China

IN THE EYE OF A PERFECT GLOBAL STORM

Having learnt from Russia's adventurism in Ukraine, China, unless pushed into a corner, is unlikely to take potentially catastrophic risks anytime soon if it fails to achieve anything less than a lightning victory (over Taiwan) in the face of a similar tsunami of international censure and sanctions.

An unpredictable Omicron variant and the sudden Russian war on Ukraine have further shaken an already weakend global economy in the wake of now over two years of supply chain dislocation, since the onset of the Covid-19 pandemic, not to mention a tectonically disruptive trade, technology, economic, and ideological warfare against China as the world's largest trader and manufacturer. According to *The New York Times*, international organizations and think tanks have begun slashing economic forecasts due to dislocations of global energy, food, and commodity supplies, as well as China's sweeping city lockdowns to contain the Omicron outbreak. As per International Monetary Fund (IMF), world output was expected to slow this year to 3.6%, down from 6.1% in 2021, compared with its January growth forecast of 4.4%. Food and commodity inflation is raging across the globe, albeit to various degrees. *The Economist*'s cover story of April 23, 2022, highlights "the Fed that failed" over inflation, suffering "a hair-raising loss of control". Consumer prices in the US in March were 8.5% higher than a year before, with nearly a fifth of Americans agreeing inflation is the country's most important problem. In response, for the first time since 2018, the Fed has raised rates by a quarter percentage point from near zero. This is bad news for markets worldwide.

China in the eye of the storm

Already battered by trade and technology sanctions, China is in the eye of this global storm. So it was surprising that China was able to maintain a 4.8% GDP growth in the first quarter of 2022, higher than the 4% for Q4 2021. Nevertheless, this hides a marked decline in both manufacturing and non-manufacturing activities as reflected by the weak Purchasing Managers' Index (PMI) in March. My reading is that against almost impossible odds, China's growth momentum has been sufficiently robust to have registered 4.8% growth in the first place. A lot depends on how long China continues to maintain its "dynamic zero" Covid strategy, severing ties with the global economy.

According to a 19-April-2022 research note by Natixis, a French bank, China's retail sales collapsed in March with –3.5% growth Year-on-Year (YoY), down from 6.7% in the first two months of 2022. Restaurant sales plummeted to –16.4% in March from 8.9% in January and February. Nevertheless, this is against the background of a 6.3% YoY increase in household disposable income for Q1 2022, (even if trending down from an 8.7% YoY increase for Q1 2019 before the full onset of the pandemic). Similarly, against unprecedented headwinds, a 6.3% YoY increase in Q1 2022 in household disposable income suggests strong fundamentals for domestic consumption, a bulwark prioritized by Beijing's "dual circulation strategy", lessening overdependence on exports.

According to a *Reuters* poll on April 14, China's economic growth is likely to slow to 5% in 2022 amid renewed Covid-19 outbreaks and a weakening global recovery as a result. Growth is then forecast to pick up to 5.2% in 2023. However, real GDP growth was not expected to fall below 4%, thanks to Beijing's infrastructure push and the surprisingly strong data seen in January and February.

As flagged up in my piece in *The Global Analyst* December 2021 issue, China is doubling its impressive high-speed rail network to 70,000 km by 2035. Together with a dense network of expressways and electric railways, this will connect all of China's cities and towns with 200,000 people and above, however remote, many forming dynamic city clusters. Together with advances in the digital economy, this is designed to overcome flagging productivity due to worsening demographics. What is more, this will hasten the urbanization rate, doubling China's consumer middle class to 800 million by 2035, laying a solid foundation for a more consumer-driven economy.

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Ample room for economic stimulus

As anticipated, on April 15, China's central bank announced a cut by 0.25 percentage points of its Reserve Requirement Ratio (RRR), the amount of cash that banks must hold in reserve. This marks the third reserve cut in the current easing cycle, following 50 percentage points cuts in July and December last year.

More fiscal, monetary, financial, and economic easing measures are in China's arsenal to revive the economy. This is enabled by its lesser risk from inflation as the world's largest maker and exporter of consumer goods with considerable overcapacity.

Implications of the Ukraine war

China is walking on a tightrope of a US-led Russian sanction trap. Nevertheless, the direct impact of the Ukrainian war on China is relatively limited. What is more important, when the Ukraine war is finally over, is China is likely to benefit hugely. The reasons are manifold. First, a weakened and ostracized Russia would become much more dependent on China as a large, if not the largest customer, for its energy and agricultural resources. Second, before the war, Ukraine already had China as its largest trading partner. After the dust has settled, this relationship is likely to redouble as China will be interested in helping with Ukraine's reconstruction to boost its role as a Belt and Road Initiative gateway to the rest of Europe. Third, as the world's largest shipbuilder, China is set to benefit from a subsequent surge in demand for more oil tankers as European countries seek to diversify oil supply from Russia to the Middle East and America. Fourth, as the dollar has indiscriminately been weaponized for unilateral sanctions and denial of access to dollar-based financial reserves, more and more countries, not least Russia, are exploring supplementary, if not alternative, mechanisms or payment systems for bilateral trade settlements and reserve deposits, if only by way of hedging. Fifth, as 130 countries worldwide have China as the largest trading partner, the use of the Renminbi (RMB), the Chinese currency, for bilateral trade with China is likely to gain traction. This would benefit RMB's internalization as well as hasten the development of China's digital sovereign currency.

Interview

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"There is no sign China will meaningfully change the zero-Covid policy."

What is hurting growth in the mainland?

The obvious answer is the zero-Covid policy, and it has mattered a great deal in March and April of this year. But growth was slowing long before even the first outbreak of Covid in late 2019. China's labor force is shrinking and it has failed to improve education nearly as much as it could, so labor's contribution to growth is shrinking. China is highly indebted for its income level, cutting into the capital contribution to growth. The Communist Party still does not allow private ownership of land. Innovation has been discouraged by Xi Jinping's attacks on the private sector. All the sources of growth have been weakening.

What is your overall outlook for 2022 and the subsequent year?

Whenever forecasting China's economy, there is what will happen and what the government says will happen. The government is likely to report GDP growth of 5.0% or more, trending higher in the second half. It will say that the target may have been missed due to Covid, but China has rebounded past that problem. In this case, the official growth target for 2023 will be a bit lower than for this year. What happens depends on Covid. There is no sign China will meaningfully change the zero-Covid policy. There is still the possibility of large-scale stimulus this year, but it won't work if there are widespread lockdowns, and it is getting late for stimulus to have much impact in 2022. If China struggles with Covid for multiple months longer, true GDP growth could be as low as 1.5%.

As usual, a weaker 2022 enables a stronger 2023. If Covid has a terrible impact this year but much less next year, 2023 GDP growth could be above 7%.

Much of the current debate over China's economy boils down to a debate over what the leadership of the Communist Party wants. In the past, the Party wanted rapid growth to create jobs. But China's labor force is shrinking and that is no longer necessary. The Party certainly doesn't want a rapid fall into economic contraction and will act strongly to prevent that. But it has much less reason to chase fast GDP growth.

All these dynamics are likely to weaken, though not yet enough to topple, the dominance of the greenback.

Fear over Taiwan

A hotly debated question is whether President Xi may take a leaf from President Putin's book to recover Taiwan by force. In a testimony to the Senate Appropriations Committee regarding the fiscal year 2022 budget for the Defense Department on June 17, 2021, Chairman of Joint Chiefs of Staff General Mark Milley advised that China lacks the full capacity to invade Taiwan until 2027, and did not seem to intend to do so in the near term. However, a Harvard Kennedy School Belfer Center Report, dated December 16, 2021, by Graham Allison et al., posits that the era of US military primacy is now over. China, in particular, has the capability to deliver a fait accompli on Taiwan before Washington could decide how to respond.

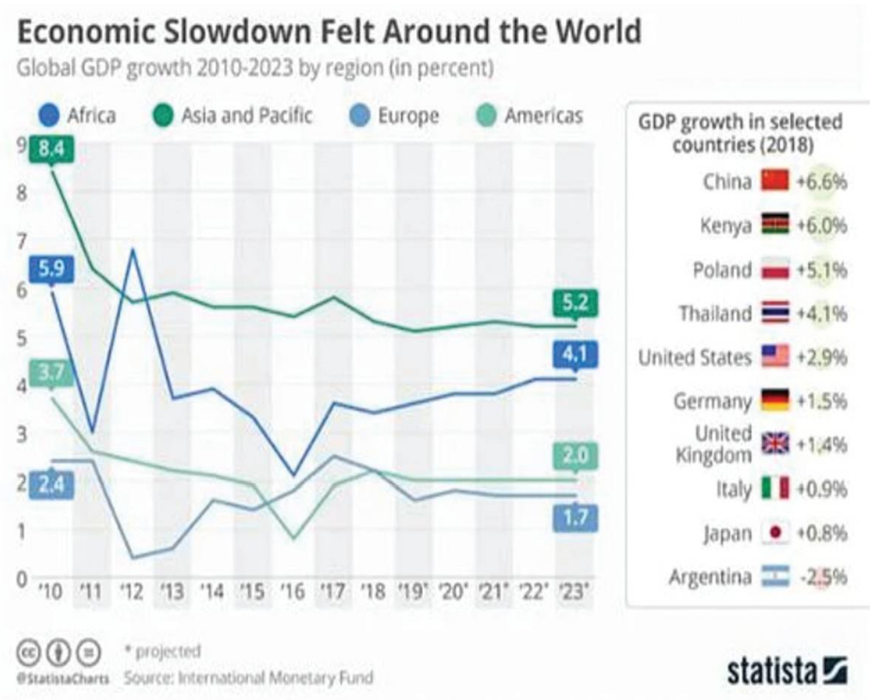
Nevertheless, capacity cannot be equated with adventurism. An overwhelming majority of Taiwanese people oppose unification. However, with a million Taiwanese and their families working and living on the Mainland, most prefer the status quo. Indeed, a majority of the Chinese people regard Taiwanese as kith and kin.

In any case, having learnt from Russia's adventurism in Ukraine, Beijing, unless pushed into a corner, is unlikely to take potentially catastrophic risks anytime soon if it fails to achieve anything less than a lightning victory in the face of a similar tsunami of international censure and sanctions. This would play havoc with China's weakening economy and already-plummeting global image. All of these run counter to realizing the China Dream of becoming a responsible and respected great power. Only a handful of small countries retain formal diplomatic relations with Taiwan, which is not a country recognized by the UN. Unless pushed into a corner, time remains on Beijing's side to achieve peaceful unification through diplomatic, geostrategic, socioeconomic, and other subtle pressures much before its declared absolute deadline of 2049, the centenary of the founding of the People's Republic of China (PRC).

Preparing for post-pandemic normalcy

As for China's pandemic lockdowns, Beijing is already taking steps to ease the restrictions applying to selected chokepoints and strategic enterprises, according to a report in the *South China Morning Post* of April 19. These take the form of "white lists" of companies allowed to resume production and operations, such as China's largest chipmaker, Semiconductor Manufacturing International Corporation (SMIC), the state-owned carmaker SAIC Motor Corp, and the electric carmaker Tesla, a key driver growing China's electric car industry into the biggest in the world. Out of Shanghai's total population of 25 million, some 390,000 residents have been infected by Omicron since March 1, with 27,200 showing symptoms. The sudden lockdown of the entire city has generated seething social discontent as essential supplies and hospitals struggled to cope. As of April 19, however, a declining number of new cases in the previous 24 hours began to be reported. Shanghai's businesses are beginning to adopt measures to enable themselves to resume production gradually as the city appears near the end of its standstill order.

The World Health Organization (WHO) now estimates that America has suffered nearly a million deaths due to the pandemic. As China's population is four times larger, pain and financial loss aside, China's "zero Covid" strategy may well prove its worth eventually. All these show that China's fundamentals remain relatively strong, a broad range of policies and measures are available to steady the boat, and light is beginning to appear at the end of the tunnel.



PRC 3.0 – Challenges and opportunities

China has abandoned the strict adherence to an annual fixed GDP growth target. After all, more meaningful than a magic GDP number are the quality and sustainability of growth as well as dynamics driving the country's long-term trajectory toward the China Dream. At the Chinese Communist Party (CCP)'s 19th Central Committee Plenum from November 8-11 this year, President Xi is expected to obtain the endorsement of a third five-year term as President and Party Secretary. He is also due to unveil a new leadership team (Politburo Standing Committee) to build "PRC 3.0.", taking China to the next level, after Chairman Mao who founded the People's Republic of China (PRC), and Deng Xiaoping who initiated China's reform and opening up.

As reflected in China's 14th Five-Year Plan (2021-25), China is expected to become a "modern socialist nation" by 2035, capitalizing on the "New Development Concept", the "Dual Circulation Strategy", "technology self-reliance", "sustainable growth", and "Common Prosperity".

However, success is by no means assured as President Xi has repeatedly referred to China's challenges (and opportunities) not seen in a hundred years. First and foremost is the US' all-out hostility against China, including across-the-board sanctions and decoupling. However, according to an analysis of January 11, 2022, in *Foreign Policy*, America cannot meaningfully decouple from China. 130 countries worldwide have entrenched China as their largest trading partner, compared with 57 countries for the US. Almost everything has China embedded in it, be it materials, components, or logistics. Seven of the world's top 10 container ports are in China (including Hong Kong).

At the Boao Forum for Asia on April 21, 2022, President Xi warned that unilateral decoupling is "fundamentally unworkable". In addition to hurting the disrupted, the disrupter or "dismantler" is also "damaged", hoisted by its own petard. Another challenge for Beijing is to find 13 million jobs this year to reverse an economic downturn. As reported in the *South China Morning Post*, China's universities produce some 10 million graduates each year, but many can't get a decent job and end up unemployed or in factories.

A 2019 report by Georgetown University's Center for Security and Emerging Technology (CSET) projects that by 2025, China's yearly Science Technology Engineering Mathematics (STEM) PhD graduates (77,179) will nearly double those in the US (39,959). This valuable scientific human capital feeds into Beijing's strategy for self-reliant cutting-edge technological innovation. Aside from certain high-tech bottlenecks, such as high-end semiconductor microchips and advanced airplane propulsion systems, an example of China's technological advance is the rapid progress in single-handedly building its space station. Three Chinese astronauts, including one female, safely returned to earth after spending 183 days in space, completing the fifth of 11 missions needed to finish the space station by the end of the year. A third challenge is China's carbon emission pledge. Some high energy-consuming provinces have struggled to meet their targets, as energy consumption restrictions caused widespread power outages, cutting off supplies to industries and residents. The annual Central Economic Work Conference on December 10, 2021 decided to loosen blanket restrictions on energy consumption, moving instead towards capping carbon dioxide emissions.

A study by researchers of China's Academy of Sciences, published on March 23, 2022, posits that the nation can achieve a carbon emission peak before 2030, but it is unlikely to achieve its carbon neutrality goal before 2060 without Carbon Capture, Utilization, and Storage (CCUS).

Outlook

In a nutshell, in the eye of a global perfect storm, China has battened down the hatches and secured sufficient ballast to maintain an even keel. So far, difficulties notwithstanding, China remains on a steady course towards its declared destination. ■

Reference # 20M-2022-05-14-01