



FEATURE

# China's economy cools as US trade tension heats up

By Ira Kalish

## Economic performance

There are signs that the Chinese economy may be decelerating. The government reported several indicators, including a sharp slowdown in retail sales and fixed asset investment. This comes at a time when credit expansion is decelerating.<sup>1</sup> Meanwhile, US President Trump intends to announce new tariffs on Chinese imports. This could also have a negative impact on growth. Given below are the details of the data released.<sup>2</sup>

- Retail sales were up 8.5 percent in May versus a year earlier, the slowest rate of growth since June 2003. Sales of automobiles were down 1.0 percent from a year earlier. Until recently, the consumer sector played a key role in sustaining economic growth in China, which was a positive sign from a long-term perspective. For the past two decades, China's economy is characterized by strong growth of investment and weak growth of consumer demand.<sup>3</sup> The slowdown in May indicates an overall deceleration in domestic demand.
- Fixed asset investment increased only 6.1 percent in the first five months of 2018 versus a year earlier. This was the slowest pace of increase since the government started keeping records in 1998. Private sector investment was up 8.1 percent, while public sector investment was up 4.1 percent. Investment by manufacturers was up 5.2 percent. Investment in infrastructure was up 9.4 percent. The overall weakening of investment might be attributed to the negative impact of higher oil prices on global demand, the Chinese government's squeeze on credit market conditions (which hurts domestic demand and raises the cost of capital), and the uncertainty fueled by the burgeoning trade dispute with the United States.
- Industrial production was up 6.8 percent in May versus a year earlier. This was a modest deceleration from the previous month, but roughly in line with growth in recent months. The manufacturing component was up 6.6 percent

from a year earlier. The modest weakening of the industrial sector is likely due to a softening of export growth. That, in turn, stems from a potential slowdown in global economic growth.

- Bank lending declined in May,<sup>4</sup> reflecting government efforts to quell credit creation in the face of rising debt. Nonetheless, the central bank cut its required reserve ratio in April to likely avoid a sharp deceleration in bank lending. Credit policy has tended to zigzag in recent years as the government attempts to limit debt on the one hand, but avoid too sharp an economic slowdown on the other. As the US Federal Reserve continues to tighten monetary policy, it is possible that the Chinese central bank will feel compelled to boost its own benchmark rate to avoid capital flight and the consequent downward pressure on the currency. So far, however, this has not happened.

## Trade

The United States announced its intent to impose 25 percent tariffs on US\$50 billion worth of imports from China. Then, following a round of talks in Beijing, the United States announced that it would put tariffs aside because China had pledged to boost imports from the United States. However, the United States later stated that tariffs remained on the table and that further negotiations would be needed to avoid tariff imposition. When the two sides could not reach an agreement, the United States announced that it would impose tariffs on US\$50 billion worth of imports from China. China promptly retaliated by imposing 25 percent tariffs on a similar volume of imports from the United States. The United States then threatened to impose a 10 percent tariff on additional US\$200 billion worth of Chinese imports. This would mean that the United States would impose steep tariffs on roughly US\$250 billion in Chinese imports, about half the amount of goods that the United States imports from China.

Notably, US exports of goods to China are less than US\$200 billion. Thus, for China to retaliate against the United States commensurately, it would have to do something other than imposing additional tariffs, or it would have to impose steeper tariffs on existing imports. China is reportedly already engaged in informal efforts to stymie US exports.<sup>5</sup> For example, it is reported that customs inspectors at Chinese ports are delaying the processing of imported goods from the United States.<sup>6</sup> However, Chinese officials deny that anything has changed.

The US administration believed it could coerce China because the United States could tax far more Chinese goods than the other way around.<sup>7</sup> The administration apparently discounted possible informal and asymmetric actions by the Chinese government—without implementing new policies—that could hurt US businesses. These include causing delays in processing traded goods. China could also stymie economic activities, including inbound investments and the sale of services in China by US companies.<sup>8</sup>

However, from China's perspective, furthering the trade dispute is not necessarily desirable. At a time when the Chinese economy appears to be slowing, China may not afford to hurt its export-oriented industries. Moreover, if the situation worsens, China could reverse course and allow stronger credit growth.<sup>9</sup> However, the potential problem with doing that is that the government has been keen to slow the growth of debt. The sharp rise in debt over the past decade is seen as a significant risk to the Chinese economy. Efforts to ease credit conditions could interrupt efforts to reduce financial risk.

Regardless of how China reacts to US tariffs, there is a risk of a significant slowdown in cross-Pacific trade. Such a trade war could increase prices, reduce real income, slow the growth of consumer and business spending, inhibit investment, reduce cross-border investment, disrupt global supply

chains, and have a big spillover effect on other Asian countries that participate in China's supply chains. These include Japan, South Korea, Taiwan, Singapore, and Thailand. Investor reaction to the latest risks of a trade war has led to a dip in equity, bond, and commodity prices in global markets.<sup>10</sup>

The dispute between China and the United States stems from two concerns expressed by the US administration—China's alleged uncompensated transfer of intellectual property from US companies to Chinese companies, and China's trade surplus with the United States.<sup>11</sup> The irony, however, is that China's overall current account surplus has been declining, both in absolute terms and as a share of Chinese gross domestic product.<sup>12</sup> This is due to a declining surplus in goods and a widening deficit in services. The United States sees the imposition of tariffs as a means to achieve a smaller trade deficit. Yet tariffs are not likely to cut the overall trade deficit. If the United States' deficit with China declines, it will probably increase with other countries.

The overall US deficit can only decline if the gap between US investments and savings is reduced. Here is why: the United States invests more than it saves. It makes up the difference by obtaining capital from overseas. This means that foreigners must either lend to Americans, purchase their assets, or directly invest in the United States. In order to do this, foreigners must accumulate more dollars than they spend. That, in turn, means that they must run a trade surplus with the United States. Conversely, the United States must run a trade deficit with the rest of the world. Can tariffs reduce the deficit? Yes, but likely not in a desirable way. Tariffs can lead to a slowdown in economic growth, which would probably entail a decline in investment, thereby producing a smaller trade deficit. Thus, cutting the trade deficit is not necessarily a desirable goal. Usually, a decline in the trade deficit is an indication of a weakened economy.

## Endnotes

1. The People's Bank of China, "Report on aggregate financing to the real economy (flow) in May 2018," accessed June 28, 2018.
2. All data has been taken from the National Bureau of Statistics.
3. Ibid.
4. *South China Morning Post*, "China surprises with May slowdown in new loans as risk controls hit lending," June 12, 2018.
5. Tom Mitchell and Shawn Donnan, "China readies non-tariff weapons in US trade spat," *Financial Times*, June 19, 2018.
6. Ibid.
7. Robin Wigglesworth, Shawn Donnan, Demetri Sevastopulo, and Hudson Lockett, "Mounting trade fears send waves through global markets," *Financial Times*, June 20, 2018.
8. Mitchell and Donnan, "China readies non-tariff weapons in US trade spat."
9. Lingling Wei, "Trade fight with US complicates China's campaign to contain debt," *Wall Street Journal*, June 19, 2018.
10. Trading Economics, accessed June 28, 2018.
11. Gabriel Wildau and Shawn Donnan, "US demands China cut trade deficit by \$200bn," *Financial Times*, May 4, 2018.
12. Trading Economics, accessed June 28, 2018.

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