China’s ‘New Normal’: Challenges Ahead for Asia-Pacific Trade

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Highlights

China has grown to become an economic powerhouse and engine of global demand. However, China’s projected GDP growth rates are now anticipated to remain below 7% per annum over the next five years. This issue of Trade Insights examines how the ‘new normal’ of lower economic growth in China will impact on the prospects for trade in the Asia-Pacific region. Key messages are as follows:

- China’s economic growth rate shows signs of a marked slowdown, from an average of 10% p.a. between 2001 and 2011 to ‘just’ 7.4% in 2014.
- Compared to the hypothetical scenario that China’s economic growth returns to pre-crisis levels within the next five years (by 2019), forecasts show that China’s ‘new normal’ (7% p.a.) would lead to a slowdown in real total Asia-Pacific trade growth from 7.0% to 5.9% by 2019. It would also reduce export growth from 7.0% to 5.8%, and import growth from 7.5% to 6.3% by 2019.
- Indicators of economic output, employment and innovation show that the Chinese economy is shifting away from intermediary (i.e. processing, manufacture, assembly and construction) activities, towards higher value-added tertiary (i.e. services and innovation) industry – which now accounts for 48% of total output and 38% of employment in China.
- The structural adjustment of China towards a consumption-driven economy may change the characteristics of intra-regional trade. Countries exporting primary and intermediate goods to China, particularly countries with special needs such as Mongolia, Turkmenistan, and Korea DPR whose economies dependent on commodity exports to China are highly vulnerable to the slowdown.
- The structural shift towards domestic consumption may also increase opportunities for countries exporting final goods – especially high-tech and branded goods – to China. This includes countries such as Japan, Malaysia, the Philippines, the Republic of Korea, Singapore and Viet Nam. However, the realisation of these gains is hampered by trade barriers, especially non-tariff ones that support import-substitution.
- China’s moves away from intermediary activities towards higher value-added services present an opportunity for low-income countries, including LDCs, to replace China in some segments of GVCs. However, the ability of countries to participate in GVCs depends on their capacity to leverage competitive labour costs and natural resources, as well as other factors such as availability and efficiency of trade-related infrastructure and services, and the openness of trade and FDI.

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Introduction

Following the accession of China to the WTO in 2001, the world witnessed a decade of extraordinary economic growth in the nation – averaging around 10% p.a. This generated an expectation that robust Chinese growth would play a stabilising role in the global economy, in the event of major global recession. The Chinese economy – supported by India – was widely expected to replace or compensate the loss of consumption growth across many advanced economies – such as those in Europe and North America.¹

Figure 1: The growth of export volume and GDP of China (Year-on-year percentage change)

However, the expectation that the world economy could be supported by robust Chinese growth has weakened substantially. For the third year in a row (since 2012), China’s economy has shown a marked slowdown – with growth rates declining from double-digit levels (before the crisis) to around 7% in 2014 (figure 1).² A statement by Xi Jinping – President of China – indicated that China is entering a ‘new normal’ (Xuequan, 2014).³ This suggests that the Chinese government anticipates moderate but

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¹ It has been argued that the high rates of consumption across many advanced economies in Europe and North America during the 1990s was made possible through a series of financial bubbles – most notably in housing – which enabled consumers to draw upon the wealth from appreciating real estate, thereby diminishing their need for saving (see Farooki and Kaplinsky, 2013). This structural weakness contributed to a rise in the balance of payments across many advanced economies.

² The slowdown of growth in China could be seen as being symptomatic of a general decline in the rate of growth of the ratio of global trade to GDP following the 2007-2009 financial crisis. However, Hoekman, ed. (2015) argues that the lack of trade dynamism in the global economy in recent years stems primarily from cyclical factors such as weakness in aggregate demand from the Eurozone and more recently from China. He also suggests that the slowdown in China could be a reflection of non-cyclical factors such as the end of an integration process of China and central-eastern Europe, explaining that higher growth rates in the past may simply have been a transitional phenomenon. Alternatively, the slowdown could represent the limits having been achieved on the ability of companies to engage in international fragmentation of production networks through GVCs.

³ The term ‘new normal’ was initially popularised by the investment management company PIMCO to describe economic
perhaps more stable economic growth in the medium-to-long term.\(^4\) The most recent estimates suggest that even this moderate growth rate may not be reached. For instance, the IMF revised its growth forecasts for China, expecting it to steadily decline to 6% by 2017 (IMF, 2015).

For Asia and the Pacific, the structural rebalancing of the Chinese economy will have important implications for trade prospects in the region. China has been a major export market, absorbing 19% of exports from the rest of the Asia-Pacific in 2014. Given the persistent weakness in demand across many advanced economies, the growth of Chinese import demand is of particular importance to both the region and the global economy.\(^5\)

**Implications for Asia-Pacific trade**

The structural rebalancing of China to a ‘new normal’ will have important implications for the trade prospects of Asia-Pacific economies. The two major structural changes are:

I. The shift from export-driven growth to consumption-driven growth

The 2007-2009 financial crisis contributed to a substantial downturn in global demand, and this has partly been reflected in China’s export growth, which has slowed down from an average of 24% p.a. between 2001 and 2008 to 14% p.a. between 2010 and 2014.\(^6\) While export growth has declined, private consumption – proxied by domestic retail sales – has grown robustly from 12.5% p.a. to 14% p.a. over those years respectively. As a result, the Chinese growth engine has been shifting away from exports towards domestic consumption. In fact, exports declined from 35% of GDP in 2007 to just 23% in 2014, while domestic consumption increased from 35% of GDP to 41% over those years.

II. The transition towards services and innovation

Tertiary economic activities (i.e. services and innovation) are playing an increasingly important role in the Chinese economy, while the share of primary industry in GDP and employment has continued to decline. In 2011, the share of workers employed in services superseded those in primary industries for the first time (figure 2a). Since then, the gap has continued to widen, and by 2013, a total of 38% of employees came from the services industry, compared to just 30% in manufacturing and 31% in primary industries. A very similar trend is observed across the economy as a whole. The share of services in total output overtook manufacturing in 2012 and the share of manufacturing in total output began to decline in 2010. By 2014, the share of services in total output increased to 48% (figure 2b).

Development indicators also support the trend of China moving towards services and innovation activities. For example, World Bank Development Indicators show that research and development – as a share of GDP – rose to a historical high of 2% in 2012 – the same share as the European Union. Patent applications also rose 11% between 2012 and 2013 while high-technology exports increased 32% over those years. Lenovo – the Chinese multinational – has also upgraded from replicating computer

\(^4\) Behind the political rhetoric, the transition of China to a “new normal” rate of economic growth is in fact an attempt by the Chinese government to reign back on unsustainably high rates of credit creation, which have fuelled a domestic credit bubble. The property and construction industry has borrowed heavily from domestic and international lenders. Public, private and financial debt has risen from 176% of GDP in 2007 to 258% of GDP in mid-2014 (Sterne and Theiss, 2014). State-owned enterprises are amongst the most indebted companies because they have easier access to credit (Magnier, Wei and Evans, 2015). The downside risks for Chinese construction have also become more apparent as the country recently experienced its first corporate bond default.


\(^6\) Calculation based on geometric mean of the growth rates during the indicated period.
products to becoming an original equipment manufacturer of computer hardware. It has more recently begun innovating in the field and now owns the patent for keyboards for tablets as clip-ons.

**Figure 2: Industry contributions to employment and GDP (percentage of total)**

![Graph showing employment and GDP contributions](chart)

*Source: ESCAP calculation, based on data from the CEIC database (accessed June 2015).*

**Trade linkages between China and other Asia-Pacific economies**

The structural changes of China, as mentioned above, will have important implications for Asia-Pacific economies, particularly those in which exports and production are highly integrated with China through both forward and backward linkages in GVCs. Although China is the world’s largest exporter, it is also an important export market for producers across the rest of Asia and the Pacific. In 2007, China overtook the United States to become the largest individual trading partner in the region – a position it has maintained since.\(^7\) In 2014, China sourced 41% of its imports from other Asia-Pacific countries, while other Asia-Pacific countries exported 19% of their goods to China.\(^8\)

Raw materials and intermediate inputs now constitute a quarter of China’s imports from other Asia-Pacific economies. A part of those intermediate imports are due for further processing and assembly, and are subsequently re-exported from China to the rest of the world.\(^9\) Using the OECD-WTO database on trade in value-added (TiVA) – around 16% of exports by China are found to draw upon the value-added created by other Asia-Pacific economies.\(^10\)

A slowdown in Chinese exports and economic growth will reduce demand for imported inputs. This has already been partly reflected in lower prices for energy and other commodities. Several Asia-Pacific economies – particularly those exporting copper, coal, iron ore and steel – have already experienced negative impacts from the commodity price decline. LDCs, LLDCs and SIDs with economies highly reliant on commodity exports to China – such as Kazakhstan, Lao PDR, Mongolia, the Solomon Islands, and Turkmenistan are at greatest risk – and may experience a further decline in exports in the short-to-medium term (see box 1).

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\(^8\) Calculated using data from IMF Direction of Trade Statistics (accessed June 2015).

\(^9\) See Chapter 1 of APTIR 2012 and 2013 for more details.

\(^10\) Calculation based on data in 2009 which is the latest available data in OECD-WTO Trade in Value Added database.
Figure 3: Primary (incl. fuels), intermediate and final goods exports to China across selected economies (Percentage of country’s total exports in 2014)


Notes: The classification of goods is based on Systems of National Accounts (SNS) which distinguish between primary, intermediate, consumer and capital goods (United Nations Statistics Division, 2011). Final goods are defined as the sum of consumer and capital goods and excluding fuels. Mirror data is used.

However, the structural shift of China towards a consumption-based economy may increase opportunities to countries exporting final goods – especially high-tech and branded consumer goods. The countries that could benefit include Japan, Malaysia, the Philippines, the Republic of Korea, Singapore and Viet Nam (figure 3). Japan and the Republic of Korea are the largest exporters to China in the region and opportunities for export to China may increase further given their strength in high-tech consumer goods. Nevertheless, there is also a possibility that imports will be partially replaced by domestic production. Competition in the Chinese market for final goods may also become more intense following the economic slowdown. The intense competition increases the likelihood of import demand for consumer goods being further constrained by trade barriers, especially the non-tariff ones, and import-substituting efforts.
In the longer-term, the transition of China towards innovation and services presents an opportunity for emerging market economies to utilise the advantages in more competitive labour costs and access to natural resources, to replace China in some segments of GVCs. However, the ability to enter GVCs depends upon many other factors such as the availability and efficiency of trade-related infrastructure, and services such as communication networks, transportation networks, logistical networks, access to financing, and minimal restrictions on trade and FDI.

**Box 1.1. China’s economic slowdown and commodity trade of Asia-Pacific countries**\(^\text{11}\)

The transition of China’s economy to more sustainable levels of economic growth contributed to a sharp fall in international commodity prices in the second half of 2014. In particular, copper, coal, iron ore and crude oil prices – traditional gauges of China’s demand – fell 6%, 14%, 31%, 58% respectively (World Bank, 2015). The combination of lower commodity prices and expectations of falling commodity imports by China has important implications for Asia-Pacific economies – which collectively account for a third of global commodity imports and exports.

**Figure 4 Economies vulnerable to downturn in Chinese demand and commodity prices**

![Graph of Economies vulnerable to downturn in Chinese demand and commodity prices]


Notes: The classification of commodities is based on clusters: 25-26_MINERALS, 27-27_FUELS, 72-83_METALS, WTO_H3_AGRRI and Total. Mirror data is used.

Exports and economic growth are at significant risk across economies reliant on commodity exports as an engine of growth. The most vulnerable economies are those with special needs (i.e. LDCs, LLDCs and SIDs) and those with a high dependence on fuel and mineral exports to China, such as: Korea DPR, Mongolia and Turkmenistan – where primary commodity exports account for 59-99% of total exports and more than 50% of total exports are destined to China (figure 4). The decline in China’s demand for commodities also adversely affects the growth of exports and GDP of large commodity-exporting

\(^{11}\)More details are available from Saggu and Anukoonwattaka (2015 a,b)
economies such as Australia (minerals) and the Russian Federation (fuel).

However, lower commodity prices may also be expected to translate into an improvement in the trade balance – through lower the cost of raw materials and fuels – across commodity importing economies. There are 32 net-commodity importing economies in Asia-Pacific region. Many are countries with special needs which run current account deficits amounting to around 11% of GDP – partly attributable to commodity import dependency. These countries include Cambodia, Kyrgyzstan, Nepal and other remote island nations (Kiribati, Maldives, Micronesia (F.S), Samoa, Tonga, and Tuvalu) which are highly dependent on fuel and agricultural imports (figure 5).

**Figure 5: Asia-Pacific net commodity importers, 2014 (percentage of GDP)**


Notes: The classification of commodities is based on clusters: 25-26_Minerals, 27-27_Fuels, 72-83_Metals, WTO_H3_Agrri and Total. Mirror data is used. GDP data is from the IMF World Economic Outlook Database (April 2015). The following countries are excluded due to insufficient data coverage: American Samoa, Cook Islands, French Polynesia, Guam, Korea DPR, Macao, China, Nauru, New Caledonia, Niue, and Northern Mariana Islands.

**Forecasting Asia-Pacific trade and growth**

Using the Oxford Global Economic Model, we model some hypothetical scenarios: (i) economic growth slows down to the new normal rate (7%) and remains at that rate throughout the next five years (2015-2019); (ii) economic growth linearly recovers to pre-crisis levels (10%) by 2019; and (iii) economic growth linearly slows down more than expected to 5% during the same period. Forecasts show that a slowdown to new normal growth rates would significantly dampen the growth of trade in the Asia-Pacific region. Compared to the pre-crisis growth scenario, China’s new normal growth of 7% p.a. would cause export growth across the Asia-Pacific region to slowdown from 7.0% to 5.8%, and reduce import growth from 7.5% to 6.3% by 2019 (figure 6). In the case that China could not maintain its
growth at 7%, the negative impacts would be enlarged. For instance, export growth would decline further to 5.2% and import growth would reduce to 5.7% during the same period if Chinese economic growth declined to 5% by 2019.

**Figure 6: Trade prospect of Asia and the Pacific under different scenarios of China’s economic growth (Annual percent change)**

![Graph showing export and import growth forecast](image)

*Source:* Forecasts based on projections at the country level using the Oxford Economic Model as of April 2015.

*Notes:* The projections are based on forecasts for 14 countries under alternative scenarios of economic growth in China: Australia, China, India, Indonesia, Japan, Malaysia, Philippines, Republic of Korea, Russian Federation, Singapore, Thailand, Turkey, Hong Kong, China, and Taiwan, Province of China. The growth rates are expressed as time-varying trade-weighted averages.

**Conclusion**

China is transitioning from a high-speed economy to its ‘new normal.’ This note explores important implications of this structural shift in the Chinese economy to the trade prospects of countries in Asia-Pacific region. Indicators of economic output and employment and innovation show that the Chinese economy is shifting away from intermediary (i.e. processing, manufacture, assembly and construction) activities towards tertiary (i.e. services and innovation) activities. Exports by China also show signs of slowing down. As a consequence, the economy is shifting from an export-driven model to one driven by domestic consumption.

A slowdown in Chinese exports and economic growth will inevitably reduce demand for imported inputs. This will negatively affect countries dependent on exports to China – particularly those exporting primary commodities and fuel. However, the transition of China also presents several opportunities for other Asia-Pacific economies. Firstly, the structural shift towards domestic consumption may increase opportunities for countries exporting final goods – especially high-tech and branded products – to China. Secondly, as China moves away from intermediary industry towards higher value-added innovation and services activities, this presents an opportunity for emerging economies to fill the gap and replace China in some segments of GVCs. Economies with more competitive labour costs and access to natural resources could potentially fill the void left by China in processing, manufacture, assembly and construction. However, the ability of economies to participate in the GVCs critically depends upon a holistic approach to policy formulation to improve trade and investment environments.
References


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