is getting bigger and bigger

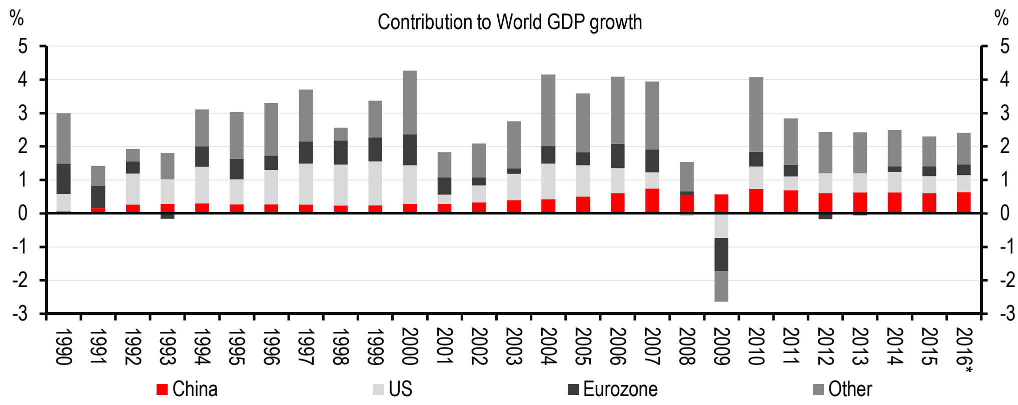


Source: World Bank

China accounts for a bigger share of global growth than Europe and the US combined

China's bigger share of world GDP means that the economy accounts for a large share of global growth despite a slower pace of economic expansion (we expect 6.7% GDP growth in China in 2016 and 2017). Although this is well below the rate of close to 20% back in 2010, China is still the most important source of global demand growth – expected to add more to global GDP than the US and the Eurozone combined. In Q1 2016, China accounted for 47% of global GDP growth.

2. China's contribution to world GDP growth is holding up as growth slows

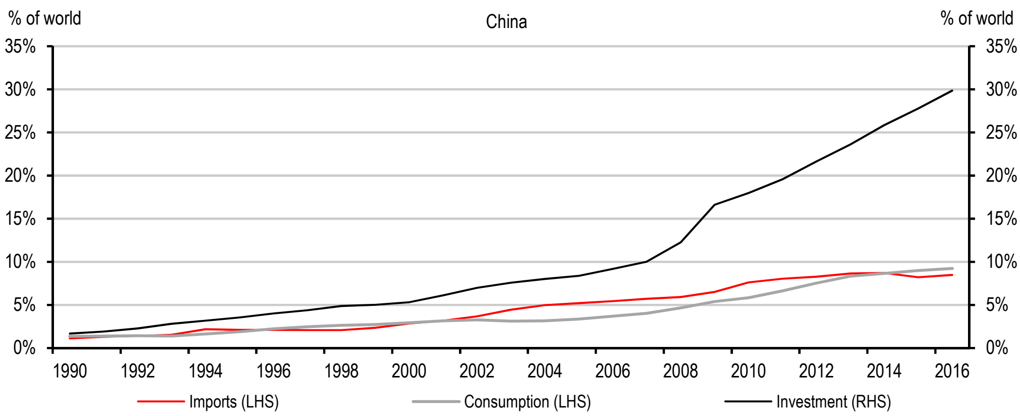


Note: Real GDP growth. * HSBC forecast for 2016
Source: World Bank, HSBC

China accounts for 30% of global investment, but only 10% of consumption

China's role is most evident in terms of investment (chart 3), where it accounts for 30% of the world's total. However, its share of both total imports and consumption is much lower at around 10%. It is here that we expect its economy to develop over the next few years as a combination of relatively fast growth and a rebalancing economy will lead to a more important role in overall global consumption (see *Global Economics Quarterly: The waiting game*, 24 September 2015).

3. China really matters for global investment demand, less so on consumption, for now



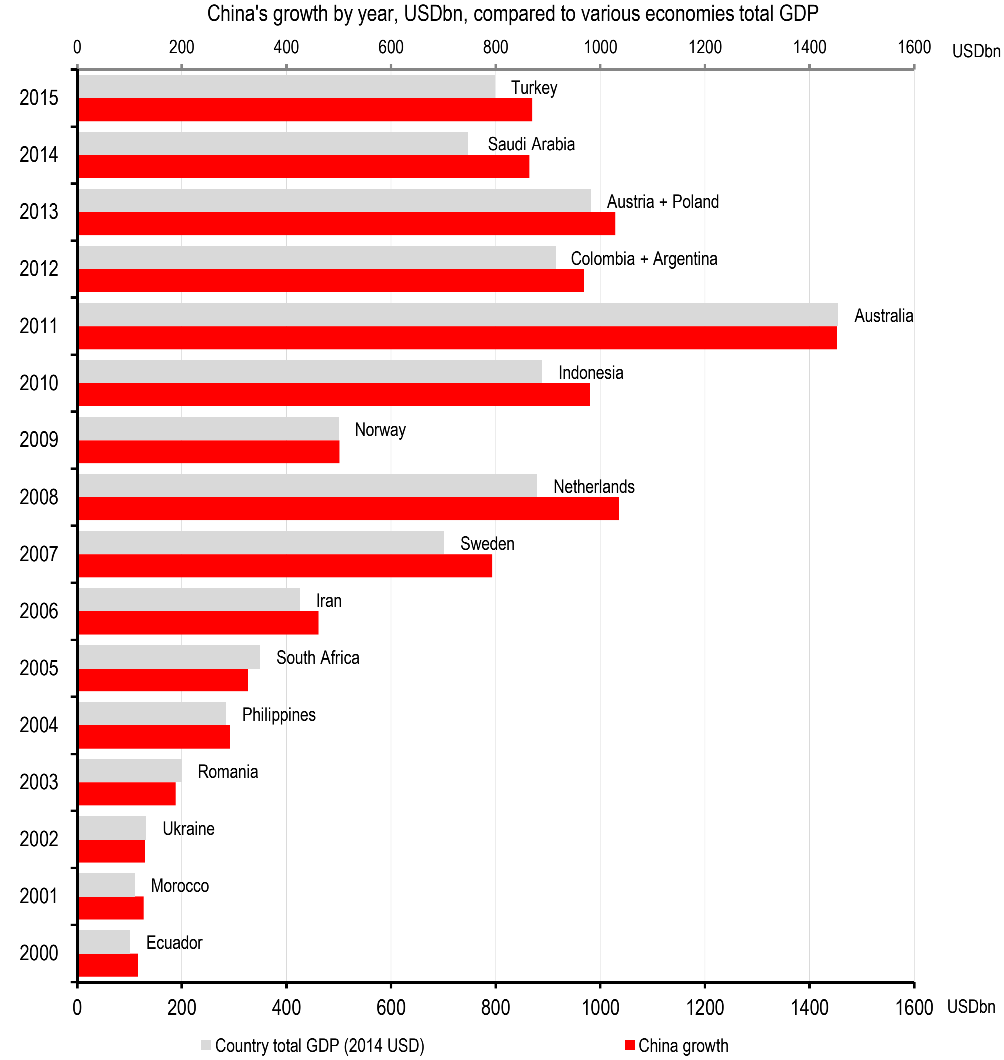
Source: World Bank, HSBC estimates

Growth maths

In 2015 China grew by the equivalent of Turkey

It is rare for an economy that is so large to grow so quickly. Slower, maybe, but the additional dollars of demand that China brings to the world economy are still considerable. In 2015, China added the equivalent of the whole of the Turkish economy (in nominal USD) to its GDP.

4. China added the equivalent of Turkey to global GDP in 2015

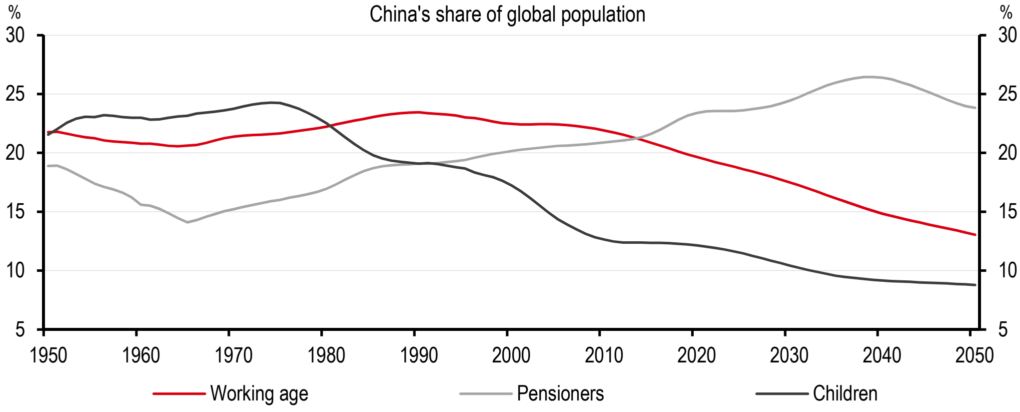


Source: HSBC calculations, World Bank Development Indicators. Note: Red bar is the rise in Chinese GDP, grey bar is respective country's

One in five people live in China

The effect is so great because of the size of China's population; 22% of the world's working-age population reside in China, and 19% of the total. Although demographics are likely to put a brake on growth due to a shrinking working-age population, strong per-capita expansion, coupled with a growing population to date, has made China's economy more important to the world economy. However, the ageing population means that China will account for a larger share of the world's elderly population and a smaller one of the world's workers. Although policy decisions to address the challenge have been made, such as removing the one-child policy, the benefits will not be seen for another 20 years, once fertility rates rise and new children join the workforce (see *An age-old question*, 30 November 2015).

5. China accounts for 22% of both the world's pensioners and workers, for now



Source: UN population division

Trade connections

It is clear that any change in the pace or type of growth China undergoes will have profound implications for the global economy. We've already seen the fallout from the slowdown in the industrial sector on global commodity markets through 2014-16 (although up a bit recently). This is not surprising when China accounts for 12% of global commodity demand.

China accounts for 13% of world commodity imports

The world's factory needs fuel

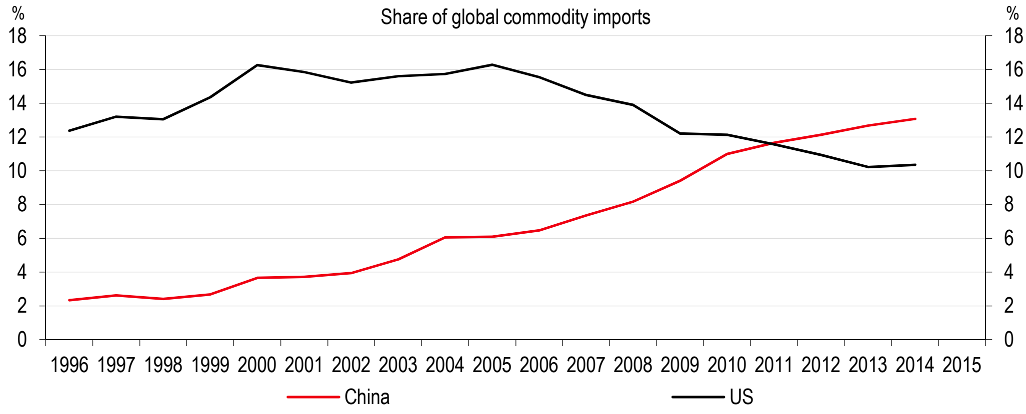
Historically, China's interactions with the rest of the world have centred on its being a manufacturing powerhouse. It accounted for roughly 25% of the world's manufacturing output as of 2015, up from less than 7% in 2000. It was also responsible for roughly half of all global copper and aluminium consumption. Some of this is produced domestically, but much is imported from countries that will be relying on China to maintain its demand.

72%

China's share of global footwear production

This big rise in manufacturing has meant that China now accounts for around 13% of total commodity imports, and even more of certain products (Chart 6).

6. China has become the world's number one commodity importer



Source: HSBC, UN Comtrade. Note: Complete full year data only up to 2014.

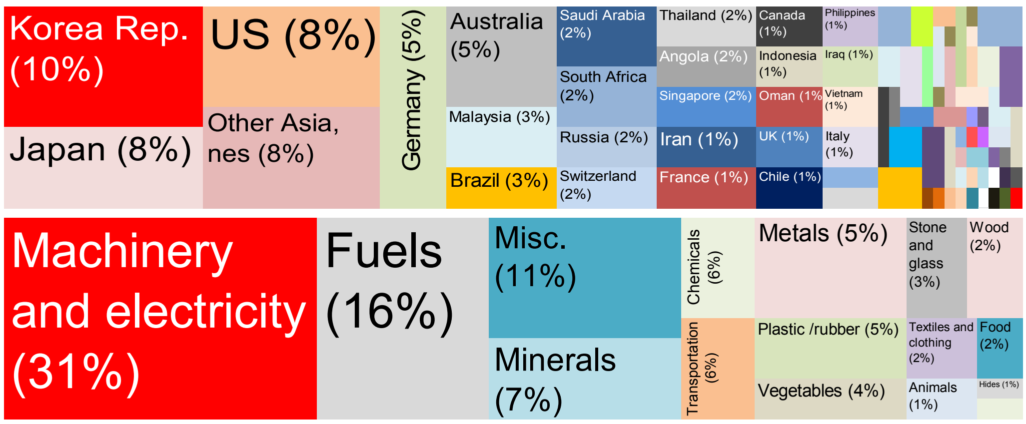
New linkages

China is crucial for the growth rates of many countries

This means that already China accounts for a substantial share of exports for some countries. In table 8 we show how this has changed for a wide selection of countries, not just those close to China geographically. Some 20% of New Zealand's exports go to China, and 18% of Brazil's. Trade exposure is high across Asia but it's relatively low in Europe despite rising sharply since the turn of the century.

Greater trade flows mean that China's role in the growth rates of other countries continues to increase. China's imports are shown in the diagram below: they are largely machinery, fuels and minerals and primarily from other Asian countries, with Korea making up the largest share of China's imports.

7. Chinese imports by market and product



Source: HSBC, produced using data from UN comtrade. Note: Asia, nes stands for Asia, not elsewhere specified

For some countries, China's import share may look insignificant, but switching the data to look at the share of exports by country to China gives a very different picture.

8. The world's exposure to China has increased enormously

	% Exports to China			% Imports to China		
	2000	Latest		2000	Latest	
Hong Kong	34.5	53.9	↗	43.0	47.1	↗
Australia	5.7	33.7	↑	7.8	20.5	↑
South Korea	10.7	25.4	↑	9.4	17.1	↗
Chile	4.7	24.4	↑	5.1	20.9	↑
New Zealand	3.0	20.0	↑	6.2	17.0	↑
Japan	6.3	18.3	↑	14.5	22.3	↗
Brazil	1.8	18.0	↑	2.2	16.3	↑
Saudi Arabia	2.4	13.3	↑	3.9	13.4	↑
Philippines	1.7	13.0	↑	2.3	15.0	↑
Singapore	3.9	12.6	↑	5.3	12.1	↑
Malaysia	3.1	12.0	↑	3.9	16.9	↑
Thailand	4.1	11.0	↑	5.5	16.9	↑
Colombia	0.2	10.5	↑	1.5	18.4	↑
Indonesia	4.5	10.0	↑	6.0	17.2	↑
South Africa	1.1	9.6	↑	3.7	16.2	↑
US	2.1	7.6	↑	8.6	19.9	↑
Russia	5.1	7.5	↗	1.9	15.1	↑
Argentina	3.0	6.6	↑	4.6	16.2	↑
Germany	1.6	5.8	↑	3.4	6.6	↗
India	1.8	4.2	↑	2.9	12.7	↑
Switzerland	1.0	4.1	↑	1.7	6.5	↑
Canada	0.9	3.7	↑	3.2	11.5	↑
France	1.0	3.7	↑	2.3	5.1	↑
UK	0.8	3.5	↑	2.2	8.9	↑
Sweden	2.1	3.3	↗	1.3	5.3	↑
Italy	0.9	2.6	↑	2.7	7.3	↑
Nigeria	0.5	2.6	↑	4.3	25.6	↑
Norway	0.4	2.3	↑	3.1	9.6	↑
Turkey	0.3	1.8	↑	2.5	10.3	↑
Spain	0.5	1.7	↑	2.6	6.1	↑
Mexico	0.1	1.5	↑	1.6	16.6	↑
Poland	0.3	1.0	↑	2.8	6.5	↑

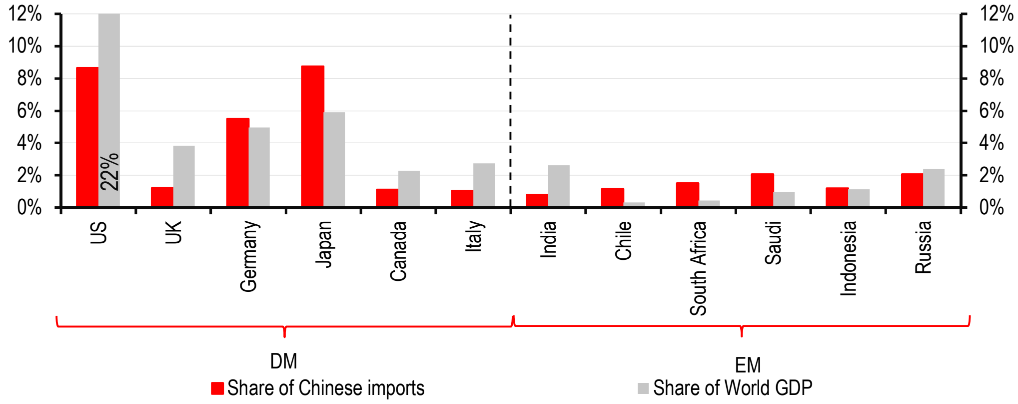
Source: HSBC, IMF DOTS. Note: ↑ shows that share has more than doubled, ↗ is a smaller increase. Ordered by current share of exports to China.

China's impact is being felt mainly in the emerging world

The key thing from table 8 is the speed at which China's role in the performance of other countries is changing. While China's share of global imports has risen from 3% in the mid-1990s to around 9% today, the change so far has been concentrated in the emerging world.
For example, Chinese demand now accounts for roughly a quarter of Chilean exports compared to just 5% back in 2000. It is also striking how low a share of western exports China currently makes up. As chart 9 shows, the emerging markets are, in general, punching well above their weight in terms of their share of China's imports compared to their size in the global economy.

China and Brazil: China has become the number one destination for Brazilian soy beans, which is one major factor leading to deforestation. The huge demand from China (29% of Brazilian soy beans exported to China) has meant an increase in the land used for farming them. In turn this has displaced other agricultural farms, which exacerbates deforestation.

9. China's imports are disproportionately from emerging markets



Source: IMF DOTS, World Bank

Source of so much demand

The pace of Chinese growth matters profoundly to the economies of other countries

And given the huge share of GDP that exports to China now represent in the GDP of some of these emerging markets, China's growth rates will have a profound impact on local growth rates. Using the relationship between Chinese import growth and GDP growth, we can see the impact that a different pace of Chinese growth may have on other countries. For example, Chinese demand may push up Korea's headline GDP by anything between 0.2 and 1.8ppts depending on the pace of growth in China, all other things being equal. This is substantial, and suggests that the world will continue to be reliant on China's domestic economy to spur growth overseas.

10. China's growth rate implications to local growth

Exports to China contribution to local GDP growth for different Chinese growth rates

China GDP growth	12%	10%	8%	6.7%	6%	4%	2%	0%	-2%
Australia	1.0%	0.9%	0.7%	0.7%	0.6%	0.5%	0.4%	0.2%	0.1%
Korea	1.8%	1.6%	1.4%	1.2%	1.1%	0.9%	0.7%	0.4%	0.2%
New Zealand	0.8%	0.7%	0.6%	0.5%	0.5%	0.4%	0.3%	0.2%	0.1%
Saudi Arabia	0.9%	0.8%	0.7%	0.6%	0.5%	0.4%	0.3%	0.2%	0.1%
South Africa	0.4%	0.4%	0.3%	0.3%	0.3%	0.2%	0.2%	0.1%	0.1%
Chile	1.2%	1.0%	0.9%	0.8%	0.7%	0.6%	0.4%	0.3%	0.1%

Note: Shows countries where Exports to China are a large share of GDP. Assumes that Chinese import growth = 3.5%+0.87*GDP growth, based on 20 years of data.
Source: HSBC calculations, UN Comtrade, World Bank.

For most developed markets, where exports to China are a tiny share of total GDP, there is clear scope for the contributions from China to rise substantially and support future growth.

New China, new winners

A developing China will bring new tastes

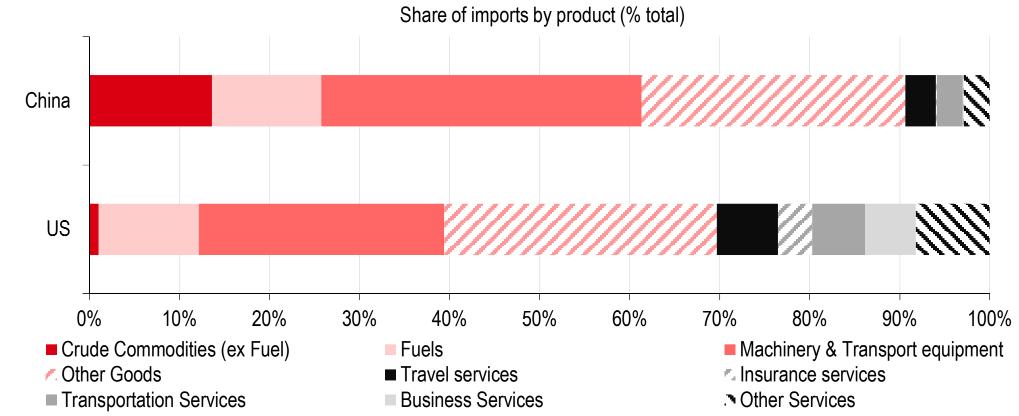
As the Chinese economy develops, this will surely change. The UK, for example, exports a lot of services (12% of GDP) and these primarily go to the US, Germany and the Netherlands. China's imports are largely made up of goods, mainly from other developing countries. As China's demand shifts towards services and higher value products such as pharmaceuticals, this may prove a boost for western economies. Those countries that haven't benefited from a growing China in the early part of this decade are now starting to do so. Just look at growth numbers in countries such as Australia, where the influx of Chinese tourists is having an impact on services exports and headline growth.

We noted earlier that Chile has benefited considerably over the past few decades as China's demand for copper and other metals has risen. Could we expect something similar for developed countries? The changing shape of domestic demand within the Chinese economy, which we outline in the next chapter, will have a profound impact on where benefits from China surface over the next year or so.

Chinese imports are commodity heavy, US imports are service heavy

Look at the breakdown of Chinese imports over the past couple of decades compared to those by the US. There is clearly a trend for them to converge, and we can see which countries should benefit from both future Chinese growth and the changing Chinese tastes. The table in the Appendix shows exports by product for key markets. It is clear which have benefited from Chinese growth over the past few decades: commodity exporters and producers of heavy machinery, which includes much of the emerging world, plus Canada, Germany and even Japan.

11. China's import mix is very different to a developed market



Source: HSBC calculations, UN Comtrade, World Bank

However, on the other side are those countries where there is clear scope to be winners over the next decade or so. The UK stands out here, with services accounting for a much bigger share of exports than all of the traditional China-centric categories. Others that look promising future beneficiaries of Chinese growth are Switzerland, India, the Philippines and France.

Chinese trade restrictiveness is a barrier to global growth

This, of course, depends on whether Chinese markets open up. While China's transition should in theory be good for exporters of higher value products, with the current level of trade restrictions that is not the case. It is currently difficult for some western suppliers to access the Chinese market even though they may be globally-competitive. See *Trading up: Services exports, a bright spot in the gloom*, 21 April 2016.

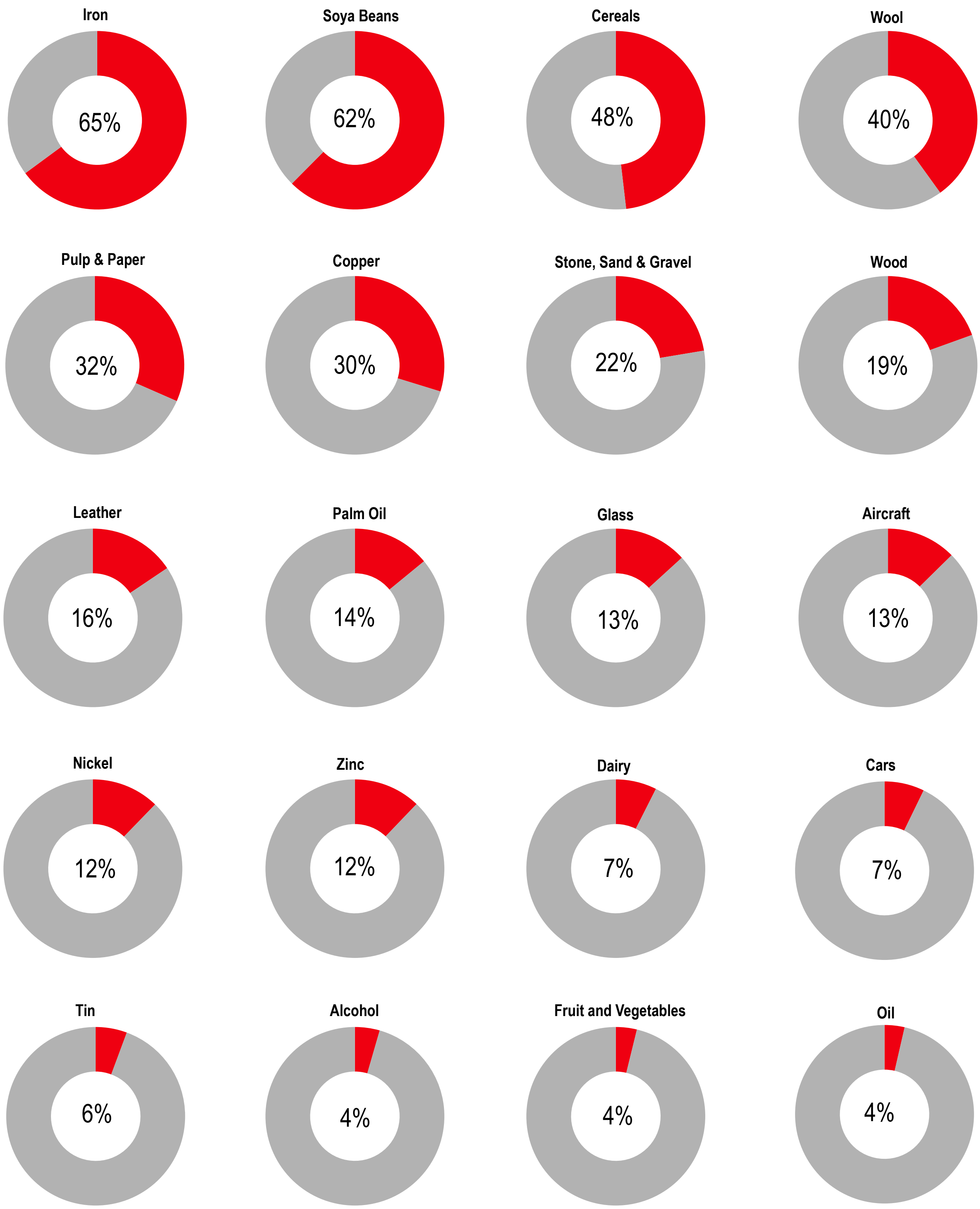
The new influence

A new China

The changing nature of China's interaction with the world is already evident. As we outline in chapter 2, the new-look domestic economy is already opening fresh channels to the rest of the world. From more and more Chinese tourists arriving in London, Sydney and New York to Chinese foreign direct investment (FDI) in Africa, the expanding role China plays in the world is clear.

The reach of China is also influencing various markets we wouldn't associate with China – from football to wine and movies to investment. The new China is extending its influence in the world in ways we haven't seen before, and that trend will only continue.

China's share of global imports of...



Source: UN Comtrade. Note: Data for 2014

Maker, buyer, investor

- From toys to machines, China's exports are moving up the value chain
- Increasingly, China is becoming a more influential global consumer of goods and services, both domestically and overseas
- Over time, China will become a greater capital exporter through more overseas direct and portfolio investment

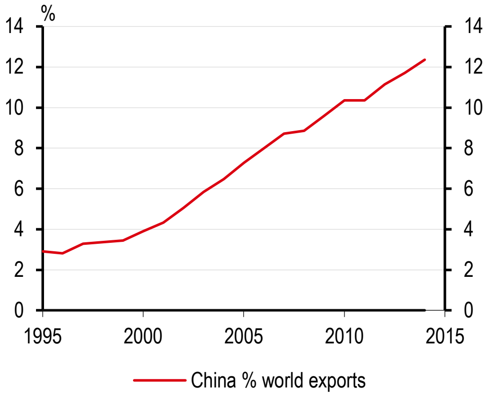
The remarkable rise of China over the past three decades has given rise to many sayings. They include “sleeping giant” and “dragon” awakening and the observation that the country has become “the world’s factory”. And there’s that one that is often used when talking about America – when it sneezes, the world catches a cold. In the previous chapter we discussed many of the developments that have given rise to these aphorisms, but we stressed that it is not purely about size and we pointed to the important changes taking place in China’s domestic economy and its relationships with other economies. In this chapter, we look more closely at those changes, in particular the country’s role as a large exporter, a global consumer and an aspiring investor.

Moving up the value chain

The rise of the 'world's factory'

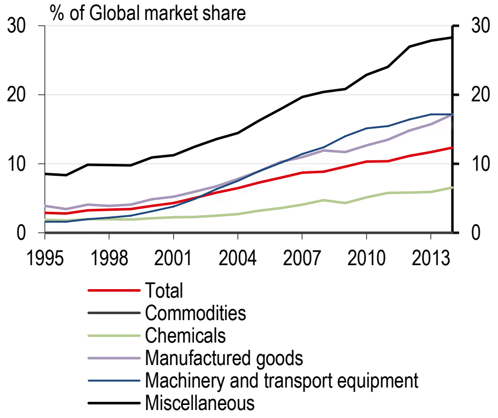
In 2001, two decades after the monumental decision by Deng Xiaoping to 'reform and open up', China joined the World Trade Organisation. Its integration into the global trade system led to dramatic shifts in the patterns of supply and demand in the global trade system, and boosted global trade volume. By the time the Global Financial Crisis struck in 2008, China was producing more than 40% of all men and women's clothing, over a third of all toys and the country’s share of global exports was 8.7% (Chart 12). The temporary disruptions of the crisis notwithstanding, by 2014 that figure had reached 12.4%. No other country, with the exception of the US in the period following the Second World War, has ever been such a large part of the global trade system.

12. Factory of the world



Source: CEIC, HSBC

13. Moving up the value chain

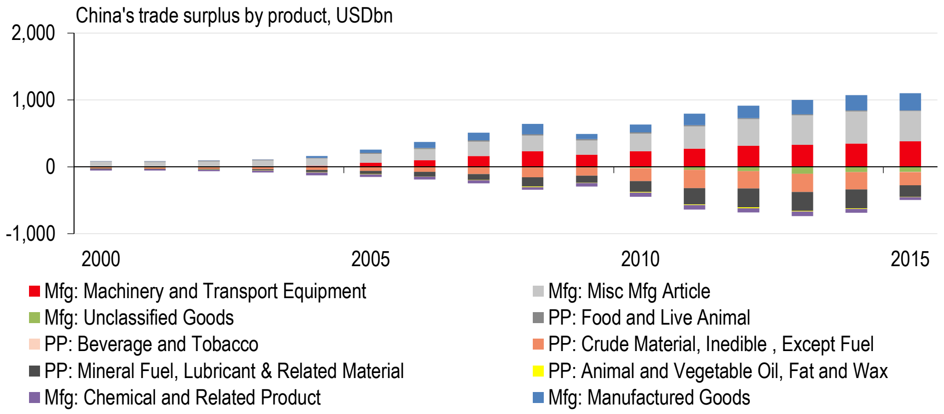


Source: CEIC, HSBC

China's economy is moving up the value chain

The story now is that China has been increasingly moving up the value chain. In 1995, labour-intensive products such as toys and shoes (grey line in chart 13) accounted for 36% of China's overall exports. By 2015, this share was down to 26%. Meanwhile, the share of machinery and transport equipment (blue line) increased from 21% to 46% over the same period. Soon this transition was starting to have a global impact. Chart 13 shows China's world share by product. Although China's world market share had increased quite steadily for most categories of products, it is the improvement in machinery and transport equipment that is the most striking. In two decades, China's global market share rose from a mere 4% to 17%. Incidentally, this is how China has increasingly earned more in terms of trade surplus vis-à-vis the rest of the world (Chart 14).

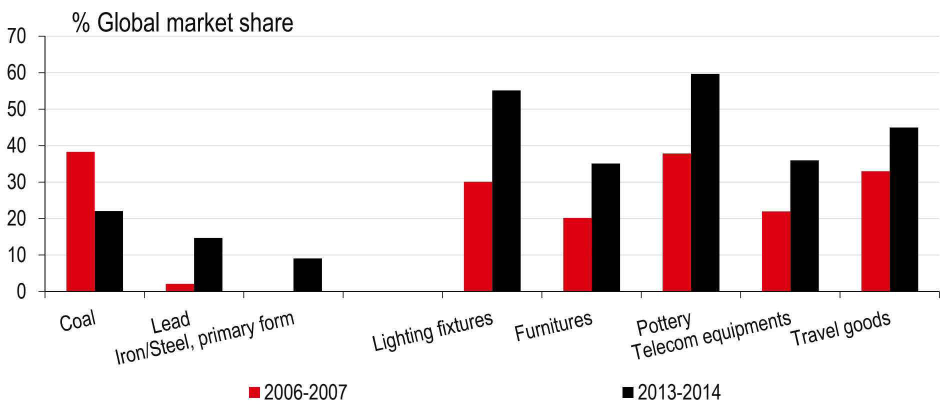
14. Trade surplus by products



Source: CEIC, HSBC

China and Australia: As China's growth shifts from being investment-led to consumer-driven, Australia's economy is shifting its growth from the mining sector towards the non-mining industries. The close ties to China kept Australia from recession through the financial crisis. See: *Australia's next opportunities in China: Moving beyond resources* (4 November 2015) for more information.

15. Gaining some, losing some



Source: CEIC, HSBC. Note: Iron/Steel was 0% in 2006-07. Those on right hand side show gaining market share, those on left show falling and small market shares.

In more recent years, a decrease in China's commodity exports has become another noticeable trend. Chart 15 shows China's declining dominance in the exports of primary commodities and metal products and an improving market share in manufactured goods such as lighting, telecoms, etc.

The transition has only just begun

So, where might China's trade go from here? On most metrics, China's export industry still has much room for improvement. China has recognised that it needs innovation to move up the value chain. It needs to differentiate its products through advances in technology, design or other attributes. The recent five-year plans have included elements related to innovation, R&D and even intellectual property rights. The transition from a low-cost producer to one that increasingly makes more value-add is a longer-term trend that has just begun and it is by no means an easy one. Greater openness to foreign investment, as well as domestic reforms, will help make this process a smoother one.

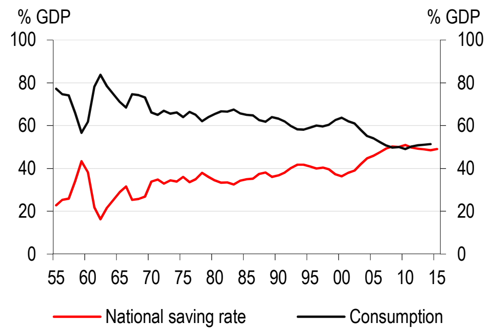
And for other emerging markets, China moving up the value chain creates opportunities. Countries in parts of Africa and Asia with lower costs of production will likely benefit from a production shift away from China and towards even lower cost bases. China's rise up the ladder may pull a few countries with it.

The middle class decade

New-found purchasing power of consumers

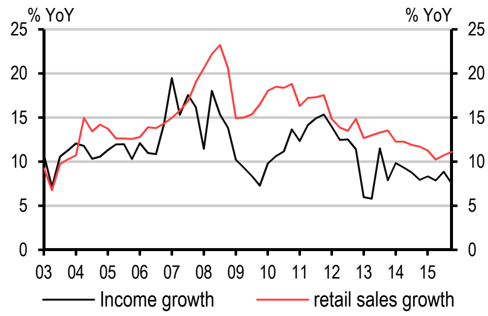
Although China's role as the 'world's factory' is more well-known, in recent years the increasing size of its economy, and rising affluence of the middle class had also attracted global attention. In fact, China has always had a large group of consumers. Chart 16 shows consumption and saving as a share of national GDP since 1955. Before the 'reform and opening up', China had an arguably more consumption-driven economy. In fact, as late as 2000, consumption was as much as 60% of the economy. As a result of a larger industrial sector, consumption's share of the economy then started to decline, to about 49% in 2010, before returning to 51% in 2014. Therefore some of the perceptions of China as a very under-consumed economy where a lot of pent-up demand can be instantly released with the right policies are rather misplaced. Moreover, there have been some signs recently that slower economic growth is putting some cyclical pressures on household consumption growth. From an economic perspective, this is not surprising. After all, a slowing economy weighs on corporate profitability, which may be translated into lower wages and/or employment.

16. The consumers were always there



Source: CEIC

17. Some cyclical concerns



Source: CEIC

60-80% of China's urban population will be 'middle class' by 2025

Despite some cyclical challenges, however, China's consumption is a structural story that is more linked with growth in the economy, and rising group of middle class consumers. In Table 18, we estimate how many more middle class consumers there may be in China over the next decade as a result of continued economic growth. We use a standard threshold that defines urban middle class as earning USD12-50 per day. In 2015, just over 40% of the urban population had an income in this range. Using the conservative assumption that household incomes grow 6.5% per year from 2016 to 2020 and 6% from 2021 to 2025 (compared with 8% in 2015), this implies over 60% (and probably close to 80%) of the population will meet this criterion by 2025.

The less necessary, and fun things in life

18. The rising middle class

Disposal income per capita, by percentile, RMB

	20%	40%	60%	80%	100%
2015	1,798	3,148	4,270	5,709	9,872
2020	2,463	4,314	5,850	7,822	13,526
2025	3,296	5,773	7,829	10,467	18,100

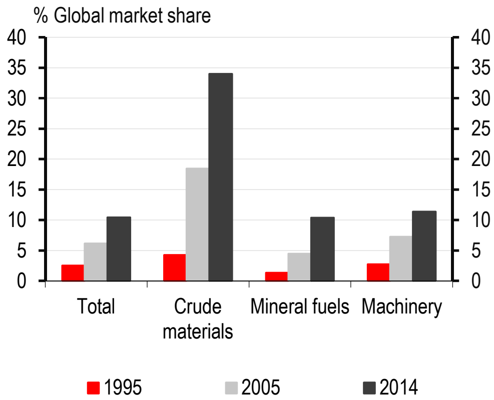
Source: CEIC, HSBC

The implications are large. Chart 19 shows China's share of global imports in key product types.

China's purchasing power has extended into just about every product type over the past decades. Its role as a large consumer is keenly felt in commodities, but it is also a major consumer of general machineries due to large investment needs. Chart 19 shows examples of a few products where China has increased its share of global consumption in recent years.

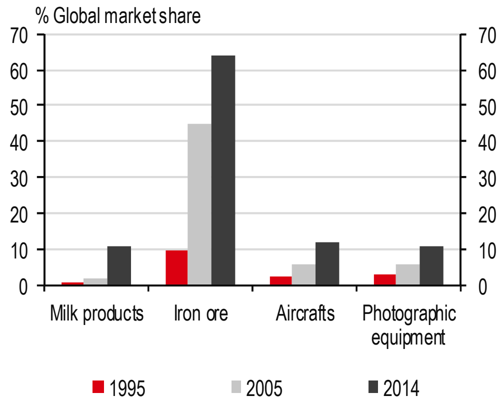
Where do we go from here? What will the new middle class, with their newly gained affluence buy? Think 'consumer discretionary', in other words, the less necessary and more fun things in life. Chart 21 shows a comparison of China vs US consumer spending patterns.

19. China is a large consumer…



Source: UNCTAD, HSBC

20. …with changing import needs

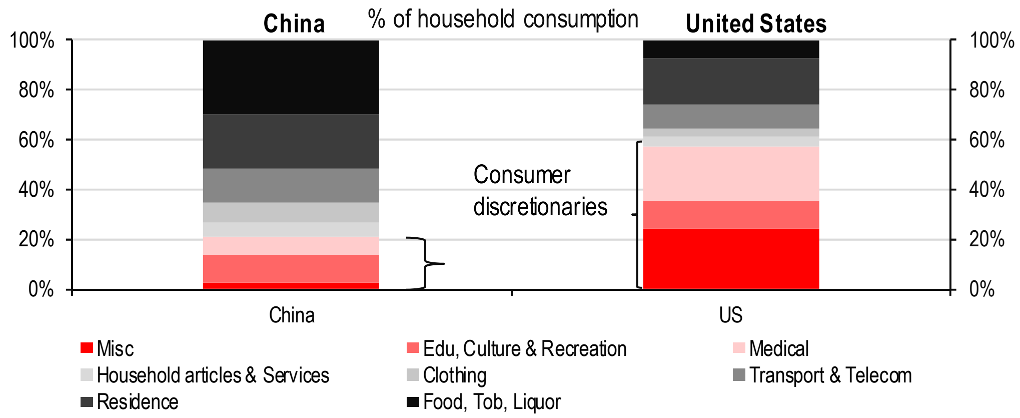


Source: UNCTAD, HSBC

Consumer tastes are changing

For a typical Chinese consumer, food accounts for around a third of monthly expenses. That is followed by clothing and accommodation, making up another third. For the typical American consumer, on the other hand, these items combined take up only a third of total monthly expenses. By comparison, the US consumer spends nearly 40% on education, culture, recreation and a whole host of other miscellaneous activities whereas their Chinese counterparts spend less than 14% on these items. As China’s income levels continue to rise, the larger group of more affluent middle class consumers will increasingly make more discretionary purchases.

21. More discretionary spending



Source: CEIC, HSBC

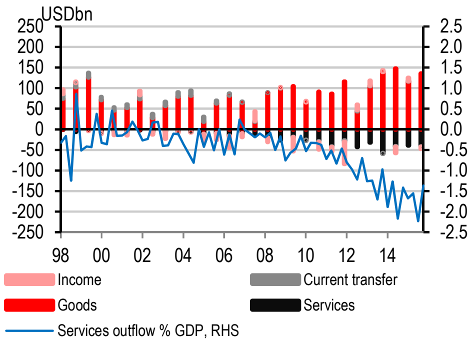
Heading overseas

The Chinese are spending more overseas

One other aspect of consumption that is sometimes overlooked is overseas spending. Domestic consumption is large and growing, but overseas consumption by Chinese consumers is growing at an even faster pace. The increase in the numbers of the middle class in China means that a large part of the global population is experiencing a material impact on its income and tastes. In 2015, 120 million Chinese tourists went overseas.

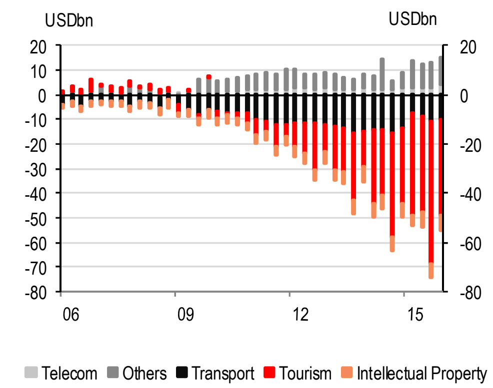
One way to analyse this development is to look at China's Balance of Payment data. Chart 22 shows how these have changed over time. Prior to the 2008-2009 Global Financial Crisis, China's services account was in sizable surplus. But since 2011, this has turned into an increasingly large deficit. As of 2015, services outflow amounted to nearly 2% of GDP. The biggest driver behind the increase in the deficit is tourism spending. Chart 23 shows that the biggest chunk of the deficit comes from tourism, with transport spending a closely related item. This is another trend that will undoubtedly become more important in the coming decade driven by a larger number of more affluent middle class consumers.

22. Don't forget overseas consumption



Source: CEIC, HSBC

23. Mostly tourism



Source: CEIC, HSBC

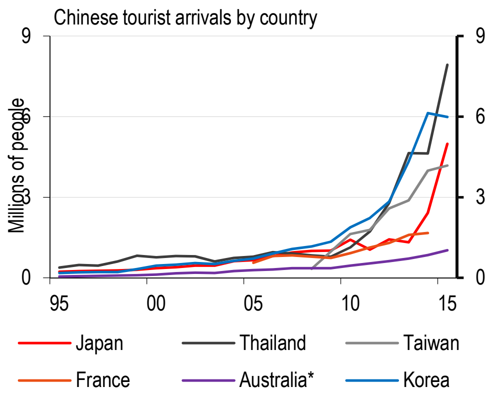
Chinese tourists are heading further afield

Where do they go and what do they spend their money on? Chart 24 shows the top destinations. While most have undergone a dramatic increase since 2011, the fastest growing destinations are Thailand and Japan. Korea is also a popular destination although there has been some moderation over the past few years. As well as visiting larger Asian economies more, there is a clear trend in Chinese arrivals in the Maldives, suggesting that Chinese tourists are holidaying in more luxurious destinations (chart 25).

Given the size of the Chinese population, a small shift in travelling trends can have a profound impact on other economies. Australia is a good example. The number of Chinese visitors has been soaring in recent years, for a variety of reasons such as education, tourism and investment. This has led to a significant improvement in Australia's services exports.

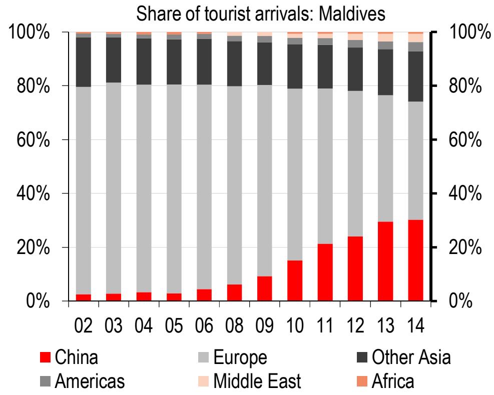
China and India: China's slowdown has helped India. Lower commodity prices give support to growth in the commodity-importing nation, while the shift to a more service-based economy may support India's exports, with just over 4% going to China currently.

24. The usual places



Source: CEIC, HSBC. Note: * National Source

25. As well as visiting more exotic destinations

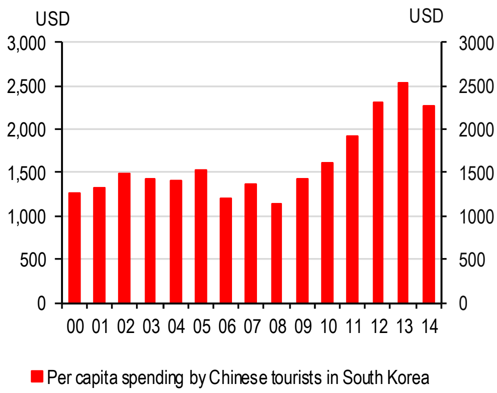


Source: Maldives Tourist board

Combining shopping with tourism

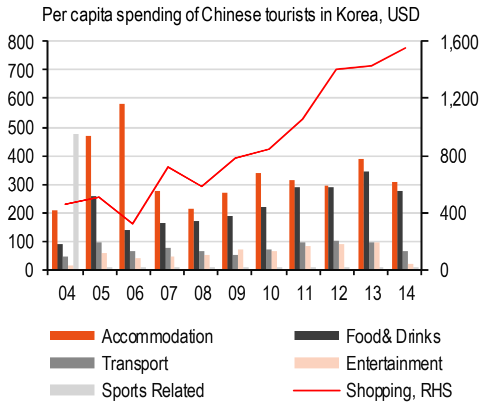
Charts 26 and 27 show the trends in per capita spending and the breakdown by product. Chart 26 shows per capita spending in Korea. Although it has fluctuated over the years, on the whole per capita spending rose an average 6% per year over the past decade. The biggest chunk of spending is 'shopping'. This is not surprising given increasing purchasing power. More interestingly, data also show that consumers are increasingly spending more on accommodation, as well as food and drink. These are signs that consumers are trying to improve the quality of their trip, a pattern that is consistent with their domestic spending habits as well.

26. Spending more…



Source: CEIC, HSBC

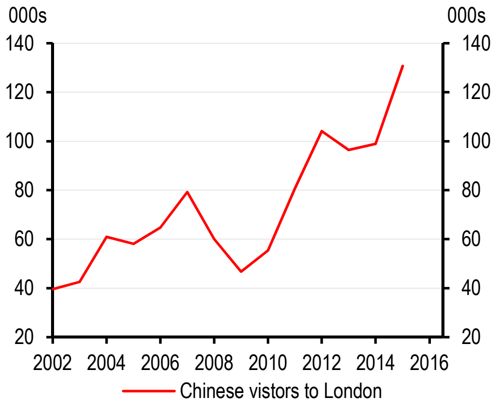
27. …on shopping and on 'experiences'



Source: CEIC, HSBC

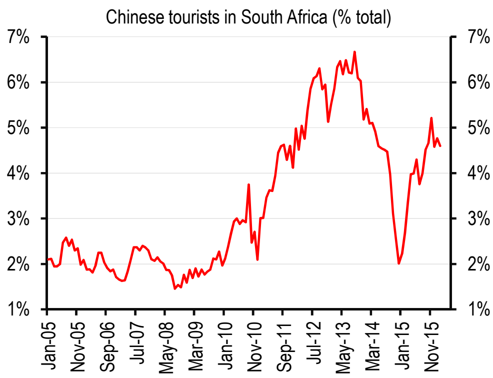
China's rising middle class and their overseas consumption patterns will continue to have global implications. As the economy develops, we would expect more and more tourists to leave the mainland and spend their new found wealth. This is clear already across Asia, but western economies will also benefit over the coming years. Chinese visitors account for only 1% of tourist arrivals in the UK but the uptrend is clear. Equally, as Chinese tourists get richer and start to travel further, a similar trend may start showing in even more exotic destinations such as South Africa, Latin America and even the Middle East.

28. London has more and more Chinese visitors…



Source: www.visitbritain.org

29. …but no impact in some destinations, yet

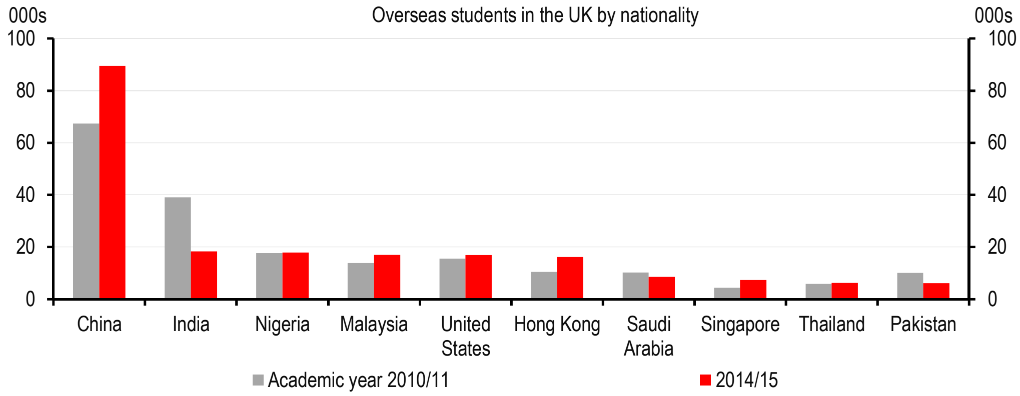


Source: Thomson Reuters Datastream

As we wrote in *The Consumer in 2050*, 15 October 2012, the tastes of populations will shift alongside wealth, and in the transition that China is expected to go through over the next decade, we estimate the amount spent on overseas travel may rise three-fold. This trend is only going to continue and more and more of the world should see the impact of China in terms of tourist arrivals rather than just commodity exports.

As well as tourists, we've seen a big rise in the number of Chinese students overseas. In the UK, Chinese students now account for 29% of the total overseas student population, and a similar number in both the US and Australia.

30. Not just tourists, students too



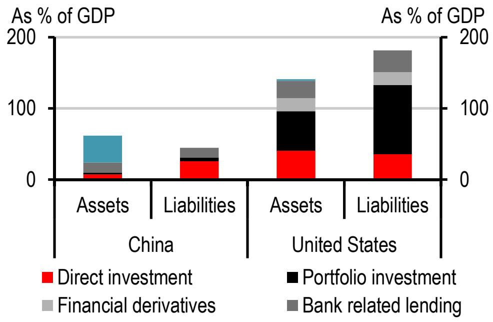
Source: www.hesa.ac.uk

An exporter of capital

An aspiring investor

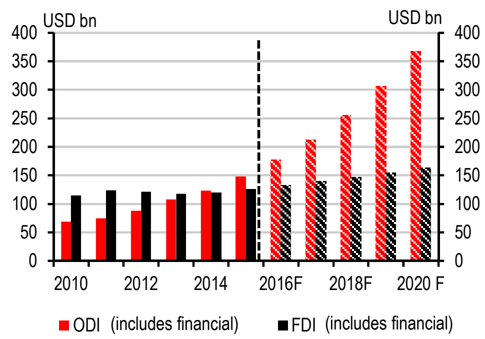
Going to new places and buying new things is one way in which China's capital is being felt overseas. But there is something even bigger going on, and that is China's capital account liberalisation process. China's current account has been convertible since 1992, making it easier for companies to conduct trade-related transactions and a feature that enabled the economy's take-off over the past decades. However, cross-border financial transactions are still largely restricted. There are many potential benefits to a further opening of the capital account. One benefit is to spur the development of the domestic capital markets, which should be better placed to finance the next stage of economic growth as China moves up the value chain, than bank lending. At the same time, financial crises in many emerging markets over the past decades suggest that with opening up, there are more risks. Therefore it pays to be very cautious. Since 2011, Beijing has been taking gradual steps to liberalise the capital account. We have closely followed China's development on this front with a series of reports (see page 34). Here we recap some of the key arguments.

31. A more open capital account…



Source: CEIC, HSBC

32. …to spur outward investment



Source: CEIC, HSBC estimates

Chart 31 shows China's International Investment Position (IIP) relative to that of the US. China's biggest asset is the large stock of foreign exchange reserves, as a result of persistent current account surpluses over the past decades. Other than this, it owns a relatively modest amount of foreign assets, reflecting a limited history of overseas investment by the private sector, including households as well as corporates. Meanwhile, on the liability side, China's largest stock of liabilities is concentrated in foreign direct investment (FDI), reflecting the fact that the economy has been relatively open to investment in the real sector for a while. FDI has played a key role in China's development to date but foreign investment on the portfolio side remains very limited.

The ODI rush

With capital account liberalisation, China will go through a transition that boosts (1) outward direct investment (ODI) by Chinese companies, and (2) inward and outward portfolio investment. Chart 32 shows ODI against FDI growth. Increasingly, Chinese companies are already making more overseas mergers and acquisitions. For example, M&A rose to USD385bn in 2015, up 213% on the year before. Anecdotal evidence suggests that the number of cross-border deals in Q1 2016 has already exceeded the total amount in the whole year of 2015.

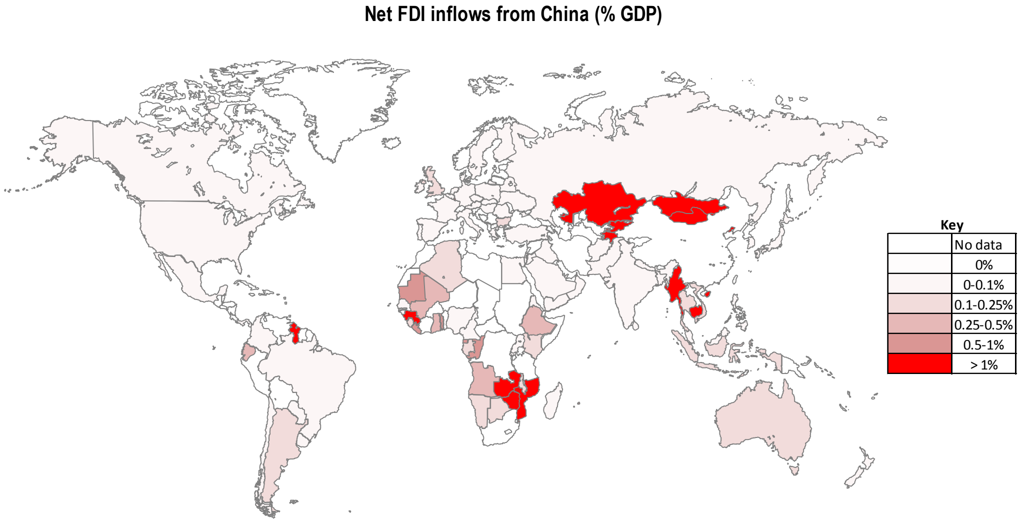
China and Ethiopia: In Ethiopia, Chinese investment has played an enormous role in building up the infrastructure of the country. The Chinese share of FDI in Ethiopia rose from 1.5% in 2000 to 16% in 2009. Industrial output grew by 21.2% in 2014 on the back of Chinese investment into light manufacturing industries.

Where do companies invest? Historically, a lot of energy and mining-related deals were done, reflecting China's large demand for commodities. But in recent years there has been a lot more diversity. Chinese companies are investing in retail, property and financial services, reflecting the growing importance of these other sectors in the economy.

Chinese FDI accounts for a substantial share of some countries' GDP

These overseas investments are already having a considerable impact on many parts of the world. Roughly 85% of China's FDI goes to the emerging world, with some countries receiving a substantial share of GDP as net FDI inflows from China. The map in chart 33 shows that many African countries as well as emerging Asian countries have Chinese investment of around 1% of GDP. For certain larger economies in Africa, such as Angola and Ethiopia, such a relationship has reasonably long standing. As China's economy becomes wealthier and relatively uncompetitive from a manufacturing cost standpoint, there is a greater incentive for Chinese firms to look overseas for manufacturing locations. Ethiopia, for example, has been touted as 'China's China'[1].

33. Chinese FDI is making an impact in other emerging markets



Source: UNCTAD, World Bank, HSBC

The developed world is also benefiting

Parts of the developed world are also feeling the benefit of China's overseas investment. For example, Chinese FDI into the UK increased tenfold between 2005 and 2014. Typically this investment has focused on growth areas such as London real estate. However, recent investment has been more diverse, such as the sale of UK restaurant chain Pizza Express to Beijing-based Hony Capital and Sanpower's USD790m investment in retail chain House of Fraser. Infrastructure investments look set to rise, and Chinese companies were heavily involved in the bidding for London City airport in 2015, before being outbid.

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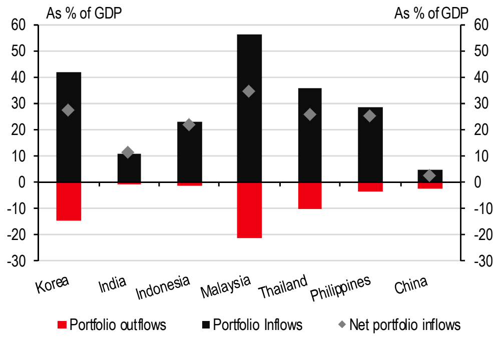
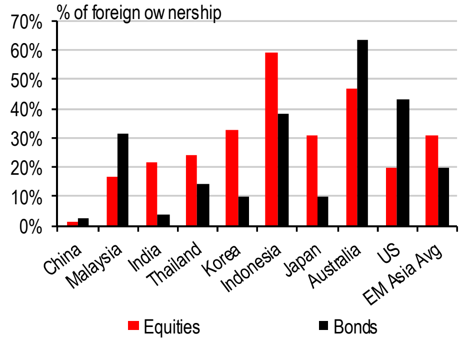
[1] See Ethiopian industry: still banking on China, Financial Times, 7 January 2016

34. Portfolio investment



Source: CEIC, HSBC

35. Two-way flows



Source: CEIC, HSBC

Portfolio investment too, though limited now

Apart from overseas direct investment by companies, portfolio investment by individuals will also feature prominently. Chart 34 shows the total portfolio investment that has gone into and come out of China. As can be expected, China's openness to portfolio inflows and outflows remains quite limited at this stage, reflecting the fact that the existing channels of investment are very restricted. Total inflows are equivalent to 5% of China's GDP while outflows are equivalent to -2.5% of GDP, compared with over 20% both ways for emerging markets with open capital accounts.

That Chinese households, with their large stock of surplus savings, are under-invested in foreign assets is frequently cited. Indeed, FX deposits as a share of total banking sector deposits are only 0.5%, compared with 5% in Korea, for example. At the same time, however, global investors are also significantly under-invested in China. Chart 35 shows inward investment into a country's equity and bond market as a share of its asset markets. To date, foreign ownership of China's equity and bond markets is less than 2%, compared with an average of 31% for equities and 20% for bonds for emerging markets in our sample. Given China's large domestic markets, catching up on the 'openness gap' would already have significant implications for global capital flows. In one of our earlier reports, we assumed that if China reaches 80% of Korea's openness in ten years' time, that would imply an additional USD1.5trn of outflows and USD1.6trn of inflows (see *China Inside Out: Capital account reforms: From people's bank to people's hands*, 2 November 2015).

Moreover, given China's surplus savings status, over time the capital account liberalisation process means that China will become a bigger capital exporter. In other words, going back to Chart 31, while foreign reserves will likely be drawn down in the process of capital account liberalisation, over time China will likely remain a net creditor to the rest of the world, owning more foreign assets than foreign liabilities (compared with the US, for example, which is a net borrower). We are just at the beginning of a very long-term process that has the potential to reshape global capital flows.

New impacts on the world

China now plays a major role in world football

The new shape of China's domestic economy means that Chinese wealth is impacting the world in many new ways, seen on a global level no more clearly than in football with the rise of the Chinese Super League (CSL). In January 2016 the league broke all manner of records in terms of transfers, routinely buying players from all around Europe for transfer fees, and paying salaries that European clubs could not match. Brazilian midfielder Alex Teixeira joined Jiangsu Suning (from Ukrainian club Shakhtar Donetsk) for a fee of GBP37.5m (USD53m) was the stand-out deal so far this year.

36. The Chinese Super league is becoming a major player in world football

Source: Transfermarket.com. Note: *2016 is January transfer window only, other years include summer.

350m Chinese fans watch English Premier League matches

Even for European football the rise in the number of Chinese fans is significant. The English Premier League estimates that 350m Chinese watch matches while in terms of stadium attendances the average CSL team now attracts more fans to its games than do Spain's top flight.

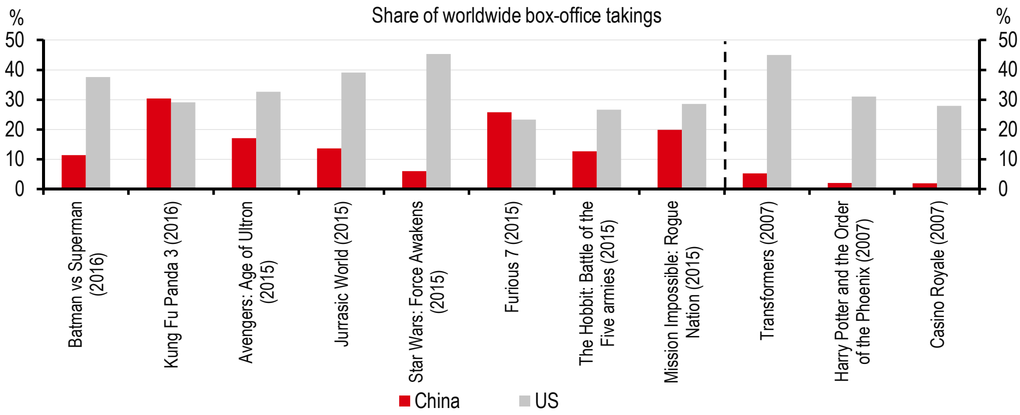
Football also plays a big role in international investment. Chinese investors now own 13% of Manchester City (England), 20% of Atletico Madrid (Spain) and 60% of Slavia Prague (Czech Republic), suggesting that China's influence in the world's most popular sport is still growing ahead of plans to apply to host the World Cup in the not too distant future.

Chinese movie fans are now driving revenues

A starring role

It's not just football. The rising Chinese middle class now accounts for a sizeable share of global box office revenues for Hollywood movies. As recently as 2007, Chinese viewers accounted for just 2% of the global takings for movies such as *Casino Royale* or *Harry Potter and the Order of the Phoenix*. However, in recent years the share has risen to over 10% for most films and appears to be on the rise (eg *Kung Fu Panda 3* hit 30% this year).

37. Going to the movies



Source: Boxofficemojo. Note: Shows selected high grossing US films from the past two years plus some comparisons from 2007.

Box office takings grew 48.7% in 2015 in China

This has come about as a result of the change in tastes of wealthier consumers. The Motion Picture Association of America (MPAA) estimates that Chinese box office takings of US films grew 34% y-o-y in 2014, and local regulators suggest that the pace of growth was even faster, at 48.7% in 2015. China's film market could well overtake North America in the next couple of years, although a large share of that demand is for local films.

Sharing a bottle

Wine demand is back while spirits are lifted

Following the fall in wine sales in 2013-14 as part of the clampdown on corruption, wine imports to China fell quite sharply. But as the middle class continues to emerge, we have seen a continued surge in sales to China, not just from France but also Spain and Chile, while China itself has started to satisfy its own demand by becoming a large producer. For example, Chilean exports of wine to China have doubled in value over the past four years.

Alongside wine, Chinese demand for other alcoholic beverages continues to rise, with beer imports rising 10-15% y-o-y and Diageo, the world's largest spirit maker, claiming that half of the company's sales growth would come from Asia, including China, in the future.

Large but poor

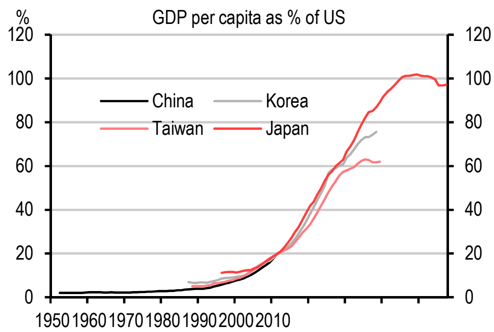
- As a developing economy with per capita GDP of just USD8,000, China still has a lot of 'catch-up growth' to do
- Being both the second largest economy but also a poor country is an unprecedented paradox
- This brings big trade and investment opportunities and challenges that require greater openness of both markets and minds

Still a catch-up story

China is still a classic developing country

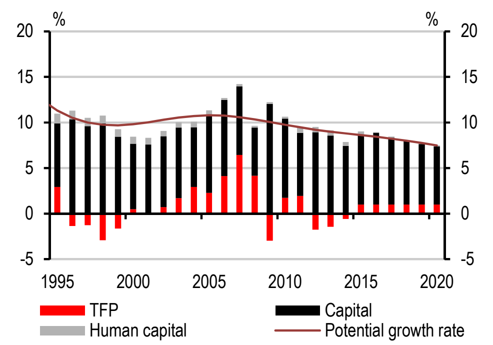
Despite its increasingly large global influence, China is in many ways still a classic 'developing economy'. With per capita GDP at less than USD8000, there are also significant regional variations. The richest province, Tianjin, has a GDP per capita of USD16,189 as of 2014. Affluent cities such as Beijing, Shanghai and provinces such as Jiangsu and Zhejiang are not far behind. On the other hand, Gansu province, for example, has a GDP per capita of only USD4,098. Closing these gaps, as well as the gap between rural and urban income will unleash significant potential that will help China through the next leg of 'catch-up growth'.

38. A classic 'convergence' story



Source: CEIC, HSBC. Note: Shows China so far, and what followed in other countries in subsequent years through 1970 to today

39. Three inputs to growth

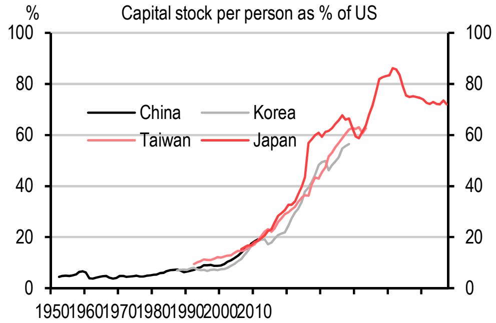


Source: CEIC, HSBC. Note: TFP = Total Factor Productivity

China is like Japan in the 1950s and Korea in the 1980s

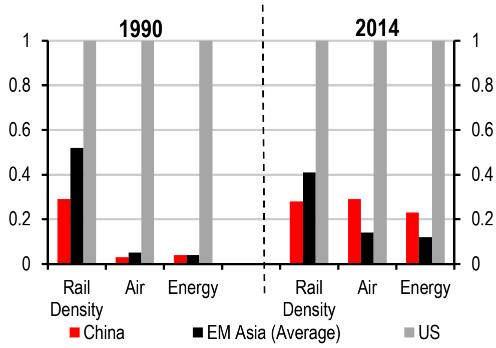
Chart 38 shows the growth in China's GDP per capita over the past decades. In classic growth theory, an economy's potential growth is determined by its distance from the 'frontier economy', or the richest economy in the world. Here we take the US as the benchmark. From this perspective, China has been largely following in the developmental footsteps of the Asian Tigers such as Japan, Korea and Taiwan. Despite China's growing influence, its GDP per capita suggests that its current developmental stage is similar to that of Japan in the 1950s, and Korea in the 1980s.

40. Capital accumulation…



Source: CEIC, HSBC. Note: Shows China so far, and what followed in other countries in subsequent years through 1970 to today

41. ...to close infrastructure gap



Source: CEIC, HSBC. Shows infrastructure density as a share of the US. So US= 1, the others are as a ratio to the US.

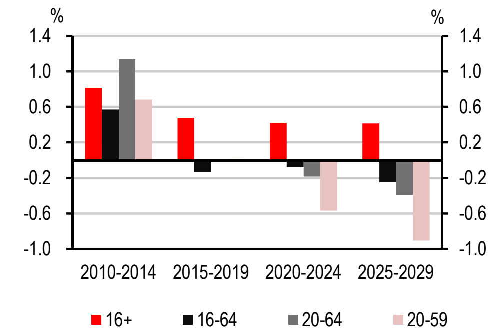
There are plenty of ways to catch up

How would the 'catch-up growth' be realised? Chart 39 illustrates the three classic inputs to economic growth – human capital, capital and productivity. Since the 'reform and opening up', China has largely grown on the back of the accumulation of capital stock as well as improvement in productivity growth. On the ground, the two forces go hand in hand. The opening up of the economy has led to a large inflow of foreign direct investment, from global companies that were keen to leverage on China's labour cost advantage and economies of scale. Increasingly, as we showed in Chapter 2, they moved into more capital-intensive production of electronics and machinery. Factories sprung up to produce the toys, bags and shoes that marked the initial phase of China's export take-off. The job opportunities attracted urban migration that reached a peak of 13 million per year just before the 2008 Global Financial Crisis. Even today, a labourer who moved from the farm to the production chain increased his/her productivity by four times. The differential was likely much bigger back in the 1990s.

The capital stock is still low

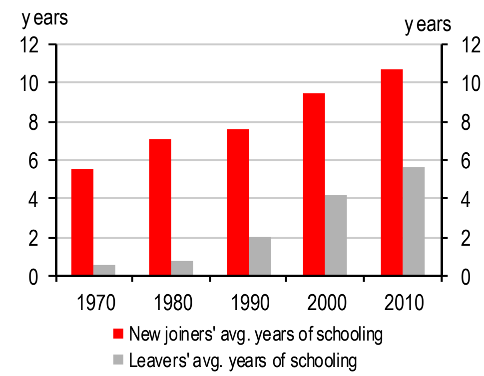
Has this growth model that featured a virtuous interplay of capital accumulation and productivity growth run its course? The data suggest that there is still some way to go. Chart 40 shows that China's capital stock per worker is just around 20% of the level of the US. This is not surprising given China's relatively low GDP per capita. But it is an important reminder that the room for further improvement in the capital stock remains large, as it should be, for a developing economy.

42. China's work force is shrinking…



Source: CEIC, HSBC. Note: Shows annualised change throughout each period in the number of people in each age bracket.

43. …but better educated



Source: CEIC, HSBC

What does this mean on the ground? Chart 41 shows three types of infrastructure capital — rail density, air travel and energy consumption. From being a densely populated and significantly under-developed economy in the 1990s, China has made significant progress in terms of improving its infrastructure. But more is clearly needed. Many look at the kilometres of road and rail track that China builds every year, and suggest that the benefits must increasingly look dubious. But China's population density is amongst the highest in the world, and six times that of the US. Infrastructure investment that improves connectivity in a densely populated economy can yield much higher positive and external benefits to the economy. This is why the per-capita measure is important. On this metric, China still needs to do a lot more, in order to move from a 'developing' to a 'developed' economy.

Demographic drag partly offset by better education

The demographic question is also frequently discussed. The working population (defined as those aged between 16 and 64 years old) will start to contract in 2016 (Chart 42). We expect this pace to pick up modestly to around -0.2% per year in the next five years. This aging process will bring fundamental changes to a society's consumption patterns and lifestyles. But it is the impact on growth that gives rise to the biggest worry. True, an ageing population will subtract modestly from growth. But we need to bear in mind the improvement in the quality of the labour over the past decade. Chart 43 shows the sharp differences between a worker's average years of education over just four decades. As a result of the rapid improvement in educational attainment, China's average years of education have increased from less than 6 years in the 1970s to 11 years in 2010. We estimate that once the return on these education improvements are factored in, the demographic drag lessens by a half (see *China's labour market puzzle*, 23 January 2015).

Urbanisation is the way out

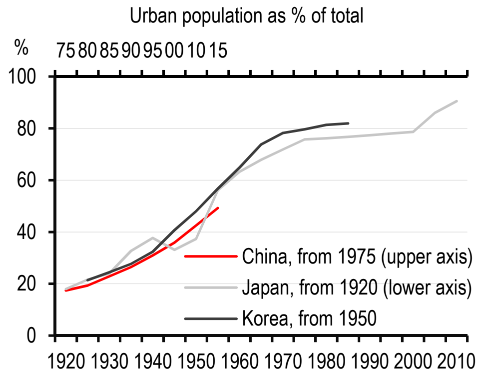
That China has room to grow is not a controversial topic. But many have asked, where will that growth come from? In other words, what are the economic opportunities that will enable China to capitalise on its still under-developed capital and labour force and keep growing?

Another decade of higher-quality urbanisation is key to escaping the 'middle income' trap

The biggest driver is urbanisation. China's urbanisation rate today is just 50%. Within the urban population, around 270m are migrant workers who work and live in urban areas without entitlement to urban social services, such as public housing, healthcare and pensions. Excluding these migrant workers, only 34% of China population are urban residents. That this wave of migration has gone on for more than a decade, moving an average of 7m people per year from rural to urban areas, is a testament to the vast economic force that is at play and the appeal of a better life.

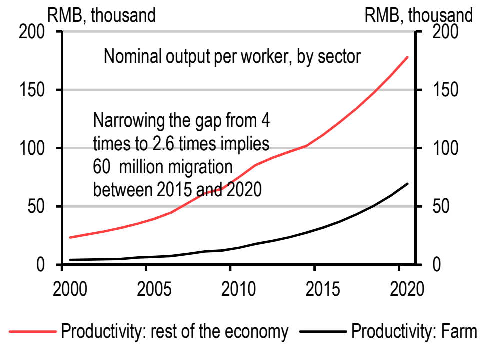
China and Chile: Although 25% of its exports go to China, Chile is changing the mix, with wine exports up more than 30% in 2015.

44. A well-trodden road…



Source: CEIC, HSBC

45. …to higher productivity



Source: CEIC, HSBC

How much longer can this process go? Chart 44 shows the breakdown of rural residents. Around half of the very young rural residents are already effectively working and living in the cities. But there are still 190m rural residents under the age of 40 living and working on the farms. The over-supply of workers on limited agricultural land is a key reason behind China's extremely low agricultural productivity. Escaping this significant 'under-utilisation' is a key push factor behind urban migration.

And the pull factor is better pay in the urban areas. Chart 45 shows the productivity gap (measured by output per worker) in the rural, manufacturing and services sectors. The gap between the rural sector and the manufacturing sector is still as large as five times. The gap between rural and the rest of the economy is four times. The attraction of higher productivity, expressed in higher wages and incomes, will remain a key pull factor behind urban migration.

270m

Number of city workers still to be turned into proper urban consumers

And urbanisation is not just a story about quantity. There is a quality aspect that will increasingly become more important. The 270m workers who live and work in the cities are currently not part of the urban economy, mostly due to outdated administrative restrictions. Gradual inclusion of this group of people into urban life, will help convert them into urban consumers. With rights to purchase public or private housing, and with the ability to relocate their families, these workers can become a more productive part of the urban economy, and particularly urban consumption. Their inclusion will spur demand for more and better public (and private) investment in healthcare, education, old age care, and urban infrastructure. Alongside increasing quantity, improvement in quality of urbanisation also has great potential in supporting China's economic growth in the coming years.

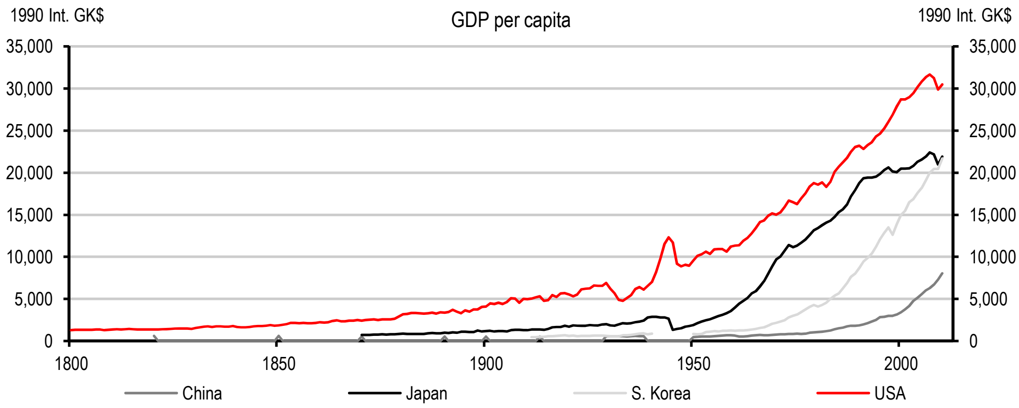
The Chinese government made an ambitious promise to make the economy 'upper-middle class' by 2020. To do this, the economy needs to grow by a minimum of 6.5% per year between 2016 and 2020. From a supply side perspective, there is clearly room to grow further. From a demand side perspective, there are also obvious drivers of growth that can be drawn on.

The paradox

Catching up will further reshape the economic landscape

That China is a classic 'developing economy' is self-evidently clear to any visitor who ventures outside the large metropolises such as Beijing and Shanghai. These developmental needs that must be met in order for China to escape the so-called 'middle income trap' present big, but not unprecedented, challenges to China's policy makers. With the right policies, the next decade of urbanisation, technological catch-up, and the maturing of a better-educated labour force will reshape the economic landscape.

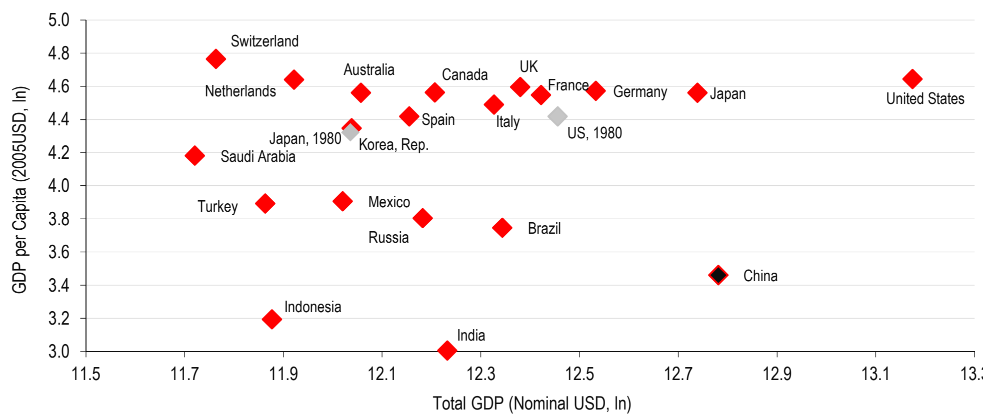
46. China is still poor



Source: Angus Maddison database, HSBC. Note: In Geary–Khamis dollars.

But managing a growing China is not just a challenge for the Chinese policy makers. It is also an unprecedented challenge to the rest of the world. Here is the nub of China's paradox. This is an economy where GDP per capita is still below USD8,000 (on a par with Bulgaria and Botswana). Despite many years of rapid growth, China's GDP per capita is still a fraction of that in developed economies (Chart 46). At the same time however, China's economic mass is already the second largest in the world. In 2015, China's total GDP was USD11trn, equivalent to 13% of global economic output, second only to the USD17trn of the US. The world has never seen an economy as large but also as poor as China (Chart 47).

47. China is both large and poor – a rare case

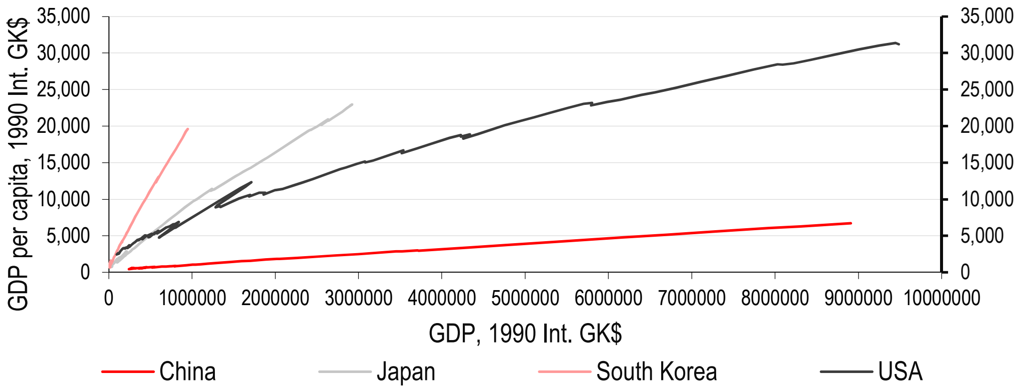


Source: HSBC, World Bank. Note: ln is natural logarithm of the data

Unprecedented challenges and opportunities

Chart 48 puts this in historical perspective. The take-off of the US economy, another large economy but with only a sixth of China's population, came close. But from a historical perspective, the rise in its national wealth was still more or less proportional to its rising income level on a per capita basis. The take-off of the so-called 'Asian Miracle Economies' such as post-war Japan and South Korea, made but a small impact on global GDP, before their per capita incomes converged to the levels of high-income economies. In other words, there is no historical precedent.

48. Unprecedented opportunities and challenges



Source: Maddison database, HSBC. Note: Shows a scatter of total GDP growth and GDP per capita in Geary–Khamis dollars

China's paradox presents more opportunities…

China's paradox of being both large and poor has been at the heart of the many misplaced hopes and scepticisms about its economic model, or indeed its economic future. The staggering size of its economic mass and population often generates much pessimism about its ability to grow even larger. But economic growth has always been about the per capita figure, not the aggregate. After all, China has grown from the 11th largest economy to become the second largest over the past two decades. Yes, it still needs to grow by another 40% before it can become a high-income economy. But the fact that it managed to grow from a per capita income of USD700 in 1996 to USD8,000 today was in itself the most telling lesson in the power of economics. And its size aside, China's developmental path is by and large rather conventional. We have already argued that China can continue to grow by increasing and improving its capital, making more use of its better-educated labour force. There are always going to be difficulties. But that path to economic prosperity is well-trodden.

…that smaller markets cannot see

Therefore a more constructive way of approaching China's trilemma is to work with the challenges and opportunities such a paradox presents. In the previous chapter we discussed what China's changing roles as a producer, consumer and aspiring investor means for the global economy. The scale of the country's economy means that there are big opportunities for international capital to remain involved in China's next phase of development. This natural draw of international capital, as well as the natural urge for Chinese capital to invest outward will be key factors to support global growth in the coming decade. The potential to contribute so much to global demand is beyond the capacity of smaller markets such as, say, Bangladesh or Vietnam.

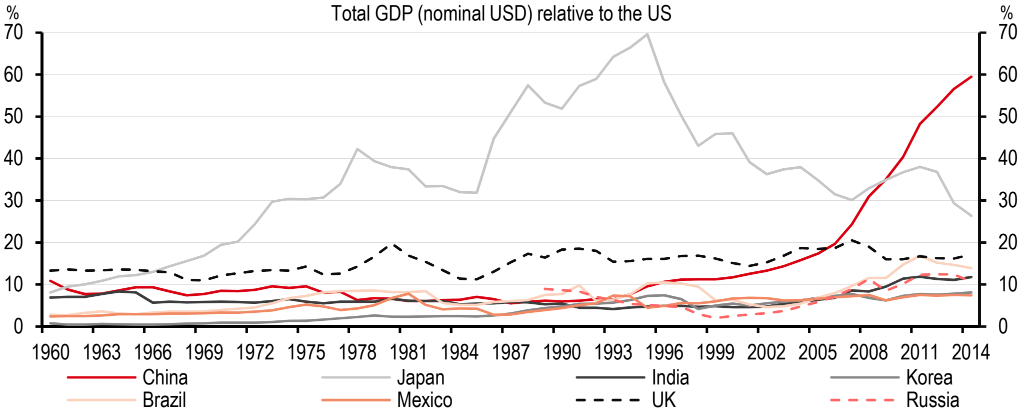
Competition dynamics

A new competitor for the rest of the world

Meanwhile, China's position as a big player in the global economy means that it is now seen as competition by western countries when it was not previously. The consequence is that countries may simply become more protectionist. In a world where global trade remains very weak, this would not be a positive step.

The transition in Japan brought little in the way of international cooperation on the trade front. Faced with internal pressures from domestic producers that could be hurt by greater openness, Japanese-US trade agreements were few and far between, and those that were agreed were often vague and drawn-out. A similar situation may arise from the current election process in the US. Depending on the outcome, it could potentially lead to policies aimed at closing itself off from Chinese trade and competition – this would be to the detriment of both its own and global growth. History suggests that extensive cooperation between China and the US may be hard to come by.

49. China's rise to global power is closest to Japan's move in the 1980-1990s



Source: World Bank

Openness is key

China needs to open up more for the world to feel the benefits

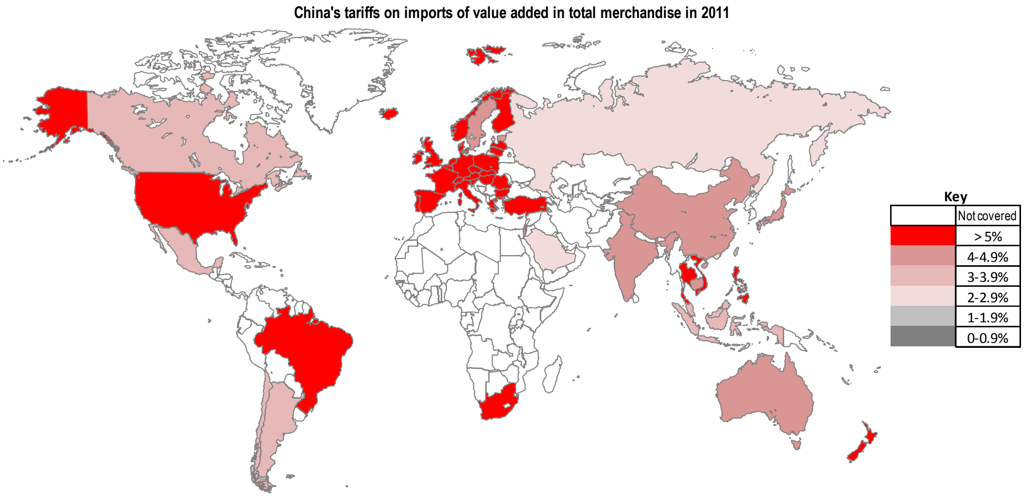
The future role of China in the global economy and the breadth of its influence will depend very much on how politicians react to these challenges. A large, competitive economy could be seen as a threat, but it could also be seen as an opportunity, with a wealthier consumer that's ready to import foreign goods too. China's involvement in trade deals such as the upcoming expansion of the ITA, the expected ratification of the Trade Facilitation Agreement and, subject to its completion, the Regional Comprehensive Economic Partnership are all steps in the right direction.

50. China's trade restrictions were very high…

Source: WITS
Note: Trade-weighted average applied tariffs

Back in 2000 China's trade restrictions were very high (chart 50). But as the economy has grown in prominence, things have started to move in the right direction (chart 51). China's entry into the WTO in 2001 and subsequent international treaties have meant that trade flows have been able to improve. For example, in 2000 Brazil faced an extremely high 41% average tariff across all products and shipped only USD553m in goods to China. In 2011, the tariff dropped to an average of just 2.3% and Chinese imports from Brazil increased to USD14bn.

51. The trade door opens wider



Source: WITS
Note: Trade-weighted average applied tariffs

China can do more to lift trade barriers with developed markets

If more can be done on this front, and China can bring down trade barriers with developed markets as it has with the emerging world, then its economy may be able to play an even bigger role in supporting global growth. For more on China's role in global value chains, see *Trading up: Revitalising Asian trade links*, 2 March 2016.

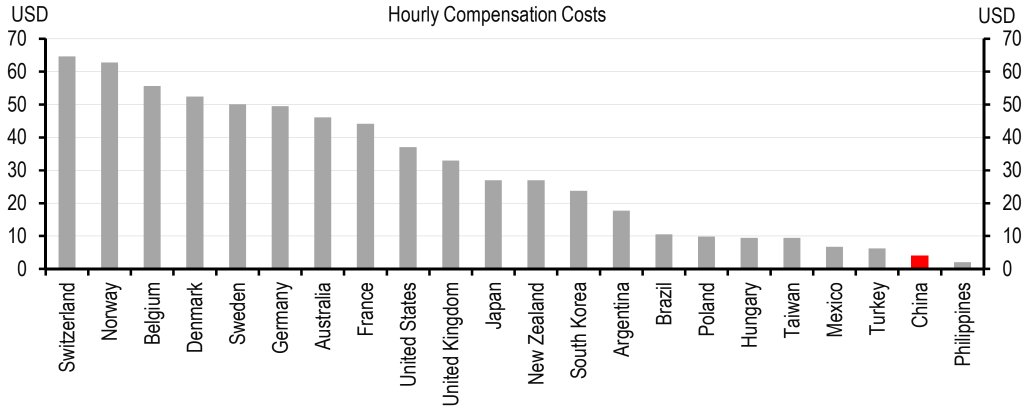
Policy implications

China's future growth and relationships with the world will have profound implications for central banks and governments.

China put disinflationary pressure on the rest of the world

One of these is prices. As we've argued, China's economy can still provide low costs of production compared to other markets, as shown in chart 52. This helps keep global goods prices down. As China's role in the world economy continues to grow alongside its share of global manufacturing production the competition that international companies now face will continue to increase. Improvements in logistics and transportation mean that Chinese products will enter the global market in greater numbers.

52. It's still very cheap to produce in China



Source: Conference Board. Note: Data for 2014.

This has been a key factor in the very low goods price inflation in many developed markets. Even before the fall in the oil price, goods prices were falling year after year, holding back headline inflation rates. This effect is likely to remain.

Global producers need to be competitive in China

At the same time, with China becoming a bigger and bigger market for the exports of goods, there will be pressure on firms all over the world to control costs. To compete when selling into the Chinese market, companies will need to keep prices down to appeal to the lower-income Chinese consumer. This is already happening with technology products: Apple, for instance, has released a cheaper version of the iPhone to gain market share in China. Simply put, a large, and relatively poor, China will continue to bring disinflationary pressure to the rest of the world unless its own domestic inflation rate rises sharply.

Some central banks may need a rethink

For central banks that have prices as a policy priority, this creates a headache. Some, such as Sweden's Riksbank, are already deliberating changing their mandates in response to structurally low inflation. In countries where the domestic economy is able to generate inflation, central banks may be unable to raise rates due to lower global inflation (see *Fed & the global economy: Why the global output gap will slow US rate rises*, 14 December 2015).

Conclusion

China already plays a major role in the world economy, primarily by driving commodity prices and demand for emerging market exports. And its role is set to get both bigger and broader. The growing wealth of Chinese consumers is set to continue and with it will come more services, imports and new interactions with the world economy.

For this to happen to the fullest extent there needs to be more openness. The Chinese economy needs to open more to the world and trade barriers need to be lowered. Only then will we see the true impact of the new China.

Appendix: Recent China and global economics publications

China

Is Beijing shifting its policy stance? 11 May 2016
https://www.research.hsbc.com/R/29/LxQStGm4QIut

China Inside Out - How worrying is China's debt? 21 April 2016
https://www.research.hsbc.com/R/29/vjf7nCh4QIut

China economic spotlight – how monetary easing works, 20 April 2016
https://www.research.hsbc.com/R/29/lnbCmpQ4QIut

Supply side reform isn't enough for China, 6 April 2016
https://www.research.hsbc.com/R/29/JvfsNCk4QIut

Asian Economics Quarterly – this may take a while, 7 April 2016
https://www.research.hsbc.com/R/29/RJldWDV4QIut

On the New Silk Road IV – Why China's overseas investment will keep growing, 18 March 2016
https://www.research.hsbc.com/R/29/BGpfntR4QIut

NPC: The main messages – Policies to support growth and reforms, 17 March 2016
https://www.research.hsbc.com/R/29/FrJqzn74QIut

China – Managing the cost of supply-side reforms, 11 March 2016
https://www.research.hsbc.com/R/29/pF6XKHv4QIut

Don't sweat China's demographics, 18 March 2016
https://www.research.hsbc.com/R/29/KWF2b7n4QIut

China Economics and Currencies: The rise of the Redback V - 31 March 2016
https://www.research.hsbc.com/R/29/jnMdcxp4QIut

Global

The rise of protectionism – Trading Up Special, 12 May 2016
https://www.research.hsbc.com/R/29/RmcCv9t4QIut

Global PMI wrap-up – struggling for growth, 5 May 2016
https://www.research.hsbc.com/R/29/Fbzgbnk4QIut

The demographics divide – Which emerging markets will grow old before they get rich? 4 May 2016
https://www.research.hsbc.com/R/29/CKDQfCK4QIut

Macro Health Check – Not out of the woods, 18 April 2016
https://www.research.hsbc.com/R/29/DlSlzNM4QIut

Global economics quarterly – Growing pains, financial strains, 23 March 2016
https://www.research.hsbc.com/R/29/gMBjbSb4QIut

The world economy's slow puncture – the deflationary trap and the difficult escape, 15 March 2016
https://www.research.hsbc.com/R/29/sBKhPLv4QIut

Global commodities – Oversupplied, but for how long? 4 March 2016
https://www.research.hsbc.com/R/29/STHMLGK4QIut

Oil prices and the world – the ups, the downs and the future policy implications, 1 March 2016
https://www.research.hsbc.com/R/29/FPfzQSc4QIut

Appendix

Exports by product

	Services	Of which:										Goods	Of which:									
		Transportation	Travel	Communications services	Construction services	Insurance services	Financial services	Computer and information services	Royalties and license fees	Other business services	Other		Food and live animals	Meat and meat preparations	Crude materials, inedible, except fuels	Mineral fuels, lubricants and related materials	Animal and vegetable oils and fats	Chemicals	Manufactured goods	Machinery and transport equipment	Misc. manufactured articles	Unclassified goods
North America																						
US	30.3	4.0	7.5	-	0.2	0.7	-	0.8	6.1	5.4	5.6	69.7	4.9	0.8	3.7	6.7	0.1	9.1	6.6	24.0	6.7	7.0
Canada	15.3	2.4	3.2	0.6	0.1	0.4	0.8	1.5	0.6	4.9	0.8	84.7	7.1	1.0	7.6	23.5	0.5	6.9	9.6	21.8	3.7	3.1
Asia																						
China	9.4	1.8	2.4	0.1	0.7	0.2	0.0	0.6	0.0	3.4	0.0	90.6	2.3	0.1	0.6	1.3	0.0	5.2	15.6	40.8	24.6	0.1
Japan	18.9	5.0	1.4	0.1	1.4	0.2	0.5	0.2	3.8	5.9	0.4	81.1	0.5	0.0	1.3	1.8	0.0	8.4	10.4	47.4	7.1	4.3
India	32.2	4.1	4.1	0.4	0.2	0.6	1.5	14.0	0.1	5.6	1.7	67.8	6.8	1.1	2.2	13.2	0.2	8.5	16.4	10.4	8.9	0.2
Australia	18.4	1.9	11.1	0.4	0.0	0.2	-	0.5	0.3	2.7	1.2	81.6	9.6	3.6	28.1	22.1	0.2	4.0	5.0	4.6	1.7	2.8
Korea	15.4	6.0	2.0	0.1	2.5	0.1	0.5	0.1	0.7	3.0	0.4	84.6	0.7	0.0	0.9	7.6	0.0	10.1	11.3	46.7	7.1	0.1
Indonesia	11.8	2.0	4.6	0.8	0.3	0.0	0.2	0.1	0.0	3.3	0.4	88.2	6.1	0.0	6.5	25.9	11.2	5.8	11.6	10.7	10.3	0.0
Malaysia	16.8	2.4	9.2	-	0.5	0.2	0.2	1.1	0.1	3.0	0.1	83.2	2.8	0.0	1.9	18.4	6.0	5.7	7.4	32.7	7.9	0.4
Thailand	19.8	2.8	12.9	0.2	0.2	0.1	0.1	0.0	0.1	3.1	0.2	80.2	10.2	1.0	3.5	3.8	0.2	9.2	10.3	33.8	8.1	0.0
Hong Kong	17.0	4.7	4.2	0.2	0.0	0.1	1.8	0.1	0.1	5.6	0.1	83.0	1.1	0.3	0.5	0.2	0.0	2.9	8.5	53.5	15.8	0.1
Philippines	33.8	3.0	6.5	0.8	0.1	0.1	0.1	4.9	0.0	18.1	0.1	66.2	4.6	0.1	4.3	2.0	1.6	2.4	5.9	38.4	6.8	0.0
Singapore	24.3	8.7	3.8	-	0.3	0.6	3.2	-	0.3	4.9	2.5	75.7	1.2	0.0	0.5	12.8	0.1	9.9	3.1	35.1	7.0	6.0
New Zealand	28.8	5.6	15.7	0.6	0.0	0.1	0.5	0.8	0.7	3.7	1.1	71.2	36.1	8.1	7.8	2.1	0.2	3.3	4.9	4.1	2.4	2.4
Western Europe																						
Germany	15.8	-	-	-	-	-	-	-	-	-	-	84.2	4.0	0.7	1.4	1.9	0.2	12.5	10.5	40.3	8.8	4.1
France	32.1	6.4	7.2	1.0	0.5	1.2	1.0	1.0	2.0	11.3	0.5	67.9	6.3	0.6	1.5	2.7	0.2	12.4	7.6	26.9	8.0	1.8
Italy	18.1	2.5	7.2	1.1	0.0	0.4	0.4	0.4	0.7	5.0	0.3	81.9	4.9	0.5	1.0	3.1	0.4	10.3	15.6	29.5	14.9	1.8
Spain	29.5	4.9	12.3	0.5	0.9	0.3	1.1	1.4	0.2	7.2	0.6	70.5	8.7	1.4	1.7	4.7	1.1	9.9	11.0	22.5	6.8	2.8
UK	42.8	5.2	5.1	1.2	0.4	3.7	9.0	2.0	2.0	13.0	1.3	57.2	2.5	0.3	1.2	6.8	0.1	9.3	5.8	21.9	7.7	1.7
Norway	25.9	10.7	3.2	0.8	0.3	0.2	1.4	0.8	0.2	8.0	0.3	74.1	5.9	0.0	1.2	48.0	0.1	2.0	5.4	6.9	2.0	2.6
Sweden	29.5	4.7	4.3	0.9	0.4	0.4	0.6	3.6	2.6	11.6	0.4	70.5	3.7	0.1	4.9	5.7	0.1	8.2	12.9	25.9	5.9	3.0
Switzerland	26.5	1.8	4.8	0.4	-	1.6	4.8	-	5.5	7.2	0.6	73.5	2.1	0.0	0.6	1.1	0.0	28.8	6.2	14.3	18.8	1.4
CEEMEA																						
Poland	18.6	5.4	5.3	0.3	0.8	0.2	0.2	1.1	0.1	4.9	0.3	81.4	8.6	2.0	1.9	3.3	0.2	7.2	16.1	30.8	11.2	0.1
Russia	11.7	3.6	2.4	0.3	0.9	0.1	0.2	0.4	0.1	3.4	0.3	88.3	2.7	0.0	2.8	61.9	0.4	4.3	9.4	3.6	1.1	2.1
Turkey	23.0	6.1	14.1	0.3	0.7	0.5	0.3	0.0	-	0.2	1.0	77.0	7.6	0.4	2.3	2.9	0.5	4.3	21.2	21.4	15.1	1.3
South Africa	15.4	3.0	8.5	-	0.0	-	-	-	0.1	1.8	2.0	84.6	7.6	0.3	14.9	9.4	0.2	7.0	22.9	18.7	3.0	0.4
Nigeria	2.4	1.1	0.4	-	-	0.0	0.0	0.0	-	0.0	0.7	97.6	1.1	0.0	1.0	88.9	0.0	0.1	1.8	2.8	1.9	0.0
Latin America																						
Brazil	15.1	1.0	2.6	1.3	0.0	0.2	-	-	0.2	7.8	2.0	84.9	18.4	6.1	22.2	7.4	0.5	5.5	9.4	12.1	1.5	1.7
Mexico	5.0	0.3	3.8	0.1	-	0.7	-	-	0.0	-	0.0	95.0	5.0	0.4	1.9	10.2	0.0	3.8	6.7	56.6	9.5	1.0
Argentina	16.1	2.3	5.5	0.3	0.0	0.0	0.0	1.8	0.2	5.4	0.6	83.9	34.4	2.4	7.8	3.9	5.2	8.1	4.9	14.0	0.8	2.3
Chile	12.7	7.2	1.8	0.2	-	0.3	-	0.2	0.1	2.3	0.5	87.3	17.2	1.1	29.7	0.8	0.3	4.1	29.8	3.1	1.3	0.0
Colombia	10.7	2.8	5.8	0.5	-	-	0.1	0.1	0.1	1.0	0.3	89.3	9.1	0.1	3.2	60.3	0.6	6.1	5.0	2.6	2.3	0.0

Source: UN Comtrade, World Bank

Notes

Notes

Notes

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Julia Wang and James Pomeroy

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