Macroeconomic View China

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Can China continue its rapid growth in the face of rising tensions with the US?

This time last year, we were concerned about the effects of the coronavirus on the Chinese economy. Despite being the epicentre of the initial outbreak, the Chinese economy has emerged stronger than before, with 2020 GDP growth estimated at +2.3% while advanced economies collectively declined -4.9%. For 2021 and 2022, China's economy is projected to grow at +8.1% and +5.6%, compared to +4.3% and +3.1% for advanced economies. The Chinese dealt with the coronavirus more effectively, requiring just 4.7% of GDP in additional fiscal stimulus compared to 16.7% in the United States or 16.3% for the United Kingdom.[1]

In past Insights, we have assessed the scope for continuation of China's economic outperformance by examining what we call the "three pillars of Chinese growth model". Those three pillars include: 1) economic rebalancing towards consumption and services away from foreign investment and heavy industry, 2) protecting debt sustainability and 3) maintaining political stability, both internal and external. A brief update on each pillar is provided below but our high-level conclusion remains that Chinese growth will continue to outperform other major economies – even if growth slows below their official targets of 5.5%. The shift towards a consumption and services-based economy will continue with domestic consumption expected to double by 2030 and China will increasingly use its internal demand as a lever to influence those countries exporting to China. This should create plenty of opportunities within the public and private investment markets.

The main risks to this scenario are geopolitical. In the short-term, the new US administration will maintain a hardline stance on China, particularly with respect to the technology sector that is seen as critical to national security.

However, there will be a number of differences in approach compared to the previous administration. This includes a reduced focus on goods tariffs, a greater emphasis on opening up Chinese markets to services (financials, healthcare etc.) and enhanced focus on climate change, with possible new tariff s related to carbon emissions.

The new US administration will also elevate the issue of human rights and proactively engage and recruit strategic allies including Europe, Japan, and South Korea to pressure China into sticking to international norms. Over the longer-term, China's territorial ambitions in the region, particularly around Taiwan, and its desire for more comprehensive control over the South China Sea are critical risks to monitor. While tensions could escalate inadvertently, experts do not see China deliberately initiating a war over Taiwan in the short-term. But it is clear that the strategic rivalry between the US and China will continue to intensify over these issues and this rivalry will be one of the defining themes that shapes the world over the next decade.

1. The rebalancing process appears to have slowed during the pandemic but will likely accelerate in the coming years.

China was able to maintain positive GDP growth of +2.1% in 2020 despite the overall global GDP slowdown of -3.5%, although most of this growth came from investment rather than consumption gains (Exhibit 1). Nevertheless, it is remarkable that full-year consumption levels were almost unchanged in the year 2020 despite the severe lockdowns, unlike in most other major economies. Looking ahead, the IMF expects the Chinese economy to grow at +8.1% and +5.6% in 2021 and 2022, respectively. Moreover, forecasts suggest Chinese private consumption growth to average around 6% per annum through to 2025, which is greater than expected GDP growth over the period. Nominal wages are expected to grow by at least 9% and 7% in 2021 and 2022 receptively. The emergence of the Chinese consumer, combined with an increased decoupling from the West, will create more "national champions" across all sectors of the economy.

[1] Source: IMF Database of Fiscal Policy Responses to Covid-19, January 2021. Reflects above-the-line fiscal measures classified as additional spending or foregone revenues.

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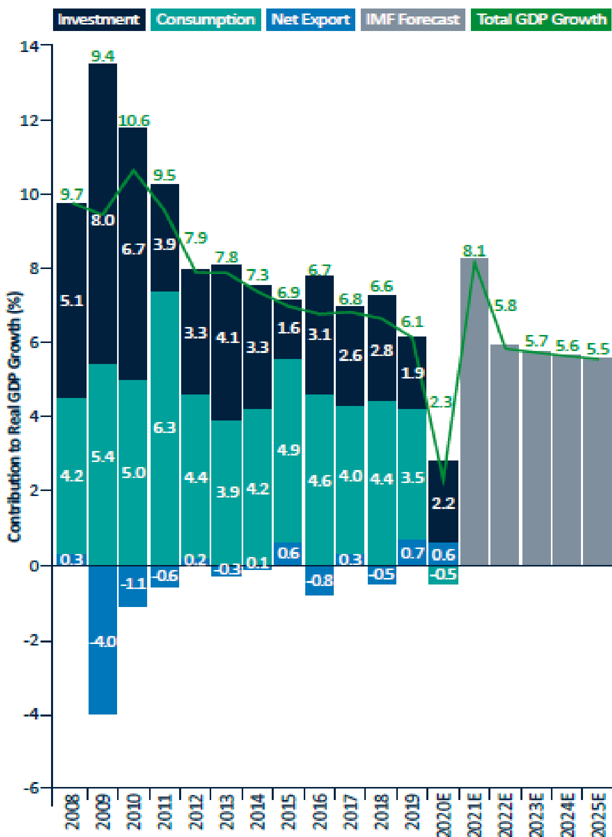
However, while China has made some progress towards rebalancing over the last decade, economic growth still has a strong reliance on government-sponsored investment. Moreover, Chinese households still maintain some of the highest savings rates in the world (Exhibit 2). In July 2020, Xi Jinping outlined a policy of "dual circulation". By this he aimed to clarify that any tilt to domestic consumption did not mean China would be eschewing trade, but instead "to better connect the domestic market with the international market" to "achieve more robust and sustainable development." In this light, the slow pace of the rebalancing process can be seen as consistent with more recent policy objectives. Ultimately, the goal is to rely on the gravitational pull of the world's biggest consumer market to attract foreign investors and suppliers to China on Beijing's terms.

Exhibit 1

Rebalancing progress has stalled



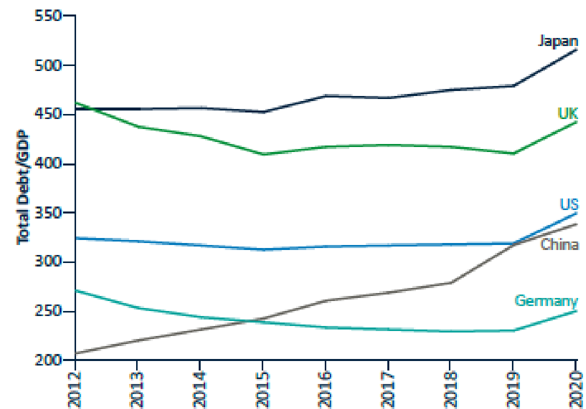
Source: National Bureau of Statistics China, IMF

2. China's debt burden remains high but not out of proportion with other major economies

Similar to other economies, China's debt reduction plans in 2020 were sidelined in favour of providing the necessary economic support during the pandemic. The consolidated fiscal balance widened from -4.9% in 2019 to -6.5% of nominal GDP in 2020. Key fiscal stimulus included spending on epidemic control and medical equipment, unemployment insurance, tax relief, and public investment. Total debt – which includes corporate lending, national and local government lending, and all household debt – is estimated to have reached 335% of GDP in 2020. This figure is lower than that of Japan, the UK and now even the US. If we exclude debt internal to the financial sector, a common method when assessing debt levels, total debt in 2020 is estimated to have reached just over 280%.

Exhibit 2

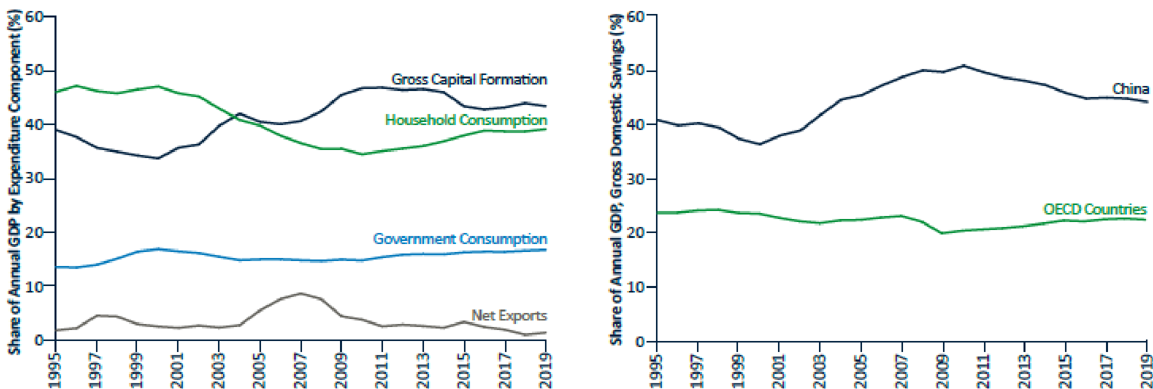
China's total debt to GDP is growing but is not out of proportion with that of advanced economies.



Source: The IMF World Economic Outlooks - October 2019 and October 2020

Exhibit 3

China still maintain some of the highest savings rates in the world



Source: World Bank

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Similar to other major economies, this debt burden will likely be supported by a more accommodative monetary policy. The Peoples Bank of China (PBoC) reduced its policy rate from 4.05% to 3.85% in April 2020. Experts highlight that risks of interest rate increases are low and that hawkish policy rhetoric has softened since January, limiting the risk of over-tightening.

3. Political risks still remain

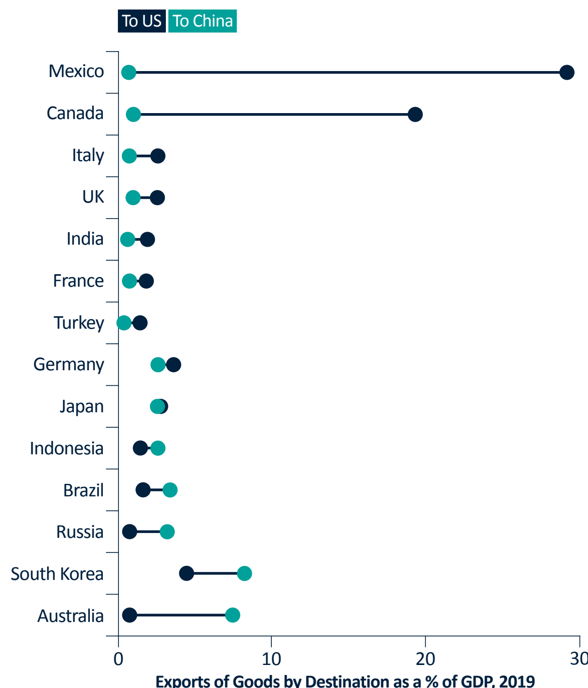
Internal politics appear relatively stable for now following the successful pandemic response

While China's command economy has achieved record growth over the past two decades, as it moves into the club of advanced economies, it is increasingly faced with important trade-offs. On the one hand, the government is committed to maintaining strict control over the economy and even many aspects of private citizens lives. On the other, no advanced economy in the world has survived over time without embracing some form of democratic rule. Also, the government's stated goal of boosting household consumption and services will over time create a more well-off and educated middle class, who are likely to turn their attention to seeking greater freedoms as their wealth increases, as their basic needs of food and shelter are assured. While there are occasional internal challenges, at present many experts do not see elevated risks of political instability. According to Kevin Rudd, Australia's former prime minister, President Xi experienced some political difficulty in the early part of 2020, owing to a slowing economy and the COVID-19 pandemic, whose Chinese origins put the Chinese Communist Party (CCP) on the defensive. However, by the end of 2020, Chinese media were hailing him as the party's new "great navigator and helmsman," who had prevailed in a heroic "people's war" against the novel coronavirus. Indeed, Xi's standing has been aided greatly by the less than stellar management of the pandemic in the United States and many other Western countries, which the CCP has highlighted as evidence of the inherent superiority of the Chinese authoritarian system. Moreover, just in case any ambitious party officials harbour thoughts about an alternative candidate to lead the party after Xi's term is supposed to end in 2022, Xi recently launched a major purge—a "rectification campaign," as the CCP calls it—of members deemed insufficiently loyal.

Outside of Beijing, there are ongoing social issues, particular around the treatment of minorities. There are credible reports of a massive crackdown on China's Uighur minority in the region of Xinjiang as well as various acts of repression in Hong Kong, Inner Mongolia and Tibet. In the face of international protest, the central government has come to believe that China's economy is now strong enough to weather any US sanctions. Such sanctions, if imposed by the US, may now be less likely to be adopted by other countries, given the rising importance of China as a destination for global exports (Exhibit 4).

Exhibit 4

For some countries, China's market is on a par with or even larger than that of the US



Source: *IMF*

Nonetheless, the CCP remains sensitive to the damage that can be done to China's reputation by continuing revelations about its treatment of minorities. As such, China has become more active in international forums, including the UN Human Rights Council as well as expressing support for environmental initiatives. On balance, as long as the economy continues to grow at a rapid pace, the risk of internal social unrest creating major instability appears limited.

External political and geopolitical risks are rising

Despite the arrival of a new US administration, the conflict that arose between the US and China over the past two years is set to remain a feature of the global economic landscape. The first phase of the conflict was part of a broader US war on trade during 2018 - 19 as the Trump administration addressed perceived inequities in the framework governing international trade. The tit-for-tat increase in the US and Chinese tariffs along with the threat to NAFTA and other trade agreements is estimated to have shaved 0.5% off global GDP last year, as the "US war on trade" depressed global business sentiment, transmitting the shock well beyond the US-China conflict.

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While the US-China trade war has abated, the underlying conflict has always been about far more than trade. Global leadership in key areas of technology, as well as national security issues, are at the heart of tensions that are creating a great-power struggle. As sabre rattling on tariffs has died down, tensions have escalated in the technology arena as the US has placed constraints on several Chinese companies. China's reaction has been muted thus far as it has focused on moving towards self-sufficiency in key technologies. However, China remains highly dependent on foreign-produced foundational technologies, notably its reliance on semiconductor imports necessary for military and communications applications as well as the digitalisation of the economy.

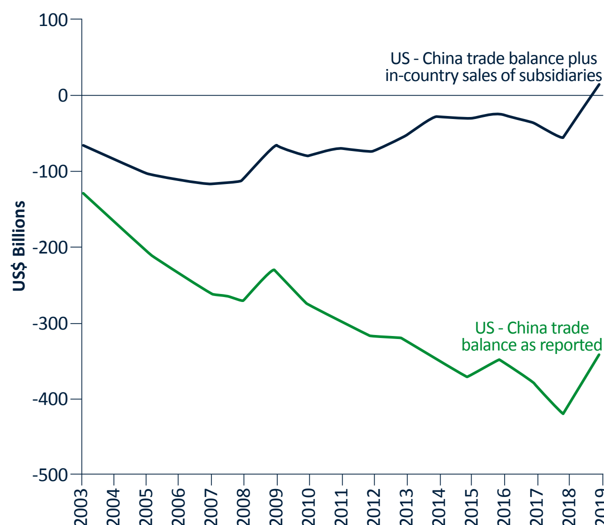
The financial sector is currently an area of both cooperation and conflict. Financial openness was a key component in the Phase One US-China trade agreement, and China has generally abided by its commitments. However, the US's recent actions show a willingness to limit US capital flows to China. That these have been linked to geopolitical issues highlights the central role of geopolitics in this conflict. A broad set of issues (including US support for Taiwan, freedom of navigation in the South China Sea, democracy in Hong Kong SAR, and human rights issues throughout China) underlie the willingness of the US to employ trade and financial market tools in a policy of China containment.

How will Biden's policies towards China differ from Trump's?

There are three key dimensions of the US-China relationship that Biden has already changed, or is shortly expected to change, US policies: tariffs, multilateralism and environment. We expect Biden's administration to maintain the Trump era policies in the area of technology (IP protection in particular) and the opening of access to China's financial sector.

— **Reduced reliance on tariffs:** On the trade front, both the US and China are likely to abandon the Phase One framework on quotas tariffs and import quotas will likely be re-calibrated to China's willingness to ease access to US services firms (including finance, insurance, health, legal, and e-commerce). This shift reflects a recognition that the US has a comparative advantage over China in services while China has an advantage in manufacturing. It has also been the Chinese government's stated long-term objective to allow increased foreign competition in services to raise productivity. As shown in exhibit 5; the US does a lot of business in China via its subsidiaries, particularly in services. Increasing this activity is positive for both the US and China and a cooling in the US-China trade tensions is helping to reduce global business uncertainty.

Exhibit 5
US-China trade balance, including and excluding sales through US subsidiaries located in China



Source: *JP Morgan, Deutsche Bank*

— **Less America First, more multilateralism in dealing with China:** The US is likely to change its tactics from engaging with China solely on a bilateral basis to moving toward a multilateral approach involving traditional allies. This could end up restructuring and expanding the WTO to include services and technology transfers and amend the concession accorded to China in exempting SOEs from standard subsidy restrictions. It is also likely that under a restructured WTO (with a resurrected Appellate Body), anti-dumping rules could include general subsidies (e.g., an undervalued exchange rate and financial repression) rather than just specific subsidies as at present.

— **Environmental protection concessions are likely:** John Kerry, the new environmental tsar under Biden has floated the idea of carbon tariffs to replace existing goods tariffs. These would apply to all countries exporting to the US, but China would be particularly impacted. Cooperation on environmental protection would be marginally negative for China's growth and positive for Europe, where much of China's environmental equipment will be sourced.

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Areas where the policy will not change:

- **Technology: decoupling.** The race for global leadership in many key technological innovations is well underway, including 5G standards, quantum computing, AI, and biotechnology. In vying for dominance in these areas, the US and China have set about decoupling, reducing cooperation, restricting technology sharing, even shutting down trade in some cases. Maintaining leadership in advanced and foundational technologies for semiconductors will remain a US priority and targeted restrictions or sanctions on individual Chinese companies are likely to continue.

- **Financial Services: A rare opportunity for cooperation.** This is another area where the existing trend will continue under Biden. The financial sector remains an oasis of cooperation and further integration. China has already begun opening up its financial market, with foreign financial institutions facing fewer restrictions in accessing Chinese consumers financial sector and foreign investors accessing China's onshore capital markets more easily.

The impact of any supply chain onshoring on China is expected to be minimal

As noted above, the combination of the pandemic induced supply shortages (e.g., PPE, facemasks, and semiconductors for automotive production) as well as a slowing of globalisation trends due to rising protectionism, has increased talk about moves towards sourcing diversification and onshoring of critical supply chains. On 25 February 2021, President Biden signed an executive order directing a broad review of supply chains for critical materials. The executive order mandates a 100-day review of supply chains for four areas: semiconductors used in products from cars to phones; large-capacity batteries used in electric vehicles; pharmaceuticals and rare-earth elements that are key to technology and defence. Biden is also calling for a separate, one-year review of supply chains covering six broader sectors, from technology to food production.

While this US executive order does not single out any country, China is perhaps most exposed as the world's largest exporter. However, China has already reduced reliance on exports massively, from c. 27% of its GDP ten years ago to c. 17% today. Clearly, diversification of sourcing away from China, combined with the trend toward onshoring of production will have a negative impact on China's growth rate looking forward. It is early in this transition, which will have us watching for the quantitative impact this may have on China's growth. At this stage, our view is that this will be a slow-moving process where Chinese companies partially fill the gaps created by adding new markets where China benefits from global buyers diversification away from other source countries. In the end, we expect the longer-term impact on Chinese growth to be minimal.

Taiwan - the most likely potential source of conflict

While the crackdown in Hong Kong has dominated headlines over the past two years, it is not an issue around which the UK as its former colonial ruler or any other Western power appears willing to engage too strongly with China. Taiwan, however, is a different story.

Kevin Rudd believes that President Xi's paramount goal is securing control over Taiwan sometime before the year 2035 at which point Xi will be 82, the same age as Mao was when he passed away. Xi appears to have concluded that China and Taiwan are now further away from peaceful reunification than at any time in the past 70 years. This is probably correct as the promise of reunification under a "one country, two systems" formula has evaporated as the Taiwanese look to Hong Kong, where China has imposed new national security laws, arrested opposition politicians, and restricted media freedom.

With peaceful reunification off the table, China's strategy now is clear: to vastly increase the level of military power that China can exert in the Taiwan Strait, to the extent that the United States would become unwilling to fight a battle that it would probably lose. Without US backing, China believes Taiwan would either capitulate or fight on its own and lose. On 23 January 2021, three days after Joe Biden's inauguration, Chinese military aircraft simulated missile attacks on a US aircraft carrier during an incursion into Taiwan's air defence zone, according to intelligence from the US. TThe People's Liberation Army sent 11 aircraft into the south-western corner of Taiwan's air defence zone on January 23, and 15 aircraft into the same area the next day, according to Taiwan's defence ministry.

According to Kevin Rudd, this thinking, radically underestimates three factors: the difficulty of occupying an island that is the size of the Netherlands, has the terrain of Norway, and boasts a well-armed population of 25 million; the irreparable damage to China's international political legitimacy that would arise from such brutal use of military force; and the deep unpredictability of US domestic politics, which would determine the nature of the US response if and when such a crisis arose.

In summary, Beijing is sending a clear warning to the Biden administration that Taiwan is its "red line" – namely Taiwanese independence but also any interference in Beijing's access to Taiwanese-made semiconductors. While

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risks could escalate inadvertently, experts do not see China deliberately initiating a war over Taiwan. On balance, the experts we survey expect both sides to refrain from outright geopolitical conflict, but to intensify a strategic rivalry over the next decade, particularly in the tech sector. Also, the new US administration will elevate the issue of human rights and proactively aim to engage strategic allies including Europe, Japan, South Korea, etc. to isolate China if and when it strays from international norms.

Partners Capital's Responsible Investment Framework for investing in China

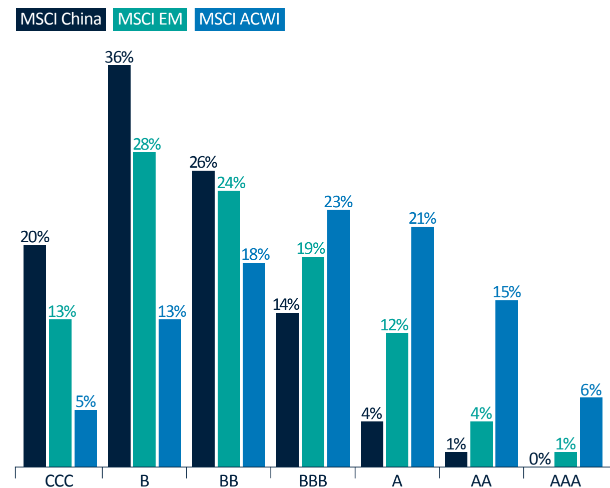
Driven by the news of human rights abuses against minority populations in China, our Responsible Investment Committee has recently reviewed our investments in managers of Chinese equities, as per our standard process for any investment with potential ethical or reputational considerations. Our conclusion at present is to retain our allocations, but to do so via active managers focused on businesses with no state involvement. These managers are selected using a process that incorporates ESG considerations.

While the news of human rights abuses associated with Chinese authorities is deeply concerning, we conclude that the government is separate and distinct from the private sector enterprises in which we are invested. More broadly than China, we take the view that an investment in a private sector company that is domiciled in a certain geography, does not necessarily represent approval of government policies within that domicile. The example of China is different from most countries given the prevalence of State-Owned Enterprises in which the Chinese government does have large equity ownership stakes and strategic control. However, our investment policy in China is to allocate away from such companies. Our allocations are almost exclusively invested in independent companies, many of which have developed innovative technology or are benefitting from the rapid digitalisation of the Chinese economy.

Furthermore, our firmwide ESG policy is that when investing in sectors or geographies with heightened ESG risks, the asset managers through which we invest need to have a higher standard of ESG integration incorporated into their investment decision-making process. In addition to the aforementioned issue of state-level human rights concerns, Chinese corporations tend to have significantly lower ESG scores than their Western counterparts. Exhibit 6 shows the dispersion. The MSCI ACWI index has 42% of companies ranked as AAA to A according to MSCI's ESG ratings. In comparison, China has only 5% in the top rankings. A majority of 56% of Chinese companies are ranked CCC or B (the lowest two ranks). While the trajectory is positive (i.e. the MSCI ESG ratings are improving), they remain significantly behind developed market companies.

Exhibit 6

MSCI ESG Data Scores – China, Emerging Markets and Developed Markets



Note: *MSCI China Index Constituents with ESG Rating data as Aug. 1, 2019 = 487, n. MSCI Emerging Market index constituents with ESG Rating data = 1154, n. MSCI ACWI Index constituents with ESG Rating data = 2205*

Source: *MSCI ESG Research as of Aug 1, 2019*

Finally, Partners Capital believes that investors can have a significant positive impact by engaging with "poorly performing" companies from an ESG perspective and improving their scores via active engagement.

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