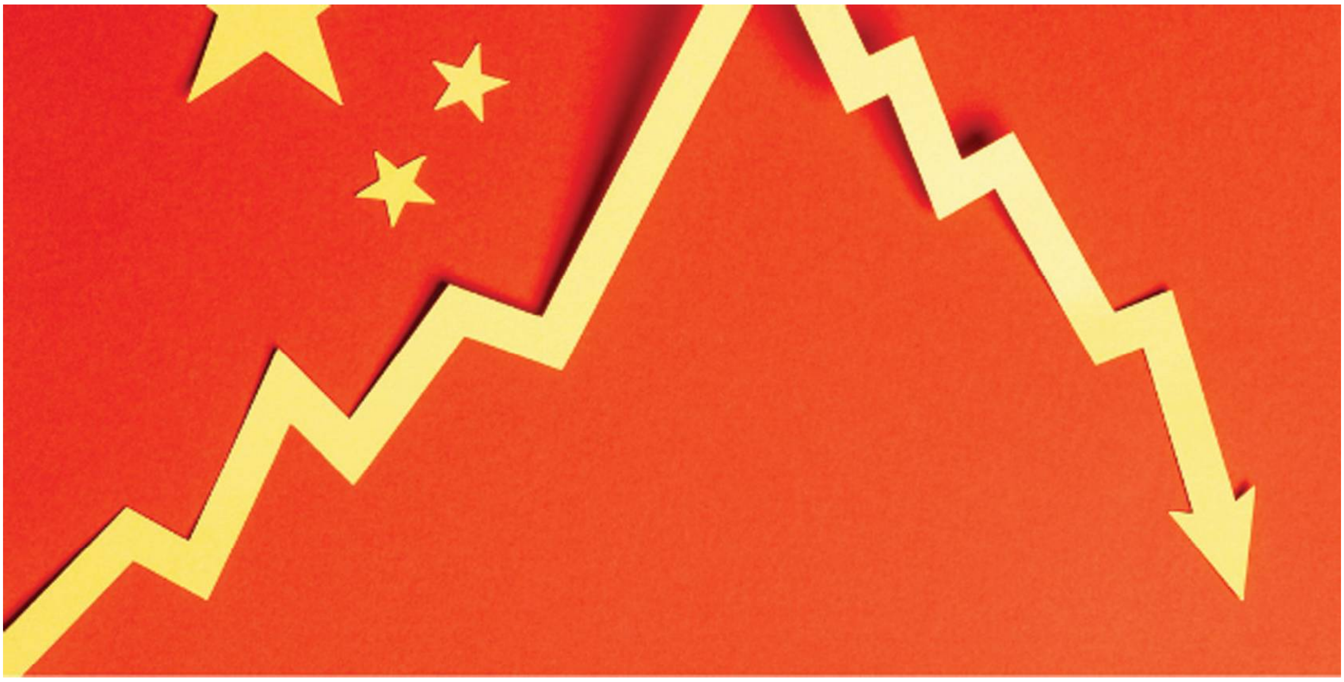
China

IS DEEPENING ECONOMIC SLOWDOWN EXISTENTIAL?



China's plummeting economy is not a downhill slide. Nor is it an existential threat. Nevertheless, it is a rare perfect storm combining a rebound from the Covid-19 pandemic, the repercussions of the Ukraine war, and intensifying US anti-China tactics.

According to a report in the *South China Morning Post*, China's April exports fell by 25.9%, down from 14.7% in March, while imports remained flat.

Data from the National Bureau of Statistics (NBS) show that the so-called 'troika' of retail, industrial and fixed-asset investments all performed worse than expected.

Retail sales fell by 11.1% year-on-year (y-o-y), the lowest since March 2020; industrial value-added changed from expansion to contraction, hitting a record low of 2.9%. Fixed asset investment grew only 6.8% in the first four months, lower than expected. The employment situation deteriorated markedly. The urban unemployment rate expanded slightly to 6.1%, from 6.2% in February 2020, which was the second-highest ever. The unemployment rate for young people aged 16 to 24 was as high as 18.2%, a record. Bloomberg Economics estimates that Mainland China's economy contracted by 0.68% y-o-y in April. UBS believes that the economic growth in the second quarter may be lower than 2%. Citigroup lowered its forecast for economic growth in the mainland this year from 5.1% to 4.2%. The economic growth in the second quarter may only be 1.7%. ING Bank estimated that the economy continued to contract in the second quarter, down 1% y-o-y.

My article "China: Is Slowdown for Real?" in the February 2022 issue of *The Global Analyst* explained why China has been achieving a relatively high GDP growth rate over the last few decades. Faced with a multitude of headwinds, both domestic and external, its growth engine appears to be fast losing steam. Innovative and sustainable growth, rather than sheer GDP targets, is now the new direction. However, currently, China's economy seems to be heading toward the cliff, raising questions if this is a canary in the coalmine of an existential threat.

To answer these questions meaningfully, it is necessary to examine critically the nature of the latest economic slide. The reasons are essentially threefold: "dynamic zero-Covid" lockdowns, Ukraine war repercussions, and the US' intensifying confrontations.

Dynamic Zero Infections

There seems to be an entrenched global misunderstanding of what "Dynamic Zero" actually means, exemplified by the World Health Organization (WHO)'s latest questioning of its sustainability.

As outlined in a January 10, 2022, explainer on the State Council website, it is *not* a blind headlong march towards an impossible dream. It is rather a vigorous process to deliver an outcome where the pandemic will no longer be a life threat to the vast majority of people. Its components are early detection and isolation, timely treatment, and effective prevention. It aims to detect and stop early outbreaks in their tracks, protect lives, especially vulnerable groups, and empower society to return to normalcy as soon as possible.

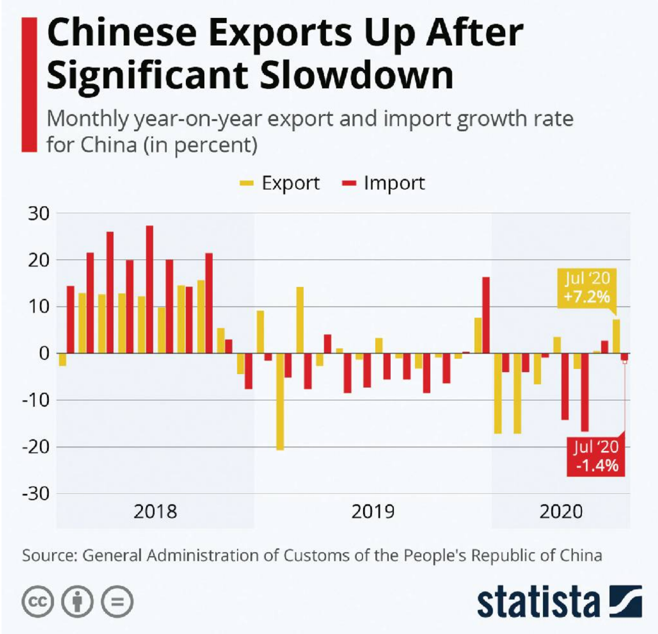
As explained by the Ministry of Foreign Affairs Spokesperson Zhao Lijian on May 11, 2022:

"China's dynamic zero-Covid policy is not aimed at realizing zero infection, but rather at bringing Covid-19 under control at the minimum social cost in the shortest time possible to effectively protect the health, normal life, and production of the 1.4 billion Chinese people to the maximum."

"According to an analysis published by *The Lancet* in March, global estimates of excess deaths indicate 18.2 million people may have died because of the Covid-19 pandemic, with the excess mortality rate estimated to be 120 deaths per 100,000 population globally, 179 for the US, and 0.6 for China."

"Based on new modeling by scientists in China and the US, China risks over 1.5 million Covid deaths if it drops its tough dynamic zero-Covid policy. China's huge population also means that relaxing prevention and control measures will inevitably lead to the death of a large number of elderly people."

Early alarm notwithstanding, according to a report in the *South China Morning Post* on May 17, 2022, Shanghai has reached a milestone in keeping community infections at zero for days, en route to its scheduled June reopening. However, other Covid flashpoints, albeit so far limited, are happening in some other cities and provinces.



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Barclays Bank China thinks that with the epidemic improving, the April data may show that the worst situation of China's economy has passed. However, this does not mean a return to paradise. There is ongoing downward pressure on the real estate market and only moderate improvement in the consumption and service industries. A strong economic rebound is not expected. On the other hand, ANZ Bank judged that given more government support, annual growth in 2022 is expected to reach 5%, with the caveat that support policy for another year is unsustainable. So next year's economic growth rate is expected to reduce from 5.1% to 4.2%.

Morgan Stanley predicts that China's economy may contract by 0.5% quarter-on-quarter in the second quarter; thereafter, growing by 1.9% y-o-y for the remainder of 2022; and by 4.2% for the whole year.

Goldman Sachs believes that economic indicators in May and June will gradually improve. Barring black swans and even stricter prevention and control, the worst seems to be over.

Changing fortunes of the Ukraine war

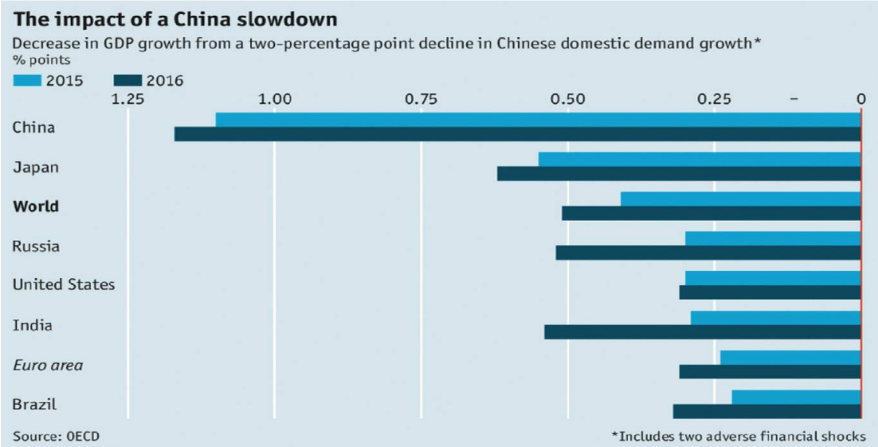
Beijing has so far refrained from getting actively involved as a broker over Ukraine. Any even-handedness would be seen by the US as pro-Russia. On the other hand, following the US hymnbook would be ignoring Russia's security concerns; nor would it be in China's best interests.

Nevertheless, China finds itself caught in a quandary. In the face of a US-led Western coalition to sanction, ostracize, and cripple, if not topple, Russia, Beijing is neither willing nor able to ignore Western demands not to help Putin's war efforts, notwithstanding Beijing's consistent opposition to unilateral sanctions and substantial geoeconomic and geopolitical complementarity between the two socialist countries, both as America's main adversaries.

Meanwhile, like the rest of the world, China is feeling some pinch from higher energy and foodstuff prices resulting from the Ukraine war, albeit moderately, given China's massive production capacity, adequate oil and food stockpile, and availability of imports from other sources as the world's largest trading nation.

As reported by CNBC, China's consumer price index rose by 2.1% in April from a year ago, the fastest since November. Excluding food and energy prices, the consumer price index rose by a muted 0.9% in April from a year ago.

On the other hand, when the dust finally settles, the end of the Ukraine war could turn out to be a bonanza for China. A devastated Ukraine and a weakened and isolated Russia are respectively likely to welcome China's trade and investments. China has long been Ukraine's largest trading partner for its massive energy and agricultural output. Ukraine's dire need for reconstruction could embrace the deep pockets of China's Belt and Road Initiative as a gateway to the rest of Europe. Likewise, an ostracized Russia is likely to rely on energy and agricultural exports to China even more, helped by an increasingly warmer climate in Russia's far east, thanks to climate change.



Russia's exclusion from dollar-based international payment systems would boost the use of the Renminbi (RMB), China's currency, as a medium of bilateral trade. Other countries wary of Uncle Sam's penchant for weaponizing the dollar may likewise be attracted to the RMB as a useful hedge. After all, China is the largest trading partner for 123 nations compared with 57 for the US. This is likely to boost RMB's status as a burgeoning international currency, including its budding digital equivalent.

Meanwhile, the exodus en masse from Russia of virtually all Western brands, including the likes of McDonald's, Starbucks, Marriott, Louis Vuitton, BMW, Ford, H & M, and Dell are handing a clean slate to ambitious Chinese brands and enterprises. One of my Chinese friends living in Moscow was delighted to report the sudden market availability of a rare Chinese beer!

US across-the-board pushback against China

As part and parcel of the US's all-out trade war against China, hundreds of Chinese goods and products have been under US tariffs, including those imposed by the former Donald Trump administration. Added to these are Chinese companies under US sanctions for supporting alleged human rights violations. These embargoes and strictures have resulted in massive disruptions in the world's supply and value chains. As

Beijing Is Juggling Too Many Challenges at Once While Growth Drops, Making a Crisis More Likely

Beijing risks making a misstep as it attempts to manage seven economic policy challenges at once.

1. Slow deleveraging: While credit growth has moderated to come in line with economic growth, debt-to-Gross Domestic Product (GDP) ratios remain high and steady.
2. Persistent financial risk: Financial regulatory overhaul continues, but new shadowy corners pop up as soon as old ones get regulated, while property prices remain elevated.
3. Monetary/external imbalance: The strategy of using monetary liquidity to support the financial system amid regulatory tightening is running headlong into Federal Reserve tightening, weakening the renminbi, and retesting capital controls.
4. Geopolitics: Even before the Trump presidency, China and the US were poised to become competitors as China climbs the value chain and offers an alternative model. For a country as large as China, the middle-income trap is harder because it also leads to a Thucydides Trap (the pattern of established powers fearing rising powers, historically leading to conflict three-quarters of the time and likely to strain China's integration with Western economies).
5. Social contract: Convincing people to accept lower growth and higher default risk will be difficult.
6. Attracting foreign investors: Convincing international investors to use the renminbi and invest in China requires a credible commitment to avoid capital controls.
7. Sectoral restructuring: It will take decades to rebalance the economy toward domestic consumption, services, and advanced manufacturing, reform state-owned enterprises, and deepen capital markets.

China faces this array of challenges while its sustainable growth rate is falling by half, from a 10% average over four decades to a new normal around the 5% middle-income average. Beijing faces a daunting array of growth, financial, geopolitical, and other challenges, making its idiosyncratic risk factors quite high.

Courtesy: atlanticcouncil.org

the bulk of America's imported consumer goods is from China, absent immediate alternatives, the outcome is rapidly rising US domestic inflation, not helped by Ukraine-war supply-chain disruptions and price hikes in energy and agricultural products. As reported by CNBC on May 10, 2022, America's inflation rate is hitting a historic north of 8%. Prompted by Treasury Secretary Janet Yellen, President Biden is mulling the repeal of some tariffs on Chinese goods imposed by Trump as an immediate palliative, with eyes on the coming mid-term election. As I flagged up in my May 8, 2022, piece, "What The Economist omits to address in President Xi's vision of a global security order" in *World Strategic Insights*, a Rome-based online publication, the US seems turbo-charged to segregate the world into two camps, framing this as a contest of the century between democracy and authoritarianism.

However, notwithstanding the draconian across-the-board sanctions and other restrictions, according to Wang Huiyao, founder and president of the Center for China and Globalization (CCG) in Beijing, in 2021, "global trade hit a record $28.5 tn, up 25% y-o-y and 13% higher than in 2019, before the pandemic struck. For all the talk of decoupling, US-China trade swelled more than 20% last year, to $687.2 bn. Even with war in Ukraine, global trade is forecast to grow in 2022, albeit at a slower pace".

"Cross-border investment also surpassed pre-pandemic levels last year, swelling to $1.65 tn. China, in particular, is more integrated into the global economy than ever. In 2021, its foreign direct investment inflows rose by a third to an all-time high of $334 bn. In the first quarter of this year, they grew by more than 25% y-o-y". "Globalization isn't dead, It's just not American anymore", Wang quipped.

Outlook 2022 and beyond

As forecast by Fitch Ratings, China's 2022 GDP growth is expected to slow from 4.8% to 4.3%. The agency has however revised its 2023 growth forecast slightly higher to 5.2%, from 5.1%, on the assumption that the government will phase out its 'dynamic zero-Covid' policy gradually over the next year.

The Ukraine war is likely to drag on much longer than expected. However, its impact on China's economy is unlikely to be severe. When the war ends, China is poised to be the largest beneficiary by way of expansion of trade, investments, and fresh markets for Chinese goods and services.

The US's bipartisan animosity and aggression toward China are intensifying. This is nothing less than a "struggle of the century" as the world's extant superpower feels threatened by a rising near-peer rival with a diametrically-different ideology, culture, and race. Beijing is under no illusions about this prolonged conflict. It is doubling down on self-reliance in innovation and cutting-edge technologies, widening outreach to the developing and less-unfriendly world, including a reformed Belt and Road Initiative, and a more proactive global diplomacy.

The 20th National Congress of the Chinese Communist Party will be held in Beijing in the second half of 2022. President Xi Jinping is expected to secure his third term as China's supreme leader, along with a new suite of top lieutenants (other members of the Politburo Standing Committee) and other rising stars in the Politburo.

As reported in the *South China Morning Post*, Xi has made the current Central Committee (talent pool for the Politburo) the most educated one in the party's history, with 28% of its full members holding doctorates and 12% having received education overseas. In the coming leadership shakeup, more cadres with backgrounds in Science, Technology, Engineering, and Mathematics (STEM) will be taking on key roles, including those with outstanding achievements in aerospace, semiconductors, and advanced manufacturing. This is supported by China's huge reservoir of STEM human capital, the largest in the world by sheer numbers. As outlined in my last piece "China in the Eye of a Perfect Global Storm" (*The Global Analyst*, May 2022), China's yearly STEM PhD graduates (77,179) will nearly double those in the US (39,959) by 2025.

As China Goes, So Goes the Global Economy

In calculating contagion risks, the IMF finds limited global reliance on Chinese final demand and capital markets, meaning the sharpest spillovers would be regionally concentrated. Kenneth Rogoff, the International Monetary Fund's former chief economist, calls this "wishful thinking," warning that investors are already jittery about profit growth, much of which relies on future business in China, even if the capital market linkages remain underdeveloped. Rogoff also cautions that, unlike US recessions, a Chinese downturn could coincide with rising US interest rates. Rogoff concludes by warning that China's inevitable growth recession "will almost surely be amplified by a financial crisis, given the economy's massive leverage," and that this "would constitute the third leg of the debt supercycle that began in the US in 2008 and moved to Europe in 2010."

Whether or not China suffers a crisis, the global economy will enjoy less support from the twin engines of credit-fueled Chinese growth and aggressive monetary easing that powered the last recovery. If not for China, the global recession would have cut 50% deeper and the series of shocks throughout the recovery (euro crisis, taper tantrum, oil price decline, etc.) may have tipped the world back into recession. By contrast, high debts and low yields may well bring a major test of global economic and political stability with the next global downturn, whether or not it is triggered by China.

Courtesy: atlanticcouncil.org

Outlook

China's plummeting economy is not a downhill slide toward the cliff. Nor is it an existential threat. Nevertheless, it is a rare perfect storm combining a rebound from the Covid pandemic, the repercussions of the Ukraine war, and intensifying US anti-China tactics. With the pandemic set to metathesize into a milder endemic across the world, China's economy is likely to gradually return at least to partial recovery, ready to carry on its struggle for greater technological self-reliance, a recharged domestic market, and progress toward the China Dream of national renaissance. ■

Reference # 20M-2022-06-04-01