China in 2017 and Risks to the Global Economy

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Introduction

On 14 February 2017 the US and the Americas Programme at Chatham House hosted a breakfast discussion with the economist and author George Magnus, associate at the University of Oxford’s China Centre. The speaker previously worked as a senior economic adviser and in other roles at UBS Investment Bank.

The topic of the discussion was ‘China in 2017 and Risks to the Global Economy’. Attendees included senior representatives from government, business, academia and the media. This meeting was part of the Chatham House series US and European Perspectives on Common Economic Challenges, and was held under the Chatham House Rule.

Some major points of discussion included:

- A US–China trade war is looming. President Trump and his trade team have stated their commitment to taking a more aggressive stance – particularly regarding China – against perceived unfair trade practices affecting the US.
- Trump’s recent agreement to honour the One China policy has taken the immediate sting out of this new phase in US–China relations.
- With the 19th National Congress due to take place in the autumn of 2017, China has an incentive to prevent any escalation that might give rise to a full-blown trade war.
- Despite President Xi Jinping’s speech at Davos in defence of globalization, China cannot replace the US as the champion of the liberal, rules-based international economic order.
- If no changes are made to its high liability-to-asset ratio, imperfect capital-control policy and unrealistic growth targets, China will face an extended period of domestic economic challenges.

Discussion summary

Despite the recent de-escalation in US–China tensions, following President’s Donald Trump’s stated agreement to honour the One China policy, the new administration still views trade as a zero-sum game and a powerful tool with which to exert pressure on China. China remains the principal economic rival to the US, and a continued aggressive stance can be expected from the Trump White House. However, the Trump administration has not yet formally declared China to be a currency manipulator, as his election campaign had indicated that it would. Instead of implementing a threatened 45 per cent trade tariff, the US is more likely to seek concessions in other ways, such as by encouraging US companies to begin investigations into what are deemed unfair trade practices by China. China will likely respond by targeting US companies such as Boeing. Thus, it is likely that current tensions will escalate into a US–China trade war.

For China, 2017 is the year of the 19th National Congress of the Communist Party. In order to maintain market stability and prevent domestic turmoil ahead of the meeting, the Chinese government is likely to accept some US provocation without immediate retaliation. China’s trade surplus with the US means that a trade war would likely impact the former more than the latter, even though investment has supplanted trade in goods as the driving force of China’s economic growth.

China has benefited from the global liberal order, open borders and globalization. At the 2017 World Economic Forum annual meeting in Davos, President Xi Jinping spoke robustly in defence of
globalization. The US's recent withdrawal from the Trans-Pacific Partnership (TPP) has raised concerns about a possible retreat from its position as the champion of the liberal, rules-based system of governance. However, despite President Xi’s commitment to openness on the international platform, the reality is that business and movement are highly restricted by the state, meaning that China cannot replace the US as global leader in the liberal economic order.

The Chinese dominance in US treasury bonds could be used to prevent a US–China trade war. Dropping these holdings, however, is an unlikely course of action for China, as this would cause a major uproar in financial markets.

‘Trumponomics’, which promotes tax cuts, deregulation and increased fiscal spending, will initially lift the US economy. However, stimulating an economy at close to full employment means that US interest rates and the value of the US dollar will increase, exerting further downward pressure on the renminbi.

The prospects for an offshore renminbi market will be unrealistic as long as China maintains a trade surplus and restrictions on capital flows. Even though there has been an increase in international usage of the renminbi, this has yet to come close to the other currencies in the SDR (special drawing rights) ‘basket’, such as the US dollar and the euro, that are predominately used throughout the global economy. As long as liquidity is not exportable, the renminbi will not become a true global currency. And the longer capital controls persist, the less likely this becomes. China’s recently introduced capital controls have lessened concerns regarding capital flight, but cannot prevent capital from leaking abroad.

One of the most pressing problems for China is not so much its high levels of debt as the increasingly risky funding structure of its liabilities. In 2006–07, the system relied almost exclusively on stable household deposits. Wholesale funding of banking sector lending has, however, risen rapidly since then, from 4 per cent to 30 per cent, and is unlikely to contract to the levels of a decade ago.

Since 2014 China has seen a surge in credit supply. As non-banking financial institutions found ways around the regulations, they packaged loans and sold them to banks. China’s high loan-to-deposit ratio will not imminently result in a banking crisis of the kind the West experienced in 2008–09, but the rapid rise of short-term funding both increases volatility and reduces China’s ability to respond to sudden shocks.

China has been highly focused on maintaining high growth targets, fearing that reduced targets will ultimately lead to slower growth. Instead of abandoning its growth targets altogether, there is scope for some meaningful revision, but any policy change prior to the 19th Congress is unlikely.

China’s current ambition to shift more from manufacturing to a higher service-sector contribution to the economy could indicate that China’s real target is not growth but employment. For the time being, services remain a small sector of China’s economy. The recent shift has mostly centred around traditional services, while there are numerous obstacles facing the more dynamic parts of the service sector that drive economic growth.

The fast-paced development of robotics, potentially replacing traditional jobs, could become another challenge to the provision of employment. Even though this development is not unique to the Chinese economy, the lack of a social security net and the size of its population means that China may be affected more than its competitors.