Near-Term and Long-Term Prospects for the Chinese Economy

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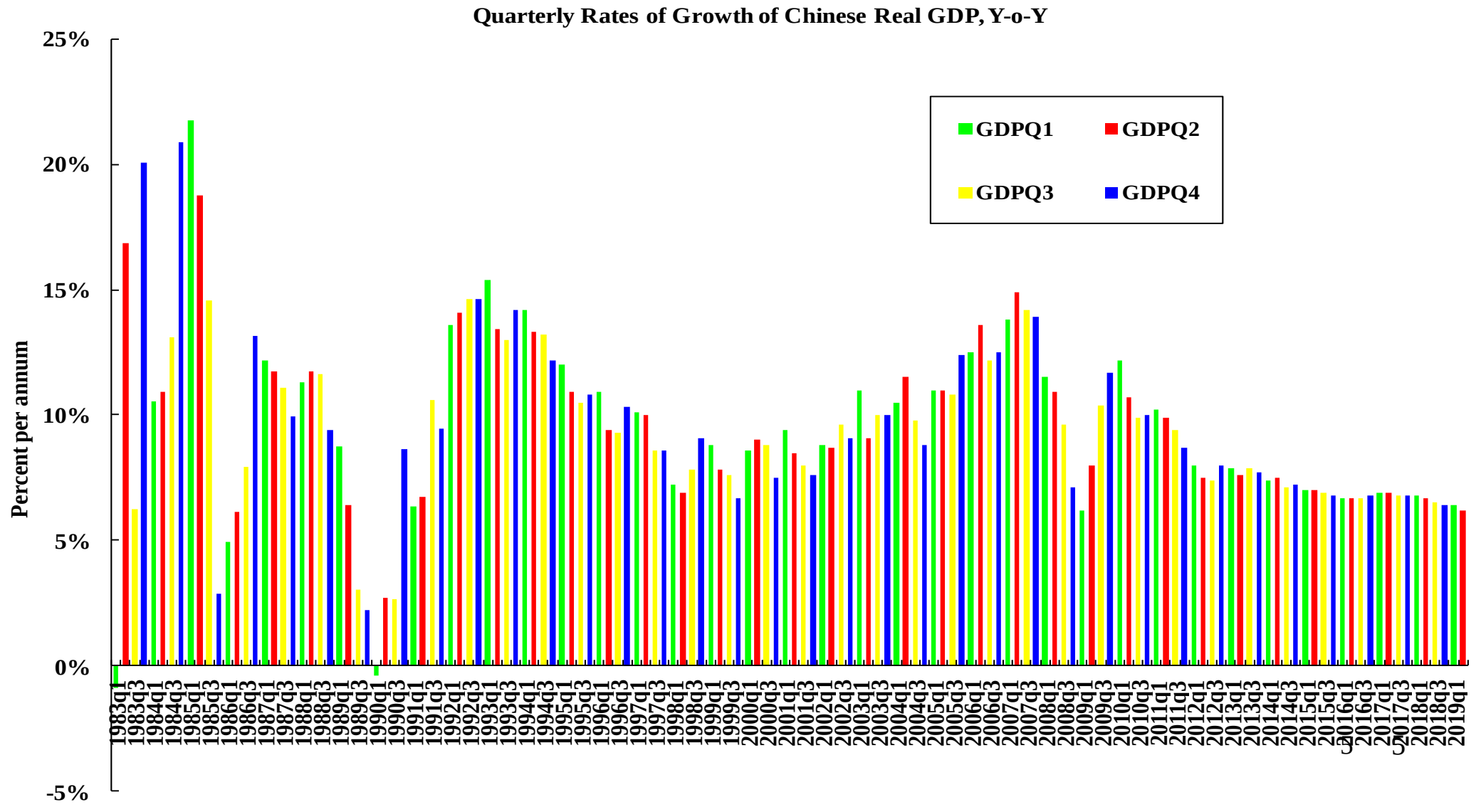
Introduction

- In 2017, the Chinese economy grew 6.8%. For 2018 as a whole, the rate of growth of Chinese real GDP was 6.6%, exceeding the target of 6.5%. For 2019H1, the Chinese economy grew 6.3%. Overall, there was a decline of between 0.5% and 0.6% The results also reflected the impacts of the expectation of a trade war since January 2018 and the uncertainty it created, as well as half a year of U.S. tariffs on Chinese exports to the U.S., in addition to the rise of rates of interest globally.
- Thus far, the trade war does not seem to have done too much noticeable damage to the Chinese economy. However, the 6.3 rate of growth in 2019H1 might have also reflected the (positive) effects of accelerated shipments of Chinese exports of goods to the U.S. in an attempt to beat the imposition and increases of tariffs.
- The uncertainty and unpredictability created by the trade war has affected both investment, including fixed investment, and consumption negatively.

Introduction

- In the following chart, the quarterly rates of growth of Chinese real GDP, year-on-year, are presented in colour-coded columns (light green for first quarter, red for second quarter, yellow for third quarter and blue for fourth quarter). The six quarterly year-on-year rates of growth were, from 2018Q1 through 2019Q2, respectively: 6.8%, 6.7%, 6.5%, 6.4%, 6.4% and 6.2%. It is clear from the chart that the rate of growth of Chinese real GDP has stabilised--an L-shaped soft landing. The decline in the rate of growth over the six quarters was 0.6%.
- However, the 6.2% rate of growth in Q2 was the lowest rate of growth of the Chinese real GDP since 2009Q1, when it also grew 6.2 percent.
- This magnitude of the decline in the rate of growth is well within the expected range of the potential negative impact caused by the U.S. tariffs on Chinese exports of goods to the U.S. I predicted that the maximum negative impact to the Chinese economy, assuming that half of Chinese exports to the U.S. are halted, would be 0.45% in the first instance, and eventually cumulatively 1.2% if all the indirect effects are included.

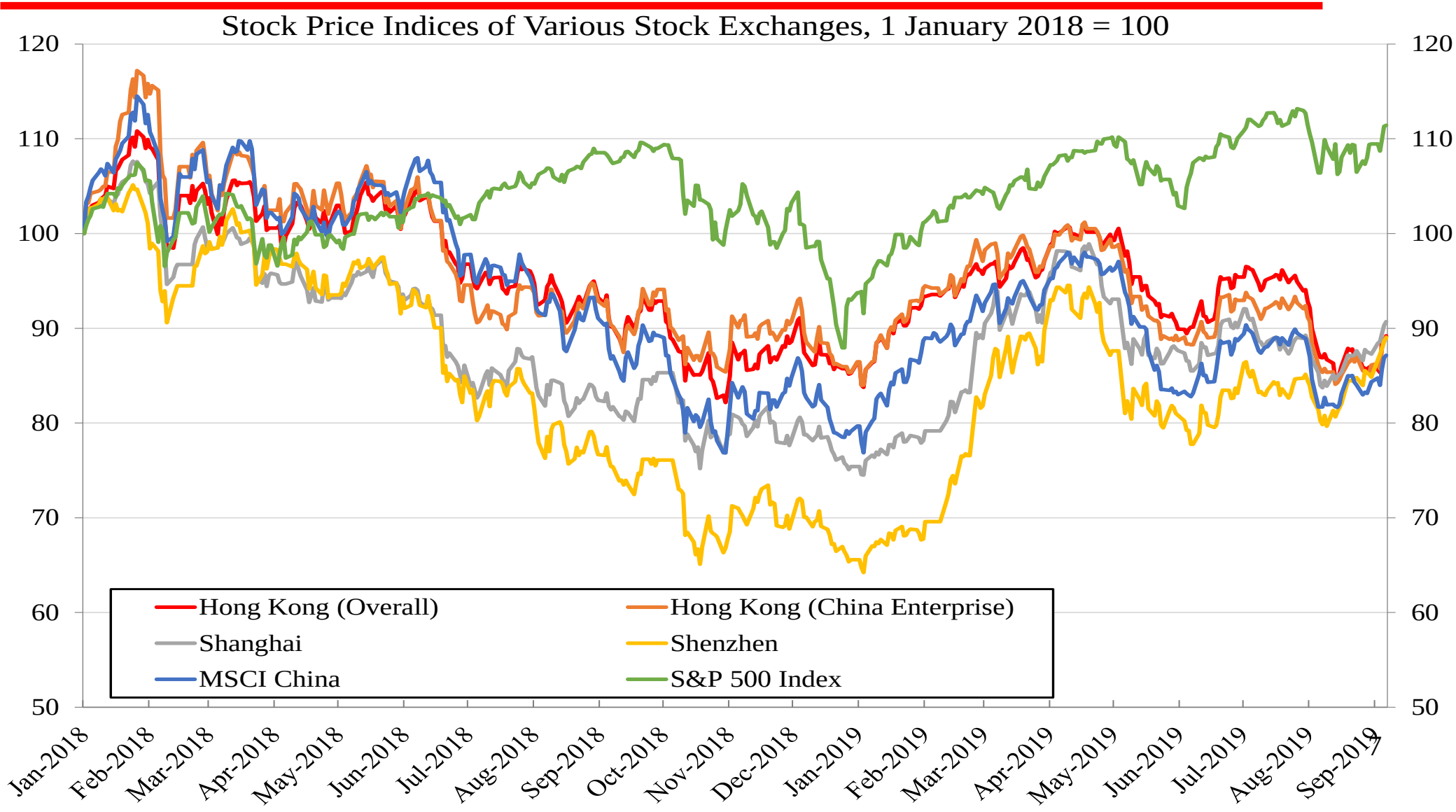
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



The Immediate Impacts of the China-U.S. Trade War

- The Chinese stock markets have already taken a hit. This is an area where the psychological factor dominates. As of the end of 2018, the shares on the Shenzhen Stock Exchange had on average lost 30%, Shanghai 20%, and Hong Kong 10%. In contrast, the Standard and Poor 500 Index of U.S. stocks did not suffer any loss on a whole-year (2018) basis.
- It should also be borne in mind that the increase in the rates of interest in the U.S. and elsewhere in 2018 would also have affected asset prices around the world negatively, so it was not solely the effect of the China-U.S. trade war.
- At the beginning of 2019, the Chinese stock market continued to fall, until the latter part of January, then it began to rise, buoyed by hopes of a successful conclusion of a China-U.S. trade agreement. However, since May 2019, it has become quite volatile, reflecting the progress or lack thereof of the trade negotiations, reacting to every trade-related tweet of President Donald Trump.
- The Standard and Poor 500 Index also fell at the beginning of 2019, but has also recovered and showed a gain of approximately 10% from the beginning of 2018. However, it has experienced volatility similar to the Chinese stock market price indices more recently.

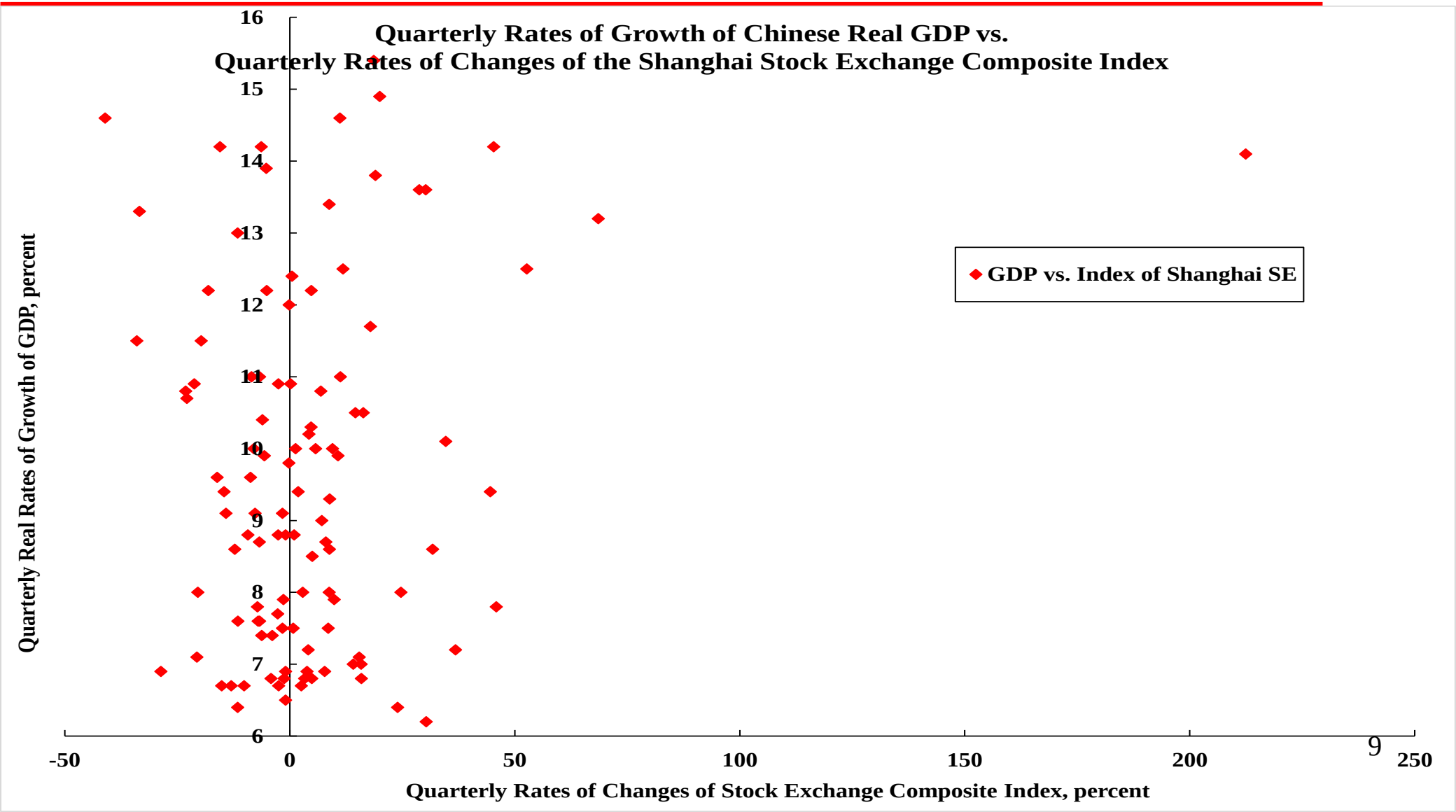
The Chinese, Hong Kong and U.S. Stock Market Indexes, 2018M1 to Date



The Immediate Impacts of the China-U.S. Trade War

- However, the Chinese stock markets are not a good barometer of the state of the Chinese real economy. There is essentially no correlation between the rate of growth of Chinese real GDP and the rate of growth of the Chinese stock market price index (see the following scatter diagram between the quarterly rates of growth of Chinese real GDP and the Shanghai Stock Exchange Composite Index).
- The majority (over 80%) of Mainland Chinese investors are individual retail investors. They are typically short-term traders who tend to leave the market at the first sign of potential trouble. The average holding period of individual Chinese investors is less than 20 trading days. The Chinese institutional investors have a slightly longer average holding period of between 30 and 40 trading days.
- The short holding period is due in part to the fact that Chinese publicly listed enterprises pay little or no cash dividends. Investors can make money only through frequent trading and have little incentive to hold a particular stock long term.

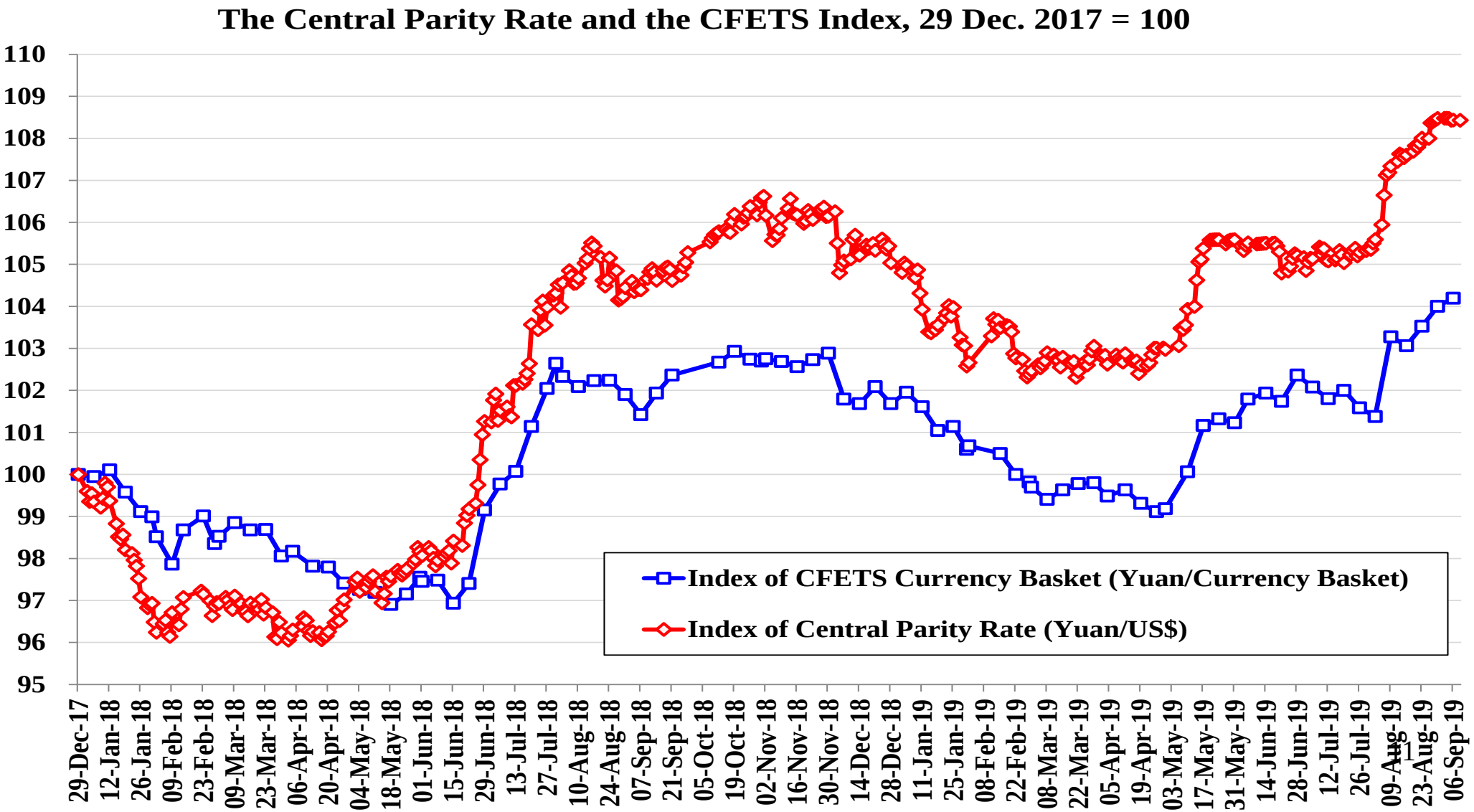
The Quarterly Rates of Growth of Chinese Real GDP versus the Chinese Stock Price Index



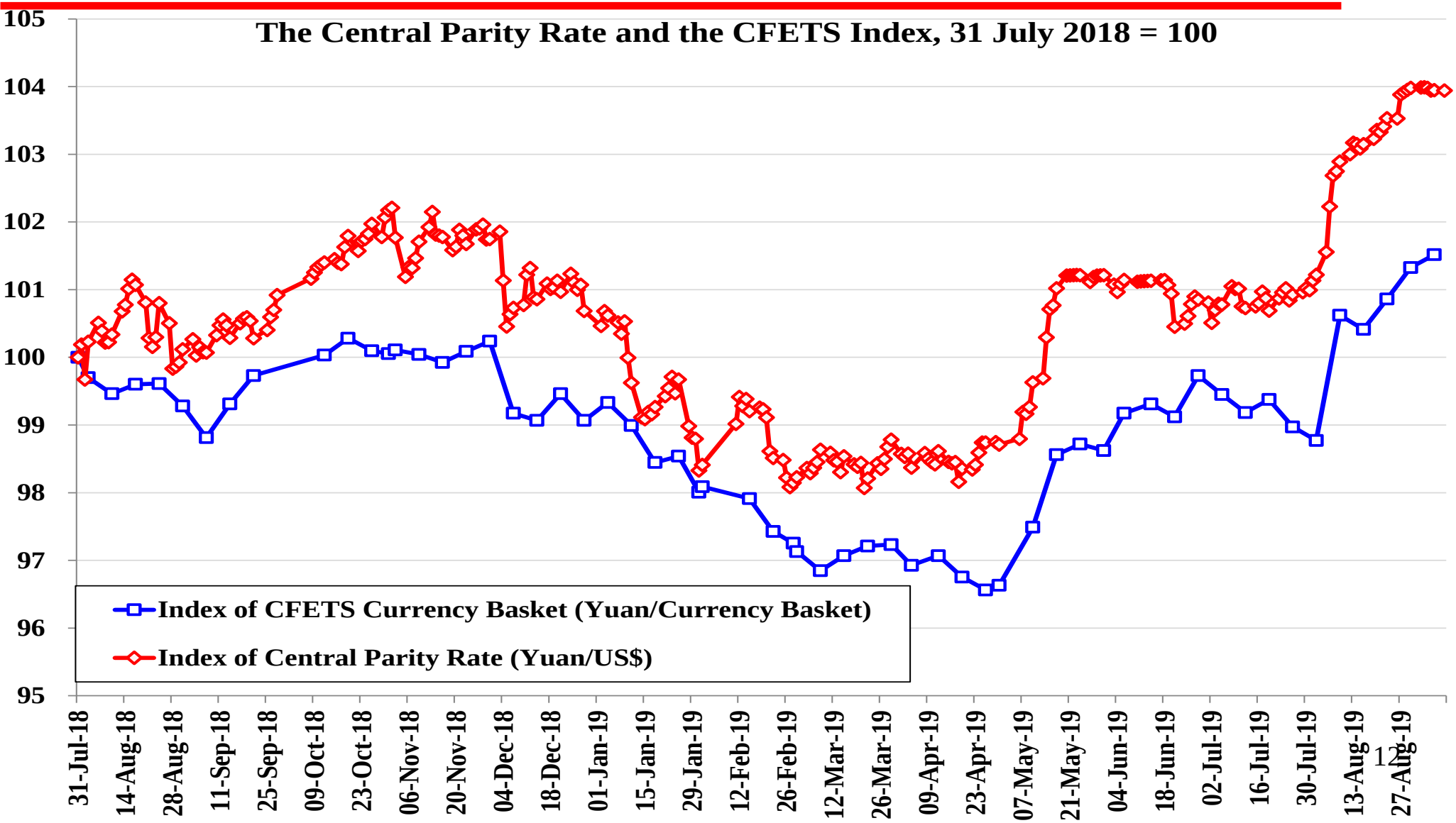
The Immediate Impacts of the China-U.S. Trade War

- The Renminbi exchange rate has also been affected by the trade war. In 2018, relative to the US$, the Renminbi devalued by approximately 8% from the end of January 2018 (at one time almost 10%).
- However, relative to the CFETS (China Foreign Exchange Trade System) Index, which tracks the exchange rate of a Chinese trade-weighted basket of currencies, the onshore Renminbi central parity rate has only devalued by approximately 4%. Our focus should be on the onshore central parity rate rather than the offshore rate and on its relation to the CFETS Index.
- The Renminbi does not follow the US$ any more because the U.S. accounts for only slightly more than 20% of Chinese international trade. For the Renminbi to follow the US$ when the US$ rises with respect to other currencies implies that China will raise its price of exports to all its other customers that account for almost 80% of its exports, which makes very little sense. Similarly, when the US$ falls with respect to other currencies, if the Renminbi follows the US$, it will imply that China will lower the price of its exports to all its other customers, which also makes little sense.

The RMB Central Parity Exchange Rate and the CFETS Index, 29/12/2017 to the Present



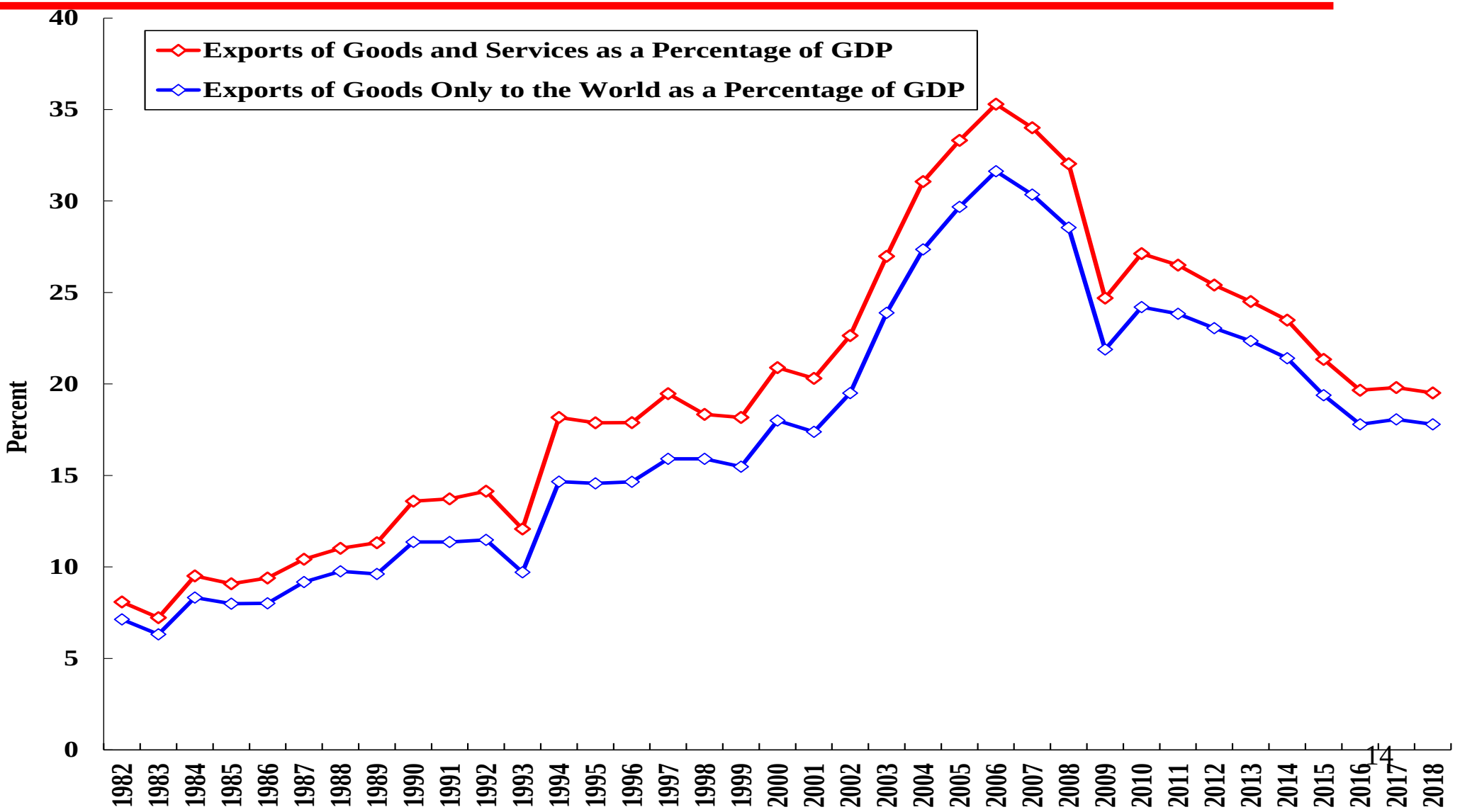
The RMB Central Parity Exchange Rate and the CFETS Index, 31/07/2018 to the Present



The Real Impacts on the Chinese Economy

- Over the past ten years, Chinese dependence on exports has been declining. The share of exports of goods and services in Chinese GDP has fallen from a peak of 35.3% in 2006 to 19.5% in 2018. The share of exports of goods to the U.S. in Chinese GDP has also fallen by half, from a peak of 7.2% in 2006 to 3.6% in 2018. This sets a cap to the total amount of potential damages to the Chinese economy as a result of the U.S. tariffs. (See the following charts.)
- The 3.6% in 2018 represented an increase from the 3.4% in 2017. However, the increase reflected the acceleration of exports of goods to the U.S. from China in anticipation of the imposition and increases of tariffs. The trend of Chinese exports of goods to the U.S. as a percent of Chinese GDP is downwards.
- During this same period, the growth of Chinese exports to the world and to the U.S. has also slowed significantly. Chinese exports to the world grew at an average annual rate of 23.5% in the decade 1998-2007, but slowed to only 5.9% in the following decade, 2008-2018. Similarly, exports to the U.S. grew at 23.7% per annum in the decade 1998-2008, but slowed to less than 6.6% per annum in the most recent decade. Exports is no longer the engine of Chinese economic growth.

Chinese Exports of Goods and Services and Goods Only as a Percent of Chinese GDP



Chinese Exports of Goods and Services and Goods to the U.S. as Percent of Chinese GDP

The Real Impacts on the Chinese Economy

- The direct domestic value-added content of Chinese exports to the U.S. is less than 25%. Thus, the maximum loss in Chinese GDP, assuming that half of the exports to the U.S. is completely halted, in the first instance, may be estimated at 0.45% (3.6%/2 x 0.25), a manageable level, especially for an economy growing at an average annual real rate of 6.6 percent and with a per capita GDP of US$9,410 in 2018.
- However, the reduction of exports leads to a reduction in the demands for domestic inputs used in their production, which in turn leas to a second-round reduction in the demand for domestic inputs used in the production of the domestic inputs. With the indirect, that is, second-, third-, fourth- and higher-round effects of the reduction of Chinese exports kicking in, the total domestic value-added affected will eventually increase to 66 percent cumulatively. This implies ultimately a maximum total loss in Chinese GDP of 1.2% (3.6%/2 x 0.66). In absolute terms, this amounts to US$156 billion in 2018 prices.

The Real Impacts on the Chinese Economy

- If all of Chinese exports of goods to the U.S. are halted because of the prohibitive tariffs, the maximum total loss in Chinese GDP would be doubled, to 2.4%, still tolerable. These losses are all estimated assuming that nothing is done in response to the imposition and increases of U.S. tariffs.
- It is instructive to recall what transpired during the Global Financial Crisis of 2008-2009, which was triggered by the collapse of Lehman Brothers in the U.S. in September 2008. Chinese exports of goods to the world and to the U.S. declined by 16.0% and 12.5% respectively in 2009, with a total decrease of Chinese exports of US$230 billion (in 2009 prices), approximately the same magnitude as half of Chinese exports of goods to the U.S. in 2019. Yet the Chinese real GDP still managed to grow 9.7% and 9.4% in 2008 and 2009 respectively. What this shows is that a decline in Chinese exports of goods of this magnitude is still quite manageable for the Chinese economy.

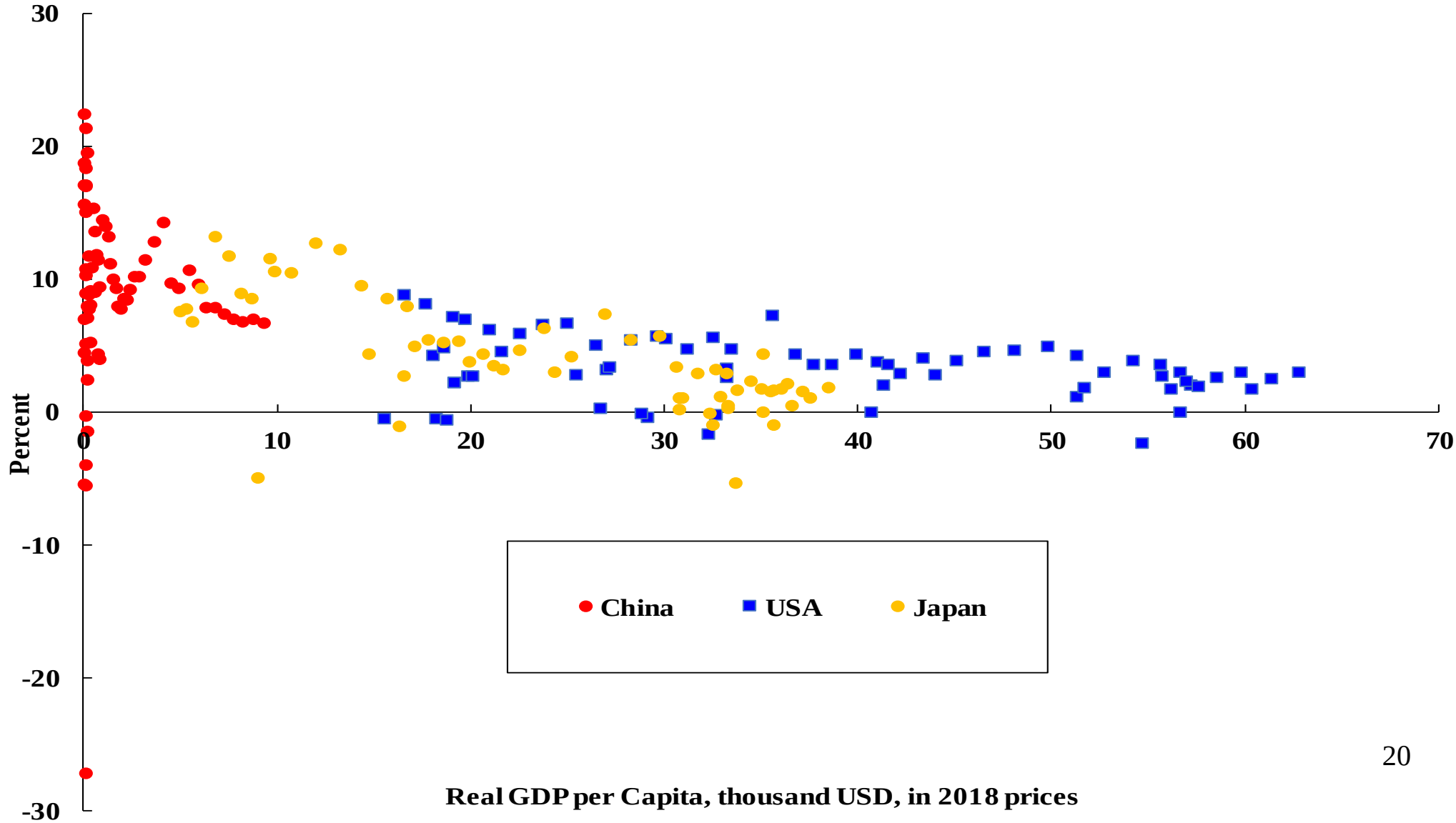
Near-Term Forecasts by International Organizations

	World Bank			IMF	
	Real GDP Growth Forecasts			Real GDP Growth Projections	
	2019	2020	2021	2019	2020
World	2.6	2.7	2.8	3.2	3.5
China	6.2	6.1	6	6.2	6
the U.S.	2.5	1.7	1.6	2.6	1.9
EU	1.2	1.4	1.3	1.3	1.6
Japan	0.8	0.7	0.6	0.9	0.4
India	7.5	7.5	7.5	7	7.2

The Long-Term Prospects of the Chinese Economy

- It is assumed that the Chinese economy will continue to grow around 6% per annum for a few more years, declining gradually to between 5% and 6%, and that the U.S. economy will grow at an average rate of 3% per annum between now and 2050.
- The U.S. economy grew 2.9% in 2018, close to its long-run average of 3%. The rates of growth of 2019Q1 and 2019Q2 were respectively 3.1% and 2.1%. Both the U.S. Federal Reserve Board and the U.S. Congressional Budget Office expect 2.3% growth for 2019.
- It may be thought that the Chinese economy will be unable to sustain an average annual rate of growth of between 5% and 6% for such a long time. Past experience shows that the rate of growth of an economy declines as its real GDP per capita rises. But given the still relatively low level of real GDP per capita in China, and the low level of its capital per unit labor, such a rate of growth should still be possible for at least several decades (see the following charts in which the experiences of China, Japan and the U.S. are compared.)

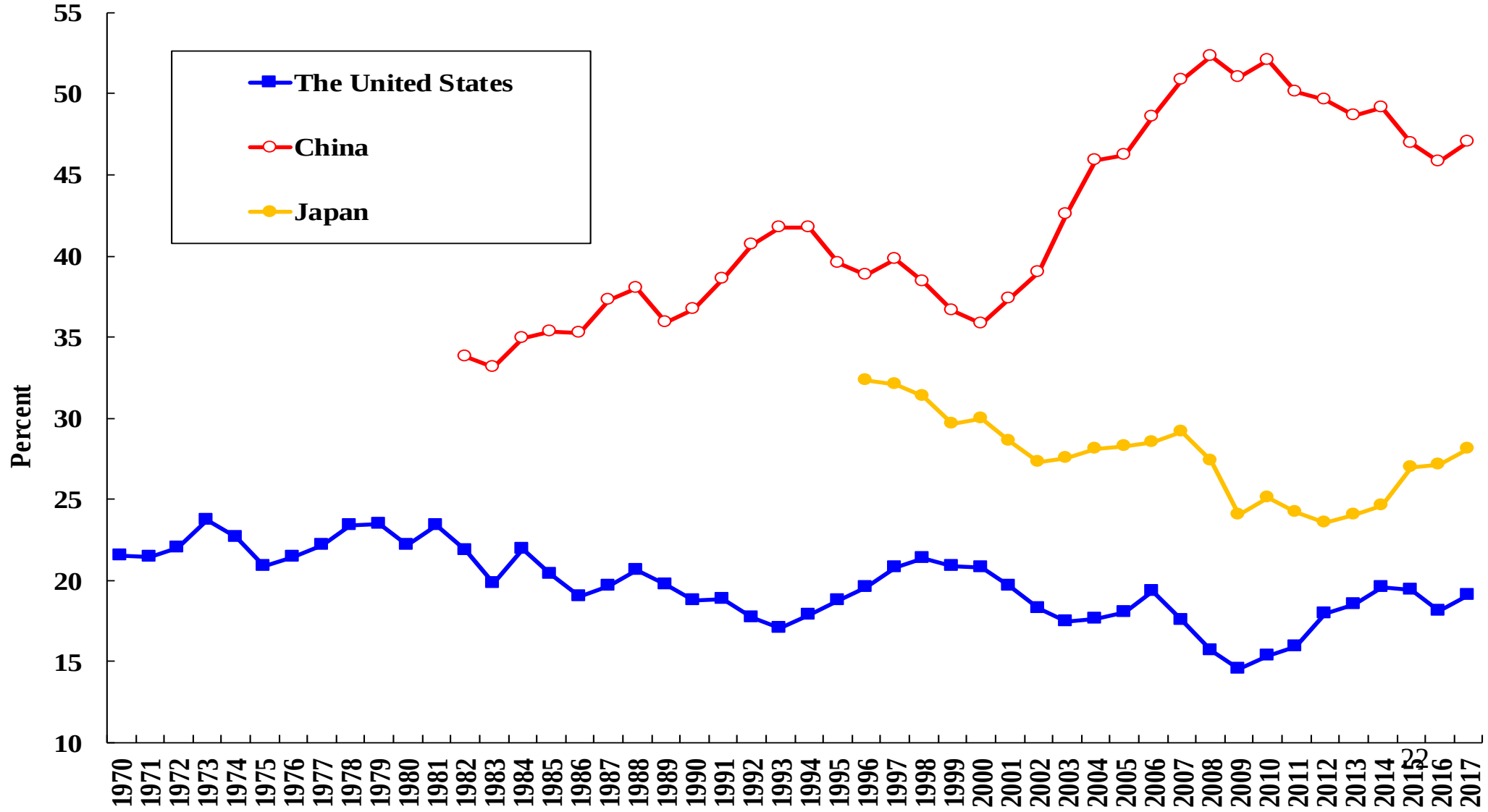
Growth Rate vs. Level of Real GDP per Capita (2018 tril. US$): China, Japan and the U.S.



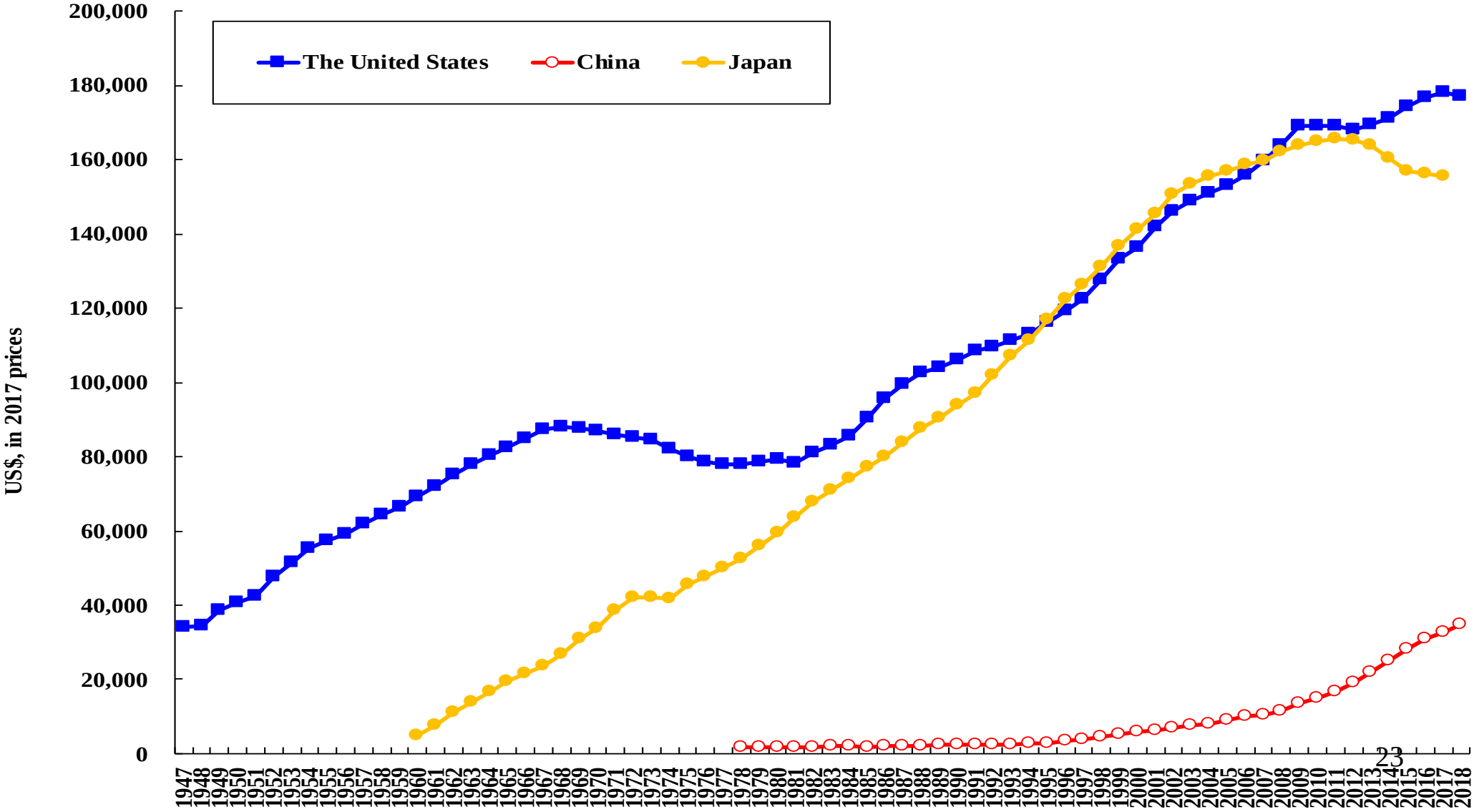
The Long-Term Prospects of the Chinese Economy

- The Chinese national savings rate is very high, which enables a very high investment rate. The capital-labour ratio of the Chinese economy is still very low compared to the U.S. and Japan. There is a great deal of room to grow.
- In addition, there is still significant surplus labour in the Chinese economy. The share of employment in the primary sector is around 30% whereas the share of GDP originating from the primary sector is below 10%.
- The manpower problem can be solved by increasing the mandatory retirement ages from their current 55 for women and 60 for men.
- China has significantly increased its investment in human capital and Research and Development. It already has the largest number of internet users in the world. Moreover, it still has significant room to grow.

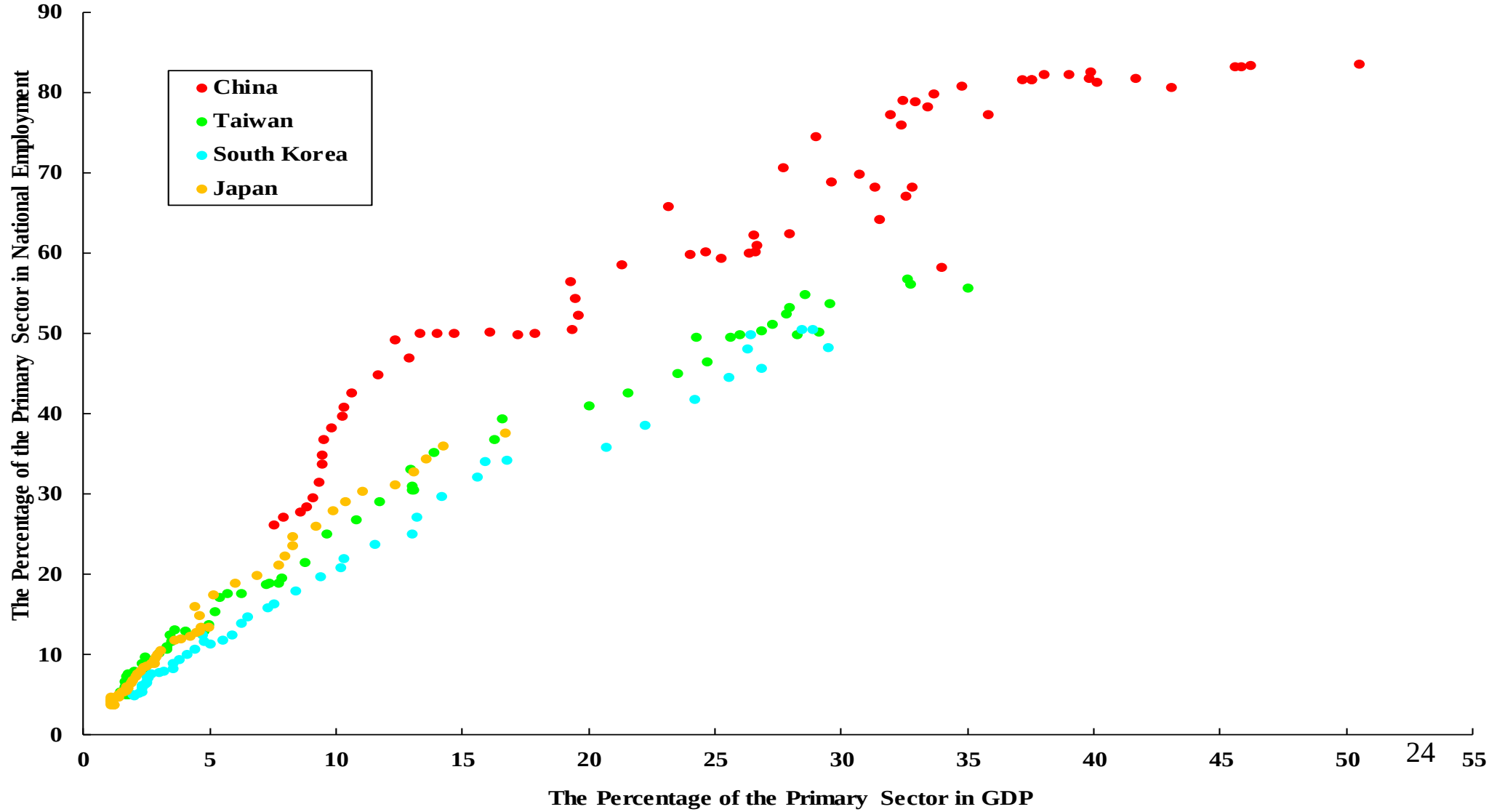
Comparison of National Savings Rates: China, Japan and the U.S.



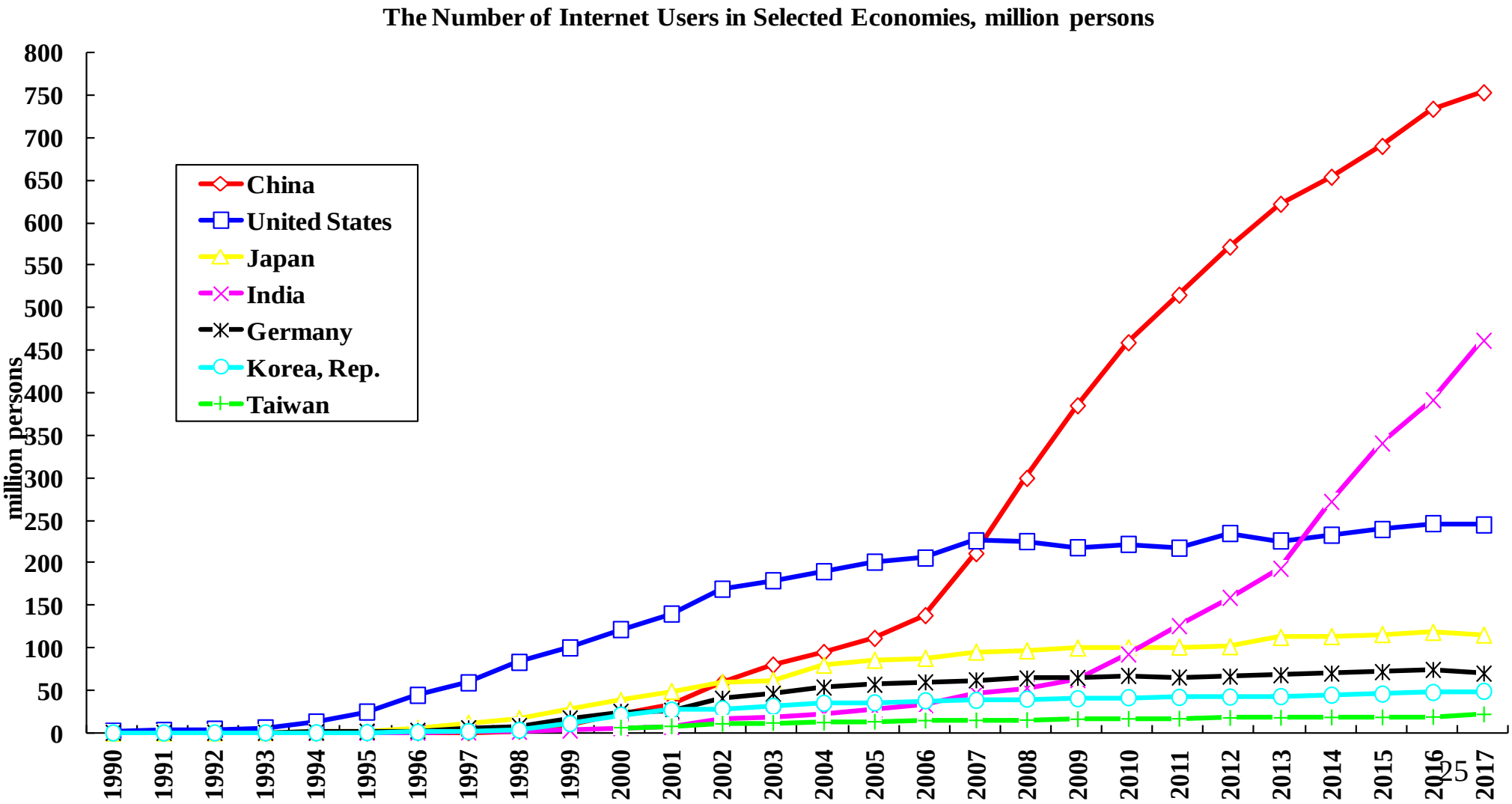
Comparison of Capital-Labour Ratios: China, Japan and the U.S.



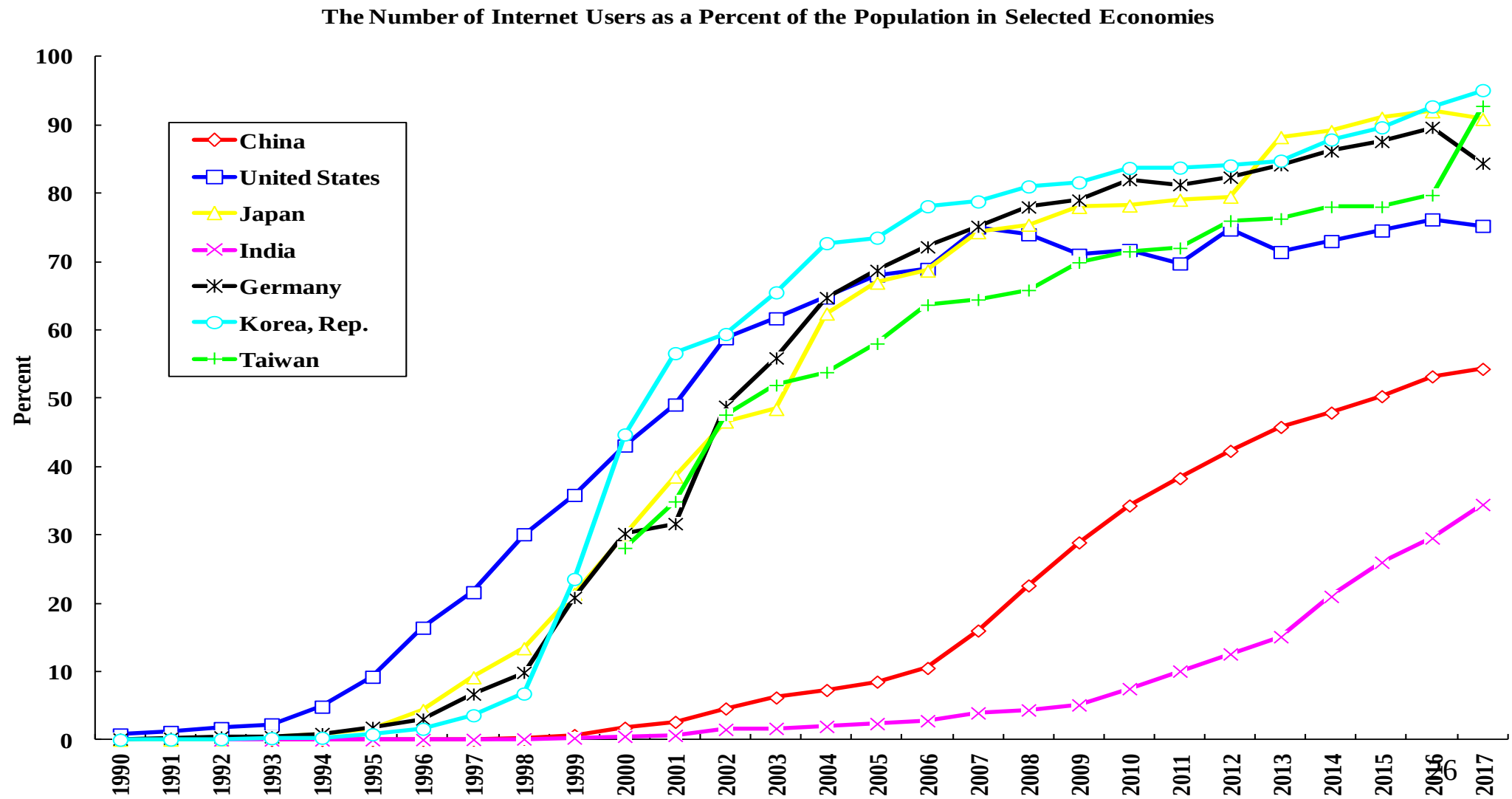
Scatter Diagram between the Shares of Employment and GDP of the Primary Sector



The Number of Internet Users in Selected Economies



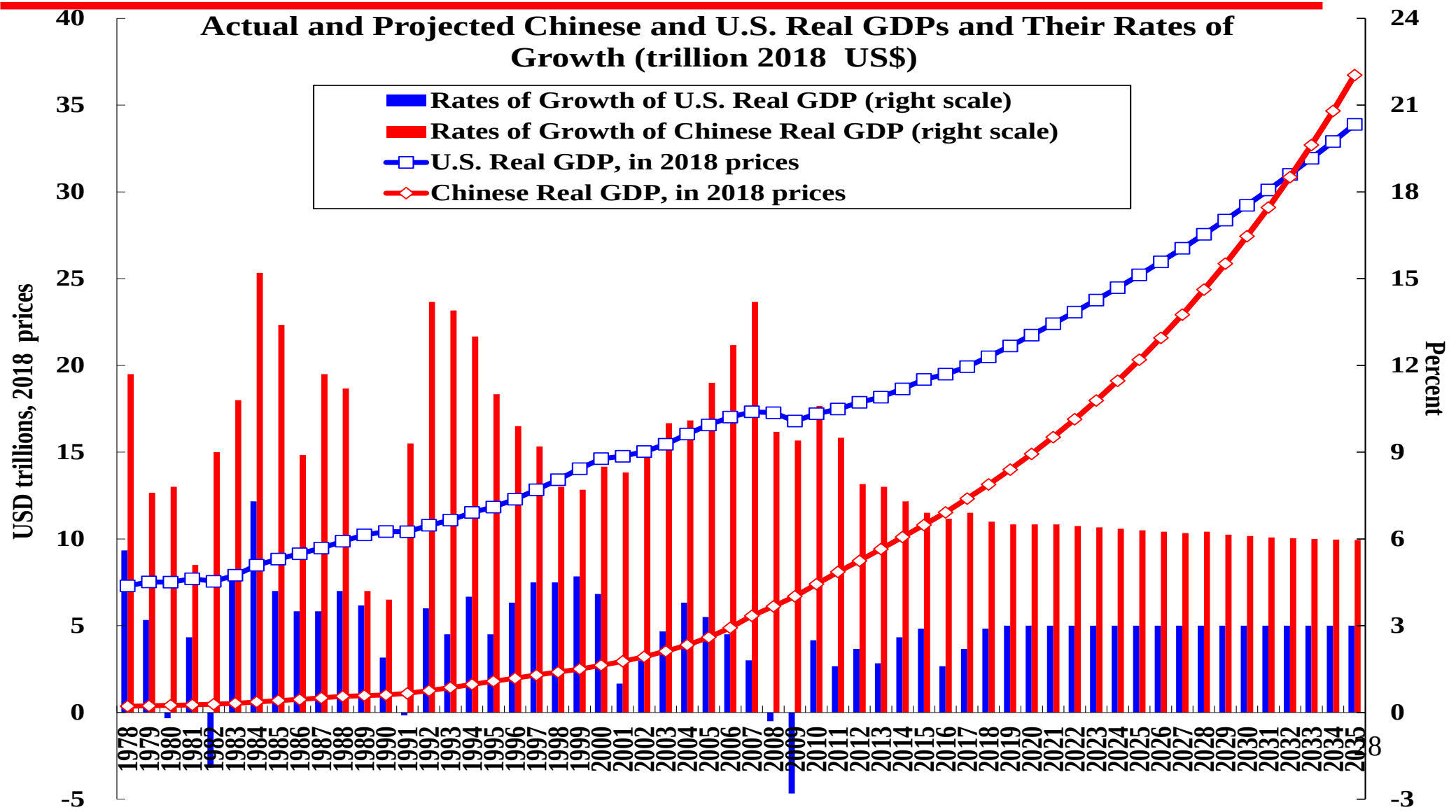
The Number of Internet Users as a Percent of the Population in Selected Economies



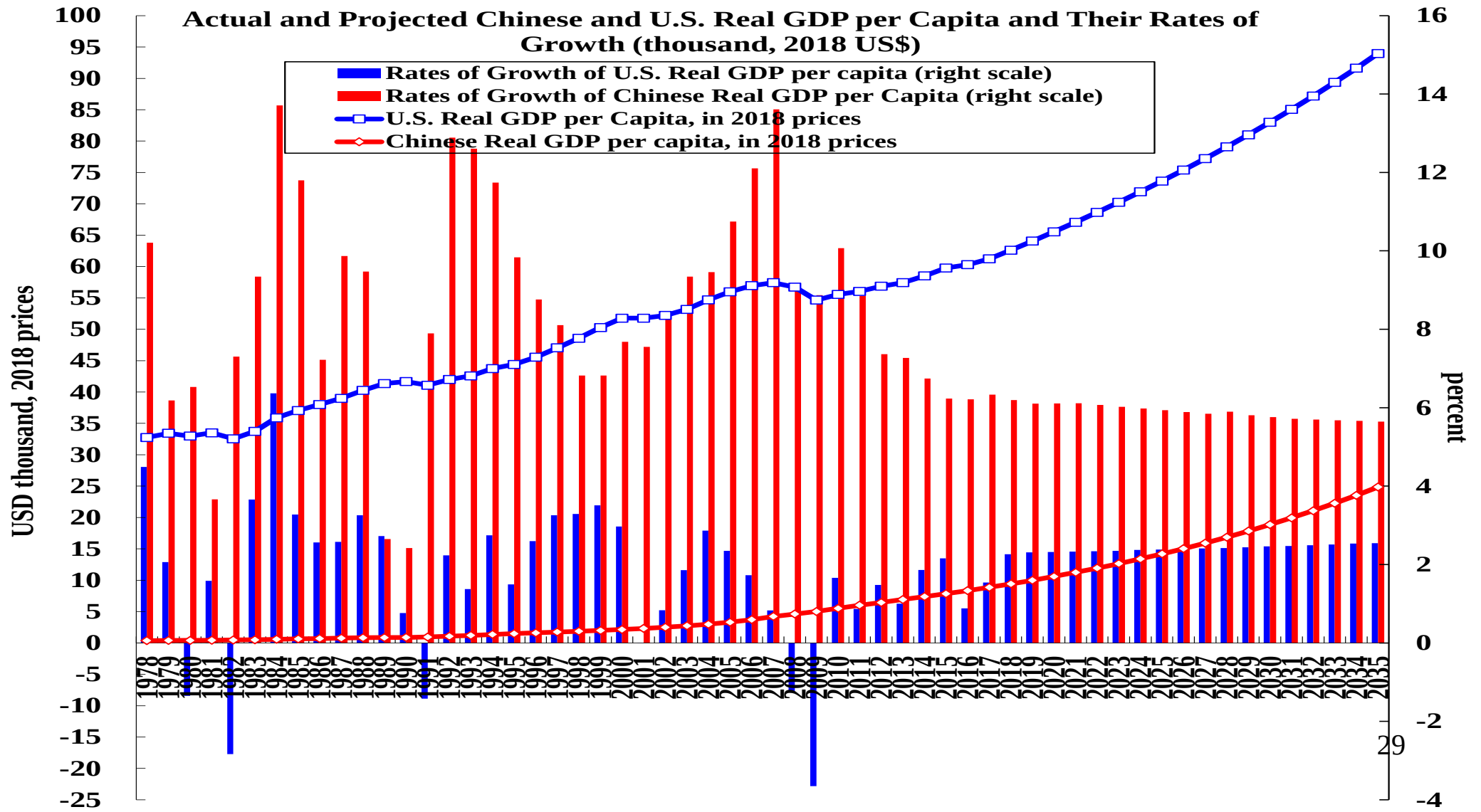
Projections of the Future

- Our projections show that by 2033 (plus or minus a couple of years), Chinese real GDP will surpass U.S. real GDP (US$32.7 trillion versus US$31.9 trillion), making China the largest economy in the world. However, in terms of real GDP per capita, China will still lag behind significantly, with US$22,088 compared to US$89,363 for the U.S.
- By 2050, Chinese real GDP will reach US$83 trillion compared to US$53 trillion for the U.S. In terms of real GDP per capita, China will reach US$53,408, still below the current (2018) level of U.S real GDP per capita of US$62,609, compared to US$138,693 for the U.S.
- It will not be until towards the end of the 21st Century for the Chinese real GDP per capita to catch up with the U.S. real GDP per capita.

Actual and Projected Levels and Growth Rates of Chinese and U.S. Real GDP (2018 tril. US$)



Actual and Projected Chinese and U.S. Real GDP/Capita and Their Annual Rates of Growth (1,000 2018 US$ & %)



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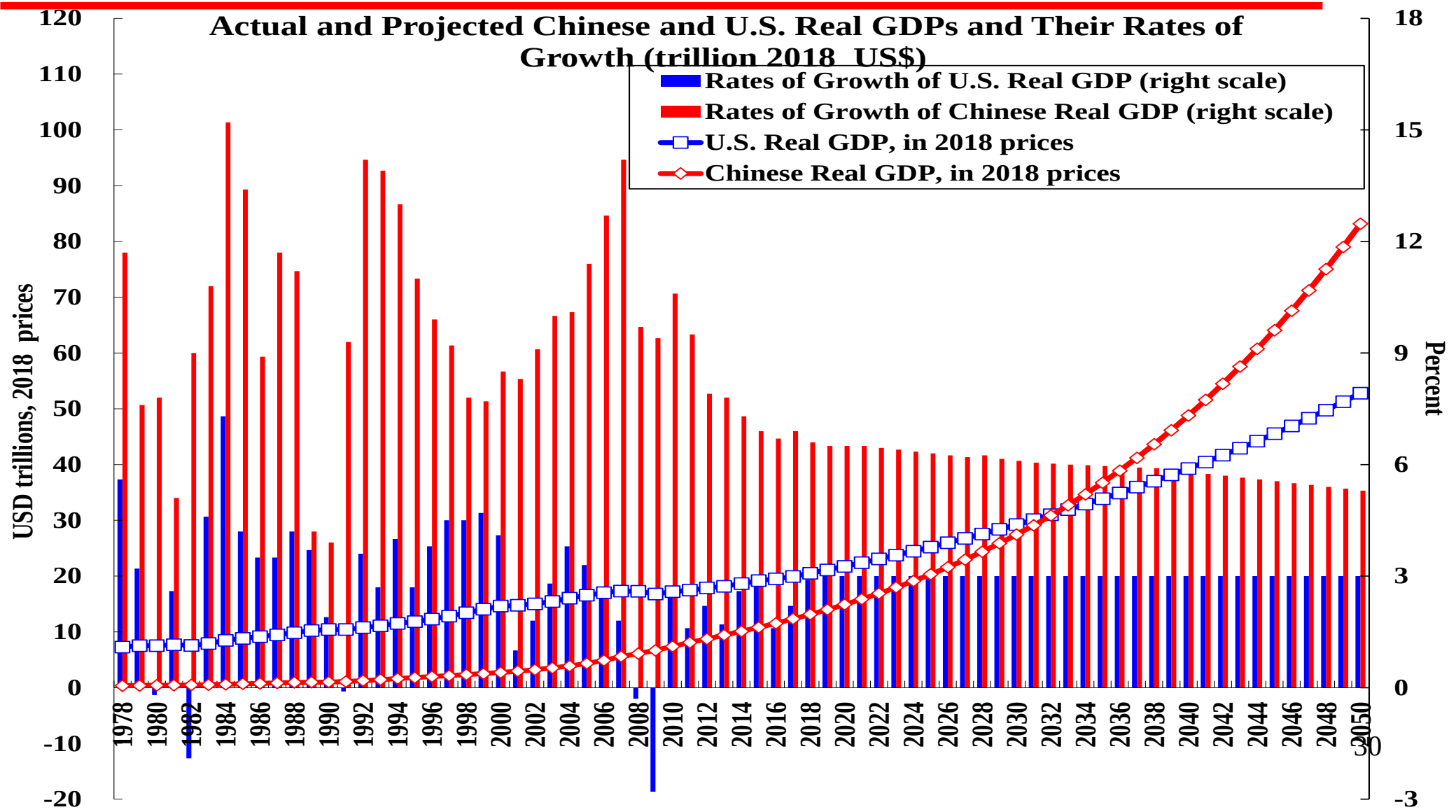
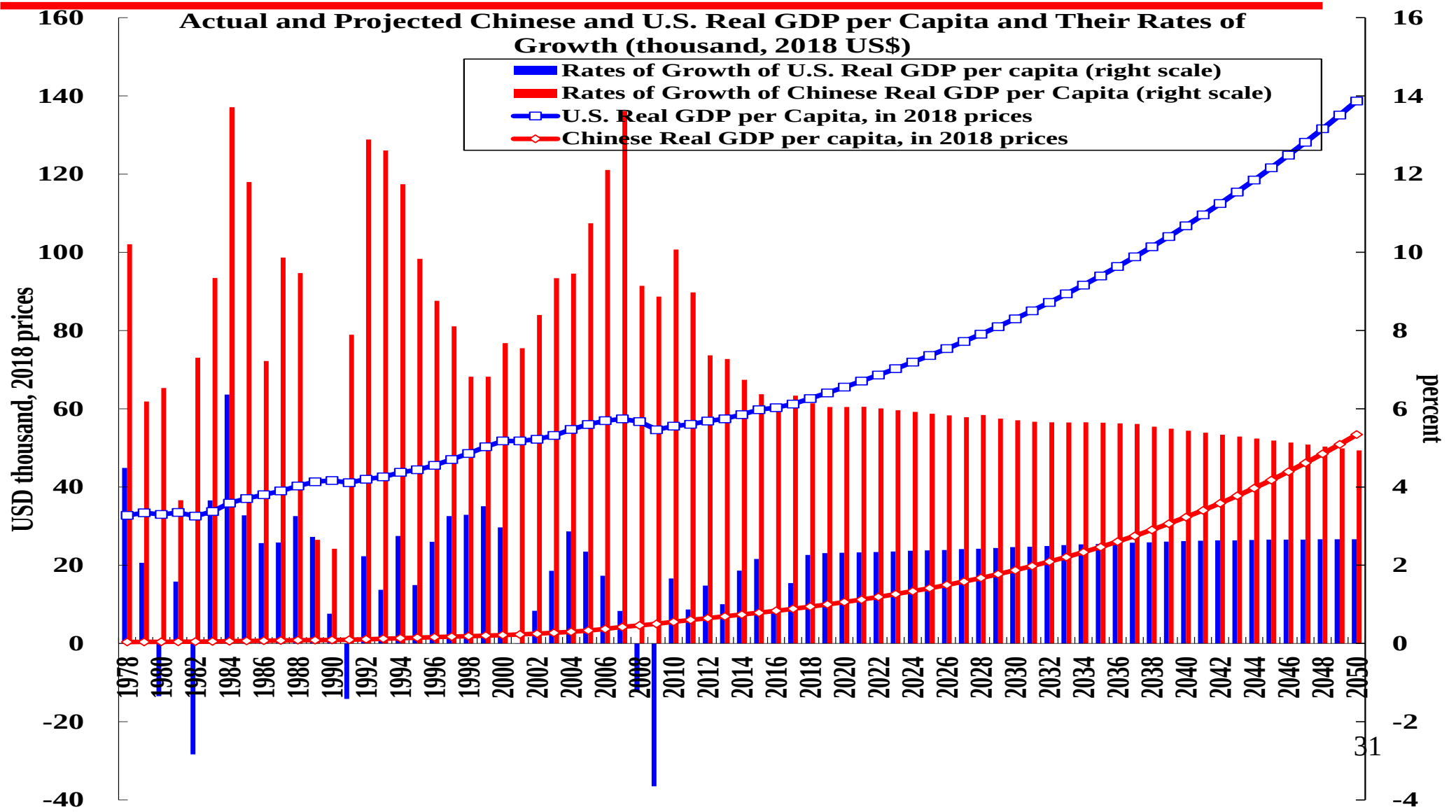


Actual and Projected Chinese and U.S. Real GDP/ Capita and Their Rates of Growth (1,000 2018 US$)



Concluding Remarks

- The competition between China and the U.S., whether friendly or unfriendly, can be assumed to be an ongoing and long-term one. It is the "new normal". The trade dispute is only a symptom of the potential possible conflicts between the two countries.
- Prof. Graham Allison, of the Kennedy School of Government at Harvard University, has written a book titled **Destined for War**, about the inevitability of a war between China and the U.S.
- As a rising power challenges the dominance of an established power, the established power is likely to respond with force. He refers to this "inevitability" as the "Thucydides Trap", drawing on the book by Thucydides, **History of the Peloponnesian War**, a war between Athens and Sparta.
- However, the rise of the former Soviet Union between the end of the Second World War and 1990 provides a counter-example that an established power and a rising power must go to war. The truth is that a thermonuclear war today is so devastating that there are effectively no real winners. It is this "mutually assured destruction" that prevented the Soviet Union and the U.S. from going to war. And it will similarly prevent wars between major powers in the future.

Concluding Remarks

- The direct real impacts of the China-U.S. trade war are relatively small and manageable for the Chinese economy. However, the uncertainty and unpredictability that it has created, and the negative influence it has on public confidence and expectations, have also affected investment and consumption and hence the real economy.
- Regardless of whether China and the U.S. can reach an agreement, once it is settled one way or the other, it will at least eliminate the uncertainty. And firms and households can make their investment and consumption decisions accordingly.
- The Chinese Government is expected to implement cuts in tax, including the value-added tax, corporate and individual income tax, and social insurance contribution rates. It will also continue investing in basic infrastructure projects such as high-speed railroads, urban mass-transit systems and a nationwide 5G network of base stations.
- Additional investments in public goods provisions such as environmental preservation, protection and restoration, education, health care and elderly care are also possible.

Concluding Remarks

- The Chinese economy grew 6.3% in 2019H1, it should be able to achieve a real rate of growth of at least 6% for 2019 as a whole.
- It is expected to continue to grow at an average annual rate of between 5% and 6% for at least a couple of decades.
- Chinese GDP will catch up with U.S. GDP in the early 2030s. However, Chinese GDP per capita will catch up to the U.S. level only towards the end of the 21st Century.