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A Componential Analysis of the Impact of a Trade War on China's Economic Growth

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China and the USA are currently embroiled in an acrimonious geo-economic tussle. Accusing China of eroding its industrial base and perpetrating "economic aggression" towards the US in the form of technology theft and economic espionage, President Trump levied two tranches of tariffs on imports from China valued at USD 250 billion. A third tranche on USD 267 billion worth of imports, which would effectively involve all Chinese imports, will come into effect should the two sides fail to reach an agreement within the 90 day pause negotiated during the G20 summit at Buenos Aires in December, 2018. Observers still consider it likely that the tussle could develop into a protracted economic conflict.

What impact the US-China trade war will have on China's economy is a contentious issue which bitterly divides observers. Pessimists claim vindication on the basis of recently published Gross Domestic Product (GDP) data in the third quarter of 2018 that depicts a modest slowdown in China's growth. Similarly, a recent analysis by the IMF expects that China's GDP, at the end of 2019, will be 1.6 percentage points lower than it would otherwise be, should the trade war extend into a protracted dispute (Carter 2018). Optimists, on the other hand, contend that economic rebalancing renders China less vulnerable to disruptions in foreign trade and invoke memories of China's resilience to the global financial crisis of 2008. This paper performs an evaluation of the impact of these contestations on the main components of China's economic growth across the short and long run.

Components of Economic Growth

GDP refers to the monetary value of all goods and services produced within a country's borders during a given period of time. The monetary value of any good or service can be expressed as either the expenditure incurred by its consumer, or the income earned by its producer. The former perspective, due to its focus on the demand levels of economic agents, is more relevant to an examination of China's economic growth. As per the expenditure method, GDP is an aggregation of three broad components: final consumption expenditure, investment expenditure and net exports. Contestations in the economic domain have implications for all three of these components and must be parsed individually.

Final Consumption Expenditure

China, unlike countries such as the USA and India, is not a consumption-led economy. At 47.3 per cent, China's gross domestic savings rate in 2017 was far higher than the world average at 24 per cent (World Bank 2018). In part, this is explained by the frugality of the Chinese household. Additionally, and more importantly, encouraging high savings was a deliberate policy decision in the post-Mao reform period. For three decades since, China's growth relied heavily on cheap credit, in combination with cheap, unskilled labour to produce low quality manufactures which were then exported to the world, where demand for these commodities was high. Much of this cheap credit was made accessible by the high savings rate which kept banks capitalised (Wright and Rosen 2018). As such, foreign trade supports a large proportion of economic activity and incomes, and continues to play an integral role in China's economy.

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However, with decades of high growth driving up wage rates, China's low quality exports are losing competitiveness in markets and its previous growth model is approaching obsolescence. As discussed in the upcoming section, while China is attempting to sustain exports by developing competencies in high quality manufactures, such a transition cannot be affected in a short period of time. As such, foreign demand cannot be relied upon to consume China's economic surplus - this responsibility must be borne by China's household consumers if growth is to be sustained. However, in the short run, a trade war can have a deleterious impact on household demand and signs of this are becoming apparent in China.

Import growth, a determinant of domestic demand, recorded a six per cent decrease in September, 2018 relative to the previous month and remain weak in November, 2018 (Tan 2018; Financial Times 2018) - a predictable effect given that America supplies approximately 8 per cent of China's total imports as per 2017 data (International Trade Centre 2018). With respect to consumer good imports - a metric directly related to household consumption - the USA is the largest source. While China has largely enjoyed success in diversifying its consumer good import relationships, the USA's share has increased from 8 per cent in 2006 to 13 per cent in 2016 (Zhang et. al.). In contrast, the shares of Japan and South Korea witnessed marked decreases.

Many observers contend that costlier imports will not affect consumption since Chinese households and businesses will simply consume locally or approach other suppliers in the global market. In the case of households, this argument may hold some merit, since the share of consumables in China's total imports from the US is only 6.4 per cent of the total[1]. However, the same cannot be said for businesses since intermediate goods constitute a sizeable 63.7 per cent of the total. Chinese goods producers will have to pay higher prices for these alternatives and surpluses are bound to shrink. Retail sales in China, a component of consumption expenditure, took somewhat of a beating quickly after the trade war escalated in July, 2018, with 50 major retailers posting a 3.9 per cent drop (Li 2018). As of November, 2018, they have fallen to a 15 year low. Moreover, disturbing the trade ecosystem will harm income levels; according to research conducted by JP Morgan Chase, at the current level of tariffs, China is expected to lose 700,000 jobs (*Bloomberg* 2018).

Growth optimists strongly contest these numbers. Nicholas Lardy of the Peterson Institute of International Economics rejects the notion of a slowdown due to faltering retail sales by pointing out that real per capita consumption expenditure has, in fact, increased during the first two quarters of 2018, indicating an increase in non-retail sales (Lardy 2018). Data released by China's National Bureau of Statistics also shows that the share of final consumption expenditure in total GDP growth has, indeed, steadily increased over the first

[1] Author's calculations based on UN Comtrade data.

two quarters of 2018 (National Bureau of Statistics 2018).

However, it is difficult to conclude from these numbers alone that *households* will continue to ramp up consumption in the short run. Both retail sales and final consumption expenditure consist not only of household consumption but also consumption by the government. Higher final consumption expenditure figures, therefore, may not reflect organic, household driven growth. Keynesian stimulus in the form of government consumption is required precisely when households cannot be relied upon to maintain the buoyancy of the economy. China's State Council has already vowed to boost spending, particularly in infrastructure, to preserve growth levels (Tang 2018). It is uncertain, therefore, whether an increase in these figures reflects greater household consumption or greater stimulus by the government. Discretionary spending i.e. household expenditure on non-essential consumables has, in fact, observed to be weakening in 2018 (Wang 2018).

With respect to the long run, optimists contend that consumption will be strengthened by China's growing middle class. This is not a foregone conclusion. China's population is ageing considerably and old dependents generally consume less than the norm. While young dependents are considered heavy consumers (Nie and Palmer 2016), data suggests that China's abolition of the One-child Policy has not produced much of an increase in the births which will help add to the number of young dependents in the long run. The expansion of social security, another enabler of consumption, has also supposedly not picked up pace under Xi Jinping (Setser 2018). Finally, high housing prices compel households to stash their income away in savings (International Monetary Fund 2018); household debt in China has consistently increased for the past six years as per data published (Bank for International Settlements 2018).

Ultimately, the task of increasing the Chinese economy's household consumption expenditure will not be without hassle, especially amid trade disruptions that can encourage frugality. While Keynesian stimulus could ensure GDP numbers on paper in the short run, government spending cannot be relied upon for long run growth and development.

Investment Expenditure

In response to the uncertainty engendered by the trade war, the People's Bank of China (PBoC) pumped 109 billion USD into the economy in October, 2018, the fourth such injection in the year (Financial Express 2018). Prima facie, credit expansion appears to be a deft method of grappling with the situation. Other things being constant, an increase in money supply expands output. Indeed, gross domestic capital formation contributed to a third of China's GDP growth in the second quarter of 2018 (National Bureau of Statistics 2018). Moreover, credit fuelled investment expansion is what enabled China to weather the shocks of the financial crisis in 2008.

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However, investment expenditure administered via credit expansions is a recourse of rapidly dwindling efficacy, precisely because it was indiscriminately utilised following the previous crisis. Political compulsions to maintain growth in the aftermath of the financial crisis resulted in credit allocation that was not sufficiently predicated upon sound economic rationale. Expectedly, China's incremental capital output ratio (ICOR) has increased incessantly since the stimulus of 2008, meaning that investment today would generate lesser economic growth than it would in previous years (Dieppe et al 2018). Moreover, implicit state guarantees have encouraged moral hazard among Chinese borrowers - bad debts hit a record high in the second quarter of 2018 (Bloomberg 2018). When combined with decentralised lending procedures, this means that China's financial regulators have a tough time restraining lending (Wright and Rosen 2018).

The Chinese administration is aware that, in its current state, debt renders the economy significantly vulnerable. In February, 2018, the State Council vowed to recalibrate the credit system and encourage strategic investment and deleveraging of companies (*South China Morning Post* 2018). In a speech to the Central Committee for Financial and Economic Affairs, Xi Jinping himself alluded to the imperative to facilitate "high quality growth" by preventing and defusing financial risk (*Xinhua* 2018). As such, China's administration would be loath to sanction such stimulus as would encourage indiscriminate lending, particularly in the short run.

Credit fuelled investment spending would go against the Xi administration's agenda of rolling back implicit guarantees and facilitating financial rationality. Backtracking on that commitment would likely do more harm than good - policy caprice is anathema to wealth creation.

With respect to credit expansion in response to deflationary tendencies engendered by trade disruptions, China's hands are tied. In the third quarter of 2018, the PBoC declared that it would not resort to a strong stimulus to shore up the economy and would maintain a "prudent and neutral" monetary policy (*Reuters* 2018; *China Daily* 2018). Indeed, the 2018 stimulus is roughly a fifth of the post-financial crisis one. Credit fuelled investment spending would go against the Xi administration's agenda of rolling back implicit guarantees and facilitating financial rationality. Backtracking on that commitment would likely do more harm than good - policy caprice is anathema to wealth creation. Investment driven stimulus is unlikely to intensify in the short run.

Net Exports

At first instance, recent trends in China's foreign trade appear rather enigmatic, especially given that it is the epicenter of the disruptions. China's trade surplus with the US rose to a record high of 34 billion USD while exports to the world increased at a breakneck rate of 14.5 per cent in September, 2018 (Leng 2018). A *Financial Times* survey of 200 Chinese exporters in October, 2018, revealed that export expectations were relatively optimistic for the short run, despite a modest slowdown in business and an increase in operating costs (*Financial Times* 2018). Two factors are most likely responsible for this. Firstly, the nine per cent depreciation of China's currency boosts the competitiveness of its exports and appears to have temporarily offset the price rise created by tariffs. Secondly, Chinese exporters are likely front loading i.e. scrambling to perform transactions as they expect more tariffs to come into effect in the future.

With respect to exports in the short run, the Chinese administration ostensibly has some arrows in its proverbial quiver. The Ministry of Commerce declared two iterations of export tax rebate increases in September and October, 2018 (*Global Times* 2018). There is also more room for China's currency to depreciate with interest rates in the US rising. At the same time, the aforementioned remedies face tangible constraining factors. China's trade partners such as the EU and Japan will be displeased should cheap imports flood their markets on account of seemingly artificial tax and currency manipulations (Johnson 2018). It is highly unlikely that an increase in exports will continue unabated amid tariff escalations in the short run.

Meanwhile, as mentioned in the previous sections, China is losing the wage cost advantage that fuelled its low quality, export reliant growth model. Therefore, in the long run, China's export capabilities will rest largely on its ability to achieve competitiveness in high value added, technology-intensive manufactures.

China's technological advancements, however, are at the root of the ongoing trade war. The prevalent animosity in US-China relations is, in large part, inspired by China's use of investment, joint venture requirements and cyber espionage techniques to dubiously acquire American technology. A report by the White House Office of Trade and

Manufacturing Policy went so far as to label China's modus operandi as "economic aggression" (White House 2018). It was not incidental that China's offer to increase imports from the US failed to prevent the escalation of tariffs; the Americans are likely to tie any deal relaxation in acquisitions of technology. Insofar as the USA's motivations behind initiating the trade war are to compel China to reduce its absorption of Western technology, its innovation-based export capacity is also brought in the crosshairs.

Nevertheless, China is unlikely to capitulate in its quest for technological advancement on account of the large payoffs it can generate, both economic and political. Firstly, a move up the value chain would result not only in greater exports, but it would also allow for healthier lending and an improvement in the ICOR, thereby cleaning up bank balance sheets and mitigating financial risks. As such, technology and innovation will avail China a double dividend. Secondly, technological advancement has been intricately tied up with the People's Republic of China's sense of national pride ever since its inception (Feigenbaum 2017). China's solution to contend with the animosity towards its industrial policy so far has been to merely tune down the rhetoric and bluster surrounding 'Made in China 2025' (Leng and Yangpeng 2018). In reality, technological advancements are highly unlikely to be jettisoned for the assurance of short term economic stability. China's exports should be expected to fall in the short run but rebound thereafter, as movement up the value chain begins to bear fruit.

Conclusion

Effectively, the trade war compels China to choose between economic stability in the short run and growth in the long run. It is highly likely that one can only come at the cost of the other. In the short run, neither can households develop profligate consumer habits, nor can producers breach technology frontiers to bump exports. This is especially true in scenarios of uncertainty such as tariff disruptions and investment regulations. As such, maintaining growth in the short run would require state intervention in the form of monetary and fiscal stimuli. However, as discussed in the section pertaining to investment expenditure, beyond a certain tolerable threshold, such intervention would exacerbate structural inefficiencies vis-à-vis debt. This would compromise China's economic growth in the long run.

A prudential strategy for China would be to allow its economy to slow slightly in the short run, while the administration focused on remedying its financial sector inefficiencies and developing technological competencies which will bear fruit in the long run.

From a purely economic perspective, a prudential strategy for China would be to allow its economy to slow slightly in the short run, while the administration focused on remedying its financial sector inefficiencies and developing technological competencies which will bear fruit in the long run.

However, political exigencies will preclude strict adherence to economic rationale and encourage some risky moves. China's leaders, in particular, are likely to exhibit a preference for economic stability in the short run, insofar as their political careers are dependent on it. As mentioned in the previous section, China will not do so by foregoing advancements in technology and placating the US. It will also not undertake broad stimulus, as discussed with regard to investment expenditure. Rather, one should expect the administration to incrementally inject fiscal and monetary stimuli, in a restrained fashion, while reiterating its commitment to financial sector reform.

Even so, these are paradoxical signals to be transmitting to markets and could precipitate defaults in the future - much will hinge on the abilities of asset managers. Ultimately, stimulus will grant the Chinese economy some more time to cultivate better sources of productivity. Much will, therefore, depend on whether China will succeed in expediting technological advancement in the short and medium run all while cultivating an environment for sustained market-led innovations. As such, China's economy is veritably performing a tenuous tightrope walk. The odds that China's leaders will oversee a seamless and smooth transition to modernity are worsening thanks to President Trump's trade war. ■

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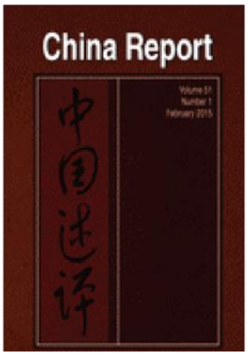

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