The Run to China – Another Example of Herd Behavior?

Abstract

China is in. Major new investments in China are announced almost daily by global companies. This happens despite the fact that China sooner or later will face painful changes and adjustments because of its huge structural deficits. In this analysis, the conclusion is that market potential and present purchasing power serve as the major driving forces for the China offensive of Western enterprises. However, psychology has an impact on the current China boom as well.

The question is: Are the current mood and anticipated market potential good indicators for sustained corporate success? Experience teaches us that this is not always the case. Historically, big emerging markets – with good potential and relatively big populations – sooner or later have experienced economic crises, even in modern times: Mexico, Brazil, Indonesia, Russia, to name a few. For this reason, foreign companies should pay more attention to risk analysis and neglected scenarios on the economic and political future of China. China could serve as an extremely interesting case of combining economic theory as well as research including modeling and practical application. In this paper, some interesting research is quoted. It would be very useful for all global academic and corporate players to get more confirming, or diverging, research on these aspects of the Chinese economy.
1. China has become a global player

There is no doubt that China has achieved a remarkable economic upswing since Deng Xiaoping started his economic reforms in the late 1970’s. The figures tell it all. According to John’s studies 1), poverty levels have been coming down since the economic liberalization process was started about a quarter of a century ago. This is an important achievement despite a generally assumed increased inequality of income, shown for instance by Demurger et al. 2)

Important countries like the U.S. and Japan have become increasingly dependent on low-price imports from China in recent years. But the opposite is also true. Chinese exports to the U.S., Japan and the EU amount nowadays to about half of total Chinese exports. China’s integration into the world economy is now most certainly a fact.
Only a couple of years ago, China became one of the top ten exporting nations. In 2002, China was already number five after the U.S., Germany, Japan and France. One year later, China (probably) advanced further, to number four. The trend seems obvious. At the same time, the increase of imports is noticeable as well. During the past decade, imports almost quadrupled.

Another success story for China is its attractiveness to foreign investors. In 2003, foreign direct investment amounted to 57 billion USD, which made China the number two host country for foreign investment. Numbers in the range of 40-50 billion USD have been usual in recent years. Many econometric models have contributed to the opinion – Zhang’s is one of them – that FDI promotes income growth and that these positive effects so far have been strongest in the coastal areas. This can be confirmed by all corporate practitioners who usually agree that FDI preferably has taken place there. This is not only a recent development recent, but was also the case in the past: for transport reasons.
In 2003, the increase of Chinese imports contributed – according to my own estimates – ¼ percentage point to global growth. This is not negligible in an underperforming world economy.

Some other figures tell us even more. In 2003, China has been a major lender helping finance the U.S. deficit in the balance on current account. China accounts for one-third of global oil demand and one-sixth of global paper consumption. Chinese steel consumption is huge in a global perspective as well. China boasts almost 5000 cement factories. But despite these big numbers there are shortages in almost every imaginable sector. This makes Western investors ambitious – sometimes too ambitious and too myopic to consider the bottlenecks and shortages in China. Needs are not always the same as future demand – which is very important to remember; finally, tackling shortages and consequently factor input will be very decisive for the long-term prospects of the Chinese economy. The outcome is not sure. What will the supply of energy, water, metals, human capital, financial markets and also the state of institutions and the environment look like a decade from now?

2. The positive sides of the economy

This analysis is targeted at the potential risks in the Chinese economy. But it is still essential to look at the positive aspects and trends as well. From a purely macroeconomic point of view, GDP growth is considerable (2003: 9.1%) and 9.3% during the past decade. There are, admittedly, major statistical uncertainties and significant
inequalities in income distribution. On the other hand, which country in the world avoids major GDP revisions?

Another positive factor is that some hundred million people seem to have an education that gives them the chance to move forward. And many people are eager to improve their educational levels. This is certainly promising. A number of economists (for example, Mankiw, Murphy, Porter, Romer, et al.)\(^5\) have convincingly demonstrated that human capital formation is decisive in determining the trend of economic growth. For instance, positive human capital formation makes a country, region or city more attractive to foreign investors. However, it should not be forgotten that there is also research that rejects a significant relationship between the formation of human capital and growth which Schweickert/Thiele\(^6\) clearly single out. The reason for these skeptical attitudes is the fact that the human capital comparisons between countries tend to neglect quality differences in education. Furthermore, it cannot be ruled out that given China's ongoing economic expansion, bottlenecks will emerge in education as well. Can the formation of human capital happen sufficiently fast in the long run? Sustained high GDP growth assume a continuous long-term rise in educational levels. This is a topic not many economists discuss intensively – maybe because no one has the answer.

WTO membership means that China must open its economy much more for the international movement of goods, services and capital. This will happen gradually – but probably not without at least occasional disputes and distortions. In any case, WTO membership will gradually make China more of a market economy. This is certainly positive for the Chinese economy in the longer run, even if the road will be very bumpy at times. In general terms, WTO membership favors Chinese long-term competitiveness both domestically and in the international arena. However, these positive effects should not be overestimated. Clarke\(^7\) warns convincingly that WTO membership has quite a limited impact on its international legal practice. Clarke argues that WTO membership does not require a perfect legal framework per se and – which may be important – that a potential non-fulfillment of WTO rules will not automatically lead to dispute settlement procedures. Chinese interpretations of WTO rules could be stretched considerably. This could be something to consider in the board rooms of global companies.
In economic terms Brooks/Ran Tao 8) belong to the authors who discuss the effects of WTO membership on China's labor markets. They find high GDP growth is needed in order to avoid major negative effects on employment or as they also put it: “The main challenge facing China’s labor market in coming years is to absorb the surplus labor into quality jobs while adjusting WTO accession”. In the very long run even China will have a demographic problem because of many years of low population growth.

Liberal trade optimists should theoretically have a positive view on China’s increasingly active role in the world economy. China is currently adding to world demand and GDP – and will continue to do so as long as political and economic distortions can be avoided. Analyzing imports of the old industrial world, one easily can realize the growing Chinese share of national imports. This has had a dampening effect particularly on American and Japanese consumer prices in recent years. On the other hand: How will huge Chinese demand for commodities affect global inflation in the longer perspective?

Merchandise import shares of Chinese goods in the U.S., Japan and Germany

Watch exports from the U.S., Japan and Germany to China, and the picture looks quite similar! China is gaining weight for Western and Japanese exporters. It should be added that trends of exports do not even tell the whole Chinese internationalization story, since the Chinese market also absorbs goods (and services) that are produced by foreign investors in China.

A new positive element should be the forthcoming amendment of the Chinese constitution implementing the
protection of private property rights. In theory, this change sounds promising. However, it remains to be seen what this improvement of conditions for private ownership will mean in practice. It should not be forgotten that China now has something like 2.5 million private companies with around 35 million employees. Apart from that, more and more Chinese become apartment owners; this fact makes private property protection important not only to foreign companies but also to an increasing number of Chinese people.

Conclusion: China has the potential to make many positive long-run contributions to the world economy. However, looking at all the political, social and structural-economic challenges that China has to tackle in the future, it would be naïve to expect that periods of problems and disappointment will be avoided.

3. The structural problems in the economy

Despite important positive developments, China is also a country that already now faces big problems – and many problems have yet to emerge ⁹). It might be better to describe China as a continent rather than as a country. Taking this approach makes it easier to understand the wide range of ethnical and structural disparities – and the difficulties of conducting an effective economic policy for the whole nation. 800 million people still live in the countryside with much lower income than is noted for the urban population.

In my opinion, a great number of foreign executives underestimate both the number and the range of Chinese structural problems. This happens because of many analysts’ concentration on GDP growth, market potential and low costs. Swedbank’s China Survey ¹⁰) of March 2004 reports that only 11% of the participating 40 economists think that foreign companies are not underestimating all future risks in China.

Many structural problems can be listed in this context. Some examples are:

- the dominating role of government economic planning
- the lack of understanding a market economy
- the dysfunctional banking system
- many bankrupt state-owned companies
- major social and regional disparities
• an inadequate pension system  
• big disparities in education  
• enormous shortage of commodities  
• a corrupt bureaucracy.

This list can be made much longer and should be part of strategic corporate considerations and decisions.

A sustained recovery of the dysfunctional banking system is without doubt one of China’s major forthcoming challenges, without knowing when serious action finally will be taken. Regardless whether non-performing loans (NPL) are roughly 20% or 50% of total credit stocks – probably the latter figure is closer to truth than the lower and official one – the existing enormous bank problems are not free of charge forever and will become very much a fiscal burden some time in the future. Recently, there has been an increasing effort to reduce the massive shortage of capital of the state-owned banks. However, much more strengthening of capital reserves is needed. This, also because of the opening of the Chinese banking market to foreigners by the end of 2006, as a result of WTO’s liberalization rules. Cleaning the books of the Chinese banks will be an enormously difficult process.

According to Fernald/Babson\(^1\), the bad shape of the Chinese banking gives strong reasons for major concern. The two authors add that “it is dangerous for a country to have weak, poorly regulated banks making policy loans to inefficient, overleveraged state enterprises – a reasonable description of China”. This should be said even if an imminent banking crisis is not expected. Fernald/Babson also remind us of the fact that “in a market system, pressures generally force rapid adjustment when institutions are, or are perceived to be, insolvent; these mechanisms do not operate fully in China. For example banks can continue to operate regardless of balance-sheet weaknesses, because of the government’s support.” Apart from this, experts on China also talk about the risk of local or regional real estate bubbles which certainly would be impossible to manage by the already heavily suffering banks.

Today government debt is running – maybe – 40% of GDP, depending on the accounting methods and other factors. This means that merely cleaning up the bad banks could lead Chinese public finance into very uncomfortable regions. Unfortunately, there is absolutely no transparency for figuring out future fiscal development in China.
This reminds me of one the most experienced American experts on China, John Frankenstein, who always closed his comments on China at the time I met him in Hong Kong by adding the following question to his judgments and forecasts: “Who knows?”

Frankenstein’s “analysis law” on China is for example supported by the already quoted European survey made by Swedbank. Almost half of the participants expect a major downturn in the Chinese economy without giving any timing. More than 40 per cent of the economists believe such a negative development could run for a long period – from next year already. Again: Who knows?

The lack of transparency is a topic also concerning many other areas of the Chinese economy. This can be said about statistics, the real state of individual public and private enterprises, the banks, the number of unemployed rural citizens floating around in the cities, the environment, etc.

Foreign investors should be aware of both insufficient corporate governance and transparency. It should not be forgotten that China, despite its moves to more market economy, still is dominated by the rules of a planning economy. This also means that given rules of a market economy mostly are not really understood and applied at most public administration levels.

Regarding regional disparities, one gets this fact confirmed by traveling around the country. Coastal regions and Beijing have visibly performed much better growthwise in the past two decades than, for instance, central and western China. Referring to Demurger, S. et al., these authors come to the conclusion that the strongly expansionary regions in China benefited particularly from important deregulation policies. Thus, Demurger et al. argue that the best strategy would be better to reduce regional disparity by extending deregulation policies to the west and by improving infrastructure in the lagging provinces.

In my view, deregulation would not be sufficient but could correct some distortions if China really wants to achieve a division-of-labor-effect in its own country. If China can achieve major progress in this respect – which seems to be far from sure - growth potential could get a new dimension. A similar conclusion could be reached if the research result of Shang-Jin-Wei and Yi Wu 12) could be verified further, i.e., that Chinese cities which are open for trade and globalization demonstrate a greater decline of income inequality in both urban and neighboring rural areas. It
could be very useful if research could give the world some more evidence on these two very important issues. This is also true of the conclusion made by Kui-Wai Li\textsuperscript{13} that productivity is higher in coastal provinces than in inner provinces. Apart from that, Kui-Wai Li deserves recognition for their research confirming that foreign direct investment – in China largely greenfield investment – is more useful than state-funded investment injections.

According to research and general wisdom, corruption is regarded as an important impediment to growth. Despite poor transparency in many areas, the Chinese leadership regularly admits that corruption is one of the main problems of the Chinese economy and society. However, Chinese corruption is so deeply rooted that major improvements cannot be foreseen for a long time. According to Transparency International\textsuperscript{14} China is ranked as number 66 out of 133 countries on their corruption scale. Finland is the least corrupted country in the world. Since corruption means unnecessary transaction costs and inefficient distribution of financial resources, the negative impact on growth is obvious, despite current good growth figures. No one can actually expect a sharp decrease of corruption in the foreseeable future.

4. A probable Chinese strategy

There is no doubt that the new Chinese leadership with president Hu Jintao and prime minister Wen Jiabao on the very top have an ambitious global and regional economic short- and long-term strategy. In this connection, the strategy of internationalizing the country had been pushed by past president Jiang Zemin (who still can be considered as influential).

One can speculate about the long-term economic strategy of the Chinese leaders all the same. Chinese leaders need high rates of growth for three reasons. First, to reduce regional economic disparities. Second, to achieve a more equal income distribution. Third, to keep the party’s dominant position intact. To achieve these goals, they will need to allow markets to function to an ever-increasing extent. Something else that Chinese leadership will be forced to do is to visibly improve educational levels. This implies huge volumes of both imported technology and knowledge.

Swedbank’s “China panelists” conclude that broadening educational opportunities can be seen both as a risk and a positive challenge for the Western world and Japan. It’s a
positive challenge because of the increasing pressure on companies and governments in traditional industrial countries to become more innovative. However, no one knows how this challenge will be handled in individual countries. There will be losers as well. Pessimists see potential risks in massive future Chinese exports with gradually increasing value-added. Such goods would threaten many Western, Japanese and other Asian producers. Optimists – dominating in Swedbank’s survey – think that Chinese progress will push Western and Japanese R&D and see this development as an exogenous driving force. However, it could be wiser to be more reluctant with a clear answer. Besides, we already hear anecdotal comments by executives at global companies that investments in China are made partly at the expense of other Asian countries.

Looking at the development of Chinese exports, there is no doubt that China in the next decade even will try to become a much bigger global player than it already is today. This is necessary to make it possible for China to earn the foreign exchange that will be needed to pay for rising imports. Whether deeper penetration can be achieved without a protectionist reaction from the U.S. and EU remains to be seen. If there are future massive market-share gains by Chinese producers, there could be strong reactions from Washington and Brussels.

For some time, relatively noticeable Chinese strategy has been to put economic reforms in the first place – and not political ones. The Chinese find this priority much more attractive than the Russian example which preferred putting politics in the first place. In any circumstances, China has a big disadvantage to India in this specific respect: singled out recently by Gary Becker and others 15). Both positions have – in my opinion – important disadvantages all the same. In particular this polarization of approaches will result in other important reform areas being underestimated or neglected. This is particularly true when it comes to institutions which have a sizable impact on growth trends. According to theory and empirical research the institutional messages of Douglass North and consorts should be included in all economic analysis that is done on China. An important aspect must, of course, be given priority by the Chinese leaders: the fight against bottlenecks and shortages. One should not forget that high growth rates also assume the need for much more resources every year. This concerns human capital, energy, commodities, financial services and other input factors. In
the worst case, structural shortages in these areas could jeopardize high long-term growth; in the best case demand can go on surging.

5. Behavioral finance can be applied

Behavioral finance has become a popular research area in the past decade. Psychology means a lot to individual decisions and markets. This is what behavioral finance is all about.

Many academic researchers have come to the conclusion that behavioral finance can be applied in a historical perspective \(^{16}\). For example, it helps explain bubbles ex post. It also helps interpret certain statistics. This has, of course, some advantages. One is that an increasing number of analysts are realizing that judgments of an economy should be based on factors besides available statistics.

Consequently, behavioral finance still cannot serve as a numerical forecasting tool. But it can give signals as to future risks, particularly when herd behavior has been noticed for quite some time. Substantial increases that have been going on for some time could mean overshooting, or could mean exuberance with increasing risks of a forthcoming downturn.

What behavioral finance can do is send massages about risks that concern overconfidence and sometimes even bubbles. Milton Friedman once said to me that the worst thing about bubbles is that we never know about their existence until they burst. This is certainly true. However, extremely strong moves on a specific market over a considerable period give hints on exaggerations and overconfidence – and consequently on disappointment and/or future negative market reactions.

Today, there is good reason to suggest that the current global corporate emphasis on China should also use some behavioral finance. After having myself studied 100 corporate leaders’ comments in Swedish and international newspapers on their motives for investments in China, three main arguments can be singled out in the following order:
• the size and potential of the Chinese market

• the need to outsource to low-cost countries, which helps protect jobs at home

• the rapidly growing presence of key global competitors in mainland China.

The CEO of Siemens, Heinrich v. Pierer, put it this way (translated): “The risk of not being in China is far bigger than the risk of being there” 17). Obviously, many Western and Japanese leaders feel the same way about participating in the ongoing Chinese boom.

There are several reasons for that. Market potential and cost-cutting were already mentioned. To some extent, it also seems to be a matter of self-justification. Many executives certainly do not want to be criticized some time in the future for having taken a reluctant strategic position in China. Doing what many competitors do can quite easily be explained – following the herd usually feels safer. Or, one can apply the words of John Maynard Keynes that “wordly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally.” 18)

There is also reason to apply what behavioral economists call “overconfidence”. Robert Shiller describes this “as people think more than they really do” and that “there are a lot know-it-alls-out there” – people who are followers of the herd and believe that they understand everything completely. My experience tells me that this phenomenon is at least partly true of many foreigners doing business in China these days.

There may be a third important psychological factor that may contribute to the ongoing China euphoria. Media report big stories about China’s growth and Western investments there, without any questioning. We have seen such exaggerated – or short-sighted – reporting in the past during the internet boom. Robert Shiller writes about that in an aggressive, but correct, way “that most people are not interested in long-term economic growth forecasts for the aggregate economy. Economic theory would suggest that they should be interested, if they are behaving rationally. But in fact the topic is too abstract ...” This psychological wave should not be underestimated either.

Finally, a fourth driving force for the run to China is the shortage of rapidly growing major economies in the world. Put it otherwise: there are more and more mature
economies. Many OECD countries suffer from low, or mediocre, growth at the best. Big catch-up economies with underexplored potential have become rare. There are, perhaps, only three: India, Russia and, of course, China. This constellation of many mature – and only a few big – markets with obviously good growth potential puts a lot of psychological pressure on executives to be active on these few big emerging markets.

6. Summary
Morrison makes a good summary of globalization. She writes: “Globalization has brought about dramatic changes in the ways that people live and work, opening up new opportunities but also creating new risks and uncertainties ...”

These lines can certainly be applied to China as well. China is a country with lots of both opportunities and risks. Without any doubt, China will become a much more important global player in the world economy in the medium and longer run.

However, the way for China to get there will be quite bumpy, with inevitable distortions because of the great number of structural deficits. This should be kept in mind by all the euphoric Western and Japanese corporate leaders. There will be foreign winners in China – but also many losers. A big potential market does not guarantee commercial success. Psychological pressure on Western and Japanese companies is big. Being reluctant in China can provoke uncomfortable criticism at home at least in the forthcoming years. It should not be forgotten either that suppliers to major foreign corporations can be forced by their biggest customers to join them in producing in China, without knowing the long-term outcome of such a move.

All experts in Swedbank’s “China panel” expect a major slowdown in Chinese growth at some time in the future. But half of them argue that the time for that considerable slowdown is not predictable. More than 80% of these economists also believe that foreign companies underestimate the future risks in China.

Conclusion: For this reason, business economists and corporate decision-makers should keep a close eye on all suspected herd mentality trends when it comes to investments in China – not only today but also in the years ahead. Just being a follower of fashion is not good enough – despite the huge Chinese market potential!
Appendix

Swedbank’s Special Survey on China in the Short and Longer Run
March 2004

1. Do you expect China to lose momentum some time in the future because of
   a) overheating in the economy
      Yes  56%
      No   44%
   b) structural adjustment needs
      Yes  82%
      No   18%

2. When do you expect a major downturn in Chinese growth
   during 2005-2006  9%
   during 2006-2008  20%
   during 2008-2010  3%
   beyond 2010      14%
   not predictable but it will happen 46%
   it will not happen  8%

3. In 2003, FDI was close to 60 billion USD in China. Almost not one single day passes by without more corporate announcements of further investments in China. Do you think as an analyst that there is a psychological herd mentality when it comes to Western and Japanese foreign direct investment in China – “that my company simply has to be there?”
   Yes, strongly  12%
   Somewhat      55%
   No            33%

4. What are in your opinion the five most positive factors of the future Chinese economy and market (ranked)?
   - Market potential
   - Human capital formation and steep learning curve
   - High GDP growth
   - Low wage costs

1 40 European economists participated exclusively for this article, most of them business economists and some of them from academia.
5. What are in your opinion the five most negative factors of the future Chinese economy and market (ranked)?

- Institutional shortages (bureaucracy, intransparency, insufficient legal system, environment)
- Political risks
- Regional and social imbalances
- Weak banks
- High unemployment

6. Do you think that companies now investing in China underestimate the future risks in that big country?

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References


10) Swedbank’s “China Survey” from March 2004 with 40 European economists, especially made for this article.


14) Transparency International http://www.transparency.org/


Statistics from SCB (Sweden), WTO, UNCTAD and EcoWin.