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Europe and China in the Global Economy in the Next 50 Years: A Partnership for Global Peace and Stability

In the past 50 years, both the European and Chinese economies experienced dramatic changes. The Western European economy was quickly rebuilt after World War II and regained its prominent status in the global economy. The Eastern European economies, after a brief period of fast economic growth under communism, stagnated throughout the 1970s and 1980s. Their communist governments eventually fell and were replaced by democratic institutions after the collapse of the Berlin Wall in 1989. The ensuing painful transition from a planned economy to a market economy has achieved mixed results. While some fell into a middle-income trap, others have succeeded, entered the European Union and adopted the euro, and their living standards have converged steadily to Western levels. However, the 2008-09 global financial crisis, which erupted in the US, has severely undermined the European economy, especially those countries in Southern periphery. With huge debt levels, high unemployment and low growth, it appears that the European economy will continue to stagnate for the foreseeable future.

China, on the other hand, has also experienced huge changes in the last 50 years. It experimented with socialism with Chinese characteristics from the 1950s to the 1970s. However, this experiment turned out to be a disaster, turning China into a marginal economy in the world, despite its huge population. After Deng Xiaoping assumed leadership in the late 1970s, China changed course and adopted market-oriented economic reform by welcoming foreign investment and encouraging foreign trade. After its 2001 accession into the World Trade Organization, both its growth momentum and economic integration into the global economy accelerated. China has emerged as the largest trading nation in the world, surpassing the US in 2013. Over the last 37 years, China has grown an average 9.7 per cent per annum, its per capita income has risen from $226.70 to $7,846.50 (as of 2015), and China has become the second largest economy in the world, measured in nominal US dollar terms, next to the US. In fact, according to a World Bank study, it could now be the largest economy in the world, with a PPP-measured GDP of $18.0 trillion, slightly bigger than the US economy ($17.4 trillion).[1]

China's transition to a market economy since 1978 has seen much closer trade and economic relations with Europe than before. Europe is now China's largest export market, and some large EU countries such as Germany and Spain also view China as their largest export market. In 2005 China was still a net importer of capital from the EU. Ten years later, China became a sizeable investor in the EU market, with a total investment of $9.8 billion, exceeding the EU investment in China of $6.7 billion in 2014. This trend will likely continue, facilitated by the negotiation of a possible bilateral investment treaty and even a free trade agreement (FTA) in the future.

This article argues that China's continued economic rise presents a rare opportunity for Europe. As China is likely to rebalance its economy from an investment-led to a consumption-driven one, the size of China's consumer market will reach $14.1 trillion, or about 92 per cent of the corresponding US market in 2020.[2] This huge market could be a potential growth engine for the European economy. In addition, China's "One Belt and One Road" initiative – the Silk Road Economic Belt, stretching northwest from China's coastal area through Central Asia, the Middle East and on to Europe, and the Maritime Silk Road, running from China to Southeast Asia and then to North Africa – was announced in 2013 and will be vigorously implemented in China's 13th Five-Year Plan (2016-20). This initiative, which is open to collaboration from other economies, could present investment-led economic opportunities to the European economy. However, to fully take advantage of these opportunities, both economies will need to overcome some economic frictions and trade protectionism tendencies. While China will need to open its markets further for foreign participation, Europe will also need to formally recognise China's economy as a market economy, negotiate a bilateral investment agreement and eventually work towards an FTA.

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1 World Bank, World Development Indicators, December 2015.

2 See L.-G. Liu: Is China's Consumption Ready to Take Off?, Policy Brief, Peterson Institute for International Economics, forthcoming.

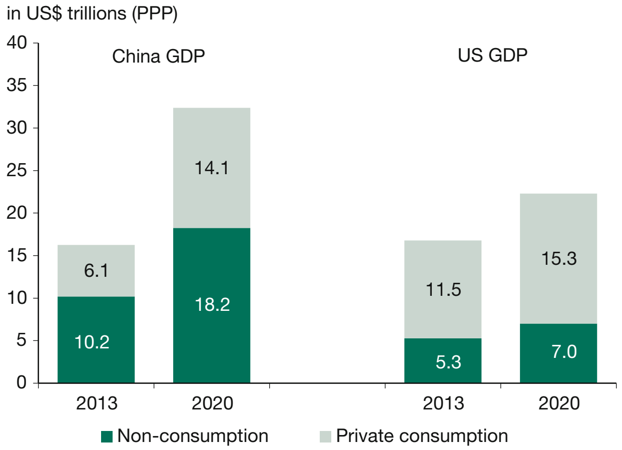
This article proceeds by first looking into China's rising consumer market and discussing potential opportunities to the European economies. Next, it examines China's One Belt and One Road initiative and argues that this could be an opportunity for European economic recovery and a long-term strategy to stem out illegal migration. It then discusses the state of China-EU economic relations, proposes a policy agenda to leverage mutual strengths and concludes that a constructive bilateral economic relationship will help contribute to global growth and prosperity.

Tapping China's consumption market

While China's share of consumption to GDP remains low, its total private consumption in value terms deserves attention. The size of China's private consumption is already very large. In 2014, its nominal value was estimated to be $3.9 trillion, representing just 38 per cent of China's GDP. Given its huge size, China's consumption is not only locally but also globally relevant and significant. There is significant room for China's consumption to grow, as its share of private consumption to GDP has been well below the international average. According to the latest World Bank data, private consumption represented 60 per cent of global GDP in 2013.[3] For countries categorised in the middle-income group – including China – the average consumption ratio was 56 per cent of GDP, or 18 percentage points higher than that of China. China's consumption-to-GDP ratio has actually been falling steadily over the past three decades.

However, this trend will likely reverse within the next five years. First, significant reforms have taken place to rebuild a social safety net and reduce people's precautionary savings motives. Since the global financial crisis, China has spent 850 billion renminbi to revamp its medical insurance programme. This programme now covers every citizen, and a catastrophic medical insurance programme, supplementing the existing one, was rolled out in 2015. This universal medical insurance programme will be improved progressively by expanding coverage and depth. In addition, China's pension reform has also made significant progress. In 2014 the government consolidated coverage by introducing the Urban-Rural Resident Basic Pension Scheme. The goal is to cover 900 million people by 2017 and 1 billion people by 2020, raising the coverage rate from the current 80 per cent mark to 95 per cent. In the countryside, land reform experiments are being undertaken, with the goal that the current land-leasing title will be transferrable, thus effectively shifting a significant wealth effect from the state to farmers. Meanwhile, financial liberalisation, e-commerce and an enhanced logistics network will entice consumers to spend more. These fundamental reforms, together with a rapid urbanisation drive and the emergence of a middle class, will greatly boost China's consumption. It is estimated that by 2020, China's private consumption will represent 44 per cent of its GDP, or $14.1 trillion, and based on the World Bank's new PPP measure, the Chinese consumer market will be around 92 per cent of the size of the US consumer market (see Figure 1). This represents a dramatic jump from the current values of just 36 per cent of GDP and 53 per cent of US consumption.[4] China's rising middle class will spearhead the consumption growth. Over the next five years, 61 million new middle-income households will enter the market, and China's 250 million-strong middle class households – with an average income of $37,000 in purchasing power parity terms – will make up 93 per cent of the total urban consumption, compared with 85 per cent in 2014.[5]

Figure 1
China's consumption to approach US level



Source: L.-G. Liu: Is China's Consumption Ready to Take Off?, Policy Brief, Peterson Institute for International Economics, forthcoming.

China's rising consumption will likely boost certain sectors more than others. As Figure 2 illustrates, the following sectors would likely see significant increases in consumption growth in the next five years:

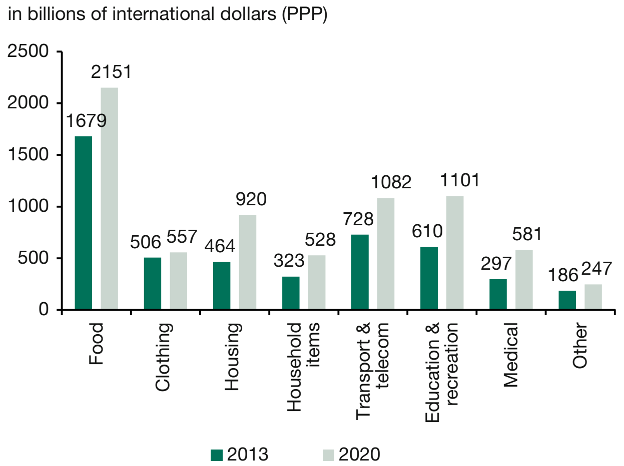
Transportation and telecommunications: Total spending in transportation and telecommunication will rise 50 per cent to $1.1 trillion (PPP) by 2020. This will be driven by higher car ownership (currently just 24 cars per 100 households), more domestic travelling and higher spending on telecommunications services. China's new passenger car sales were 19.7 million units in 2014, over five

3 World Bank, World Development Indicators, 9 September 2015.

4 Assuming a constant exchange rate of 6.5 renminbi against the dollar, China's consumption market is projected to reach $7.6 trillion in nominal terms by 2020, compared with $3.9 trillion in 2014, representing an annual increase of $614 billion, or 4 trillion renminbi.

5 See L.-G. Liu, op. cit.

Figure 2
China's urban consumption structure



Source: L.-G. Liu: Is China's Consumption Ready to Take Off?, Policy Brief, Peterson Institute for International Economics, forthcoming.

times higher than in 2004. Sales of communication appliances by large enterprises reached 269 billion renminbi in 2014, a six-fold increase from a decade ago.

Real estate: Housing-related expenditures will likely surge to $920 billion (PPP), representing a two-fold increase, due to demand for better-designed, high quality and bigger housing as income increases. The latest data show that residential floor space per capita was about 33 square metres in 2012, up from 26.4 in 2004. In addition, related upstream (i.e. construction material) and downstream (furniture and household appliances) sectors will also see large demand increases.

Education and recreation: Consumption of education and recreation services will increase over 80 per cent to $1.1 trillion (PPP). Parents will continue to spend a large amount of income on education for their next generation, while leisure spending will also grow rapidly. Currently, the average expected number of years of schooling for Chinese residents is still much lower than it is in OECD economies. As income rises, domestic demand for education services, including privately funded schools and private classes, will rise substantially. In the meantime, the number of students going abroad will continue to grow. Recreational spending will also become more important for Chinese consumers. The sharp rise in movie box office revenue – by 36 per cent in 2014 and by 48 per cent in the first half of 2015 – is a case in point.

Medical services: The amount spent on medicines and medical services will almost double to $581 billion (PPP), reflecting, on the one hand, better and more expensive medical resources for the better off and, on the other, an ageing population that will lead to higher demand for medical services, despite the ongoing healthcare reforms in China. China's dependency ratio (i.e. the population of those older than 65 per 100 people) rose to 13.0 per cent in 2015, from 10.3 per cent in 2005, and this trend is expected to continue. By 2030, the dependency ratio will reach 25.3 per cent, further raising the demand for drugs, medical services and hospital treatments.

Other industries: While the increase in other industries will not be as prominent, the increasing middle class population and rising incomes will still broadly benefit almost all sectors. For example, the share of expenditures on food will fall five percentage points, from roughly 35 per cent to 30 per cent by 2020, but the total amount spent will increase by 28 per cent, even in terms of PPP.

European economies have also been benefiting from China's rising consumption. For example, premium carmaker BMW's China sales surged 16.6 per cent to 456,732 units in 2014, making China its largest market. Daimler recorded sales of 281,588 units in China in 2014, making China its second-largest market behind the US. Aside from luxury cars, sales of other luxury goods, such as cosmetics, watches and high-end fashion, are also rising rapidly. Reportedly, China has already become the world's largest luxury consumer market.[6] If China's rising consumption were to continue over the next five years, and given the comparative advantage of the European economy, Chinese consumption could be an important engine of growth for the European economy.

Sino-European collaboration on the New Silk Roads

Despite the long distance between them, China and Europe were once linked by ancient trade routes known collectively as the Silk Road, on which Chinese-produced silk, tea and other products were transported by camels and caravans through the vast Central Asian region, crossing deserts and mountains, before eventually reaching Venice. The ancient Silk Road was functional until the mid-15th century, when wars, technology, and the rises and falls of Chinese and European dynasties ultimately led to its breakdown, thus relegating the ancient trading routes to a cultural fairy tale and an economic relic.

Today the ancient trading routes are about to be revived. China's One Belt and One Road programme, also called "New Silk Roads", was announced in late 2013 by President Xi Jinping, first in Central Asia and later in Indonesia, and will be implemented as an important foreign econom-

6 China Daily: China world's biggest luxury consumer, 21 February 2014.

ic policy and initiative in the country's 13th Five-Year Plan (2016-2020). As Figure 3 illustrates, the Silk Road Economic Belt stretches northwest from China's coastal area through Central Asia, the Middle East and on to Europe, and the Maritime Silk Road runs from China to Southeast Asia and then to Africa.

Politically and strategically, China's One Belt and One Road initiative is a direct response to the Obama administration's "Pivot to Asia" policy, announced in the fall of 2011 with an aim to strengthen the military alliance and economic order the US has established in the Asia Pacific region during the Cold War in order to hedge, sometimes contain and ensure a peaceful rise of China.[7] However, China's initiative does not intend to create an alliance and is open for international participation without regard to a country's political system, religious orientation and military alliance. Economically, the One Belt and One Road initiative also attempts to foster economic growth in the region by sharing China's development experiences and leveraging on China's development assistance. Specifically, the One Belt and One Road initiative aims to encourage Chinese firms to invest abroad in emerging market economies along the historical trade routes of the Silk Road, now separated into the Silk Road Economic Belt and the Maritime Silk Road. This initiative may help diversify China's large foreign exchange reserve holdings, primarily in the form of US Treasuries currently earning little return, into a formidable force of foreign direct investment in both the developing and developed worlds. By exporting technology, transferring development know-how and facilitating industrialisation through the use of Chinese long-term finance to less developed economies, China will not only find a growing market, promote economic development and create demand for its exports along the One Belt and One Road, but it will also potentially help diversify its foreign exchange reserve assets.

This Chinese initiative is open for international participation, and Chinese authorities have welcomed and solicited Europe's participation. This could present an economic opportunity for Europe. Hit hard by the global financial crisis, European economies continue to face great economic difficulties and political challenges, such as an unsustainable debt problem, a high unemployment rate, weak domestic demand and the recent surging migration from the Middle East and North Africa. The One Belt and One Road initiative will bring about economic opportunity by creating large demand for infrastructure investment,

Figure 3

Silk Road Economic Belt and Maritime Silk Road

Source: Xinhua.

but it will also potentially facilitate economic development and instil political stability in the regions from which great numbers of illegal migrants are coming.

The One Belt and One Road initiative will also encourage financial cooperation between China and Europe. China has set up a Silk Road Fund with an endowment of $40 billion, and the fund has already started making investments. The broad focus of the fund will be infrastructure investment and energy development, as well as facilitating industrial and financial cooperation. Promoting the "coming out" of Chinese high-end technology and production capacity will be another emphasis of the fund. Reportedly, the fund's initial size will be $10 billion, funded by foreign exchange reserves ($6.5 billion), the China Investment Corporation ($1.5 billion), the Export-Import Bank of China ($1.5 billion) and the China Development Bank ($500 million).[8]

Another source of potential funding to accelerate the One Belt and One Road initiative could be the China-sponsored Asian Infrastructure Investment Bank (AIIB), for which 57 countries have currently signed up, including some key European economies. This new multilateral development financing institution has an authorised capital of $100 billion. Given that the majority of the member economies are One Belt and One Road countries, the AIIB is likely to become a financing vehicle to help China accelerate the One Belt and One Road initiative and facilitate the exporting policy of its enterprises. Anecdotally, local governments have already started to formulate their local investment plans to match the initiative, aiming to utilise the transportation route for market access to Europe. The

7 M.E. Manyin, S. Daggett, B. Dolven, S.V. Lawrence, M.F. Martin, R. O'Rourke, B. Vaughn: Pivot to the Pacific? The Obama Administration's "Rebalancing" Toward Asia, Congressional Research Service, 7-5700, 28 March 2012.

8 Silk Road Fund: The Silk Road Fund Begins Operations: An Interview with Zhou Xiaochuan, 16 February 2015.

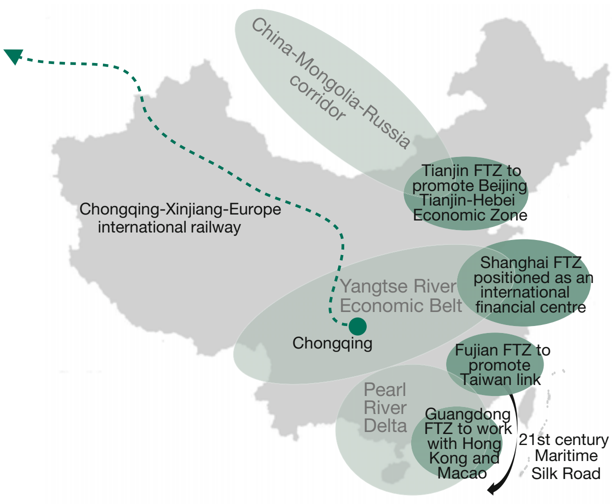
Fujian Free Trade Zone, for instance, is considered the starting point of the Maritime Silk Road (Figure 4). In April 2015, China signed a package of deals worth $46 billion to develop an economic corridor between China's north-western autonomous region Xinjiang and Pakistan's Gwador Port. This port will allow Chinese oil tankers from the Persian Gulf to port and ship oil and gas to China's Xinjiang-Shanghai oil pipeline directly. In addition, Chinese manufacturing products could also be shipped via land to Gwadar and then re-shipped to the Middle East once the road and rail links are completed. Chinese, Pakistani and other international companies will be involved in communications infrastructure and power generation projects.

The infrastructure needs in the emerging Asia Pacific economies and elsewhere are huge, and they are unlikely to be fulfilled by China alone. This leaves room for collaboration between Europe and China in both private and development finance. The Asian Development Bank estimates that the total infrastructure investment needed in the Asia Pacific region in the period 2010-20 is approximately $8 trillion. Together with projects already in the pipeline and high priority projects, the total infrastructure investment needed per year in Asia Pacific amounts to about $750 billion.[9] The latest forecast by the private consulting firm Oxford Economics suggests that infrastructure investment from the Asia Pacific region will likely grow from seven to eight per cent annually over the next ten years.[10] By the end of 2025, the region will constitute 60 per cent of the global infrastructure investment (see Table 1). Specifically, China's infrastructure spending is expected to increase from 22 per cent of the world total in 2012 to 36.4 per cent by 2025. Emerging Asia, including China, India, Indonesia, Malaysia, the Philippines, Thailand and Vietnam, is expected to increase from 30.4 per cent in 2012 to 47.7 per cent of global infrastructure investment by 2025. The emerging Asia countries account for almost half of the world infrastructure investment, indicating a major geographical shift of infrastructure spending from the West to the East.

A policy agenda for the future

As China regains its previous global economic status, the China-Europe economic partnership will become an equal one. Over the last 20 years, this trade relationship has become China's most important one (Figure 5). Increasingly, more EU countries such as Germany, Hungary and Spain, as well as non-EU countries such as Russia, also treat China as their most important trading partner.

Figure 4
China's free trade zones



Source: CEIC.

In the near term, a pressing bilateral trade issue is for the EU to recognise China as a market economy. This status will help reduce bilateral trade frictions and protectionist tendencies and make it difficult for some EU companies to rely on anti-dumping duties to keep competitors at the gate. In addition, the EU recognition will also allow the WTO to finally recognise China's market economy status. This international recognition will also strengthen the hand of Chinese reformers, who face significant resistance domestically from left-leaning party officials. Despite such resistance, after close to 40 years of economic reform, China's state-owned enterprises have become much less important to its economy and are playing a more limited role in international trade, while the private sector now contributes over 60 per cent of GDP. Given the pressing need to rebalance the economy and encourage consumption, China refrained from using a cheap currency policy to boost exports after the global financial crisis. Meanwhile, its determination to get its currency included in the IMF's Special Drawing Right (SDR) also showcased its intention to open its capital account and use external forces to push through more difficult reforms in the financial sector, such as interest rate liberalisation and domestic capital market development. It appears that the EU has started consultations with China on its recognition as a market economy, and this will be finalised by the second half of 2016.

Another short-term issue is the negotiation of an EU-China bilateral investment agreement (BIA). The BIA is expected to be concluded by the end of 2016, and such an agreement could become a stepping-stone for the EU to negotiate an EU-China free trade agreement. A similar bilateral investment treaty between China and the US is also underway, but it has made limited progress and been stymied by

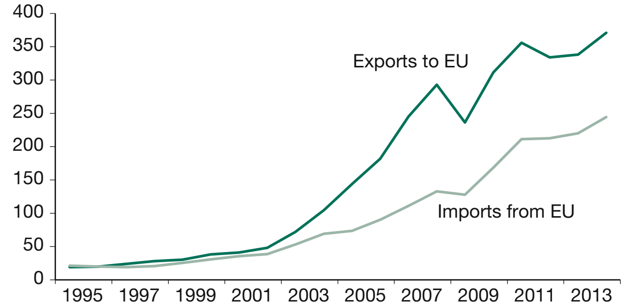
9 Asian Development Bank: Infrastructure for a Seamless Asia, Asian Development Bank and Asian Development Bank Institute, 2009.
10 Capital project and infrastructure spending: Outlook to 2025, PwC and Oxford Economics, 2015.

Table 1
Global annual infrastructure spending by sectors

Sector/ sub-sector	2013 Asia-Pacific US$ millions	2013 Global US$ millions	2025 Asia-Pacific US$ millions	2025 Global US$ millions
Road network (including bridges and tunnels)	345 330	579 783	745 194	1 137 559
Railroad network (including stations and terminals)	122 187	208 099	279 525	444 835
Sea ports	43 463	57 669	106 874	132 642
Airports	23 777	62 327	49 213	107 898
Telecommunications	165 554	372 933	418 052	819 012
Power generation	128 420	342 485	349 366	729 130
Electricity transmission	123 482	208 057	320 446	469 844
Water supply and treatment	74 953	163 669	294 703	438 476
Hospitals	88 285	284 542	278 855	595 029
Total	1 115 451	2 279 564	2 842 228	4 874 425

Source: Capital project and infrastructure spending: Outlook to 2025, Outlook to 2025 Data Modeller, PwC and Oxford Economics.

Figure 5
European and Chinese trade relations
in US$ billions



Source: CEIC.

political considerations. An EU-China BIA could help accelerate the stalled China-US BIA by creating some competition effects. As a sign of its good will, China announced in September 2015 that it would become the first non-EU nation to participate as a contributor to the EU's €315 billion investment plan. Reciprocally, China has been admitted as a member of the European Bank for Reconstruction and Development (EBRD), a European financial institution for European regional development issues. Indeed, such reciprocities bode well for China and the EU to collaborate on the One Belt and One Road initiative by leveraging the lending capacities of the EBRD and the newly established AIIB to engage in development financing in Central Asia, Eastern Europe and even Southern European economies that have been badly affected by the global financial crisis.

A medium-term policy issue for the EU and China is to engage in negotitions on an FTA. China has reached many FTAs with OECD economies, such as Chile, New Zealand, South Korea and Australia, in addition to many FTAs with developing economies such as the China-ASEAN FTA. Meanwhile, China also proposed to establish an Asia Pacific Economic Community free trade area, which would include all APEC economies, including the US, to boost regional trade and accelerate the Doha round of global trade negotiations that has been stalled for close to 15 years. For political reasons, China has not been invited to participate in the US-sponsored Trans Pacific Partnership (TPP), a selective FTA in the Asia Pacific region and an important economic piece of the overall US Pivot to Asia strategy. An EU-China FTA could demonstrate that an FTA can transcend political considerations and set a positive example for the US and China, the largest and second-largest economies, to work together, facilitate freer trade globally and contribute to global economic growth and political stability.

Conclusion

This article argues that the close trade and economic relationship between the EU and China can be strengthened further by China's economic rebalancing, rising consumption and new initiative to revive the ancient trade routes between China and Europe via infrastructure investment and economic development. This new economic landscape offers a rare opportunity for Europe to rely on China's rising consumption as an engine for growth. Meanwhile, the One Belt and One Road initiative will also help boost demand for investment and encourage economic development in an area of vital importance to Europe's economic and political interests.

As China regains its historical economic status, relations between the EU and China will become equal, allowing more mature dialogues in many economic and political areas. Indeed, some positive postures by some key economies in Europe on issues ranging from the AIIB to the renminbi's inclusion in the IMF's SDR have demonstrated that productive collaboration is easily attainable. The world economic landscape has already become a tri-polar one, with the EU, the US and China as the largest economies in the world. Their cooperation will be vital to global economic growth and political stability. A more constructive EU-China relationship in the global economy will potentially relieve the political and economic tensions between China and the US and contribute to global peace and prosperity.