Research @ Citi Podcast, Episode 1: Year of the Dragon—China's Place in the World

Host: Lucy Baldwin, Global Head of Citi Research

Guest: Johanna Chua, Head of Emerging Market Economics, Citi Research

Transcript:

Lucy Baldwin (00:00)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. I'm delighted today to be joined by Johanna, Head of Emerging Market Economics at Citi. Today, we're going to be talking about China and its future. There have been questions around the impacts of the current property crisis, demographics, and of course, rising geopolitical tensions—all of which have led to question marks about China, both as an economic power, but also as a military power, and therefore its overall place in the world.

And Jo, maybe you can start and kick us off by framing a question that we often get asked, which is: Have we reached peak China? And I ask that in the context of the geopolitical de-risking we're seeing, the real estate woes, and of course the increasing encroachment by the state in certain areas, which of course impacts confidence.

Johanna Chua (01:07)

Thank you so much, Lucy. I'm happy to be here. Clearly, over the last number of years, the rise of China's economy relative to the share of global GDP has stalled. Now, having said that, I still think there's still plenty of room to catch up in the future. But I think there are very fundamentally, valid questions about to what extent that pace of catch-up will be slowing down. We had a very sharp acceleration and catch-up, obviously, with a lot of the productivity boom that we saw after China entered into the global trading system, and there was so much reform and productivity improvements and technology transfers that happened to that.

But I think now there's a lot of questions as China's share of global manufacturing value added has gotten so large. It's like 31% of global manufacturing value added. And obviously, we're seeing a lot more tensions with other economies, particularly in the U.S., as China's rise becomes, poses a bit of a threat in terms of the strategic dominance of the U.S. in the global kind of order, in international order, and as well as some of the policy choices that China is also making, partly on the back of the national security geopolitical backdrop, but just its own domestic politicized choices about how it wants to pursue its development. And what we've seen in China over the last several years is we've seen a rising role of the state in a lot of, you know, the economic activity, in the economy, the role in the share of investment. And a lot of concerns that role of the state and kind of a bit of a reduction in kind of the importance of the market could have productivity consequences that could lower long-term growth.

And it just seems over the last number of years, you know, the consumer rebalancing seem to have taken a back seat because I think what's happened in China over the last seven years is there's been a lot more focus towards manufacturing and industrial policy, and we're seeing that now more recently. And I think part of that was really accelerated by the national security concerns. I mean, I certainly think that in 2019, when we had Huawei put into the entity list, I think that was like the Sputnik moment that drove an acceleration or a doubling down of China's drive towards technology self-reliance and using kind of state-level influence to drive that. And that, I think, has both political and economic consequences that we are still trying to grapple with.

Lucy Baldwin (03:23)

So, Jo, when you pull all of this together, you know, help us break it down into the short-term sort of cyclical challenges that China is seeing versus these longer-term, much more structural ones that really require a lot of reform and a lot of policy response here. I think there might be some people listening that think, well, do you know what? Some of the shorter-term data points that we've seen this year are, actually kind of look okay, and some of the markets are now bouncing off the bottom. Has the policy response perhaps already been enough to give confidence and provide some resilience to the economy?

Johanna Chua (03:56)

Yeah, absolutely, Lucy. I think the short-term cyclical data has improved. And I think a big importance to that is we've seen a little bit more proactive fiscal policy. I think the other thing that helped China activity a little bit more is, you know, that everyone was calling for a U.S. recession, and in the end, U.S. recession hasn't materialized and global goods manufacturing rebounded. And because China's policy has been so geared towards production, and some of that clearly also being exported, that alongside the fiscal policy, the global manufacturing rebound also provided a bit of lift on China. So I think in the short term, we're going to be okay to reach 5% growth target, and, you know, we upgraded our growth target back in late March.

I think the challenge is there's been very limited fiscal support to households. In fact, we really didn't get any fiscal transfers to households. Core inflation, you know, for the last two years have been kind of averaging like about 0.6, 0.7 percentage point, which means that there's really no urgency for people to buy things or invest. And then I think the other thing, obviously, is the real estate market. We still continue to see signs that real estate market down cycle is persisting, despite some effort to relax or ease some of the demand restrictions. So because two-thirds of household net worth is still tied to real estate, you know, with continuing drag of confidence from the real estate, with some of those cyclical kind of headwinds and lack of support on the consumption and services and ongoing uncertainty and insecurity about employment and job prospects, I think the consumption side still remains fairly more weak. So I think the growth is very unbalanced. It's very supply/production supportive, but not really very demand supportive.

And the challenges over the long term is, I think, I think with this real estate down cycle, usually will take a couple of years to pan out. We don't really see a lot of major driver to reflate or rebound that consumption support. And policy at this point, both monetary and fiscal, is still very, very restrained, and I think that is feeding into prolonged low, low, low inflation expectation. So I worry that we have these risks of “Japanification”, that we're still obviously dragging demand. And I think the other structural headwind we need to kind of struggle with is, I think there's still a question about productivity growth. To what extent overall productivity growth can be revived by China's push for a high tech and innovation.

Lucy Baldwin (06:19)

Jo, that's great. Let's dig into that in a little bit more detail because it is a question we get frequently, whether we're seeing Japan 2.0 here, given demographics, given debt overhang, given the deflating property bubble—many of which are factors that contributed to Japan's malaise just a few decades ago. Take us through your thoughts on that, how concerned you are that this is Japan all over again.

Johanna Chua (06:44)

So I think we have to understand what Japanification means. And Japanification doesn't mean it's exactly like Japan. So I don't think China's growth rate is going to be as low as Japan. Clearly, the potential growth in China is much higher because obviously, the level of developments, the returns, you can still generate a lot of low-hanging fruits to drive growth. There's still room for technology catch-up. But I certainly think there's a lot of similarities in Japanification, because it's not just the growth rate that we should look at, but it's looking at how growth is performing relative to potential, whether you're closing the output gap in terms of driving up inflation, inflation expectations to a more optimal level. I certainly think that this story is going to take a longer time. I think this is going to drag on for a lot longer.

My worry is there's a bit of self-reinforcing dynamic here. Because the economy obviously continues to have deficient demand and inflation is low, it further depresses people's expectations about inflation, and therefore they delay consumption, they delay investment. And as you know, we're trying to de-lever, to get off, to get over this kind of Japanification. You want to kind of, kind of get over the debt overhang. But the challenge is when you're looking at debt ratio and trying to think about de-leveraging, you also need to look at the denominator, not just the numerator—the denominator meaning that nominal growth matters in order to be able to grow out of your debt problem. Doing policies that are very conducive to production, which then could end up having a lot of chronic overcapacity, which is further amplifies or prolongs the deflationary pressure. I just worry that growing out of the debt problem becomes more challenging if nominal growth, including nominal growth driven by inflation, becomes quite depressed.

I think China's government have a strategy of trying to substitute away from real estate by driving new innovative sector, high-tech innovation, high-quality growth. Certainly, China is demonstrating a lot of excellence in certain leading-edge technology, for example, what we're seeing in their accomplishments in green goods. The problem in trying to drive your growth on policy that's driven by manufacturing, or high-end manufacturing, rather than demand is that China is already so large. It's like the second largest economy in the world. It's 31% of global manufacturing value added. If you're a small open economy, you could drive a lot of export-driven growth. But when you're a very large economy with such huge impact on global value chain, you have a lot of spillovers in the rest of the world that can be quite destabilizing and can create a lot of protectionist backlash.

But even now, as we've seen since last year, where we saw huge gains, you know, China's exports to EU has been so strong and is gaining a lot of market share, but you're starting to see also protectionist backlash from EU, which is China's largest trading market. So, you know, again, I think that frictions of tariff or non-tariff barriers that it could face and also the fact that the size is so large and also the fact that even though you have some success of some companies doing well, say auto BYD taking the lead, you know for every, you know, successful company, you also have a lot of companies even domestically in China that cannot compete. So it has a very uneven impact on the overall manufacturing space when you're allocating capital by industrial policy. So my worry is that, you know, I think there's a limit, and I think this growth drive driven by production is not enough to boost household consumption, because, you know, unless you really create enough dramatic enough jobs on that sectors, but a lot of these sectors are also using a lot of automation, advanced manufacturing. You're not creating enough employment and jobs, and you're not able to offset that with wealth creation for the broad base of households where households are still tied to real estate. I think it's going to create this imbalance for a lot longer period.

Lucy Baldwin (10:10)

So that's fascinating. This concept of rebalancing, resetting, reallocating resource. Let's talk through that in a little bit more detail. You know, in particular, we hear an awful lot about how the industrial policy is orientated to segments such as EVs, green tech, advanced manufacturing, semiconductors. All of this, as you say, to boost productivity and growth. But it's also very much in the national security interest and in this bid to become self-sufficient from a tech perspective. Talk us through in a bit more detail how successful you think this is going to be.

Johanna Chua (10:43)

Yes, so Lucy, I think precisely because some of the things that are driving China's policy is driven by national security and not so much just growth or economic growth objectives per se, I fear that they are willing to sacrifice, you know, profitability. Or, you know, productivity growth in lieu of strategic dominance and national security. I think we've seen it certainly, you know, as I mentioned to you earlier in 2019, with what happened with Huawei, and obviously what happened with export controls on semiconductor—or high-end semiconductor—we're in the world that geopolitical rivals can take advantage of any asymmetric leverage they have on trade to gain further leverage. And that is a security vulnerability this country faces.

So therefore, there's really a lot of gains to be made by making sure you're more self-reliant and you insulate yourself. And so for China, for example, because of the restrictions on semiconductor, and China is at the lagging position on technological and semiconductor, that's going to hurt China. They're going to have to spend more. They're going to have to deploy a lot more resources. There'll be a lot more less efficiency, and it's going to take longer for them to catch up, for example, in advanced manufacturing. And that will have a cost in terms of slowing down their innovation. China doubling down and say, Okay, I need to be ahead of the other technology, so they're willing to expend sources or run excess capacity for a little bit longer than, you know, a little bit more than what is efficient is a consequence they're willing to pay because they want to make sure that they remain strategically dominant.

Will they succeed or not? I mean, they can succeed, but the question is, at what cost? There's an opportunity cost by these policy decisions that the government is making, because as I said, I think their objective function is shifting. If they're not rebalancing their economy towards consumption and services that is more sustainable, I think China, you know, to maintain this national security, they are going to end up paying the price of, you know, lower long-term growth.

Lucy Baldwin (12:29)

That makes sense. And, Jo, I think there's a view that's forming that China is obviously seeking to make itself increasingly self-reliant that you're articulating here. And yet at the same time is continuing to hope that the rest of the world maintains its reliance on China for a variety of reasons. And obviously, that is a very complicated picture. Talk us through how you feel that is going to play out. And in particular, for example, you know, you've talked about the fact that China is this manufacturing powerhouse globally. Which are the countries—and I'm thinking of some of the obvious names like Germany here—that are going to be most impacted by all of these things we're talking about. And I guess a question to throw in alongside that is how fiscally constrained is China now to really push forward with that strategy around independence but also continued interdependence with the rest of the world?

Johanna Chua (13:26)

First of all, you're absolutely right. I think the geopolitics is obviously very important. One thing to note in China is that we all talk about de-risking from China, but because inflation has been so much lower in China than its trading partners, and China continues to expand and invest in its capacity, in a way, I think this China industrial policy and keeping things very cheap is making de-risking from China slower. China is trying to slow down this de-risking because they're making it more economically costly because China, it's just very hard to compete with China. So even though we talk about a lot of reshoring, friendshoring to Mexico or India, I think there's an argument to be made: the process would have been faster if not for the fact that China continues to double down. And that does slow down other incentives of other countries to further expand investment and why FDI hasn't picked up.

The main rival, obviously from a geopolitical standpoint, is U.S. So I see obviously there's a lot of risk. And if we have a Trump victory in the next election, they could further add further to the tariff risk and also kind of clamp down on the way Chinese supply chain is still accessing the U.S. market, via Mexico and Vietnam.

I think EU is the one that's very interesting because obviously, although U.S. has been de-risking from China in the last couple of years, EU has not really de-risked much from China. And so the question is, will there be more and more pressure for them to de-risk, meaning reducing their import reliance from China, which is difficult because of the fact that China is so competitive. So on the one hand, you know, there's obviously a lot of concerns that moves to the high-end industrial policy is creating a lot more competition for a lot of industries in higher-tech goods, even in Germany and a lot of industrial countries in Europe. That certainly is a challenge. That is maybe a motivation for some of these restrictions and tariff investigation or subsidy investigations, for example, on EVs or wind turbines. So we could see a lot of that more going forward. And I think the question is how far and how serious will be the push by EU because I think EU is very different from U.S. You know, you can't just impose random tariffs via executive order. You have to follow kind of EU rules, so there's a procedure to it. But certainly there is more pressure for more of that protectionism to pick up. And I think the consequence of that is, I think China in order to maintain market access to Europe—because Europe is so important—China will probably have to allow more of its private firms to establish production hubs in Europe to access the European market.

I think that China is banking on the global South. I think the global South is less inclined to put a lot of trade protectionism risk because China, a lot of the global South are commodity exporters like LatAm, Middle East, Africa. So obviously China is a very large trading partner, and ASEAN countries obviously also sell a lot to China. So the global South is probably going to have a very limited asymmetric ability to put trade protectionism against China. So they are a captive market for Chinese goods. But I think what China really needs EU in order to maintain growth rates that they want, and that's going to be an issue that we need to watch.

Look, I think the challenge with China is, I think they still have fiscal capacity, because notwithstanding debt having gone up, gross government debt having gone up a lot, certainly since COVID, if you look at what's happening in China, it's very similar to Japan. Because we have chronic deficiency of private sector aggregate demand, and therefore a relatively elevated level of precautionary savings, and a lot of returns to investment, people are seeing returns to investment in China declining because obviously growth is slowing, that you still have a lot of excess savings in China, relative to investment. And a lot of that is driving demand for safe assets. So if you look at government bond yields in China, they're still relatively low. So I think, borrowing costs still being relatively low, notwithstanding a high increase of government debt, there is more room to borrow.

The issue is, is the policy choices. What does government do with their fiscal capacity? That to me just doesn't seem to be the priority at the moment. The priority is: Let's make sure we still dominate global industries of the future. Let's make sure that we can defend ourselves from other countries trying to weaponize technology against us. And so if this policy is going to continue, even at the cost of lower growth, that seems to be the policy choice that they're making. So I really don't think at the moment that it's a fiscal capacity, to spend to rebalance the economy. I think it's a willingness issue at the moment.

Lucy Baldwin (17:29)

That's very clear. And as I hear you say this, Jo, you know, it's fascinating that there is a huge opportunity, clearly, for China to dominate trade, perhaps in the global South going forward. You've got Europe somewhere in the middle with its rules-based order, where it's around negotiation, bargaining, particularly around areas such as green-tech goods and that ability to maybe facilitate some production relocation. And of course, the U.S., as you say, very clearly, is really where it's at in terms of this potential new Cold War and the escalation of tariff risk as we head into the eve of the U.S. election. So just to wrap up this session, Jo, where do you see the risk, obviously, with Trump potentially talking about a 60% tariff being introduced? Is that a complete game changer for this topic?

Johanna Chua (18:21)

First of all, I'm not sure whether 60% will really happen, because it's one thing if you're talking about tariffs back in 2018–19, when inflation was very low. I think you start imposing those type of tariffs in an environment where China is such a still strategic provider of goods, I mean, there's a lot of inflationary consequence on that. So again, we don't know if that's really just a bargaining kind of opening salvo in what is going to be a bargaining strategy going forward to China. But certainly, I definitely think there is a risk that we could end up having maybe a lower tariff than what that is. But certainly, certainly a tariff risk is quite high. And therefore, that could knock off GDP growth in China. I think some of our estimates were saying if we have a tariff of say, 15 to 20%, that could knock off GDP growth by another half a percentage point, for example, in China.

I think the other thing to watch out for is, you know, China is trying to access U.S. markets certainly by investing a lot in a global South like Mexico or Vietnam, and there's been a lot of noise out of Trump talking about Chinese companies investing in Mexico to access tariff-free access to U.S. And so maybe there could be tighter scrutiny of supply chains going through Mexico impacting the U.S. market by enforcing more tightly regional content rules and maybe trying to pressure Mexico to impose stricter investment screening rules on Chinese investment. So those are the things that we could see happening.

Beyond that, there's other things that are happening under Trump that could be more destabilizing, not just for China, but everyone else. I mean, obviously, if we have tariff risk, if we have more pro-cyclical fiscal policy, and if we have tighter immigration rules, all three are inflationary. And in an environment where the world is funding itself on the U.S., that has a huge impact for capital flows. Certainly, because, you know, in China's perspective, the asymmetric direction of interest rate is to go down. And if U.S. ends up being higher for longer, that again, is going to be a challenge for China.

Lucy Baldwin (20:06)

Jo, thank you. Very clear that China is indeed looking to create this new or alternative world order, and the West, of course, looking to respond to that—to decouple, to de-risk in certain areas and certain sectors. And very clear from what you're saying that there is an opportunity here, for particular areas such as the global South to really reorientate themselves in a much more meaningful way towards China and all the ramifications and impacts that those things are going to have. So thank you, Jo, for taking us through such an important topic today and look forward to speaking to you again.

Johanna Chua (20:37)

Thank you very much, Lucy.

Lucy Baldwin (20:41)

Thanks for joining today's episode of Research @ Citi. We at Citi Research provide the highest-quality products, services and content covering all major asset classes and economies around the world. If you enjoyed this podcast, you can follow us for regular episodes. And feel free to share, like, leave a comment, and subscribe. See you next time.

[Disclaimer] (21:08)