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China 2022: Competing Weather Patterns

In this issue of Sinology, Andy Rothman explains why China's 2022 investment environment will be defined by two competing weather patterns.

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China's 2022 investment environment will be defined by two competing weather patterns. The first is a clear easing cycle that is already developing in Beijing, which should result in stronger economic performance and improved sentiment among Chinese investors, who drive their domestic exchanges. The second weather system is an Arctic air mass which is rising from Washington, as the Biden administration appears intent on containing China with cold-war rhetoric and sanctions. Because China's economy is driven primarily by domestic demand, that cold front is unlikely to disrupt the easing of monetary, fiscal and regulatory policies, but it will further depress American investor sentiment towards China, leading some in the U.S. to focus more on the A-share market.

Chinese policymakers signal macro easing

Through words and actions, China's leaders have in recent weeks signaled a change of direction for the government's economic policy, towards one more supportive of growth, in contrast to 2021's focus on de-risking and tighter regulation. This will be a modest, gradual stimulus, but it should be big enough to reverse the macro slowdown that resulted from last year's overly tight policies.

The rhetorical signals have been clear. The official readout from an early December meeting of the Politburo, comprised of the 25 most senior members of the Communist Party, did not mention regulation, anti-trust or "disorderly expansion of capital"—topics that were all discussed a year ago. Instead, the Politburo meeting summary focused on supporting growth.

That was followed by the annual meeting of senior economic officials, who called for making China's economic pie larger, as part of promoting "common prosperity." While the 2020 Central Economic Work Committee meeting touted policies to reduce risks and enhance regulatory oversight, last month's meeting cited "economic development as the central task." The language and tone of the Work Committee's report suggests that while last year's regulatory changes will continue to be implemented, there will not be a new regulatory crackdown in 2022, and the regulatory environment should be more predictable.

The central bank governor said he would promote a modest expansion of credit growth, and other officials said they would make it easier for existing homeowners to qualify for mortgages to trade up to a better quality primary residence. The Ministry of Finance said China will implement a "proactive fiscal policy" and tax cuts, as well as increase transfer payments from the central government to local governments. The economic planning agency said it will "frontload infrastructure investment" this year.

Initial concrete easing steps

Official talk has been accompanied by some initial, concrete easing steps.

The central bank made modest cuts to bank required reserve ratios, and then reduced the one-year loan prime rate for the first time in 20 months.

Mortgage lending, which had been severely constrained by central bank window guidance since May, rebounded in October and November. As a result, there was a modest improvement in new home sales.

Total credit growth, which includes both bank loans and bond issuance, accelerated slightly in November, ending eight months of deceleration.

The finance ministry also provided local governments with early access to the 2022 quota for special-purpose bonds, signaling renewed support for state-directed public infrastructure construction.

Patience

It is easy to push back against the easing narrative I've outlined. Talk is cheap. And the concrete steps have been small. But, this weather pattern is just starting to develop.

This is not the dramatic stimulus Beijing deployed in response to the global financial crisis. This is more modest easing, which will be rolled out gradually, so the clear macro impact is not likely to be apparent until the second quarter of 2022.

We know enough, however, to be confident of the easing forecast.

Forecast from Washington: Cold rain and snow

Out over the Pacific, the clear easing system coming from Beijing will run into an Arctic air mass which is blowing from Washington, as the Biden administration appears intent on containing China with cold-war rhetoric and sanctions designed to weaken its globally competitive companies.

In office for almost one year, the Biden administration has yet to clearly articulate a vision for how relations between the world's two most important nations might evolve in a constructive way. Instead, the president's focus is on "stiff competition."

Speaking to Communist Party chief Xi Jinping in November, Biden noted that "how our bilateral relationship evolves, seems to me, will have a profound impact not only on our countries but, quite frankly, the rest of the world." But, Biden said their "responsibility as leaders" was simply "to ensure that the competition between our two countries does not veer into conflict, whether intended or unintended. Just simple, straightforward competition."

Jake Sullivan, the president's National Security Advisor, said he recognizes "that China is going to be a factor in the international system for the foreseeable future," so the administration's "vision" for dealing with that reality, "boiled down to a few words, is a free and open Indo-Pacific."

Secretary of State Tony Blinken tried to explain what that awkward-sounding objective really means: "When we say that we want a free and open Indo-Pacific, we mean that on an individual level, that people will be free in their daily lives and live in open societies."

Commerce Secretary Gina Raimondo, in an interview with CNBC, suggested that the administration's competition strategy includes efforts to hobble China's globally competitive companies. "If we really want to slow down China's rate of innovation, we need to work with Europe. . . We have to work with our European allies to deny China the most advanced technology so that they can't catch up in critical areas like semiconductors."

At the Pentagon, a view that Xi has an "aim of displacing America from its global leadership role" led Secretary of Defense Lloyd Austin to make the Defense Department's "largest-ever budget request for research, development, testing and evaluation."

While the Biden administration appears focused on containing China, they have not explained how efforts to weaken the world's second largest economy will benefit American families, or how this might be accomplished without also harming the U.S. economy. Or how this will help Chinese families "be free in their daily lives."

In the 10 years through 2019, China, on average, accounted for about one-third of global economic growth, larger than the *combined* share of global growth from the U.S., Europe and Japan. During the COVID era, that share of global growth has been, temporarily, even higher. China is home to about 18% of the world's GDP and population. The American economy is highly integrated with China's economy. This is nothing like the cold-war relationship with the former Soviet Union. There is, however, no sign that the Biden administration believes it is worth trying to put the bilateral political relationship back on a more collaborative, constructive path.

Of course, Xi also has a responsibility to put the relationship on a better path, and his administration's actions have contributed significantly to the political tensions. During their November video call, Xi suggested that he is open to changing course, telling Biden, "I stand ready to work with you, Mr. President, to build consensus, take active steps, and move China-U.S. relations forward in a positive direction." Biden should respond with serious attempts to determine if Xi's offer is genuine.

The Biden administration has also yet to offer a concrete plan for reasserting American economic leadership in Asia, and apparently has no intention of joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), a free-trade agreement among 11 countries, including Australia, Canada, Japan, Mexico, Singapore and Vietnam, that was established in 2018. That agreement is based on the Trans Pacific Partnership (TPP), which the Obama administration called the "cornerstone" of its economic policy in the region, but later administrations declined to join the group.

The Biden administration has also shown no interest in joining the Regional Comprehensive Economic Partnership (RCEP), whose 15-member countries account for about 30% of the world's population and GDP, making it bigger than NAFTA and the European Customs Union. Australia, China, Indonesia, Japan, South Korea, Singapore, Thailand and Vietnam are among the members of this free trade agreement, which took effect on January 1, 2022, and which is intended to eventually eliminate 90% of tariffs on trade among those nations.

"This will be a grouping of countries that will work together and try to develop new rules and new standards," Wendy Cutler, vice president of the Asia Society Policy Institute and a former senior U.S. trade official told the Wall Street Journal. "[The U.S. is] moving in the other direction."

The impact of Biden's approach

Washington's cold-war style approach to China will play out in several ways that are important to investors.

First, the impact on China's domestic demand-driven economy will be very modest. Last year was the 10th consecutive year in which the services and consumption (tertiary) part of China's GDP was larger than the manufacturing and construction (secondary) part, as rebalancing continued despite the pandemic. Exports have been unusually strong recently, but will gradually return to their pre-COVID levels, when net exports contributed little to China's GDP growth.

Second, the U.S. approach will not disrupt Beijing's easing of monetary, fiscal and regulatory policies, which should lead to stronger macro performance in China in 2022.

Third, the U.S. approach is likely to further depress American investor sentiment towards China, but will not dampen enthusiasm by Chinese investors in their domestic exchanges, leading some Americans to focus more on the A-share market.

Fourth, I worry about the longer-term impact on how Chinese citizens think about the U.S. Over the course of living in China for more than 20 years, my experience was that most people there, including most Communist Party and government officials I engaged with, had a relatively positive view of America. I'm concerned that if those people believe that U.S. policy is designed to stop their country from getting richer and stronger, the damage to the bilateral relationship will be severe, and difficult to reverse.

Fifth, there are no signs that Biden or Xi are taking concrete steps to improve the political relationship. In this environment, there are significant risks that the two sides stumble into a crisis that neither desires.

Forecasting risks

I am confident that the easing cycle underway in China will result in stronger economic performance and improved sentiment among Chinese investors, who drive their domestic exchanges. I am also confident that this will not be disrupted by the cold winds blowing from Washington. But, all forecasts come with risks. These are the three I will be watching closely.

The top risk is that the Chinese government's easing program starts out too cautiously and does not ramp up adequately until after the National People's Congress session in March. That would delay the macro recovery until the second half of 2022.

The second, lower-probability risk is a resurgence of COVID-19 in China. The number of cases, hospitalizations and deaths has remained exceptionally low, after the initial mishandling of the outbreak in Wuhan, but other nations have stumbled after appearing to have the disease under control. A dramatic rise in cases would delay a recovery in spending on consumption and services, and could overwhelm China's health care system.

The risk that worries me the most is that an accident involving Chinese and American military ships or aircraft spirals out of control, sparking a crisis that neither side desires. Some readers may recall that in April 2001, a U.S. Navy EP-3 signals intelligence aircraft collided with a Chinese Navy fighter jet over the South China Sea. The collision resulted in the death of the Chinese pilot, and seriously damaged the EP-3, which made an emergency landing at a Chinese military airfield. The 24 American crewmembers were detained, then released after more than a week of negotiations that involved then President George W. Bush and Chinese leader Jiang Zemin. Given the tense state of bilateral relations today, and the absence of dialogue and trust between the two governments and militaries, could a similar accident be handled smoothly in 2022? This is one of the reasons why I have been advocating increased engagement and dialogue between the two countries.

Engagement and values

In March 2021, I wrote an open letter to President Biden, pointing out that "getting your China policy right is important for building back our economy."

I explained that, "China drives global economic growth, so a sound bilateral relationship is important to American consumers and workers, as well as to families who are counting on stock market returns to pay for their retirement."

Here, I'd like to share the last section of that letter to the president, which explains why engagement is the best way to promote our values in China:

> "Our continued economic engagement with China, including bringing them into the WTO, has facilitated dramatic structural changes which have benefited the average Chinese citizen.
>
> China has become entrepreneurial. When I first worked in China during the early 1980s, as a very junior American diplomat, there were no private companies. But small, entrepreneurial private firms now account for almost 90% of urban employment and all net new job creation.

The extent of private ownership in China may surprise many Americans. A recent study published by the National Bureau of Economic Research found that in 2019, individuals owned 69% of registered capital of all Chinese companies, up from a 52% share in 2000.

Since China joined the WTO in 2001, per capita household income rose by 403% in real (inflation-adjusted) terms. As a result, spending by Chinese consumers—which was equal to only 15% of U.S. retail sales in 2001—is now equal to 88% of American consumer spending. China is the world's best consumer story, and many American products are thriving there. Last year, our exports to China of livestock and meat rose 61% YoY by value, making it our second-largest market, and those shipments are up 556% compared to 2001.

Most Chinese lead a healthier life, and their children have far better access to education. In addition to a better standard of living, most Chinese citizens also enjoy far greater personal (although not yet political) freedom. The absence of political rights and the rule of law in China are serious long-term problems, but its citizens have the freedom to run their own lives to a degree that was unimaginable just 25 years ago.

Of course, not all Chinese have been permitted to enjoy these new freedoms. Mr. President, I share your frustration over the limitations of engagement in achieving our objectives with the Chinese government. But we need to be clear about what has been accomplished, and realistic about whether alternative policies will achieve more, or less.

Mr. President, you recently said that our foreign policy must be conducted "with American working families in mind." I think that continued economic engagement with China, based on a level playing field for our companies, supports your objective of our domestic economic renewal.

You also said that "when we invest in economic development of countries, we create new markets for our products and reduce the likelihood of instability." Working with our allies and partners to update the global trade and financial architecture we designed decades ago, and continuing to incentivize the Chinese government to abide by these rules, is the best way to earn back our leadership position and reduce the risk of conflict between the world's two largest economies."

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