Victor Shih

Ho Miu Lam Chair Associate Professor at the School of Global Policy and Strategy, UC San Diego

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"U.S.-China Relations in 2019: A Year in Review"

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Summary:

- The trade conflict has impacted China's economy across a broad spectrum. It has lowered the growth of China's exports to close to zero and has depressed its exports to the U.S. in absolute terms.
- Investors have also slowed their investment in trade-intensive sectors, especially in the behemoth electrical machinery sector, which saw investment decline by close to 10%.
- Chinese firms also are facing drastically lower pricing power. Both consumer durables and IT equipment are seeing negative growth in wholesale prices, compared to a year ago. Meanwhile, the debt level of Chinese corporations continues to rise rapidly, which means many firms are trapped between declining per unit revenue and high debt.
- The Chinese economy is also seeing additional headwinds from its high level of local debt, estimated by Chinese economists to be 66% of GDP. In an attempt to slow the growth of debt, infrastructure investment growth has fallen to the single digits. This situation is unlikely to reverse.
- Still, due to increasingly draconian repression of dissent and extensive purges within the ruling Chinese Communist Party in the past six years, Xi Jinping remains the undisputed leader of China. It would take a truly massive economic shock to threaten his power.
- Further slow-down in the economy and continued protests in Hong Kong likely will give rise to internal debates in the upper echelon of the CCP. This will force Xi to choose distinctive actions in these highly contentious debates.
- In recent years, China has increased the level and breadth of state intervention in its economy. Bankruptcy, overseas investment, and lending are now placed under much stricter state control than had been the case five years ago. This trend is unlikely to reverse in the near future as China grapples with mounting debt and the trade war.
- China has weaponized its currency by weakening it vis-a-vis the dollar. A by-product of devaluation is that it will increase the credit risk of Chinese debtors, who have cash flows and collateral mainly denominated in RMB but have borrowed close to 3 trillion dollars from foreign lenders and counterparties. The U.S. needs to require banks, as well as large pension and mutual funds, to carry out thorough audits of their exposure to RMB denominated assets and guarantees so as to reduce exposures to devaluation risks.
- To combat Chinese industrial policies and technology theft, the U.S. will need to increase multi-lateral efforts to increase transparency on China's financial subsidies to technology sectors. It also should coordinate with close allies to police technology acquisition by authoritarian countries. However, complete economic decoupling is neither necessary nor desirable, even in the context of heightened competition between the two countries.

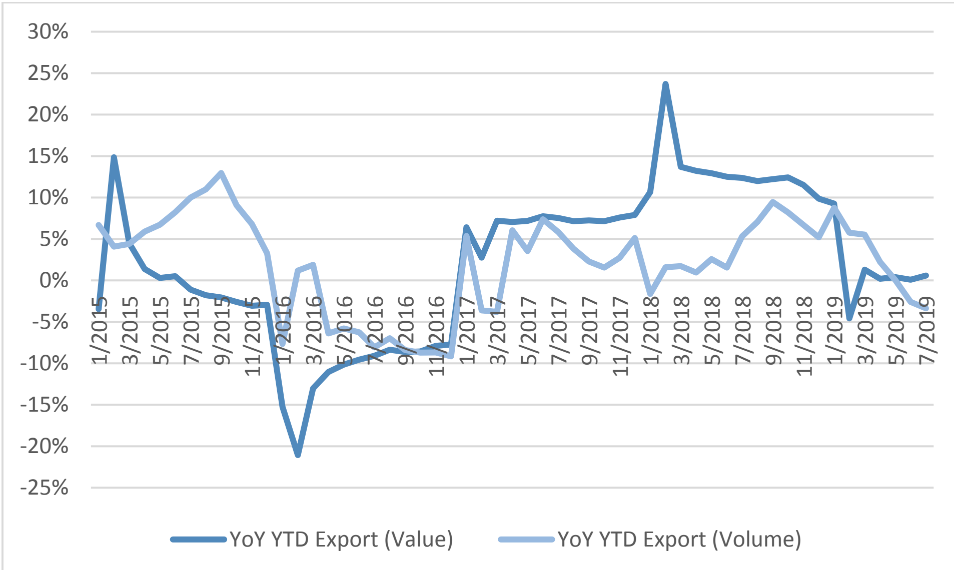
Impact of U.S.-China trade frictions on the Chinese economy in 2019

The trade friction with the U.S. has impacted China's exports, investment in export-intensive sectors, and the pricing power of export-oriented industries. First, going into 2019, one sees a visible slow-down in the growth of Chinese exports overall, and especially to the U.S., which is still China's largest single export market. **Figure 1 shows that China's overall export growth has fallen to zero in value and to negative territory in volume (Euromoney Institutional Investor PLC 2018). Figure 2 also shows that Chinese exports to the U.S. have largely been in negative territory in 2019. Chinese exports to Asia picked up somewhat into mid-year, probably reflecting some Chinese exports which are being trans-shipped to the U.S. via other Asian countries.**

The much more significant impact of the trade frictions on China's economy has been in the dramatic decline in investment growth in major export sectors such as electrical machinery and IT components. Investment in the production of electrical machinery looks like it is heading toward a -10% decline in investment by the end of this year. This represents a potential loss of $20-30 billion in capital formation in China's economy in the machinery sector alone. Interestingly, **Figure 3 shows that although investment in computer and IT equipment had headed toward negative territory at the beginning of the year, it has rebounded, but still at a lower level than in 2017 and 2018. The rebound was likely due to state intervention to prevent investment in that sector from collapsing.** The continuation of the trade conflict will further depress investment in these trade intensive sectors and drive technology related investment to other countries.

Finally, the trade frictions are likely having a negative impact on the pricing power of Chinese firms, especially in export intensive industries such as consumer durables and in IT equipment. **Figure 4 reports that producer managers are seeing negative price growth for the wholesale prices of consumer durables and computers and IT equipment.** The weak pricing power is consistent with a drop-off in exports in export intensive industries. The negative price growth also suggests that some export firms may be lowering wholesale prices in order to counteract the impact of the tariffs. This produces a negative feedback loop for Chinese firms because as their pricing power weakens, they still need to pay interest on outstanding debt and also increase wages due to high consumer inflation driven by high food prices. This will potentially force many firms in export industries to go bankrupt, especially if prices were to decline further as they did in 2014.

Figure 1: Year-on-Year, Year-to-Date Change in Chinese Exports in Value (USD) and Exports in Volume (mt)

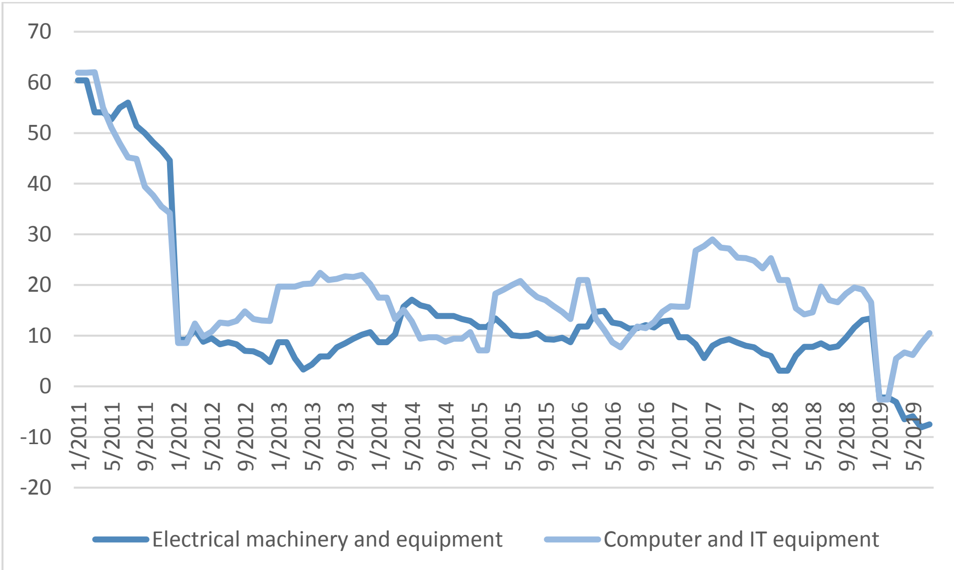


Source: Euromoney Institutional Investor PLC.

Figure 2: Year-on-Year Growth in Chinese Exports to the U.S. and to Asia

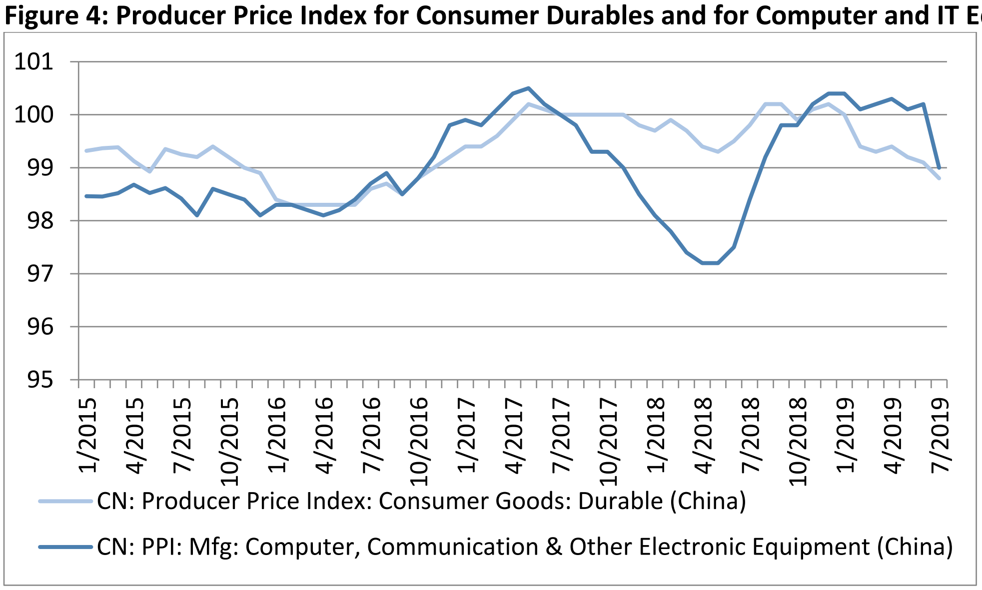
Source: Euromoney Institutional Investor PLC.

Figure 3: Year-on-Year, Year-to-Date Increase in Investment in Electrical Machinery/Equipment and Computer/ IT Equipment



Source: Euromoney Institutional Investor PLC.

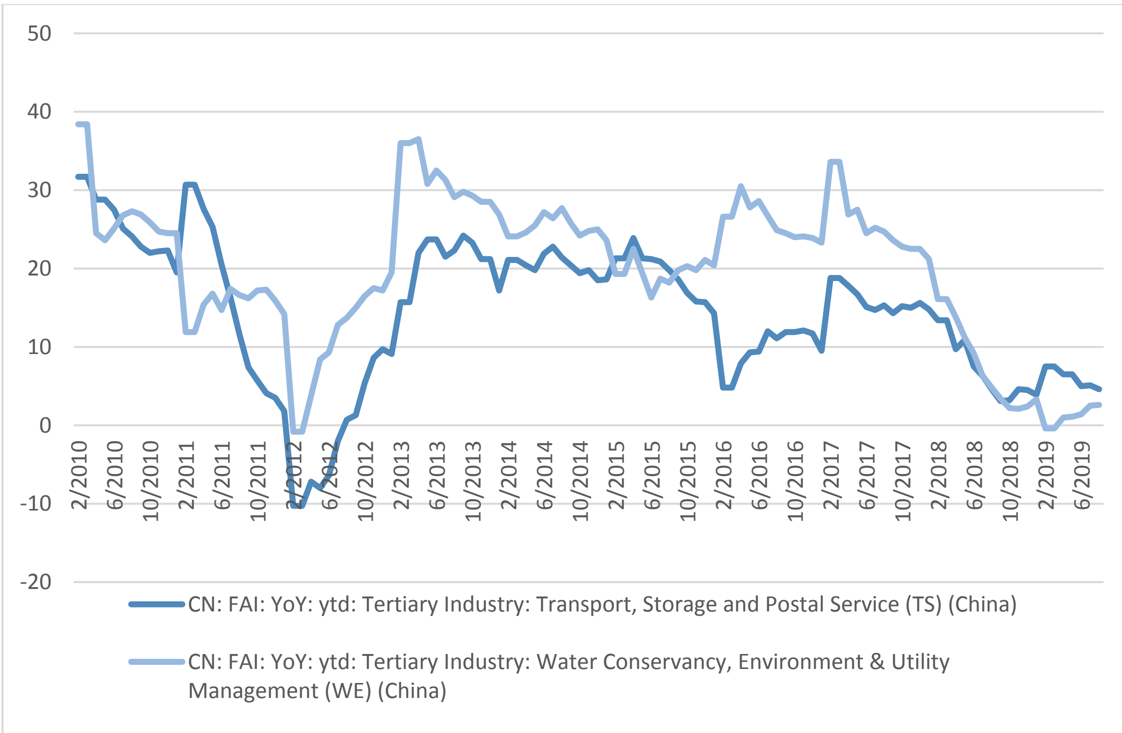
Figure 4: Producer Price Index for Consumer Durables and for Computer and IT Equipment



Source: Euromoney Institutional Investor PLC.

China's high debt level, especially among local governments, also has led to a slow-down in investment, which has created economic headwinds for China's economy. Essentially, due to excessively high local debt, estimated to be around 66% of nominal GDP in 2015, the Chinese government began a campaign to slow the pace of leveraging (Bai et al. 2016). **Figure 5 shows that the increase in infrastructure investment has slowed to the low single-digits by mid-2019 from the 20-30% range.** This constitutes a major blow to China's growth engine. On top of that, the trade war has slowed exports and investment in export intensive industries.

Figure 5: Year-on-Year, Year-to-Date Growth in Investment in Transportation Infrastructure and Water/Environmental Infrastructure



Source: Euromoney Institutional Investor PLC.

Impact of economic challenges on CCP rule and economic policymaking

For now, CCP rule seems robust due to the party's extensive control over the media, education institutions, the economy, and ultimately the police and the army. The past few years have seen even more draconian policies imposed on civil society, the private sector, and ethnic minorities, including the incarceration of over one million Uyghurs in re-education camps and continual crackdown on rights advocates. Also, the party now is under the relatively unified control of Xi Jinping after six years of internal party purges. However, the trade war with the U.S. and especially the protests in Hong Kong may have provided opportunities for internal debates and disagreement within the upper echelon of the CCP to emerge. As economic losses mount in China, divergent camps will emerge urging Xi to pursue different levels of economic stimulus. For now, it seems the camp urging a moderate degree of stimulus has won the debate, but further slow-down will intensify pressure for a larger stimulus. On the issue of Hong Kong, debates doubtless have emerged on whether to pursue a hardline course of action there or not. Again, so far, the moderates seem to have Xi's ears.

Both high domestic debt and trade frictions with the U.S. have led to *increasing state intervention* in the Chinese economy. In order to prevent a financial crisis, increase credit growth, and pursue industrial policies, *China must increase the degree of state intervention because the market now acts against the desires of the party in many instances*. The Chinese government is increasingly afraid of a debt crisis, so instead of allowing the market to force thousands of firms to go bankrupt, the government, especially the China Banking and Insurance Regulatory Commission and the People's Bank of China, have directly taken over major companies thought to be in danger of defaulting on creditors. Anbang Group, which went on a buying spree in the U.S., was placed under CBIRC receivership last year. CBIRC officials currently chair hundreds if not thousands of credit committees overseeing the restructuring of debt for thousands of Chinese companies, including local government financing vehicles. Creditors have been forced to extend credit to many major debtors in order to prevent bankruptcies. Local governments in China have expended billions to bail out companies which borrowed too much using company shares as collateral. After the bailout, however, local governments have become de facto owners of hundreds of previously private companies.

China continues to prevent Chinese firms and citizens from reallocating their investment toward overseas assets. Again, here the market would like to invest much more overseas to hedge against political risks and devaluation risks, as shown in the massive capital flight China saw in 2015. However, the draw-down of the foreign exchange reserve would undermine the continual rule of the CCP, so the party cannot tolerate it. Consequentially, capital control has become much more draconian for firms and for individuals. Although Chinese citizens can legally still convert 50,000 USD from RMB to the dollar per year, they now have to fill out an extensive form stating the purpose of their conversion. Most would find it difficult to convert more than 20,000 USD for tourism and overseas purchases.

Finally, China continues to pursue very aggressive industrial policies by giving banks political incentives to lend to firms in sectors prioritized by the Chinese government and by lending to sectoral guidance funds (Zenglein and Holzmann 2019). Here again, the government is working against the market. Banks and investment funds would like to provide more capital to the real estate sector, which remains the most profitable one overall. However, the government does not want all the money it prints to go into real estate, so it has ordered banks to limit the share of new credit going to real estate and increase credit for high technology sectors.

Implications of RMB devaluation for the United States

With the RMB falling to decade-lows vis-a-vis the dollar in recent weeks, the Chinese government seems to have weaponized its currency in the conflict with the U.S. However, this weaponization has its limits and will be costly for China's other strategic plans. First, because Chinese debtors owe international creditors close to 3 trillion USD in debt, devaluation means they would need greater RMB cash flows to meet their repayments. Lower dollar interest rates have made this an easier process, but if devaluation were to exceed 5%, which seems likely, these debtors may run into repayment difficulties. The faster devaluation occurs, the more debtors will seek to convert their RMB into dollars in an attempt to limit their losses, which would cause a rapid drainage in China's foreign exchange reserve. If devaluation were to continue, the Chinese government may not allow Chinese debtors to obtain dollars, forcing them to default on their international creditors, perhaps with a special focus on U.S. banks.

According to the Bank for International Settlements, U.S. banks have claims over roughly 180 billion dollars in mainland China and Hong Kong liabilities (BIS 2019). U.S.-based pension and mutual funds own additional billions in bonds issued by Chinese entities, whose cash flows are dominated by RMB. The true exposures may be substantially higher due to extensive Chinese borrowing from overseas locations and cross guarantees. U.S. financial authorities should urge the global banking community, but especially U.S. banks and large-scale pension and mutual funds, to conduct a thorough audit of their exposure to assets and guarantees with ultimately risks denominated in RMB. For example, even if a loan to a Chinese real estate company is backed by a major state-owned enterprise (SOE), that SOE's underlying cash flows are denominated in RMB, so devaluation means that the guarantee from that SOE should be worth less today than yesterday. If a pension fund was over-weight in the stocks of Chinese companies, whose cash flows are denominated in RMB, further devaluation will severely undermine the dollar value of the portfolio. Where necessary, U.S. banks and major funds should reduce their exposure to assets and guarantees whose underlying cash flows are denominated in RMB.

Recommendations

China's industrial policy and technology theft are issues that concern many market economies. Instead of pressuring China unilaterally, the U.S. should work with close allies and partners in developing economies to derive a set of incentives for countries to join the U.S. in pressuring China to reduce the level of state subsidies for specific industries and to coordinate on the prevention of technology theft. Some potential measures include:

- Work with the IMF to increase transparency of China's financial subsidies to industries through its banking system. The IMF already has a mandate to audit the Chinese financial system on an annual basis.
- Work with close allies to coordinate policies on investment from authoritarian countries, including China.
- Coordinate with close allies and partners to develop a set of criteria for "best practices" for information and cyber-security. Companies meeting these criteria, as confirmed by a multilateral body, can qualify to win contracts for critical infrastructure and security related projects.

At the same time, a complete decoupling with the Chinese economy would be extremely costly to the U.S. economy. For most goods traded between the two countries, complete decoupling is neither desirable nor necessary. U.S. farmers produce a surplus of output which China desperately needs. At the same time, manufacturing capacity in many light industrial sectors has left the U.S. and will never return, so trading with China at least would allow U.S. consumers to take advantage of low-cost consumer goods. For critical sectors such as information technology, bio-technology, and precision machineries and robotics, the U.S. needs to invest in more basic research and create incentives for firms to also invest in research. It also will need to set up protocols to prevent technology theft and acquisition by hostile authoritarian governments.

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