Economics & Strategy

Understanding China

China-US Relationship: Self-interest vs Mutuality

Economics/China

Group Research

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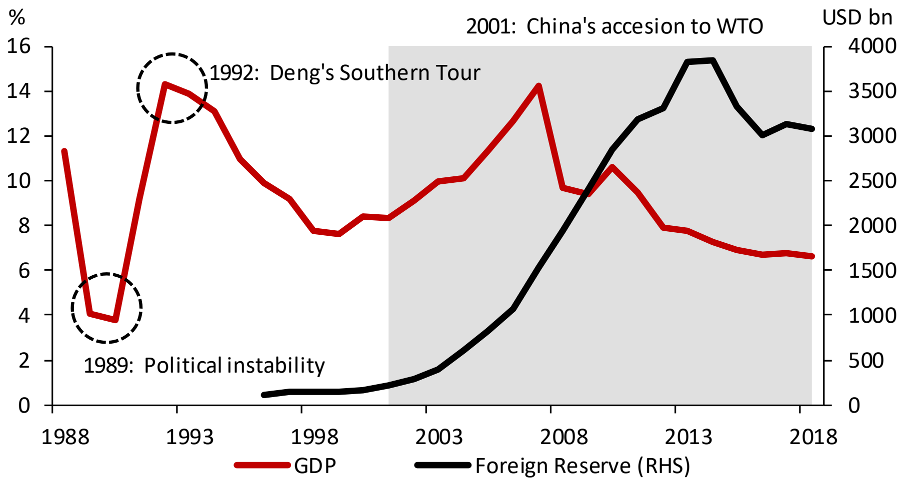
- *US-China relationship has always been driven by economic interests.*
- *Misunderstanding is normal given vast differences in cultural, history and geography.*
- *The on-going contest may embark a new path of "self-sufficiency".*
- *Mitigating trust deficit is the ultimate path of illumination.*

Steering the Stream of Time

Otto von Bismarck, the first Chancellor of Germany (1871-1890) famously commented a century ago about great powers are traveling on "the stream of time". It can neither be reversed nor redirected, but upon it can only be steered by skills and experiences. There is no exact definition of what it means. It is however one of the most famous quotes in recent history from a statesman. It is about a profound leadership intelligence grasping a window of opportunity (often narrow) shaped by confluence of economic, social, political, diplomatic and geopolitical factors, to turn clear and present dangers into long term opportunities.

"Man cannot control the current of events. He can only float with them and steer." - Otto von Bismarck

Chart 1: China's Real GDP growth and foreign resserve



Source: Bloomberg, CEIC and DBS Group Research

A good example of China steering the stream of time wisely in recent history was Deng Xiaoping's famous southern tour at the age of 88 from Jan 8 to Feb 21 in 1992. The background context was sharp fall of China's GDP to 4.1% in 1989 and 3.8% in 1990 from 11% due to domestic instability in 1989 (Chart 1). Instead of closing the door under intense domestic pressure, Deng pressed ahead with economic reform. During this monumental tour, he emphasized the importance of reform/development and

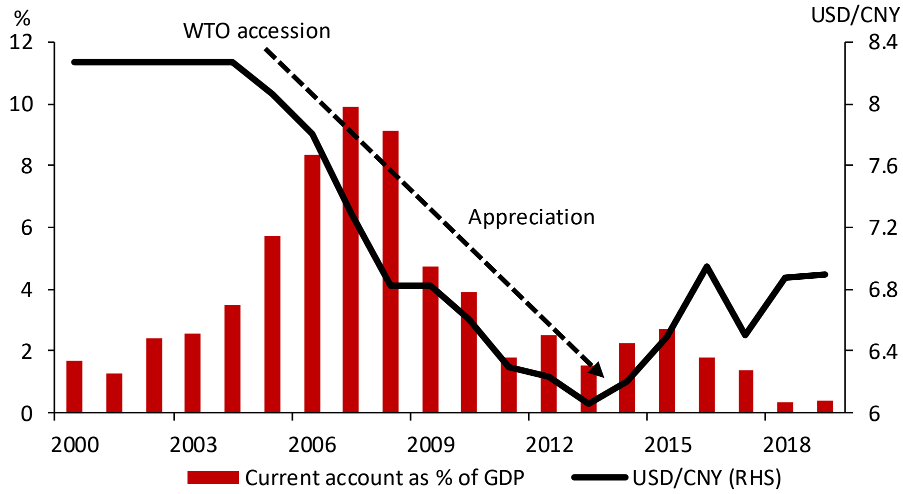
Example of China steered the stream of time: Deng's 1992 Southern Tour and 2001 WTO accession.

integration with the global economy. The timing of such was coincided with the disintegration of the former Soviet Union. The George Bush administration in the US quickly aimed at integrating the middle kingdom into an US-led world order. As a result, diplomatic relationship between US and China was fully restored in 1992. Other countries followed thru. Then, the Pearl River Delta began opening to the rest of the world. Asian countries started pouring in investment rapidly capturing low labor and land costs alongside tax breaks and various preferential treatment for foreign invested enterprises. US and European enterprises subsequently followed thru. That formed a solid foundation of China's future global dominance in manufacturing.

Another excellent example was the episode of Asian financial crisis in 1998 leading to World Trade Organization (WTO) accession in 2001. Zhu Rongji, (premier from 1998-2003), pressed state-owned enterprise (SOE) reform ahead by laying off millions of workers at the height of the Asian financial crisis in 1998. He had not pursued the route of competitive currency devaluation to support growth, partly because of strong balance of payment position and the fact China had already devalued once in 1994. He saw the crisis was a short-term challenge.

The long-term goal, however, was to get China ready for WTO accession. It was because external competitive market forces would drive domestic economic reforms faster. Conservatives leaders were against this strategy because accession conditions imposed by the US were much harsher than other developing countries. They argued domestic industries were not strong enough to compete with the west. It was too big a gamble politically and economically for China. Nevertheless, the Bill Clinton administration finally reached a deal with China. Premier Zhu was subsequently proven to be on the right side of history. Foreign reserves swelled swiftly after WTO entry on December 11, 2001 (Chart 1). A portion of foreign reserves was wisely used to write off the non-performing loans for Bank of China and China Construction Bank, paving the way for their public listings. Ballooning trade surplus eventually led to the appreciation of the RMB for a long while (Chart 2).

Chart 2: Current account and USD/CNY



Source: Bloomberg and DBS Group Research

These two pieces of important economic history have one pattern in common: (1) China demonstrated strong will to open-up integrating with the global economy. (2) The administration under George Bush Senior (Republican) and Bill Clinton (Democrat) both reasoned embracing China into the US-led world order would create

The trust deficit between them has been kept widening.

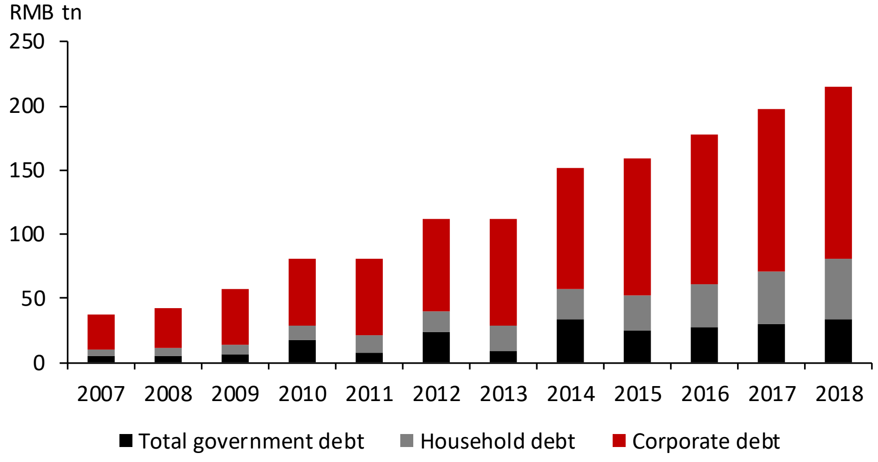
immense economic benefits for US in the long run. Both the US and China were steering the stream of time to maximize their long-term economic interest regardless of vast differences in the ideology behind country management. History was smooth until the aftermath of the global financial crisis 2008 exemplifying the relative economic decline of the US to China. As a result, seemingly routine arguments between them on human rights, South China Sea, and free trade commitment have increasingly become contentious. The trust deficit between them has been widening swiftly in recent years.

There are some examples to illustrate the widening of trust deficit. The famous strategic "Pivot to Asia" adopted by the state department during the 1st term of Obama Administration was largely for a general rebalance of focus from Middle East to Asia given booming Asian economies and the threat of nuclear proliferation in North Korea. But Beijing probably interpreted it as a containment strategy. China's reaction in turn drove the US into a defensive mode adopting tough stances on cyber security and South China Sea. Beijing in turn viewed such as provocations. Elsewhere, TPP is another example of trust deficit. China saw it as a containment strategy. Similarly, the establishment of the Belt and Road Initiative and the Asian Infrastructure Investment Bank (AIIB) was perceived by the US as China's bold attempt to rewrite a US-led world economic order.

The on-going contest may embark a new path of "self-sufficiency".

Such trust deficit under the Donald Trump administration deepened rapidly. The strategy of "engagement" has changed to "containment". The sharp escalation of trade/tech war suggests the contest between them is likely a long run phenomenon. If the trend persists, the current course of action will gradually dismantle inter-dependency between them. China may embark a new path of "self-sufficiency" or the "the new long march" at the current stream of time as Chinese President Xi Jinping commented lately (see "Understanding China: Self Sufficiency 2.0", Mar 13, 2019).

Chart 3: China debt breakdown



Note: We assume the growth rate of the central government debt statistics for 2018 is as same as that of 2017.

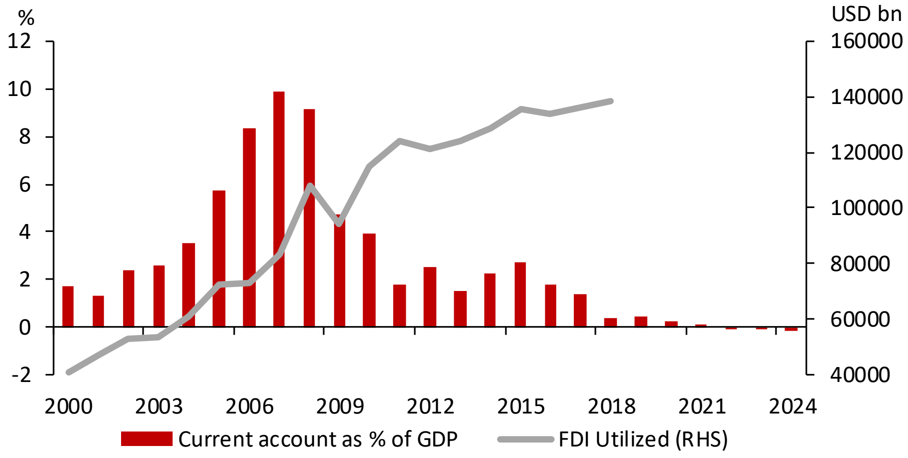
Source: CEIC and DBS Group Research

That said, it is a daunting challenge for China to execute "self-sufficiency". Such dramatic course reversal will induce shocks unpredictably of various magnitude on the global economy.

In the past decade, China had chosen a path of steady economic growth fueled largely by debt. The leadership understood the risks and began deleveraging in 2017. The unexpected trade war prevented Beijing from taking the exercise further. At this juncture, embracing the dictum of self-sufficiency entails even more credit support for the broader economy (Chart 3). Research and development on the technological front require long-term sustainable funding. Higher export subsidies to aid exporters and lower tax revenue to support enterprises also ramp up fiscal deficit.

Also, China is likely to face dwindling current account surplus (0.5% of GDP in 2018) and decelerating FDI inflow ahead due to intensifying trade conflicts (Chart 4). It is more difficult to amass foreign reserves going forward. Should 25% tariff rate be levied on all Chinese exports, the incentive for the authority to weaken the exchange rate will increase tremendously.

Chart 4: Current account and FDI



Note: Current acount figures from 2019 onwards are IMF forecast.

Source: Bloomberg, CEIC and DBS Group Research

Against such headwinds, the modest size of fiscal stimulus (1.5% of GDP) is adequate to arrest the fall of growth but not strong enough to stage a strong rebound. These are logical short-term resolutions. Consensus 2019 GDP forecast was stably at 6.3% still. The issue is not about the numerical impact on short term GDP growth, but the course of economic development for the long haul. Deployment of fiscal cannons or monetary easing can only do so much in the short term. And self-sufficiency is at best a backup conceptual plan at this stage. The urgency is to fix the "trust deficit" between US and China. It is very clear by now foreign policy matters to domestic macroeconomic management.

Global rule-based order can co-exist with the community of common destiny.

Ideally, both countries should spare effort to mitigate the trust deficit. For example, the axiom of "community of common destiny" by China need not exclude the virtue of a "global rules-based order". And the West should involve China in the participation of drafting new rules governing the world. The distinction between subject and context is ambiguous for China, while US always differentiate them clearly. This will take time to locate a middle ground. But that does not mean it can't be achieved. And whoever takes the first move of showing good gestures should not be always seen as "kowtow". After-all, the common goal is meant to maximize the long-term interest of both nations.

Should this strategy succeed in venting some pressure, the next step is to share common economic interests in the name of the global economy. After all, what brought two countries together stably for more than 60 years after the Korean War was economic interests. To be certain, Washington must accept there are differences in economic institutions due to variances of culture, history and geography. For example, complete abolishment of subsidies to SOEs is very difficult for China because they are the political foundation of institutions. It may be wiser to work on the magnitude on the penalty end should dumping occurs. Meanwhile, China could commit gradual fade out of subsidies on certain industries with a clear timetable conditional on global and domestic economic conditions. On the technology front, both sides should work out clear application distinctions between national security and commerce, followed by the establishment of mechanisms to enforce executions.

In the event of trust deficit running deeper in the short term, which is possible, then the dominant strategy is to spell out and ask directly what each country wants from each other so as to avoid further guesstimating. If China does not understand US, then she must at least understand what she needs from the US, and vice versa.

The latest white paper titled "China's Position on the China-U.S. Economic and Trade Consultations" officially issued by the State Council Information Office with a press conference on Jun 2 concluded "cooperation is the only choice for China and US for a better future. China is looking forward, not backward." There is still silver-lining ahead. The current setback in the stream of time is merely a tiny dew. Lets' remain hopeful China will steer the stream of time one more time.

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Sources: Data for all figures, charts and tables are from CEIC, Bloomberg, and DBS Group Research (forecasts and transformations).