

# The Economics of China

## Future Challenges - Part 2



Fall 2020

# The sky is not falling!<sup>1</sup> or is it?!

- In "Future Challenges - Part 1", we talked about the environmental challenge and its impact on the welfare of the Chinese population and the sustainability of economic growth.
- In this set of slides, we will talk about how global political economy challenges can affect China's future economic growth and development.
- In particular, we will talk about:
  - The recent US-China "trade war".
  - The competition for economic and technological dominance.
  - The rise of populism, isolationism, nationalism and protectionism.

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<sup>1</sup>Lau, L. J. (2019). The sky is not falling!. *Economic and Political Studies*, 7(2), 122-147.

# The sky is not falling! or is it?!

- US-China "trade war".
  - "As of October 2018, almost half of US imports of goods from China are subject to new US tariffs at various rates, mostly at 10%".
  - This rate was raised to 25% in May 2019, with a threat to impose it on almost all Chinese products imported by the US.
  - By September 2019, the threat was partially implemented, with more Chinese products imported by the US facing increased tariffs.
  - Of course, China meanwhile retaliated by imposing/increasing tariffs of some US products imported by China, and filing complaints to the WTO.
  - In January 2020, the US and China signed a 'phase one' trade deal which is supposed to roll back some of the tariffs but keep some.
  - The tennis match is still in progress...

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- The direct impact of a "trade war".
  - In principle, increased levels of trade between two countries "raises the aggregate welfare in both countries".
  - Hence, a "trade war" which leads to "an involuntary decrease in the trade between them lowers the aggregate welfare in both countries".
  - "It will be lose-lose for both countries".
  - But by how much?
  - Lau (2019) estimates that **the direct impact will be "relatively small and manageable"**.
  - From that perspective, the "sky is not falling!"

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- "The immediate impacts" of the US-China "trade war".
  - "The immediate impact of the current trade war was **psychological** and fell mostly on the Chinese financial markets".
  - "The Shenzhen Stock Exchange has seen its average stock price decline by almost 25%" in 2018.
  - "Similarly, the average price level of the Shanghai Stock Exchange has declined by 15%", and "Hong Kong Stock Exchange overall has declined almost 10%".
  - In addition, "the Renminbi exchange rate has also been negatively affected" falling by approximately 9% between Jan and Dec 2018.
  - "However, not all of the declines in the Chinese stock markets can or should be attributed to the trade war".
  - "The actual and expected increases in the rate of interest in the US by the US Federal Reserve Board also had a role in the falling prices of assets and exchange rates vis-a-vis the US dollar in emerging markets".

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- "The real impacts" on China's exports and GDP.
  - "Assuming that half of all Chinese exports of goods to the US will be halted because of the prohibitive new tariffs, total Chinese exports of goods to the world...will fall by 9.9%".
  - "As a comparison, in the aftermath of the collapse of Lehman Brothers in the US in 2008, total Chinese exports of goods declined by 16% in 2009, and the Chinese economy still managed to grow 8.7% in real terms that year".
  - "the maximum **loss** in Chinese GDP in the **first instance**, assuming that half of the exports to the US is completely halted, may be estimated at **0.43%**".
  - However, in the next period(s) there will be "reductions in the intermediate input demands of the Chinese economy caused by the reduction of exports".
  - "This implies **ultimately a total loss in Chinese GDP of 1.12%**".

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- So will the sky fall?
  - "A reduction of 1.12% from an expected annual growth rate of 6.5% leaves 5.38%".
  - "There is a **possibility that the scope of the US tariffs may be expanded to cover all US imports from China**".
  - As a result, "the full negative economic impact will be doubled to **2.24% of Chinese GDP**, but still leaving the Chinese economy an expected rate of growth in excess of 4%".
  - Moreover, "the trade war itself may also do damage to the longer-term economic relations between the two countries".
  - "For example, it may affect the future rate of growth of the trade in services between the two countries, in which the US has a persistent, large and growing surplus", especially in education and tourism.

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- Now "even though the real impacts on the Chinese economy in the aggregate are relatively small, they can be more significant for specific individual municipalities, provinces and regions, especially those oriented towards exports" like Guangdong for example.
- "In order to mitigate the negative economic impacts of the trade war, the **Chinese Government can try to increase aggregate demand**" by for example "increasing its investments" in:
  - "basic infrastructure and R&D",
  - "environmental preservation",
  - "education",
  - "health care", and "elderly care".
- "With all **the existing excess production capacities in China, supply is not a constraint**—as long as there is demand, there will be supply".



# The sky is not falling! or is it?!

- So the sky is not falling after all.
- But, wait a minute, is the "trade war" only about trade?
- "It is important to realise that there are two significant long-term developments simultaneously in play in China–US relations".
  - "The first has to do with the competition between major world powers for **economic and technological dominance**".
  - "the second has to do with the **rise of populist, isolationist, nationalists and protectionist sentiments** in the world".
- Note that this "did not begin with President Donald Trump and is not going away even after President Trump leaves office".

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- Competition for economic and technological dominance.
  - "Trade in high-technology products and in technology itself, including cross-border investment in high-technology firms, will probably remain problematic as long as there are considerations of both technological competition and national security".
  - "The US Government has long restricted the exports of high-technology products to China".
  - "It has also discouraged the use of Huawei servers and cell phones in the US", and semiconductor producers from supplying Huawei.
  - While this **could potentially slowdown technological progress in China, it could also "encourage and incentivise indigenous technological development in China"**.

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- Competition for economic and technological dominance.
  - "such competition **can potentially lead to constructive and positive as well as destructive and negative outcomes**".
  - "For example, the competition on building the fastest super-computer in the world has already resulted in both countries producing better and faster super-computers".
  - However, "the current U.S.-China conflict a particularly dangerous one, because it's possible that technologies like artificial intelligence lend themselves to zero-sum thinking and winner-take-all outcomes", warns Former U.S. Secretary of State Henry Kissinger.<sup>2</sup>

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<sup>2</sup>Quote from <https://www.marketwatch.com/story/kissinger-says-us-china-must-cease-escalating-threats-or-we-will-slide-into-a-situation-similar-to-world-war-i-2020-10-07>.

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- The rise of populism, isolationism, nationalism and protectionism.
  - "the rise of populist, isolationist and protectionist sentiments in the US and elsewhere in the world will also have significant impacts on international trade and investment (and migration too)".
  - "The root cause is that while economic **globalisation (and innovation)** have benefitted all countries in the world...**economic benefits have not been widely shared within each country, resulting in the emergence of losers**".
  - "Thus, there are people who have been left behind and whose well-being has not improved for the past two, three or even four decades".
  - "The losers believe that the government and the elite establishment have failed them and are eager to try something else".
  - In addition, "It is easy to lay the blame on globalisation, in other words, on the foreigners, and become an isolationist and a protectionist".
  - And some politicians (and thinkers?) are lovin' it!

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- So are trade wars, populist-nationalism, and isolationism the right answers to globalization challenges?
  - We said that a **trade war is "a lose-lose proposition"**.
  - The rise of populist-nationalism sentiments can take (is taking) the world into risky places.
  - How about "promotion of greater mutual economic interdependence"?
  - For example, there are "potential opportunities for China and the US to cooperate on initiatives of global interest, such as the prevention of climate change".
  - "The successful conclusion of the Paris Agreement in 2015 is an excellent example of what China and the US can accomplish if they cooperate and work together".
  - In addition, China recently signed the Regional Comprehensive Economic Partnership (RCEP) with 14 countries in the Asia-Pacific region (including countries like Japan, S.Korea, Indonesia, Australia), making it the world's "largest trade pact".

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- Zero-Sum or Win-Win?
  - **Cooperation means that countries can maintain "win-win" relationships** and "reduce the probability of an armed conflict".
  - This way China can focus on its transition from the miracle growth phase to a sustainable moderate growth phase, and the rest of the world (including the US) can benefit from China's continued growth.
  - However, for this to work, it is important that within each country: **"Everyone should be able to share in the gains** from economic globalisation and innovation".
  - "The eventual solution has to be some form of **redistribution within each country**—taxing the winners to compensate the losers so that everyone wins".