CHINA ECONOMIC UPDATE NOVEMBER 2020

China looking inward as the external environment has deteriorated

NAB Group Economics

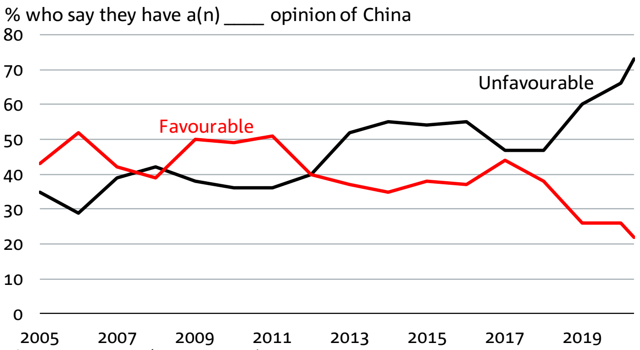
In recent months, US President Donald Trump has spoken about decoupling the United States and Chinese economies, suggesting that the US would not suffer if the two countries were to no longer trade together. Although many observers have noted that the two economies are so interconnected that such a strategy would be impractical, it appears that Chinese authorities are shifting their thinking to address an increasingly negative external environment. In part this reflects the fact that a potential change in the US administration may not result in a material change in policy towards China.

US ELECTION OFFERS LITTLE PROSPECT FOR A RELATIONSHIP CHANGE

At the time of writing, polls suggest that Democratic candidate Joe Biden is likely to win the US Presidential Election (although results in 2016 suggest caution should be taken when it comes to polling). While such a result would change the US executive leadership, it should not be assumed that this would also result in a change in US foreign and trade policy with China.

US RESIDENTS VIEW CHINA UNFAVOURABLY

Significant deterioration in recent years



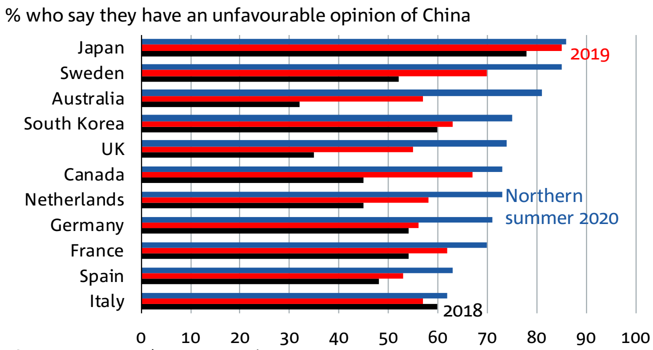
Source: Pew Research, NAB Economics

According to Pew Research, the sentiment of the American public regarding China has deteriorated in recent years and became more unfavourable over the course of the trade war and the COVID-19 pandemic. In mid-2020, 73% of survey respondents stated that they have an unfavourable view towards China, the highest reading since polling began in 2005. This view is relatively bi-partisan, with 68% of Democrats and 83% of Republicans holding this opinion.

It is also worth noting that this view is not unique to the United States. Pew Research's surveys in advanced economies also show a similar increasingly unfavourable view towards China.

NEGATIVE PERCEPTION WIDER THAN US

Other advanced economies have a growing unfavourable opinion of China



Source: Pew Research, NAB Economics

A Biden Administration would likely take a different approach to its Chinese trade policy than that seen over the past four years. Most notably, this would mean a multi-lateral approach (in contrast to the Trump Administration's unilateral action against China), with a greater role for the World Trade Organization (including a wider remit into services and technology transfers) and the potential for a renegotiated Trans Pacific Partnership (which Trump abandoned early in his Presidency). A Biden

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Administration may broaden its foreign policy beyond just trade, including human rights and environmental protection. None of these potential changes would improve the external environment for China.

IS CHINA PREPARING TO ISOLATE?

China's President Xi Jinping has made numerous statements in recent months that China's economy should shift towards a "dual circulation" (or in some sources, a "dual loop") development model. The system described primarily focusses on the domestic economy – which Xi has envisioned as becoming increasingly self-reliant for both supply and demand – as the main engine for growth, while the second "loop" is the external sector, which would supplement the domestic economy with certain foreign technologies and investment.

Specific details regarding this plan are somewhat vague, but may become clearer following the Fifth Plenum, which is meeting at the time of writing. The plenum will shape the next five year program (previously known as the five year plan), running from 2021 to 2025. It is thought that the dual circulation model could be a key part of the program.

Chinese state media has been quick to highlight that the policy is not new – arguing that it continues the rebalancing that has been underway in China's economy for some time, moving away from growth generated by an industrial sector reliant on export markets to more sustainable domestic demand. These sources have stressed that it is not about closing off China from foreign markets.

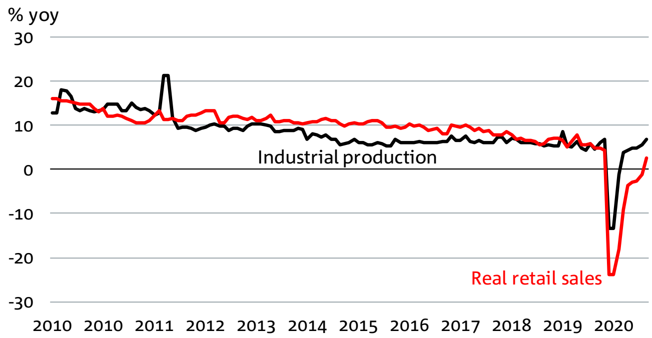
However, President Xi's comments to China's politburo have described the global economy as complicated and challenging with unstable and uncertain factors (consistent with the negative views expressed in the Pew Research surveys), suggesting that China wants to be less reliant on the outside world than has been the case in recent years.

AN UNEVEN RECOVERY AND INEQUALITY LIMITS DOMESTIC CONSUMPTION

In the near term, weakness in household consumption presents a challenge for the dual circulation model. Although China's economy rapidly recovered across Q2 and Q3 (following the sharp downturn in Q1 due to COVID-19), this recovery has been largely built on the industrial sector – fuelling residential and infrastructure construction. In contrast, household consumption has been historically weak – as indicated by real retail sales contracting year-on-year over the first eight months of the year before finally turning positive in September – albeit far below pre-COVID-19 trend growth rates.

INDUSTRIAL LED RECOVERY

Retail sales lag well behind



Source: Refinitiv, NAB Economics

According to surveys conducted by the China Beige Book, the recovery over this period was also highly uneven geographically, with stronger economic conditions in the wealthy coastal provinces, while firms in landlocked regions reported weaker output and orders in Q3. As this will impact incomes in these regions, in the short term it is likely to exacerbate existing inequality across the country that constrains consumption. Reforms to address this inequality – including significant improvements in the social safety net – may be necessary before consumers can be the driving force in the economy.

TECHNOLOGY COULD PROVE A CHOKE POINT

The "Made in China 2025" strategic plan was unveiled in 2015 and included a wide range of high technology sectors that the country aimed to be a world leader – with at least 70% self-sufficiency. A range of officials and industry bodies in the United States and European Union reacted negatively to the plan, variously suggesting that it would threaten their economies and could amount to trade protection prohibited under the World Trade Organization.

In 2020, market researchers IC Insights estimate that Chinese firms produce around 16% of the country's requirements for semiconductors. There is a broad consensus that Chinese producers are around a decade behind the leading edge producers in South Korea, Taiwan and the United States, with these producers reliant on US intellectual property.

In September, the Trump Administration restricted US exports to SMIC – China's largest computer chip manufacturer. This followed earlier restrictions on other Chinese technology firms.

The impact of travel restrictions following the global outbreak of COVID-19 highlighted the dependency of China's high tech firms on foreign engineering services – with many of these firms slower to recover than lower value manufacturing. A more isolated China might find access to intellectual property and engineering more difficult to come by – slowing its ability to climb to the highest value added levels of manufacturing and with it a key part of its longer term economic strategy.

CONCLUSIONS

Despite Chinese media commentary suggesting that the dual circulation model is a continuation of its economic transition, China's view of a more negative external environment is starkly different to the picture it faced a decade ago. While a broad decoupling of China from other major economies appears to be impractical, it is possible that a technological decoupling could occur. This would mean separate supply chains for US technology based and Chinese products and likely higher costs for end consumers.

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