Is China Ready For A Trade Shock From Trump?

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China reported an acceleration in its economic growth on Friday, just hours before Donald Trump was sworn in as US president. The Chinese economy now looks to have decent momentum going into 2017, after the major monetary stimulus in the first half of 2016. But while China's leaders have gone to great lengths to engineer a stable domestic situation, they face a lot of external uncertainty. Growth could certainly take a hit if the US under Trump makes radical changes to tax and trade policy. And while China has plenty of weapons to fight a trade war, those measures are unlikely to completely offset a sudden shock to its exports.

The pickup in China's real GDP growth in Q4, to 6.8% YoY from 6.7%, and the even more marked acceleration in nominal GDP growth, to 9.9% from 7.8%, seem to indicate a recovery that is gaining strength. The underlying business cycle though peaked in Q2 and has been decelerating very gradually since then as authorities refrain from additional stimulus. The cooling is most visible in property sales, which slowed to 12% growth in December, from 34% in September and 44% in April.

China's big stimulus of 2016 has created economic momentum for 2017

Those figures will inevitably look worse in early 2017, if only in comparison to the huge boom in early 2016. But construction is holding up well, thanks to low inventories, and the industrial sector is still enjoying the commodity reflation unleashed by the housing boom. Credit remains loose, and with the government focused on ensuring stability ahead of the Communist Party Congress in the fall, it is not going to tighten enough to kill growth.

Exports are also starting to contribute more as well—despite reported gains of only 0.6% in December. Headline export numbers have become increasingly volatile since 2012, thanks to the increase in mis-invoicing of exports to circumvent capital controls. Other indicators may now give a better signal: the imports from China reported by major trading partners

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
German PPI rose 1.0% YoY in Dec, from 0.1% in Nov	As expected; highest positive PPI growth since Jan 2013; excl. energy PPI rose 1.2% YoY	Rising German prices with loose ECB policy means fiscal policy to remain tight
UK retail sales fell -1.9% MoM in Dec, from -0.1% in Nov	Worse than -0.1% exp; YoY, sales rose 4.3%, from 5.7%	Rising inflation will increasingly squeeze HH budgets and slow UK growth
China's new born baby population was 18.5mn in 2016, highest since 2000	N/A; 45% second or non-first child, above 30% in 2013 when one-child policy first loosened	Govt estimates new born baby population in 17-20mn range by 2020, after policy easing in 2016
Taiwan export orders rose 6.3% YoY in Dec, slightly lower than 7% in Nov	Below 9% expected; Korea first 20 days exports rose 25% YoY in Jan	Taking together, Asian exports growth will be decent and positive for corporate earnings

have picked up in recent months, as have survey-based indicators of export orders. While China's exports may not be booming, I think they are definitely rising—as should be expected after a currency depreciation.

China is in a decent cyclical position, but it is not immune to trade disruptions

In short, China's economy is in a decent cyclical position: the inevitable property slowdown looks like it will be moderate, but exports are improving, as is consumer spending. Yet growth is not so strong that it would be immune to any disruption of trade.

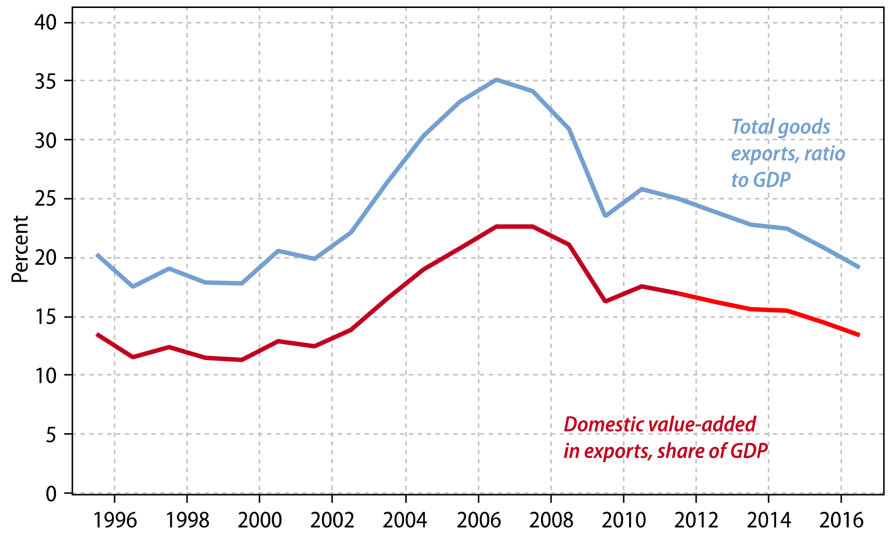
A simple calculation shows that a shock to trade with the US would have a substantial impact. The value-added generated by exports has accounted for about 15% of China's GDP in recent years (for details of this estimate see **How Much Does China Need Exports?**). Since the US accounts for about 20% of exports, that makes exports to the US roughly 3% of China's GDP. A 10% decline in exports to the US would thus knock 0.3pp off nominal GDP growth assuming no other changes.

A trade war with the US will have broader knock-on effects

But other things will change: workers will lose their jobs, firms will reduce their investment. So the total impact from that 10% drop would probably be around half a percentage point of GDP growth; for a 20% drop, a full point—enough to put the government's growth target in real jeopardy.

Exports are of declining but still large importance to China

Ratio to GDP; OECD estimates for value added up to 2011



Gavekal Data/Macrobond

What has changed for China since 2008 is its increased reliance on domestic investment

The hit to China's growth from a trade shock in 2017 would still be much smaller than in 2008. Repeated rounds of stimulus since the global financial crisis, which have focused on housing and infrastructure, have made China less dependent on external demand by increasing its reliance on domestic investment. By comparison, the share of value-added generated by exports was about 23% of GDP in 2007, before the crisis hit. Yet the export sector is still very large—it is a bigger employer than construction or the commodity sectors—and is crucial to the fortunes of China's most prosperous provinces. China's shift toward a domestically-driven economy has not advanced so far that it can just ignore the impact of a major trade shock.

Broad-based tax or tariff changes would be required to generate a major trade shock

Conventional trade disputes between China and the US would almost certainly not produce that kind of shock. The regular flow of antidumping cases and WTO lawsuits between the two countries normally leaves broad trade flows undisturbed, since they focus on specific products. A major shock to exports would require the kind of across-the-board tariffs that Trump threatened during his campaign (and which a US president does in fact have the power to impose).

Chinese exports could also take a sizable hit under tax changes proposed by Republicans in Congress: a "border adjustment" to the corporate tax rate would effectively impose a 20% tariff on all imports. The real question is whether the administration is bent on taking substantive trade actions (not just symbolic ones, like designating China a currency manipulator) in order to placate its base, or whether its talk of tariffs is a tactic aimed at extracting concessions from China.

What options would China have if tariffs or tax changes pushed up the cost of its exports to the US? A straightforward response would be to depreciate its currency by enough to offset the increased cost (indeed, economic theory holds that all countries would do this in the event of a "border adjustment"; see **Tax Reform And The Dollar**). Yet a depreciation of its managed currency is more likely to be China's last resort than its first.

Having just achieved currency stability, China will not be in a hurry to abandon it

Over the past year or so, China has yielded to market pressure to let the renminbi fall against a rising dollar—but it has also intervened to limit the decline so that the renminbi stays broadly stable against a broader range of currencies (see **The RMB: Steady As She Goes**). The central bank has spent a great deal of time, effort and foreign reserves to establish this strategy as a credible one in the market, and it would be very costly to abandon. Uncontrolled depreciation of the renminbi would risk creating uncontrolled capital outflows, which in turn would endanger the economic and financial stability the government has worked so hard to ensure.

Export subsidies are one option to ease the pain

China's interventionist government has many ways to help exporters and retaliate against the US

As China has many ways to subsidize domestic firms and few compunctions about using them, a less destabilizing response would be to simply ramp up state aid to exporters. But fiscal subsidies would inevitably be slower to arrive and more narrowly based than the benefit from a cheaper currency, so they would be unlikely to fully offset the hit to exports.

Doubling down, yet again, on housing and infrastructure stimulus would thus probably be necessary, though infrastructure spending in particular is experiencing diminishing returns. It might be easier for China's government to inflict pain on the US in return: it could tell local firms to cut imports from the US, or use administrative and legal methods to put pressure on the Chinese operations of US firms. China does not want to fight a trade war in 2017, which it would much prefer to be an uneventful year, but it has no shortage of weapons to use.