Economics & Strategy

Understanding China

Uneven impact of trade war on provinces

Economics/China

Group Research

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- *The fallout from the China-US trade war has been slow to show up though the strain has become increasingly apparent.*
- *The retrenchment in trade flows has been pronounced in coastal provinces such as Guangdong, Jiangsu, and Zhejiang.*
- *Foreign trade in the western and northeastern regions have experienced smaller pullbacks. Areas with thriving logistics infrastructure are more resilient than the rest.*
- *The Belt and Road initiative, which reduces shipping times and trade costs, will continue to pay dividends for China's interior.*
- *However, it remains to be seen whether this will be sufficient to offset the comparative advantage in labour costs of Southeast Asian economies.*

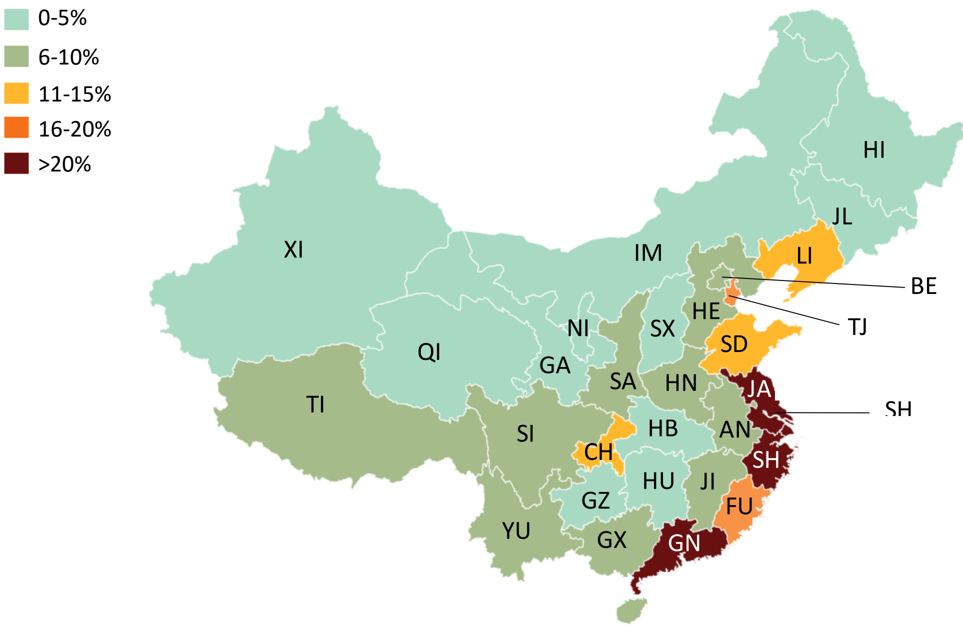
Provincial economic vulnerability to trade war (export as % of GDP)

East	
BE	Beijing
FU	Fujian
GN	Guangdong
HA	Hainan
HE	Hebei
JA	Jiangsu
SD	Shandong
SH	Shanghai
TJ	Tianjin
ZH	Zhejiang

Northeast	
HI	Heilongjiang
JL	Jilin
LI	Liaoning

Center	
AN	Anhui
HB	Hubei
HN	Henan
HU	Hunan
JI	Jiangxi
SX	Shanxi

West	
CH	Chongqing
GA	Gansu
GX	Guangxi
GZ	Guizhou
IM	Inner Mongolia
NI	Ningxia
QI	Qinghai
SA	Shaanxi
SI	Sichuan
TI	Tibet
XI	Xinjiang
YU	Yunnan



Source: Economist Intelligence Unit, Visme, and DBS Group Research

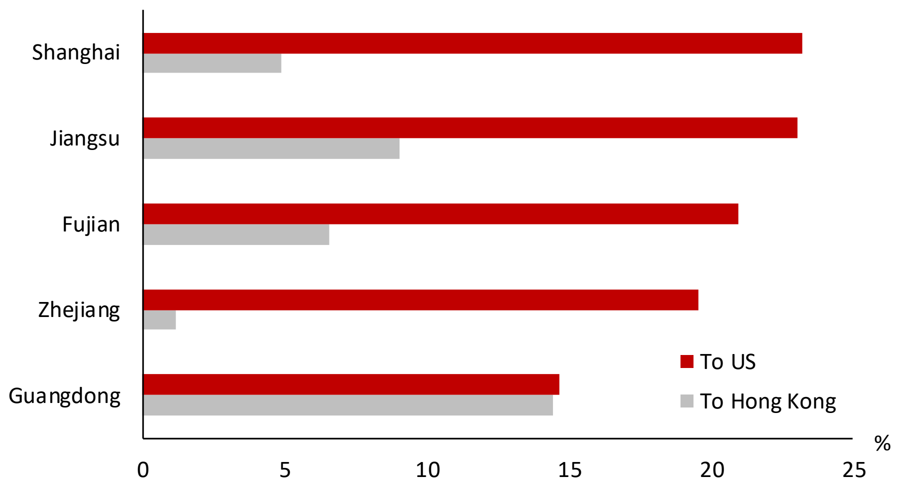
Uneven impact of trade war on provinces

US President Donald Trump has, in May, increased tariffs to 25% from 10% on USD250bn worth of Chinese products. Unless the US wins concessions on market access, intellectual property and trade imbalances, Washington has threatened to hit the remainder USD325bn of Chinese goods with tariffs. In turn, China has set tariffs on USD110bn worth of American goods. These trade measures would have negative repercussions for both countries. To China, the impact has been unevenly distributed at the local level. The retrenchment in trade flows has been more pronounced in the coastal region compared to the the rest of the country.

Coastal provinces bearing the brunt

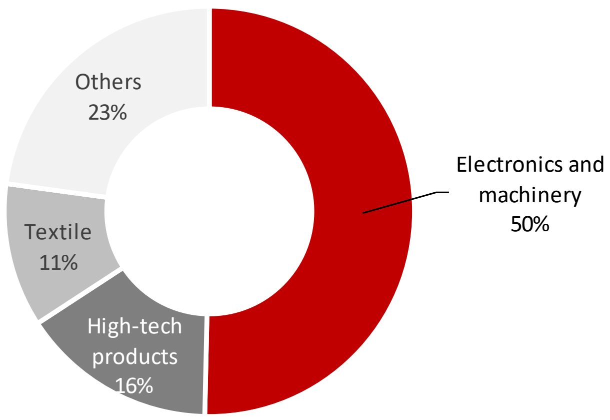
Although the industrial composition of Eastern China has shifted toward services over the past decade, manufacturing exports still accounted for a very high share of economic activity. Guangdong, which is a major export-processing base for foreign investors such as Hong Kong and Taiwan, has remained the country's largest provincial economy and is the origin of one-third of China's goods exports. Fujian, Zhejiang, Jiangsu and Shandong are also the nation's traditional export powerhouses. Their diverse manufacturing industries account for more than half of the East's exports. In 2018, outward shipment as a percentage of GDP stood at 48.8% in Guangdong, 38.6% in Zhejiang and Shanghai, and 29.8% in Jiangsu.

Chart 1: Export to US and Hong Kong as % of total export in 2018



Notes: Guangdong's data is proxied by that of Guangzhou. Fujian's data is proxied by that of Jan-Nov18.
Source: Local customs and DBS Group Research

Chart 2: Guangzhou exports by products



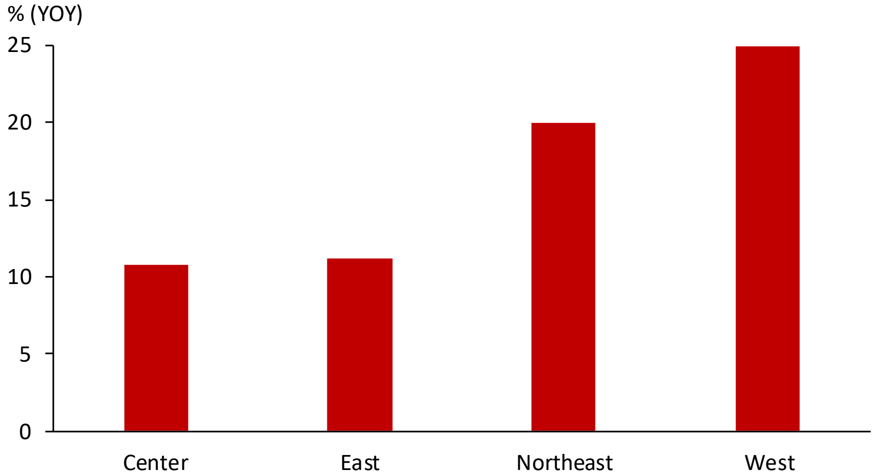
Source: Guanzhou Custom and DBS Group Research

Western and northeastern regions experienced a smaller pullback

Areas that depend heavily on trade with the US would bear the brunt of a prolonged trade war. In Fujian, Shanghai, and Jiangsu, shipments to America accounted for 21-23% of total exports. For Guangdong, the large amount of transhipments to the US via Hong Kong suggests that trade vulnerability may be even higher than official data suggest (Chart 1). Export composition also matters. In Guangdong, Jiangsu, and Zhejiang, a large proportion of exports are in the electronics and machinery industries—both of which sit squarely in the crosshairs of US trade actions. Such strain will become more apparent should trade tensions intensify (Chart 2).

The impact across provinces has been uneven. Foreign trade in the western regions and northeastern regions have experienced smaller pullbacks. Foreign trade growth rate was near 25% in the 12 western

Chart 3: Total trade by region in 2018



Source: CEIC and DBS Group Research

provinces and municipalities and 20% in the 3 northeastern provinces in 2018 (Chart 3). In comparison, the foreign trade in the 10 eastern provinces and municipalities grew 11.2% last year and contracted outright in January-May 2019.

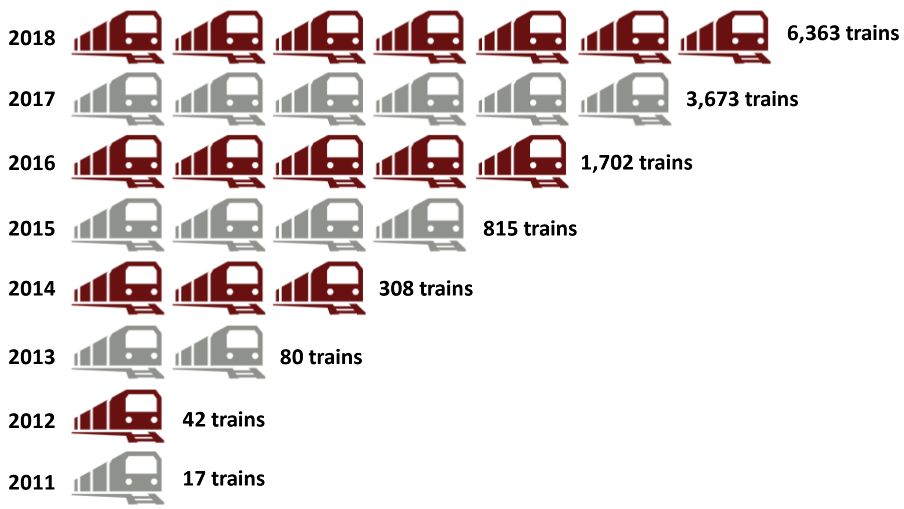
Inland areas with thriving logistics infrastructure tended to be more resilient. For instance, Sichuan, one of the country's largest producers of microchips, registered 33.7% exports growth last year. Chengdu (Sichuan's capital) International Airport is China's 4th international air hub that connects with airports in more than 160 cities in the world. Improved railway connections in recent years have also spurred a rapid growth in rail cargo of commodities and consumer goods with European cities.

New rail links reduce shipping times and costs for China-Europe trades

Inaugurated in 2013, the Rong'Ou railway express between Chengdu and Lodz provides a weekly service, reaching Poland in 11 days with freight costs at only a quarter to air-freight costs. The new transcontinental links are then parlayed into manufacturing and technology parks that attract more investment from firms looking to tap the faster and cheaper routes between China and Europe. The city is now home to the operations of global companies including IBM, Siemens, Tencent, TCL Corp. and Lenovo Group.

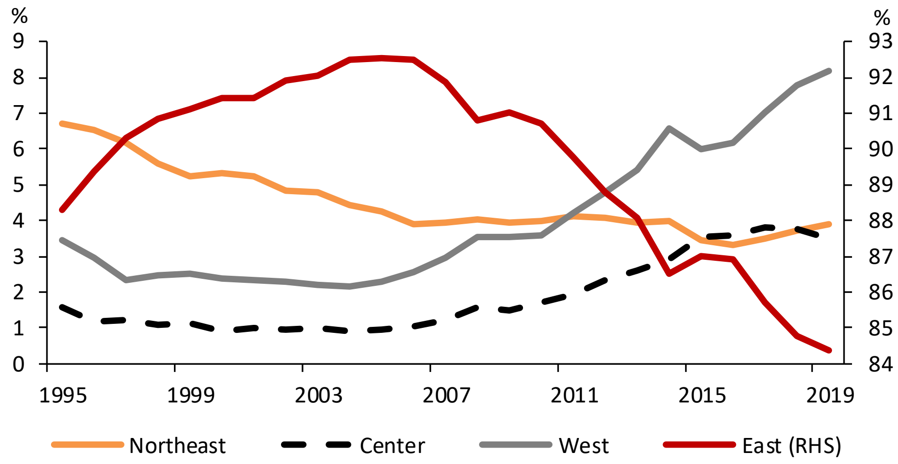
Improved infrastructure and reduced freight costs is hardly a Sichuan story alone. Xi'an, capital of Northwest China's Shaanxi province, has been the crossroad among China, the Middle East, and Europe and is the starting point of the Silk Road belt. According to local customs

Chart 4: Number of China-Europe freight trains



Source: Belt and Road Portal of China Government, Visme, and DBS Group Research

Chart 5: Share of total trade by province



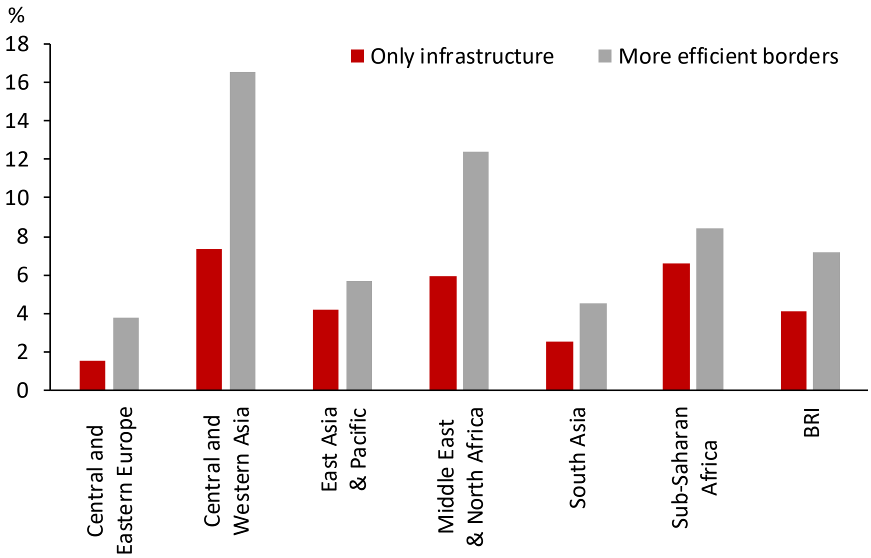
Source: CEIC and DBS Group Research

authorities, Xi'an launched 1,235 China-Europe freight trains in 2018, a six-fold surge from 2017, transporting a total of 1.2mn tonnes of goods worth USD1.72bn. That translated into a 36.1% YoY increase in import and export volume last year.

BRI has transformed the economic geography of China's interior

In fact, BRI-inspired rail projects since 2013 stretching from China's inland provinces to Central Asia and Europe have transformed the economic landscape of China's interior (Chart 4). In 2018, merchandise trade between China and other Belt and Road countries reached USD1.3tn (up 16.4% YoY). Foreign trade in the western and central regions accounted for 7.8% and 3.7% of the country's total, compared to 3.6% and 1.7% in 2010 (Chart 5). The surge in trading activities has

Chart 6: Estimated change in total trade after BRI infrastructure improvement



Source: Trade Effects of the New Silk Road (World Bank), and DBS Group Research raised the importance of manufacturing, transportation and logistics as a share of total provincial output inland. It also helped close the gap in economic development between the inland provinces and their coastal peers.

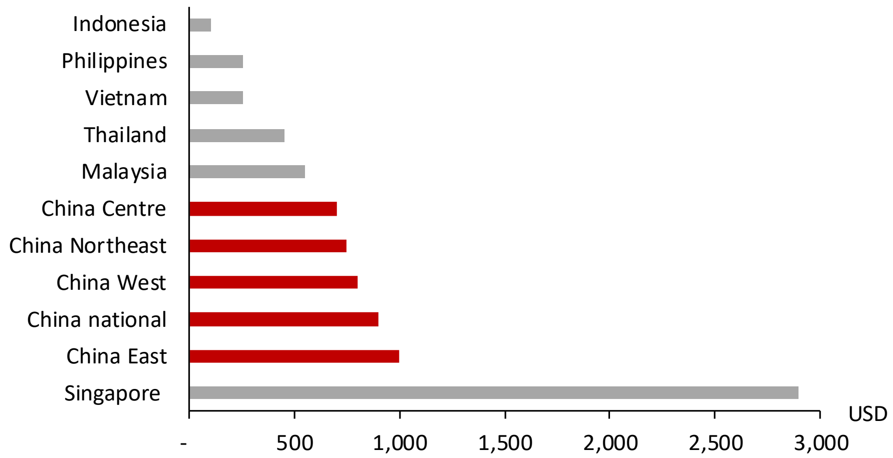
Outlook and challenges

Simmering trade tensions is the greatest risk to the outlook. Rising labor costs is another concern

Looking forward, BRI will continue to pay dividends for China's interior. A combination of improved infrastructure and better border arrangements will, according to the World Bank's estimates, lift trade for Central & Western Asia by 16.6% (Chart 6). Future gains, however, will be harder to come by. Simmering trade tensions represent the greatest risk to the outlook. Inland provinces' rising participation in global value chains have propelled investment and trade growth but this has given rise to rising labor costs too. Although labor costs are 20-30% lower than over eastern factories, they have already surpassed some Southeast Asian manufacturing hubs such as Malaysia and Vietnam (Chart 7).

With punitive tariffs making Chinese products costlier, the decision to relocate supply chains is appealing. Even those who have migrated to inland China may reconsider further investment plans elsewhere. Ensuring sustainable growth is a challnege, which requires reinvigorating the structural agenda to enhance productivity, rather than relying on monetary and fiscal stimulus.

Chart 7: Average monthly earnings in 2016



Source: International Labour Organization, NBS, Moody's Analytics, and DBS Group Research

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