China: Weathering the Trade Storm

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While there has been some calming in the U.S.-China trade war recently, it is far from over. In turn, some 'China Bears' are doubling-down on their long-held view that the Middle Kingdom is on the brink of disaster (e.g., hard landing, banking crisis or bursting of housing bubble). Though not impossible, we continue to see this as too extreme and not reflective of Beijing's recent strides to tackle financial stability risks emanating from the economy's heavy reliance on leverage[1] (*Chart 1*).

Even if the tensions flare again, the trade war is unlikely to tip China's economy into recession. But it has further complicated Beijing's goal of transitioning its economy from rapid credit-fuelled growth to a higher-quality, sustainable expansion. This drive is underscored by President Xi's 'Three Critical Battles' of preventing and resolving the major risks, conducting targeted poverty reduction, and controlling pollution. Thus, rather than undermine financial stability, the trade war is more likely to place downward pressure on China's growth trajectory, which was already facing pressure from an increasingly challenging global economic backdrop of rising interest rates and slower growth.

A Long Battle Ahead

Although Washington and Beijing have set March 1, 2019 as the deadline to resolve the trade dispute, a comprehensive deal is likely to remain elusive. Instead, there is still a meaningful risk that the trade war escalates with the Trump Administration moving to increase/expand tariffs. It is evident that Trump is not merely focused on reducing the size of the bilateral merchandise trade deficit, but also concerned about altering China's economic model. The core of Trump's complaints revolve around China's heavily managed/state-driven economy, which he argues is too reliant on: (1) excessive state subsidies/control, (2) forced/illegal technology transfer from foreign companies; and, (3) market access restrictions for foreign operators in key domestic industries.

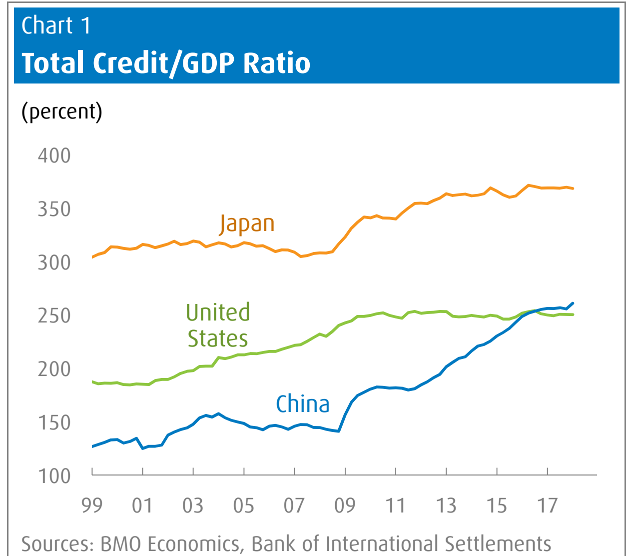
However, forcing Beijing to overhaul its economic model in one fell swoop will not be easy, especially since it has not only served the country quite well the past two decades but also because it is supported by a different political structure. These fundamental differences explain why most China watchers, including ourselves, believe the dispute won't end quickly, perhaps lasting in some form until the next U.S. presidential election in 2020.

The Economy Remains on Firm Footing For Now...

In the short-term, the knock-on effects of higher U.S. tariffs should be fairly manageable as (1) Beijing is letting its currency depreciate

[1] Although many economies display similar or even higher degrees of leverage, concerns over China largely revolve around: (1) its total credit/GDP ratio, estimated at 261% of GDP in Q1/18 by the Bank of International Settlements (BIS), is high for an economy of its relatively low income level (Chart 1); (2) the rise in credit/GDP took place over a relatively short period; and, (3) a significant portion of new credit extended could have been misallocated to unproductive/unprofitable infrastructure projects and companies.

Chart 1
Total Credit/GDP Ratio



Sources: BMO Economics, Bank of International Settlements

to help offset some of the impact of higher tariffs and (2) the drivers of China's economic growth have broadened in recent years with consumption playing an increasing role (*Chart 2*). In turn, the ratio of merchandise exports-to-GDP fell to 18.4% in 2017 versus a peak of 32.0% in 2006. Our base-case scenario factors in U.S. tariffs being raised to 25% on the additional US$200 billion of imports announced in September and a modest easing in both fiscal and monetary policies in China. The combined effects are expected to lower headline real GDP growth to 6.2% in 2019, compared to around 6.6% in 2018. If the trade war escalates (tariffs placed on all of China's exports to the U.S.) then real GDP growth could decline by another 0.25-0.50 percentage points depending on the magnitude of Beijing's fiscal and monetary policy responses.

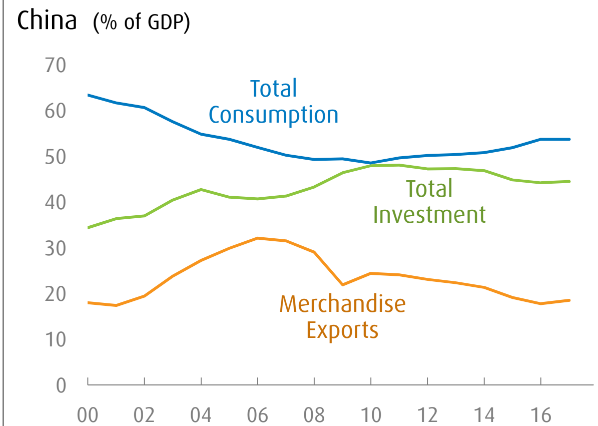
Financial markets are likely to remain heavily focused on the path of the renminbi against the U.S. dollar, particularly whether the exchange rate (currently 6.9/US$) breaches the 7.0 mark (*Chart 3*). In our view, it is reasonable to believe that Beijing will let the renminbi do so, especially if the Trump Administration increases/expands tariffs. Beyond helping to offset the impact of higher tariffs from a China export/U.S. import perspective, we believe Beijing would rather protect its stock of foreign exchange reserves (US$3.2 trillion in November) rather than deplete them by intervening in the forex market to manage the renminbi's depreciation (*Chart 4*). It bears mentioning that one of the key metrics of reserve adequacy—the forex reserves/M2 money supply ratio[2]—has continued to fall, which is why Beijing chose to significantly tighten capital controls back in 2016. At 11.5% in Q3/18, it is well below what is considered to be the minimum threshold of 20%.

Moreover, Beijing's long-term objective to curb leverage and enhance financial transparency remains largely intact. The financial deleveraging campaign—composed of an array of measures that includes increasing regulatory oversight, improving financial transparency, strengthening banks' balance sheets, reducing moral hazard risks, eliminating inefficient infrastructure, removing excess industrial capacity and cooling the housing market—has not reversed course, despite pre-emptive measures introduced to help cushion the economy (*Chart 5*). Of note, Beijing just announced plans to designate at least 50 banks, securities firms and insurance companies as domestic systemically important financial institutions (i.e., too big to fail), which will not only force these entities to increase their capital requirements but also enhance financial disclosure to guard against potential systemic distress.

[2] This ratio is used to gauge the risk of capital flight (e.g., potential bank runs).

Chart 2

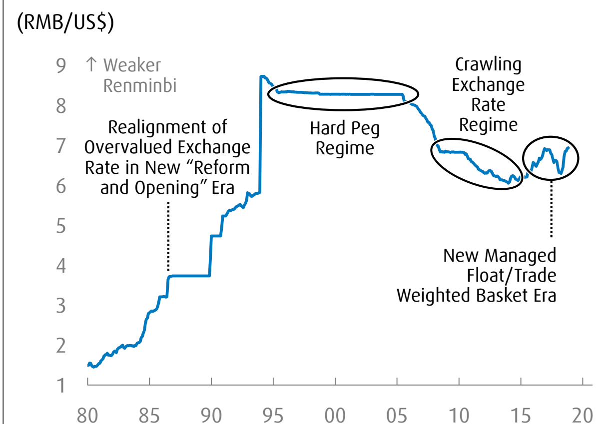
Drivers of Economic Growth Shifting



Sources: BMO Economics, Haver Analytics

Chart 3

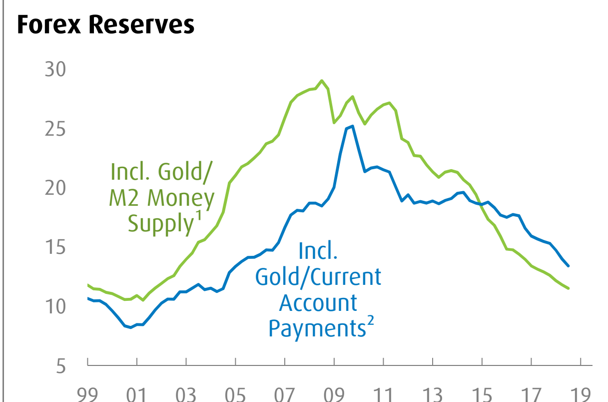
Recent Exchange Rate Regime Transitions



Sources: BMO Economics, Haver Analytics

Chart 4

Forex Reserve Coverage Ratios Declining

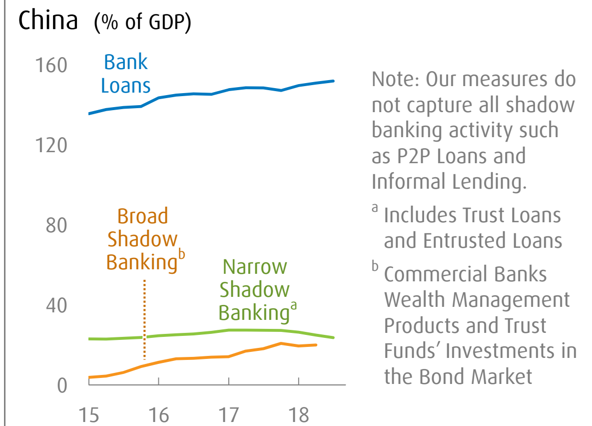


[1] (percent) [2] (months)

Sources: BMO Economics, Haver Analytics

...But the Medium-to-Longer-Term Outlook Could Become Cloudier

Chart 5
Shadow Banking Activity has been Curtailed



Sources: BMO Economics, Haver Analytics

If it becomes clear that the trade war will not be resolved over the next year, the risks to China's medium-to-long-term growth prospects would gradually increase. Beyond a potential loss of exports to the U.S., the bigger risk is that domestic investment in manufacturing facilities could be curtailed, which could reduce China's productive capacity and potential growth rate. This is magnified by the fact that the country's merchandise exports feed large globally-integrated supply/value chains, which are not effectively controlled by Mainland Chinese-owned corporations. Put another way, a foreign multinational that relies on Chinese-owned factories to produce/assemble products could begin to relocate production outside of China. Equally vital, a more fractured economic relationship with the U.S. and other countries/regions such as Europe could inhibit China's technological progress and productivity growth.

On the flipside, China is not likely to stand still if the trade war becomes protracted. We suspect that Beijing would likely increase its efforts to close the gap between the country's capabilities and that of the global technology frontier. Rather than dismantle its high-profile *Made in China 2025* plan—which is focused on developing new technologies in 10 strategic sectorsas Trump is reportedly demanding, Beijing may feel emboldened and allocate more (financial and non-financial) resources to ensure it achieves its objective. At the same time, this may prompt Beijing to accelerate some key structural reforms, namely improving the efficiency of the large number of state-owned enterprises (SOEs) or ending the preferential treatment they receive. The latter development would benefit the private sector, which has been largely responsible for leading China's recent innovation successes, despite ongoing difficulties in accessing bank credit due to the large share taken up by SOEs.

Key Takeaways

China's policymakers are unlikely to abandon their focus on stability and return to their prior 'growth at all costs' strategy. As a result, Beijing is likely to continue tweaking its fiscal and monetary policies to address the trade war's impact on the economy rather than introduce a massive fiscal stimulus program as it did in 2008[3] when the Great Recession erupted.

[3] The State Council introduced a fiscal stimulus program, largely focused on infrastructure (e.g., high speed railways, roads, airports, water) and housing, amounting to RMB4.0 trillion (12.5% of 2008 GDP) on November 9, 2008.

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