

# FRONTLINE CHINA REPORT

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## CHINA: IN A TRANSITIONAL PERIOD

by Simon Hunt



*"They've said (US Administration) that China is America's number one enemy. If you're going to call a country your number one existential enemy, you're not going to be increasing your trade and mutual dependency with it."* **Michael Hudson**, Economics Professor at University of Missouri–Kansas, 19<sup>th</sup> May 2022

*"China is tightening international production chains dependence on China to form a powerful countermeasure and deterrent capability against foreigners who would artificially cut off supply to China."* President Xi Jinping

*"In strategy, diagnosis precedes prescription of a solution. So, the proper diagnosis, I believe, is to recognize this as a classic Thucydidean rivalry, in which a genuine, rapidly rising power is in fact threatening a colossal ruling power."* **Graham Allison**, American Political Scientist talking about US–China Relations, 10<sup>th</sup> March 2022

*"...We can say there has been an overall decline in confidence in Chinese business in April. Since the BCI and its related indices look to the upcoming 6-month period, this means difficult times ahead. Comparing today with the situation over the past two years, we see the current situation is just as severe as that of March 2020, and GDP growth in the second quarter will reflect this."* **Professor Li Wei**, Director of China Economy, Cheung Kong Graduate School (CKGSB), Beijing, May 2022

## SUMMARY

- China's economy has grown from nowhere 40 years ago to accounting for 17.4% of global GDP in 2020. The real question is whether she can regain the dominance that she had in AD 1000 when she accounted for 26% of global GDP.
- The difficulties are immense. Domestically, there is a leadership squabble even though Xi will probably be re-elected for a third term, his authority may be cut.
- The economy is in deep trouble not just from the lockdowns, but from disenchantment with policies that have been pursued over the last year or so. Business and household confidence has been shattered and will take months to recover despite the stimuli packages that are being unveiled almost on a daily basis.

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- In contrast, China may have to continue experiencing rolling lockdowns into 2023 so causing impediments to economic recovery.
- Actual GDP probably won't exceed 2–3% this year and 3–4% in 2022.
- The external problems are magnifying. Weakening global business activity will impact exports; and relations with America, Europe and others are getting worse.
- A critical problem for Xi is the now obvious American containment policy and defense of Taiwan. Economic confrontation is clear-cut with a military one remaining a huge risk, one that could become an actual event in 2024.
- China will have to navigate the difficult international environment and the likely global asset crash over the next two to three years before embarking on real growth strategies. Until then the objective is just to stabilize the economy.
- China has the resources to recover: high savings, some 860 million having incomes below the national average, an enviable supply-chain infrastructure, the BRICS as an export base and gold reserves of over 40kt.

## INTRODUCTION

China's difficult issues are both domestic and international. Monetary and fiscal policy must balance both; the former requires stimuli but the option for a fully-blown stimulus as carried out in 2020 would only create longer term problems; and the latter has to allow for relations with America to deteriorate with the risk that Washington takes measures to close down key seaway choke points.

China's support for Russia with its war against NATO being pursued over the lands of Ukraine has awakened long-held fears that America's real policy is to contain China's rise and influence internationally and to derail China's growth.

In seeing where China stands globally it is important to look back to where she has come from and the progress that the country has made over the last 40-years. Nothing like China's achievement has been recorded in history and probably never will be. Here are some of these signposts.

### China Progress 1980-2020

Year	World Population	of which Poverty %	GDP \$	% World	Exports \$	%
1980	981 bn	88%	191 bn	0.17%	11.3 bn	0.5%
1990	1.14 tr	70	361 bn	1.6	49.1 bn	1.4
2000	1.26 tr	50	1.21 tr	3.6	253.1 bn	3.2
2010	1.34 tr	17	6.09 tr	9.2	1.65 tr	8.6
2020	1.41 tr	0	14.72 tr	17.4	2.72 tr	12.1

Source: World Bank

The question is what comes next? Will China be able to recapture what history tells us is that the country was the center of the universe as records back to AD 1000 show. The data shown below is taken from Angus Maddison's history AD1000 to 2000; and 2020 to World Bank's data series.

### USA & China % of Global GDP AD 1000 to 2020

	USA	China
AD 1000	0.06%	26.0%
1500	0.03	25.0
1700	0.01	22.0
1900	1.09	11.0
1913	18.9	9.0
1938	17.8	6.4
1960	24.3	5.2
1980	21.1	5.2
1990	21.4	7.8
1995	21.4	11.2
2000	21.9	11.7
2010	22.5	16.6
2020	24.7	17.4

Some institutions such as the IMF and the CIA Factbook consider that PPP is a more accurate assessment of a country's GDP. On this basis China's economy surpassed America's in 2017 and by 2020 China's GDP had reached \$24.273 trillion and USA's \$20.937 trillion according to the IMF.

Using nominal GDP data and assuming that China's economy's trend growth will be 4% a year to 2040 (versus average growth of 8.7% a year since 2000) and America's 1.6% up to 2030 and thereafter 2% a

year (average growth last 20 years was 1.6%), the crossover year should be 2037 when China's GDP would be \$28.7 trillion and America's \$28.5 trillion.

The above are trend growth rate profiles, but how does China move from today's difficult period to achieving the country's growth potential.

## THE MAIN ISSUES

The domestic and international issues are inter-linked because China's leadership is preparing for difficult relations with America and for a forecast global crash of asset values somewhere in the mid-2020s. This means that reflating the economy from its current problems will have to be cautious as government does not want to spend all its reflation tools now as it will need to keep the big guns until the world economy crashes.

### International Issues

Biden's signing into law the new Act on 27th December 2021 signaled a new tougher policy to contain China than was spoken about before. The Act effectively seeks to militarize countries surrounding China including Taiwan so as to contain China's growth and influence. The current meetings in Tokyo are part and parcel of this new policy.

Today (Monday 23rd May) Biden went one step further by saying that should China invade Taiwan America would use its military to support Taiwan (it's a commitment we made, he said). Biden has also launched the Indo-Pacific Economic Forum which is designed to deepen America's cooperation with countries in the region covering subjects such as supply chains, digital trade and clean energy.

These are steps which Beijing has long known would be surfacing. They understood that the war over Ukraine is NATO's attempt not just to contain Russia's influence across Europe but to so weaken its economy that the country can be readily absorbed into the Western Alliance.

China's leadership sees America's actions to reduce Russia's global influence as a prelude to what Washington means to do to China. America is trying to weaken both Russia and China so that they can become subservient to Washington's dictates.

However, these policies stem from a fear that Russia and China will create a new trade and currency platform – which is advanced – that would exclude the US dollar and therefore if successful would create a group of countries stretching across central Asia, the Middle East, Africa and even into S America which would prefer to deal with this New Platform rather than within the dollar's western alliance structure. If this platform succeeded, roughly half of the world would be trading without the US dollar implying the end of America's 77 years of hegemony.

The train, as it were, has left the station bound for the New Trading & Currency Platform. There will be many red signals before the train reaches its station but despite the obstacles it will get there, by 2025 in our view.

One reason is that Russian and China have been planning this New World since the SCO was founded in June 2001, followed by BRICS in June 2006 and the Eurasian Economic Union in May 2014. The new trading and currency platform is the product of years of planning.

## Domestic Issues

The leadership has many challenges to overcome to ensure that growth will continue to outpace the world, some of these are discussed below.

- The lockdowns have brought growth to an abrupt halt. There are two reasons why the leadership has chosen a covid-zero path. First, the elderly or those over 65 years number some 160 million. Should the virus hit many of them they would overwhelm the health facilities given that the Chinese vaccinations have only 25% of the strength of those in the west.
- Second, Chinese goods are embodied in nearly all global supply chains. Without these goods and components global industries slowly grind to a halt as they are unable to find alternative supplies at short notice. As Xi Jinping has said, 'China is tightening international production chains.' Lockdowns are a way of showing to Washington, Brussels etc. how much their countries depend on China.
- In effect, the lockdowns have a greater political context than an economic one. The economic pain can be righted by skillful management but the political outcome has wide implications both internationally and domestically.
- Domestically, lockdowns are one of the centers of the rumored leadership struggle between President Xi and younger members of the China Youth League, which the president has always abhorred.
- Xi's policies are to switch the focus on growth from the coastal cities to the central and western provinces where most of the households have incomes below the national average.
- The China Youth league incumbents want growth to remain based on coastal cities (the Shanghai clique). These 6 coastal cities account for 49% of the country's GDP whereas the 15 poorer ones' account for just 21% of the country's GDP.
- The dispute between the two cliques is also over property. The president wants to pursue policies that make housing affordable to all under his 'Common Prosperity' plan and to reduce the debt held by private sector developers. By doing so his policy will break the incestuous ties between the developers and local governments, as both sides have been in each other's pockets, as it were.

- The longer-term strategy is for central government to provide the purse strings for local governments by seeing that most revenues accrue to central government who then parcel out funds to local governments. The process probably includes a thinning out of local government bureaucracy over time.
- Thus, the lockdowns are more to do with the politics of the country and partly internationally rather than the economy. Lockdowns give the president the means to tighten control over large sections of the population; they weaken those sections which have gained huge wealth over the last 40 years which has weakened the structure of the CCP; and they have helped to create the tools for a leveler of the playing field or Common Prosperity.
- The substance of the policy dispute between the two factions is that the President is focusing on creating the platform for Common Prosperity and the establishment of the new International Trading and Currency platform whilst the State Council led by the China Youth League members want to focus on the domestic economy.
- Despite President Xi's rather clumsy 'old-style Maoist behavior', he will probably be re-elected since he has the support of the PLA, the security forces, nearly all of the country's 540 million rural population as well as the 190 million who have left the rural areas for the urban community since 2005. What may emerge is that Xi's victory could be less comprehensive than seemed likely a year ago thus increasing his need to seek compromises.
- Finally, there is talk that Xi may have just had a minor stroke and that the level of dissension is starting to fracture the Party. Dissension at the top of the leadership does not provide a solid foundation for sound economic policy making.
- In summary, for all of these reasons a series of rolling lockdowns may well be experienced into 2023 for political reasons and because of variants of covid which could well surface during the usual flu season.
- The Economy is in deep trouble which just a few numbers illustrate. Excavator domestic sales, a solid indicator of construction activity fell by 61% in April YOY with Caterpillar saying that they expect sales in China to be below 2019 levels this year. Auto sales despite strong growth in EVs fell by 48% in April YOY but by 12% in Jan-April months YOY.
- Household and business confidence has been shot to ribbons; households are saving rather than spending and businesses are 'running away' as one friend said to us. It will take months for confidence to return despite the new measures introduced to stimulate the economy.
- China's economy is like a tanker; it takes time to change direction. We don't think that real GDP (as opposed to reported GDP) will exceed 2-3% this year and 3-4% next year.

- Lockdowns together with a renewed thrust towards state ownership are resulting in a heavy exodus of expat business people and bankers from the mainland and Hong Kong to Singapore, Dubai and other parts of the world. The exodus includes also foreign trained Chinese. In effect, this is a brain drain of large proportions.
- China has been preparing for a growing Washington centralized world for many years. The central policy is one based on greater self-reliance which means to distance the country's imports and investments out of the western alliance countries and to reinvest in those countries which share China's international objectives based on a multilateral world without any one country dominating the universe. The policy includes liquidating asset and portfolio investments in western alliance countries.
- The self-reliance policy also means stockpiling those imports on which the economy depends whether agriculture or commodities or technological products. The policy includes investing and building industries domestically and locating imports more in countries within Asia and in S America such as Argentina, Brazil, Chile and Peru.
- Food is an intrinsic part of self-reliance as the leadership must be able to feed its population.
- China's difficulty is the lack of arable land compared with the size of its population. For instance, China fed 19% of the world's population with only 8.5% of the world's arable land last year. To tackle this issue, the leadership controls the net amount of arable land that can be converted for other use maintaining at least 307 million arable acres in 2020.
- Arable land is being increased by demolishing family houses and relocating households into modern apartment blocks so releasing new land for farming. There are some 900,000 villages in rural China which gives some idea of how much new arable land has been created: half an acre per village?
- Agriculture production has risen by an average of 7.2% a year since 2010 to RMB 7.175 trillion in 2020. However, with the decades' of focusing on manufacturing, agriculture as a percent of GDP has fallen from 34.8% in 1970 to a derisory 7.7% in 2020, though better than the low point of 7% in 2018.
- There is a new focus on expanding grain harvests through technology and scientific innovation such as by providing assistance to key seed breeding programs and expediting major biotech breeding projects.
- Imports have been a major contributor to China's food supplies growing from \$610 million in 2010 to \$4 trillion ten years later.
- Should China's agriculture share of GDP reach what it was in 2000 by 2030 and given that China's 4% trend growth should give us a GDP of \$21.8 trillion in 2030 then agriculture production would rise to \$3.27 trillion compared with 2020's \$1.1 trillion.

## Recovery

- The next few years will be difficult for China's leadership to navigate the economy through the treacherous international waters: not just the American containment policies but the expected global asset market collapse and resultant depression in the mid-2020s.
- Moreover, it takes a year or so for a new government to bed-down especially if Xi's powers will be contained.
- There are five powerful forces that will ensure that China overcomes its transitory difficulties. First it has a vision to be the center of the universe as it once was. 40 years ago, the then leadership had their vision of where China's economy would be and set out plans to achieve that objective which was to bring poverty down to zero.
- Second, households have huge savings last year totaling \$3.7 trillion rising to \$6.2 trillion by 2030 (Global Demographics). The country's gross domestic savings was 45.2% of GDP in 2020 (same as in 2019) according to the World Bank giving a likely savings of \$6.9 trillion last year.
- Third, there are about 860 million with average disposable incomes below the national average which was RMB 35,128 or \$5400 last year. Per capita income doubled in the last decade; it will do so again.



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