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Sinology

by Andy Rothman
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- This issue of *Sinology* looks at prospects for U.S.-China relations and the Chinese domestic economy in 2019.
- Trump and Xi have changed the tone and direction of the bilateral conversation, favoring engagement over confrontation. Prospects for substantive progress are now better than at any point in the Trump administration.
- In 2019, the two leaders will have to agree that rising competition between the two nations does not have to be a zero-sum game, and that cooperation and concessions, rather than confrontation, will leave both sides better off.
- China is likely to remain the world's best consumer story, with a modest boost from tax cuts. Investment by entrepreneurial firms rose 8% in October and should remain healthy.
- Beijing has not yet pulled its major stimulus levers. Policy fine-tuning will continue next year as China deals with the unintended consequences of financial sector de-risking.

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

A TRUCE OVER STEAK AND MALBEC

Over steak, crispy chocolate and a 2014 Nicolás Catena Zapata Malbec, Presidents Trump and Xi agreed to stand down from their impending trade war and instead direct their officials to focus on resolving bilateral trade problems. In this issue of *Sinology*, we look ahead to 2019, at prospects for U.S.–China relations and China's domestic economy.

The two leaders did not reach any concrete agreements on trade, but the change in the tone and direction of the bilateral conversation, favoring engagement over confrontation, is very important and is likely to provide a short-term boost to business confidence in both countries. The prospects for real progress on substantive issues with China are now better than at any point in the Trump administration.

During a trip abroad that also included the signing of a slightly modified NAFTA agreement, Trump appears to have abandoned, at least for the moment, his isolationist path. This change is presumably motivated by the realization that a trade war with America's largest trading partners would damage the U.S. economy and equity markets, and thus the president's re-election chances.

Trump called the dinner conversation with Xi "amazing and productive" and said it offered "unlimited possibilities" for both countries. Trump announced he was postponing an increase of tariffs to 25% from the current 10% on US$200 billion of imports from China—a move that had been scheduled for January 1, 2019.

According to the White House, China agreed "to purchase a not yet agreed upon, but very substantial, amount of agricultural, energy, industrial, and other product from the United States to reduce the trade imbalance between our two countries." The White House also said China would immediately "start purchasing" U.S. agricultural products, suggesting that Beijing may drop its retaliatory tariffs on American soybeans.

Ahead of the dinner, Trump had said he would ask Xi to take steps to halt the shipment of fentanyl (a powerful, synthetic opioid) to the U.S., and, according to the White House statement, Xi agreed to designate the drug as a controlled substance, "meaning that people selling fentanyl to the United States will be subject to China's maximum penalty under the law."

The two sides agreed to an extremely short deadline for further progress on trade issues, according to the White House statement:

"President Trump and President Xi have agreed to immediately begin negotiations on structural changes with respect to forced technology transfer, intellectual property protection, non-tariff barriers, cyber intrusions and cyber theft, services and agriculture. Both parties agree that they will endeavor to have this transaction completed within the next 90 days. If at the end of this period of time, the parties are unable to reach an agreement, the 10% tariffs will be raised to 25%."

More than Just Trade

Now Trump and Xi will be faced with making difficult choices if Saturday's truce is to hold. And these choices are about far more than trade technicalities.

Trump will have to accept that the U.S. must share economic and strategic power with a rising China, while continuing to take steps to help shape how Beijing uses

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its influence. Washington will also have to accept that while the past three decades of economic engagement have promoted significant change within China—from no private sector, to an economy where 85% of urban employment is with small, entrepreneurial firms; accompanied by a broad expansion of personal freedom—fundamental changes to China's political structure cannot be dictated by outsiders, but are very likely to evolve as the country becomes wealthier.

The Xi administration will have to accept that along with its professed desire to use its rising power within the existing global infrastructure, comes a responsibility to follow the rules of that system and to be transparent. Xi will also have to accept that his policies have consequences outside of China, and take responsibility for them. For example, just as the U.S. had to consider the impact of China's new WTO commitments in the 1990s on its then-impoverished northeastern rust belt, Beijing must deal responsibly with the impact of its industrial policies on employment in developed countries.

In short, the two leaders will have to agree that rising competition between the two nations does not have to be a zero-sum game, and that it is cooperation and concessions, rather than confrontation, that will leave both sides better off.

In more practical terms, this will require Xi to agree to give American and other foreign firms the same market access that domestic firms receive, and to strengthen protection for intellectual property for all companies. Xi will also have to stop his security services from stealing foreign technology and handing it to Chinese companies.

At the same time, Trump will have to abandon his misguided focus on the bilateral trade deficit and take a more rational approach to issues such as Chinese students and researchers in the U.S.

Odds of After-dinner Success

I think the odds of after-dinner success are pretty good given the very positive spin that Trump put on the meeting. He tweeted "Relations with China have taken a BIG leap forward! Very good things will happen." And with his apparent desire to avoid a trade war—which would damage the U.S. economy and equity markets, as well as his re-election prospects—I expect him to instruct his team to focus on achieving a pragmatic deal.

Xi will also want to avoid a trade war that could cost Chinese jobs, as well as access to American technology, and he must also understand that the majority of concessions sought by the U.S., such as better protection for intellectual property, are critical to the future success of his own economy.

China's Economy in 2019

Over the last five years, the growth rates of most aspects of China's economy have decelerated gradually each year. For example, the inflation-adjusted (real) growth rate of retail sales slowed by an average of 0.6 percentage points each year, from 12.1% year-over-year (YoY) in 2012 to 9% in 2017. This gradual deceleration is likely to continue in 2019, and it is important to put this into context. The base effect means that 9% real retail sales growth in 2017 generated an incremental expansion in nominal consumer spending that was 135% larger than the increase resulting from 12.4% growth in 2007. In other words, the opportunity for selling goods and services to Chinese consumers at the slower growth rate is far larger than the opportunity 10 years ago, at the faster pace.

Rebalancing Continues

This is the seventh consecutive year in which the consumer and services part of the Chinese economy has been larger than the manufacturing and construction part. Moreover, during the first nine months of the year, consumption accounted for 78% of GDP growth, up from a 46% share during the same period in 2013.

The entrepreneurial side of the economy also continued to expand. For example, the share of urban employment accounted for by privately owned, entrepreneurial firms rose from 82% in 2012, the year before Xi Jinping became Party chief, to 86% in 2017. The private sector share of China's exports, to cite another example, rose to 44% last year from 39% in 2013.

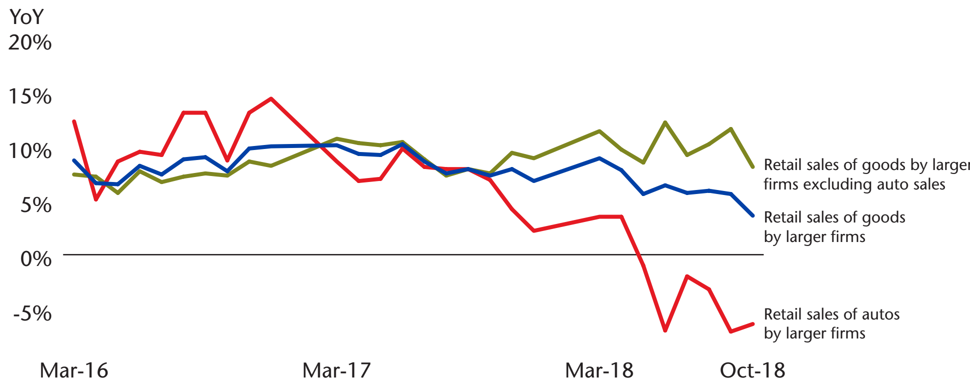
Still the World's Best Consumer Story

The growth rate of new car sales was very weak this year, and is likely to remain soft next year, but this is a reflection of changing market dynamics rather than of consumer weakness. One factor is that the used car market is relatively new and gaining traction, with sales doubling in just three years to 12 million in 2017, equal to about half of new car sales. In the first 10 months of this year, Chinese bought 19 million new passenger vehicles, compared to sales of about 14 million new cars and light trucks in the U.S. during the same period.

It is also worth noting that sales of premium model new cars have remained strong, and new energy vehicle sales were up 76% during the first 10 months of this year.

More importantly, retail sales by larger firms *excluding autos* were up 8.1% in October, compared to 7.5% a year ago.

Figure 1. **RETAIL SALES* RESILIENT**



Source: CEIC
*Excluding autos

China's listed companies are not widely held, so there hasn't been much of a wealth effect when markets have been up or down. In 2015, for example the Shanghai Composite Index peaked mid-year and then fell 31% by the end of the year. Consumer spending was unaffected, with real retail sales up 10.7% YoY during the second half of the year, compared to a 10.5% pace during the first half. I don't expect this year's soft A-share market to be a drag on consumer spending next year.

In 2019, the consumer story will continue to be supported by strong real income growth (6.6% YoY during the first three quarters of this year), mild consumer price inflation (2.1% YoY for the first 10 months of the year), high household savings and low household debt. Recent policy changes—including reductions in import taxes, and changes to the personal income tax rules which will result in the exemption of more than 100 million workers from paying taxes next year—may deliver a modest boost to consumption in 2019.

Entrepreneurial Enthusiasm

One of the most positive developments this year was the recovery in private-sector investment spending. Investment by entrepreneurial firms rose 8.1% YoY in October, up from 3.4% a year ago, and private investment has risen by 7-8% in each of the last eight months. Party leaders have stated a desire to increase support for the private sector in 2019, with further tax cuts and plans to boost lending, so I expect the recent investment trends to continue.

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Exports Will Depend on Politics, But Are Not A Key Driver

China's economy is no longer export-driven, so the possibility of Trump returning to a trade war does not weigh heavily on my overall forecast for 2019.

Net exports (the value of a country's exports minus the value of its imports) account for just 2% of China's GDP, down from a peak of 9% in 2007. In contrast, domestic consumption now accounts for more than two-thirds of China's economic growth and more than half of its GDP. Last year, Chinese exports to the U.S. accounted for only 19% of total Chinese exports, limiting significantly the impact of new tariffs applied only by the U.S. And much of the impact of new U.S. import taxes will not be borne by Chinese companies; about two-thirds of the 25 largest exporting companies based in China are foreign-owned.

It is also clear that Xi's government will step in to provide financial aid to companies that are hurt by any Trump tariffs. With fiscal revenue up almost 8% YoY during the first 10 months of the year, Beijing has the resources, as well as the political will, to support its exporters, just as it did a decade ago during the Global Financial Crisis (GFC). As a result, I do not believe a trade war would cause significant damage to the Chinese economy, or provide the Trump administration with significant leverage over Xi's government.

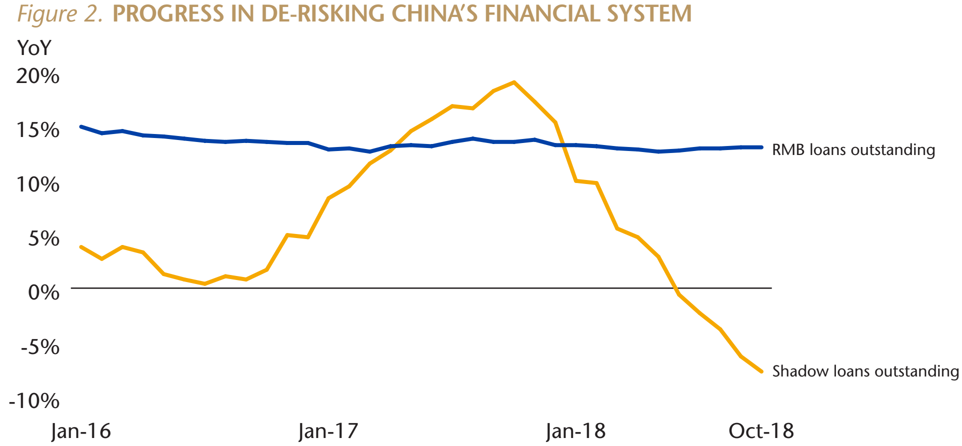
It is also worth noting that as of October, China's exports remained healthy. Total exports rose 12.6% during the first ten months of the year (vs. 7.4% during the same period last year), while exports to the U.S. were up 13.3% (vs. 11.2% last year).

Will There Be Stimulus?

Beijing has not yet implemented a significant stimulus, because the government is comfortable enough with the state of the economy that they want to continue focusing on de-risking, and because the Trump tariffs have not yet had a significant impact. The government has not pulled on its two major stimulus levers. Aggregate credit outstanding rose 10.5% YoY in October, down from 12.9% a year ago. And while spending on public infrastructure reaccelerated in October, this reflects an effort to complete previously scheduled projects that had been delayed while local government management practices were reviewed, rather than a stimulus plan to bring forward projects planned for future years, as we saw during the GFC.

In my recent discussions with officials in Beijing, however, it was clear that the government understands that although its financial sector de-risking policies, which resulted in a sharp slowdown in shadow banking activity, are good for the long term, they have created unintended economic consequences, including tighter credit conditions for private firms and weaker sentiment among domestic equity investors.

Figure 2. **PROGRESS IN DE-RISKING CHINA'S FINANCIAL SYSTEM**



Source: CEIC

Regardless of the temperature of relations with Washington, additional policy fine-tuning is coming in 2019, focused on more tax cuts, a modest increase in infrastructure spending, and efforts to boost lending to private firms. Interbank rates are likely to continue to decline. These fine-tuning measures are important and should strengthen sentiment and spending by consumers and companies, but this will not be a dramatic stimulus, and there will not be a resurgence of shadow banking activity or a return of guarantees to local government finance vehicles. Some cities will continue adjusting housing purchase restrictions, but Beijing does not plan a wholesale lifting of the restrictions now in place in over 100 cities (the main reason the growth rate of new home sales has slowed), and the government is unlikely to launch consumer subsidies for autos and appliances. Deleveraging remains a long-term objective.

Regards,

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Sources: CEIC; National Bureau of Statistics; White House Press Secretary; Marklines; National Development and Reform Commission; China Customs Administration
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