Theme and Variations of Chinese Economic Policy

Edward Ding, Chief Economist

Tel: (852) 3761 8901
Email: dinganhua@cmbi.com.hk

The report will mainly feature three macro debates. The first is about the conflict between China's structural reform and economic growth. We believe that overemphasis on GDP growth rate has many perils and hindering structural reforms is inevitably one of them. The second debate is about the middle income trap and we think what Latin America has suffered is not a result of some man-made income levels, but the failure of populist economic policies. Third, we analyze the profound changes of international merchandise trade and cross-border capital flows in the context of populism anti-globalization wave, and we believe China will still appeal to international investment.

- **The dual theme and variations: reform and growth.** With Chinese economic growth slowing down and multiple risks mounting, the balance between structural reform and economic growth-at-all-costs becomes necessary. Given the declining potential growth rate, pursuing higher growth speed may be difficult and futile. Even worse, overemphasizing the GDP growth rate will jeopardize China's economic structure. For example, it will force China to reply more on traditional sectors and state-owned enterprises, as well as raising macro leverage ratio.
- **Middle income trap: the fate of populist economic policy.** Latin American countries have long been stuck at the middle income levels and unable to enter the high income group. In my view, the root-cause of middle-income trap phenomenon in Latin America relates to the left-wing populist economic policies after WWII. Now, we are facing the situation where right-wing populism is on the stage for the first time in a century. It means that the whole set of political and economic theories after the Cold War have begun to lose their explanatory power. But history shows that populist leaders have no ways to realize their grand plans and always fail to keep promises they made to the people.
- **Profound changes of global merchandise trade and capital flows.** We expect that in the near future, China's export growth, especially exports to the US, will slow down further, hitting the production of China's export manufacturing industries, causing China's import demands to fall, and then affecting other countries' exports to China, and ultimately lowering global trade. About capital flows, negative interest rates have become the new normal for monetary policy operations in Germany, Japan etc., As one of the few countries with a normal monetary policy, China's assets, both bond and equity, have global appeal especially for long-term institutional investors. In the future, if China further opens up its financial markets and establishes a better institutional environment, I believe that China will still appeal to international capital, which will be the key investment theme that can last for several years to come.

The dual theme and variations: reform and growth

The report will mainly feature three macro debates. The first is about the conflict of Chinese economic policy between structural reform and economic growth.

Over the past 100 years of modern China's history, the May Fourth Movement of 1919 started a dual theme and variations of Enlightenment and National Salvation. The key incompatible part of these two themes reflects the fundamental contradiction between individual value and collective action. Enlightenment advocates individual value, liberation of individuality, science and rationality. Instead, the tide of salvation and revolution calls for national unity, collective action and strong passions to fight. Overall speaking, according to Mr. Li Zehou (李泽厚), a noted scholar and historian, national salvation and revolution overweighed enlightenment in China's modern history.

In Chinese economy of our time, we can still feel the similar contradiction. In the past 40 years, market-oriented reforms are undoubtedly been a profound enlightenment, while the role of the government has been similar to salvation by controlling and preserving the country's economy. Government's interventions have often hindered the market's role to allocate resources.

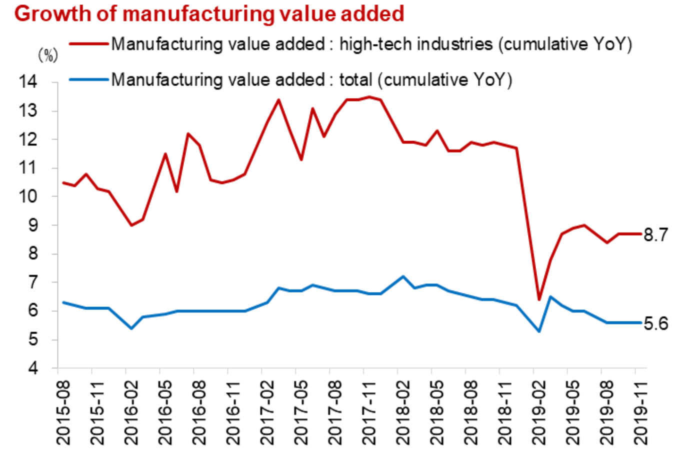
Today, I would like to discuss more about the dual theme and variations of China's structural reforms and high growth, in which structural reform is more like Enlightenment and promoting growth-at-all-costs is closer to National salvation. With Chinese economic growth slowing down and multiple risks mounting, the balance between these two themes becomes necessary.

On maintaining economic growth, it's a consensus that China's potential growth rate is on a downward track. The reasons include, on the one hand, the stagnation of growth in labor productivity and, on the other, the shrinking labor force. In the past 40 years, China's productivity has been greatly improved and the fundamental reason lies in the institutional reform and market opening. People have gained basic freedom of choice and unlocking productivity has promoted social mobility. Labor movement from sectors of low to high productivity has increased the overall level of productivity in the economy. Unfortunately, there is evidence that the improvement of China's labor productivity has faced a bottleneck in recent years. There are deeper reasons here that cannot be resolved through technological innovation. As for the shrinking labor force, it is an indisputable fact.

Given the declining potential growth rate, pursuing higher growth speed may be difficult and futile. Even worse, overemphasizing the GDP growth rate will jeopardize China's economic structure.

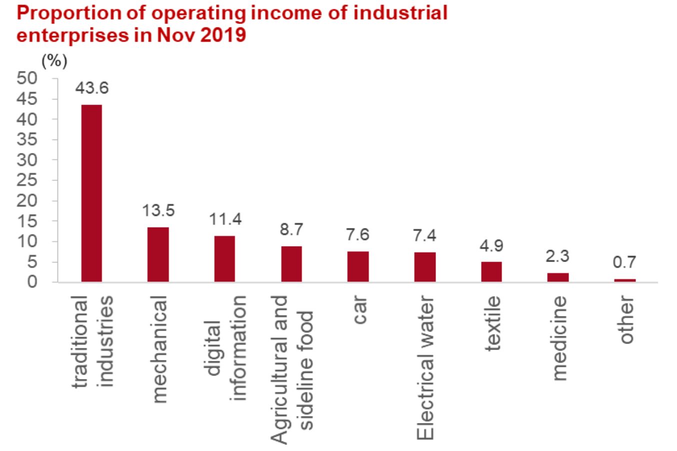
First, the pursuit of high GDP growth rate will force China to reply more on the traditional sectors. Despite the rapid growth, the new drivers of China economic growth are still small in terms of the shares in China's economy. Industrial data shows that about half of the nation's operating income is still generated from the traditional industries such as mining, metallurgy and petrochemicals. If the government is dedicated to pursue higher GDP growth, it has to invest more on the traditional sectors such as infrastructure and real estate as it did before, resulting in overcapacity and wiping out the results of supply-side reforms.

Figure 1: High-tech industry growth is higher than the industry as a whole



Source: Wind, CMB Research Institute, CMBIS

Figure 2: Traditional industries account for nearly 50% of total operating income



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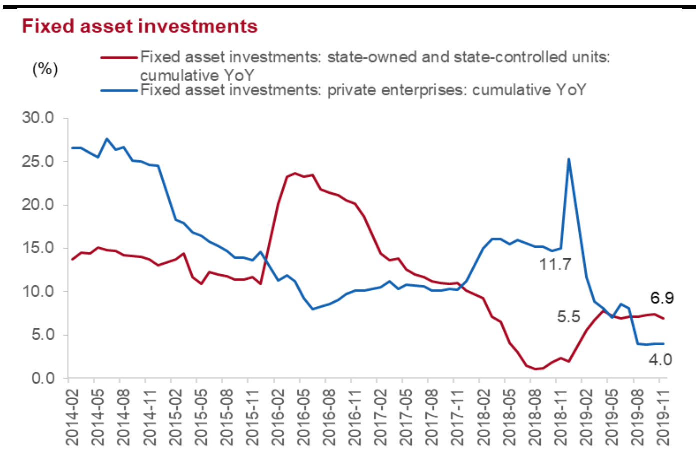
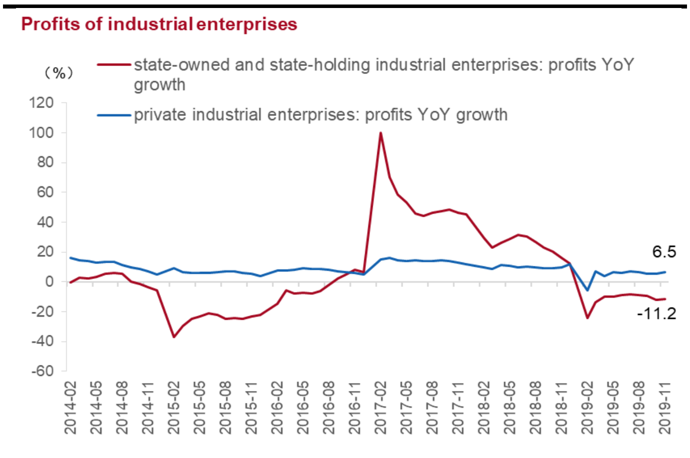
Second, excessive growth demands will hinder China's private economy. With the goal to pursue higher GDP growth in the short term, the government has no other choice but to exert pressure on state-owned enterprises, raising risks for state-owned enterprises and squeeze out private economies. Over the past year, the central government's attitude towards private enterprises has been positive, but the demand for credit by private enterprises is still shrinking. Overemphasizing on economic growth goals, state-owned enterprises must stand up and private enterprises will naturally retreat, making China's economic structure deteriorate.

Figure 3: Growth of fixed asset investment in private enterprises has fallen rapidly



Source: Wind, CMB Research Institute, CMBIS

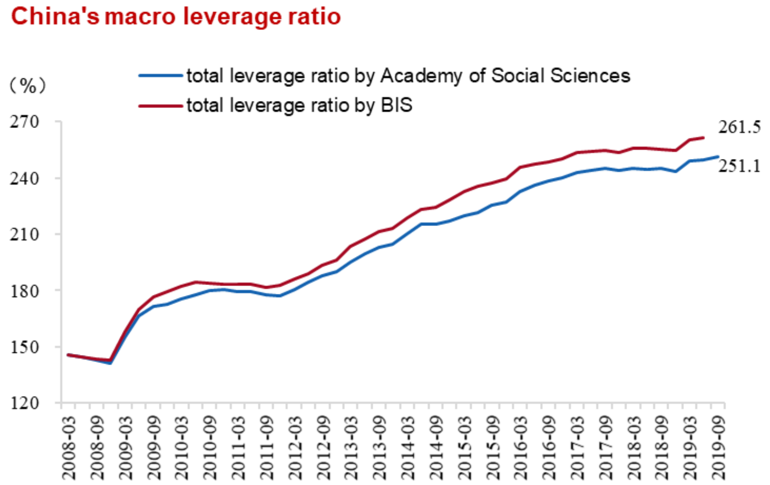
Figure 4: Private enterprises' profitability is significantly better than state-owned enterprises in 2019



Source: Wind, CMB Research Institute, CMBIS

Third, too much pursuit of growth may lead to deterioration in macro leverage. In 2019, under the demand of guaranteeing above-6% economic growth, proactive fiscal policy, especially large scale government bond issuance, quickly resulted in the rise of the macro leverage ratio that had stabilized for a considerable period.

Figure 5: China's macro leverage jumped 5.1ppt in 1Q19



Source: Wind, CMB Research Institute, CMBIS

The above mentioned aspects reflect an increasingly fierce contradiction between structural reform and promoting growth-at-all-costs. Overemphasis on GDP growth rate has many perils; hindering structural reforms is inevitably one of them.

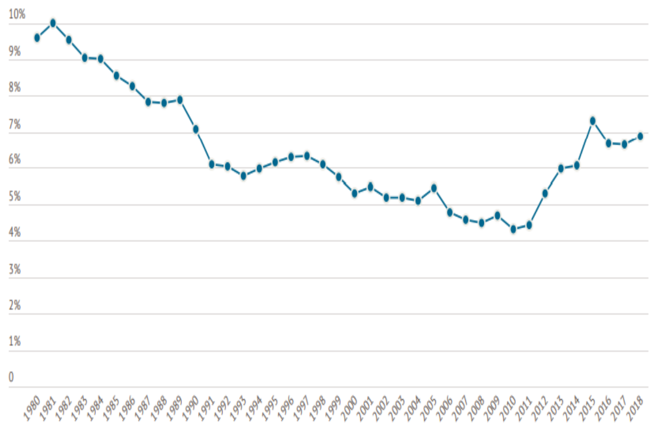
Middle income trap: the fate of populist economic policy

The second point I would like to talk is the so-called middle income trap, a vague, controversial and even misunderstood concept. World Bank's definition of high-income countries is about US$12,500 per capita. Latin American countries, especially Argentina, Brazil and Chile, have long been stuck at the middle income levels and unable to enter the high income group. How to explain this phenomenon? Some have proposed the middle income trap theory that there is an insurmountable threshold of income for these countries. In my view, the root-cause of middle-income trap phenomenon in Latin America relates to the left-wing populist economic policies after WWII. Perón of Argentina, Allende of Chile and Chavez of Venezuela are some famous left-wing populist leaders. What Latin America has suffered is not a result of some man-made income levels, but the failure of populist economic policies.

Right now, right-wing populism is surging, and Trump's rise to power and Brexit are two iconic events. One has every reason to concern because of the rise of the populism in the two oldest liberal countries, the United States and the United Kingdom. Many people will ask, what is populism? What is populist economic policy?

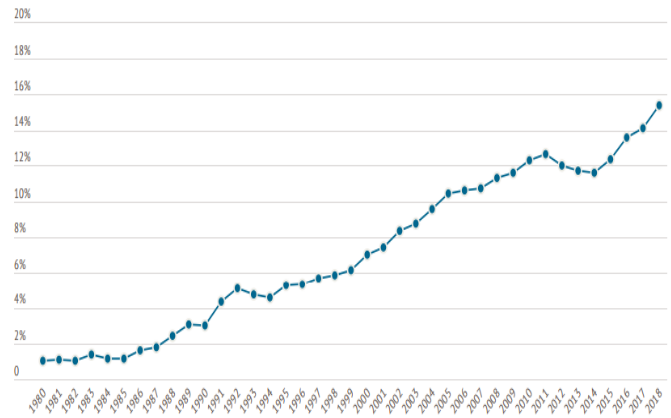
Populism is indeed difficult to precisely define because this concept is a widely used label for a diverse group of political parties, movements, ideologies, and opinions. At its core, populism advocates the "us-them" distinction by dividing a particular society into two mutually exclusive parts, namely, "the pure people" and the "corrupt elites". Populism proclaims the existence of a crisis caused by elites, seeking to challenge the dominant order and giving voice to the collective will. Populists promise to replace the existing corruption with a political order that puts the "people" back at its center and resonates with their longings and aspirations. The biggest difference between populism and democracy is populism is anti-pluralism while democracy emphasizes the balance between the interests of diverse groups and political power.

Figure 6: Radical left-wing populism rebounds in Europe



Source: Timbro, CMB Research Institute, CMBIS

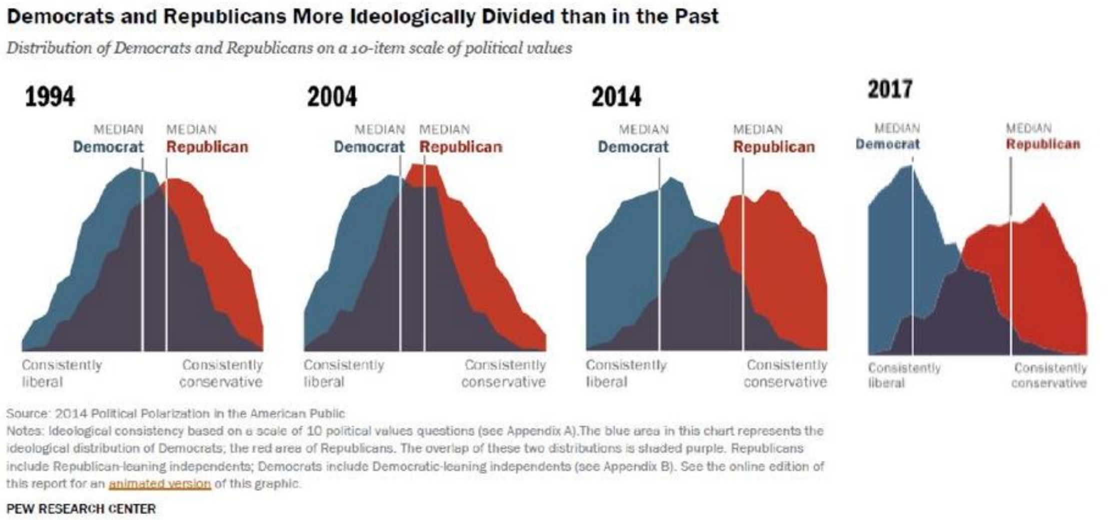
Figure 7: Average electoral support to right wing parties in Europe



Source: Timbro, CMB Research Institute, CMBIS

Traditionally, economic theories and economic policies have been conducted in a framework of right versus left, markets versus states, public versus private ownership, and individual rights versus collective responsibilities. Rising populism scrambles, breaks up and deconstructed these old dividing lines and debates. The opposite of populism is liberalism, which advocates pluralism, while populism advocates "us-them" distinction. In the past, liberalism has usually been aligned with right-wing economic theories, and populism has often been aligned with left-wing economic policies. But now, the alliance between populism and right-wing economics has occurred in the US and UK, the two countries that had been immune to populism for a long time. We are facing the situation where right-wing populism is on the stage for the first time in a century. It means that the whole set of political and economic theories after the Cold War have begun to lose their explanatory power.

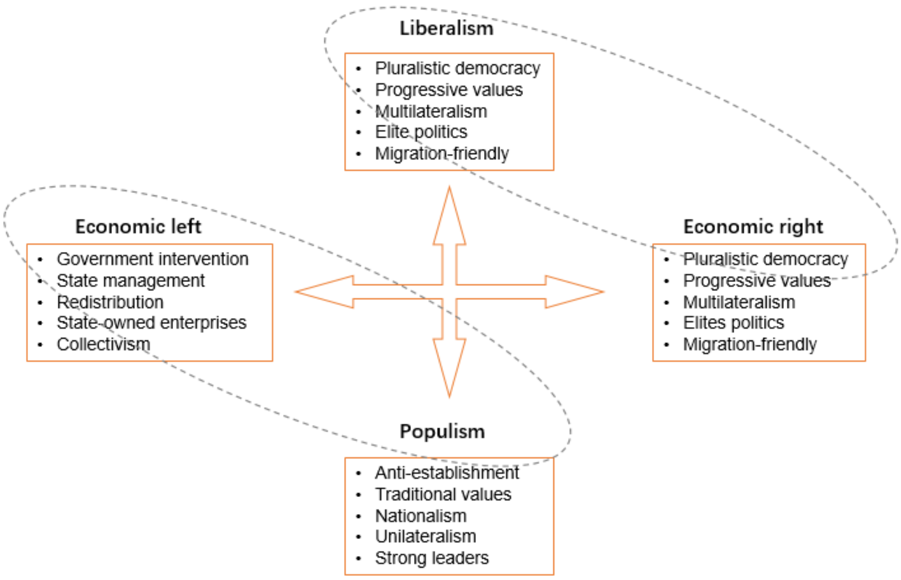
Figure 8: US politics are more divided than in the past



Source: Pew Research Center, CMB Research Institute, CMBIS

Given the importance of US and UK in world order and global governance, it is crucial to track the development of populism in these countries, which is reshaping the political, economic and trade landscape in the next five years and beyond. However, we need not be too pessimistic. Francis Fukuyama once said that far-right identity politics were pioneered by the left. Populists are mostly good at political mobilization, not economic policy. The lesson of Latin America is that populist leaders have no ways to realize their grand plans and always fail to keep promises they made to the people. As a result, no matter left or right, populism will be abandoned by their people. What we need for this is patience and time.

Figure 9: Analytical framework for populism economic policies



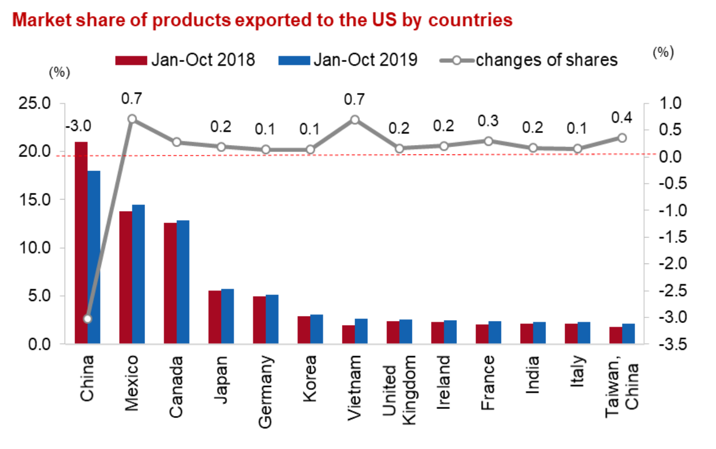
Source: CMB Research Institute, CMBIS

Profound changes of global merchandise trade and capital flows

Third, we analyze the significant changes of international merchandise trade and cross-border capital flows in the context of populism anti-globalization wave.

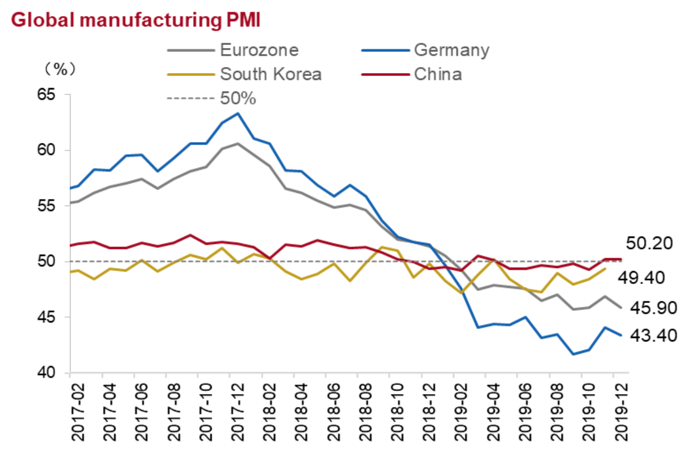
About merchandize trade, signs of changes have emerged. In 2019, the share of Chinese products in the US imports decreased by 3ppt, while Mexico, Vietnam, and Taiwan gaining more shares. It has not only dragged down the Capex investment and production of China's manufacturing sectors, but also hit the entire supply chains. The most likely scenario in the near further may be that, China's export growth, especially exports to the US, will slow down further, hitting the production of China's export manufacturing industries, causing China's import demands to fall, and then affecting other countries' exports to China, and ultimately lowering global trade. We noticed that China's major import source countries have suffered a lot. For example, in Germany, Japan, and South Korea, the manufacturing PMI dropped significantly in 2019. Global trade has become a drag of economy instead of the main driver. This trend is expected to continue for some time until another large-scale global supply chain emerges, which can replace the supply chains related to Chinese export. The prospects are still uncertain.

Figure 10: Chinese exports lose some US market share



Source: Wind, CMB Research Institute, CMBIS

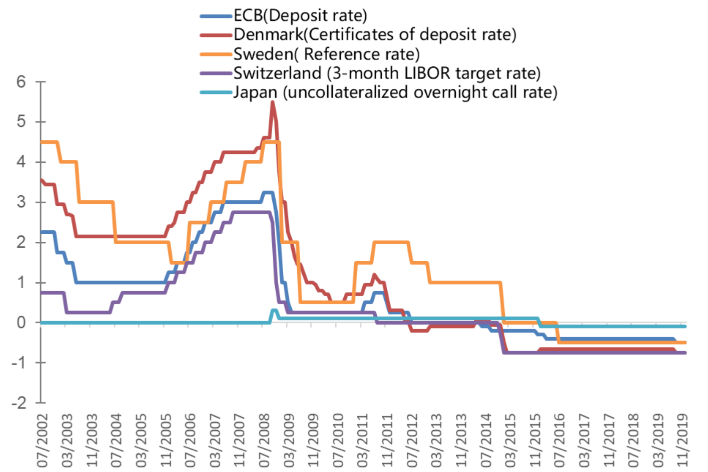
Figure 11: Chinese manufacturing downturn drags down global industry chain



Source: Wind, CMB Research Institute, CMBIS

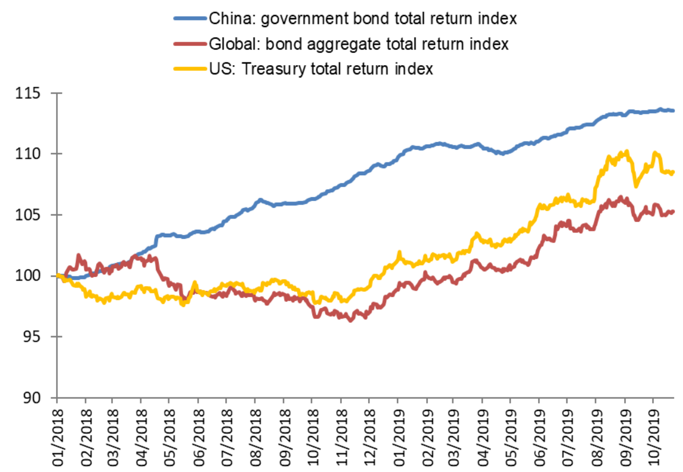
Another aspect is capital flows. We know that an important factor affecting the cross-border capital flows is interest rate spreads, because capital is destined to chase higher yields. In the context of the emergence of negative interest rates, how does capital allocation seek a way out? Today, negative interest rates have become the new normal for monetary policy operations in Germany, Japan, Switzerland, Sweden, etc., and they are spreading to other economies. However, major economies such as China, the United States, India, and Australia have not yet entered the negative interest rate range. Widening interest spreads between some countries will lead to profound changes in cross-border capital flows.

Figure 12: Five economies have adopted negative interest rate policies



Source: Bloomberg, CMB Research Institute, CMBIS

Figure 13: Return of Chinese bond investment attracts global investors



Source: Bloomberg, CMB Research Institute, CMBIS

As one of the few countries with a normal monetary policy, China's assets, both bond and equity, have global appeal especially for long-term institutional investors such as pensions, insurance companies, and sovereign wealth funds. It can also explain why more and more foreign capital flowed to China's bond market in the past few years in pursuit of higher yields, which is likely to be a long-term trend.

In the future, if China further opens up its financial markets and establish a better institutional environment, I believe that China will still appeal to international capital. From this perspective, the fundamental logic of investing in China is still valid, and this will be the key investment theme that can last for several years to come.

(The article is based on the speech given by Mr. Ding at the Xi’an New Fortune Annual Wealth Management Conference on 25 Dec 2019.)

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