A WORLD WITHOUT CHINA

By Andrew Moody

The world economy is likely to face many challenges in 2017, not least an almost unprecedented level of uncertainty. President Donald Trump took the oath of office in January 2017 and has promised protectionist measures against China and a program of fiscal expansion. The UK's Brexit negotiations are likely to begin in the Spring around the time of the French presidential, both of which could have major implications for the future of the European Union. So where does this leave China? The world's second-largest economy enjoyed a relatively benign 2016 with growth stabilizing at 6.7% in the first three quarters. External events – not least if the US imposes tariff barriers on Chinese imports – could partly derail its economic progress.

The Chinese Government made clear its own economic agenda at the Central Economic Work Conference, attended by the country's leaders in Beijing, in December 2016. It set out six directions of policy: maintaining medium-to-high "new" normal growth; stability; supply-side reform; a new development concept focusing on innovation and the development of green technologies; improving quality and efficiency and combining policies at both macro and micro level that work for the good of the overall economy. Vincent Chan, managing director and head of China research for Credit Suisse based in Hong Kong, believes for the first three months of 2017 China will be trying to work out what the new policy agenda will be in the US.

"This is the major uncertainty. You have a situation where not just China but nobody else understands what this is going to be. Politics is going to be the big issue, which will influence the economics." Chan, however, believes China's growth, assuming no major external shocks, should increase to 6.8% in 2017, 0.1% up from the level so far achieved this year. He believes it will be from export growth of 8%, compared to the 6% contraction in goods and services sold overseas in 2016. "The current high levels of infrastructure investment at two and half times the level of nominal GDP growth keeps the economy steady at 6.5% and exports will give it an additional push in 2017."

Chan says the main worry about China is not the industrial economy but the financial system, as evidenced by the weakening of the yuan. In the year to November 2016 it had an 8% trade-weighted depreciation. "It is a measure to some extent of how important the Chinese yuan has become as a global currency. I think it is less important than the US dollar or the euro but now more significant than either the Japanese yen or the British pound," he says. "You can see this with market behavior over the past two months responding to the yen falling by 15%-20%. There has been virtually no reaction. When the Chinese yuan falls by just 2% everybody seems to worry." He says the currency depreciation reflects concerns over rising debt in the system, shadow banking and bond market weaknesses. "It goes further than just being a matter of the exchange rate itself."

One of the major concerns is whether the Trump presidency is serious about imposing trade barriers on Chinese goods such as the 45% tariff on imports proposed during the election campaign. The then President-elect sent an ominous signal by appointing Peter Navarro, a professor at the University of California, Irvine, who has been previously critical of China, to the new post of director of trade and industrial policy on Dec 22, 2016.

Wang Huiyao, president and founder of the Beijing-based Center for China and Globalization, China's largest independent think tank, believes the rhetoric seems to completely ignore the reality of a globalized world which relies on very sophisticated supply chains. "This means that the iPhone is assembled in China and products sold by Walmart in the US are sourced from China. If we suddenly move away from this, consumers will be hurt – the very consumers who now seem set against globalization by voting for Trump and Brexit," he says. "We still live in a globalized world and that is a fact. We sink or swim together."

Edward Tse, founder and chief executive officer of management consultancy firm Gao Feng Advisory, believes that instead of putting up barriers, the US could receive a jobs boost from

Chinese manufacturing investment in the Rust Belt. Chinese autoglass maker Fuyao opened a new glass fabrication plant, which will be the largest in the world, in Moraine, Ohio, in October 2016, creating thousands of additional jobs in the US.

"There is no reason why a Trump government should not welcome this kind of investment because it is not taking jobs from America but adding them," adds Tse. The management guru says, however, that he is now picking up sentiment from the business community that because of the uncertainty they may prioritize investment in locations on China's Belt and Road Initiative and not in the US or Europe. "More Chinese companies are looking to identify opportunities away from Europe and the US and are looking to central Asia, Africa, south east Asia with, in particular, renewed interest in the Philippines after a major improvement in the political relationship between the two countries."

One increasing subject of debate is whether the government will abandon its target of doubling its 2010 GDP by 2020 to become a high-income country by 2020. This was one of central objectives of the current 13th Five-Year Plan (2016-20).

Duncan Innes-Ker, regional director, Asia, of the Economist Intelligence Unit, based in London, believes the China economy will struggle to maintain its momentum in 2017. He believes growth will slow to 6.2%. "What has driven growth in 2016, particularly in the second half has been the construction sector, which has been related to the strength of the housing market. Property prices in the major cities have risen 30% over the year," he says. Innes-Ker believes the current credit growth of 20% a year, fuelling debt, is becoming unsustainable. He believes the Government will wait until 2018 to tackle that, resulting in a hard landing with growth slumping to 4% but recovering to 5% in 2019. "I think if it doesn't there would be severe strains in the financial sector that would be very damaging in the longer term."

Louis Kuijs, head of Asia for Oxford Economics, the global advisory firm, based in Hong Kong, thinks there will be no major change in economic policy until after the 19th Party Congress of the Communist party of China in November when a new standing committee will be elected. He believes policymakers will manage to achieve 6.3% growth. "Growth will continue to rely on policy support in the form of fiscal expansion and, especially, generous credit growth. We do not expect policymakers to significantly slow the pace of credit expansion before the party meeting."

Tse says, "It has never been proven what a dangerous level of debt is. I don't think right now China is at any major risk." Tse, author of The China Strategy, is confident the economy will hit between 6%-7% growth in 2017, and believes debates about investment in infrastructure becoming increasingly inefficient in terms of return, miss the point. "I do not believe they take into account all the multiplier effects of having a highly efficient transport system. They might say a high-speed rail line from point a to b is not worth it but they fail to see the benefit from the point of view of the whole rail grid being improved by the additional line."

Wang Huiyao, President of the Centre for China and Globalisation (also a state councilor on the Chinese State Council, or cabinet), believes growth will remain around 6.5% next year, saying targets play an important role in driving economic activity in China. "The government mandate is to set objectives for people to reach and therefore people are motivated. I think it is important that the government has set the overall objective to reach this target."

Chan at Credit Suisse says nothing is going to change until after the key party meeting in the Autumn but he believes there is more nuance in the goal set than is often perceived. "Being a high-income society is actually a relative concept. By 2020 China might be a high-income society because other countries have not grown as quickly as it has over the previous decade. It will have achieved its objective without doubling GDP. It is not a discussion the government will have in 2017."

He believes that the concerns are not with the China economy but elsewhere. "China's real economy currently has less uncertainty surrounding it compared to many economies in the developed world right now. Last year there were discussions about whether China would significantly slow down. I don't think that is so much an issue now," he says.

American economist Stephen Roach insists it is vital for the world economy that China continues to grow solidly in 2017. The senior fellow at the Jackson Institute for Global Affairs at Yale University says that even with its "new normal" levels of growth its economy remains the engine of the world economy. "If there is a dramatic slowdown in China there would be a period of weakness we have not seen at any period since the end of World War II," he warns. Roach, also a former chairman of Morgan Stanley Asia, was speaking before giving a presentation on "The World Without China" which

looked at what would happen to the global economy without China's economic momentum, organized by the independent Beijing-based think tank, the Center for China and Globalization.

He argued that world annual growth between 1980 and 2016 would have been just 2.7% to almost 25% less than its actual 3.5%, without China growing at 9.7% during this period – and that if China's growth was to fall from the 7.6% achieved in the first three quarters of 2016 to 5% next year, global growth would almost halve from 3.4% to 1.8%. "Without China's growth the world will have fallen into a very deep recession after the global financial crisis and that would apply now," he says. Roach argues that ever since 1945, the world has had a major growth engine with the US powering the world economy in the 1950s, Europe growing strongly for much of the period and Japan and South Korea emerging before China.

"If China is not there, I don't think the US will provide it. I don't think Europe will or the rest of Asia or the resource economies will. The world will enter a period of significant weakness," he insists. Roach says that among the worst hit will be the European economies such as Spain, Greece and Italy, which already have high levels of unemployment. "There has been a lot of structural unemployment since the end of the financial crisis and the hope has been that rising global growth would be able to absorb that. This, however, will not happen in a world without China." Roach began his career as a research fellow at the Brookings Institution in the 1970s after his doctorate at New York University. He then worked for the Federal Reserve before eventually joining Morgan Stanley in the 1980s.

He first got to know China in the immediate aftermath of the Asian financial crisis in the late 1990s when he challenged himself to visit the country at least twice a month. "For about five years I spent half my time there and even now that I am teaching I still come four or five times a year," he says. Roach, who financially-backed Democratic presidential nominee Hillary Clinton, is skeptical as to how Donald Trump as president can follow a fiscal expansion strategy while imposing trade barriers on China. He argues that the US would only be able to fund the resultant increased budget deficit with Chinese savings. US savings are 2.3% of GDP compared to China's 40%.

"Fiscal expansion in a low savings economy just spells bigger budget deficits and wider current account imbalances and trade deficits. This would put the US on a collision course with the protectionist policies that Mr Trump is also prescribing," he says. "Right now it is all blue sky and optimism (with the Dow Jones index hitting record highs in December) with little regard for some of the tougher issues which may be evident down the road."

Also author of Unbalanced: The Codependency of America and China, Roach fears the world situation is currently worse than even the 1970s inflationary era. "It is hard to say from a geo-political point of view but I think it is worse. You have the populist backlashes, the lack of appetite for trade liberalization and globalization," he says. "At the end of the 1970s we had high inflation, slowing growth, the specter of inflation but we worked our way through that by economic means rather than geo-strategic cooperation." Roach was encouraged by the China Government's Central Economic Work Conference, which emphasised achieving "new normal" medium to high growth and supply-side reforms.

"China's push toward supply-side reforms is welcome and important but it is not an excuse for rebalancing the demand-side of the equation," he says. "What concerns me is that there is almost too much focus on the supply side without continuing to underscore the commitment toward consumer-led growth on the demand side. You need both supply and demand to drive China to the next phase and to avoid the middle-income trap."

Roach welcomed that Chinese President Xi Jinping attended the World Economic Forum in Davos and he believes it was a chance for China to show leadership, if the West is seen to be retreating under Donald Trump. "They will want to hear that China is still committed to deal with global issues from climate change to trade and also opening its markets and borders warmly to other nations around the world," he added.

He also believes much of the debate will be about the future of globalization, a concept almost led by China with its vital manufacturing role in global supply chains. "Just where is globalization heading? There has been a lot of push back against globalization, that is what Brexit was all about, that is what the ascendancy of Trump is all about and that is what potentially the election campaign of Marine Le Pen in France was all about," he said. "These are some of the pressures that were actively debated and discussed at Davos."

Roach argues, however, as with 2016, there is still little sign of the world finally lifting itself from the global financial crisis. "The theory of resilience of economic cycles is that economies in general are elastic organisms so imagine holding a big rubber band. The further you pull it down, the faster it snaps back. We have had a very deep downturn but a very anemic snap back," he says. "There are still enormous headwinds in this post-crisis climate. If it had not been for China, the world would be in a much weaker place." ■

Andrew Moody is a writer for China Daily