Year of the Rooster: What to expect from China's economy in 2017 and the Potential Impact of Trump's Trade Policy

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March 31, 2017

According to the Chinese Zodiac, 2017 is the year of the Rooster, an astrological sign associated with optimism, confidence, energy, and productivity.

The extent to which these qualities will be reflected in the performance of the Chinese economy this year will depend on whether or not the global recovery can improve China's exports. Propitiously, China's economy entered 2017 on firm footing. The country reported a relatively strong fourth quarter of economic growth in 2016, registering 6.8% on-year, which beat expectations of 6.7% as consumer spending in China increased. Domestic consumption in China accounted for 64.6% of total growth, and the property market rebounded. However, other indicators, such as days-of-receivables (a measure of the average number of days a company takes to collect payments on goods sold), as well as inventory levels have both increased, suggesting that China's economic health is less than robust.

Roosters can also be associated with drama. Indeed, on the first working day of the Chinese New Year, China's central bank surprised financial markets by raising lending rates to banks by 10 basis points. This rate increase could be viewed as a shift by China towards a neutral monetary policy as economic fundamentals seemed to be steady. The increase was to guard against financial risks and curb asset bubbles as the economy stabilizes in an uncertain environment. However, recent statements by the Chinese government suggest that its economy remained sluggish and that there were few options left to stimulate economic vitality. China's recent announcements about strengthening its pillars of economic development and growth, including continuing economic reforms, bolstering the manufacturing sector, stabilizing the housing market, and accelerating urbanization simply represented a continuation of strategies that were initiated last year.

Despite a strong fourth quarter, we believe that China's economy will grow at a slower pace than in the recent past. This slower growth is fundamental in nature. Although China's economic growth is starting to stabilize amid the country's transition toward greater domestic consumption and away from manufacturing and investment-led growth, China continues to suffer from overcapacity and speculation in real estate and a lack of investment in improving productivity, quality, and innovation. There has been too much reliance on directive from the government and uncontrolled overinvestment in basic manufacturing. The situation is further complicated by flights of financial and human capital.

Part of the difficulty of this ongoing transition has been inadvertently created by China's 'Going-Out' strategy to encourage Chinese to expand abroad. Realizing the perils of excess capacity and a poor understanding of market forces and the dynamics of innovation, the Chinese government embarked on the so-called 'Going-Out' strategy back in the early 2000s to encourage companies to bring home the knowledge of open-market dynamics, modern management practices, new technology, and innovation. Unfortunately, most Chinese companies have done poorly in managing their acquisitions abroad, and many have ended up investing in the real estate and hospitality industries which they largely entrust to third parties, thereby learning little that can help them to improve their competitiveness.

Until domestic consumption in China reaches Western levels, China will have to find a way to deal with overcapacity in its manufacturing sector. In order to deleverage excess capacity, China has already started to focus on trade with newly emerging countries, in particular, with neighbors such as Vietnam, Laos, Cambodia, Bangladesh, etc. These countries believe in trade and have strong appetites for Chinese-made commodity-type products such as home appliances, clothing, and accessories. This means that China will have to pursue a two-pronged approach: on the one hand, export manufacturing to those countries while, just as with U.S. consumers before the housing bubble, help them build up their economies so that they can afford to buy Chinese goods.

China's "New Silk Road," among other international cooperative projects should help. Although not a trade agreement *per se*, China's "One Belt, One Road" initiative does intend to integrate countries around China to form the largest free-trade zone in the world, covering 12 countries and about 40% of global GDP. Former U.S. President Barack Obama proposed the "Trans-Pacific Partnership" (TPP) to offset China's growing domination of international trade. President Trump's withdrawal from the TPP will likely create an economic vacuum for China to fill. Although many trade agreements exist in the world today, the most significant ones have to include either China or the United States. Unlike the United States, many other advanced economies, such as Japan, Germany, South Korea, Taiwan and others, rely on trade to survive, as they do not possess all the resources they need to be self-sufficient. It is natural, therefore, that they pursue a different path than that of the United States. Now, with an uncertain future for U.S. trade, most Asian countries will have no choice but to jump onboard China's "One Belt, One Road" initiative.

China's trade with the United States amounts to about US$600 billion a year, but China also records about US$350 billion in trade with ASEAN countries. With a potential tax penalty on imports into the U.S., many countries need to come up with an alternative plan. ASEAN countries are among the fastest growing economies, their consumers have strong appetites for Chinese-made products, and their industries need entry- to mid-level machine tools. At the same time, these countries need Foreign Direct Investment (FDI), which is largely driven by exports.

In summary, the uncertainty created by the Trump administration is forcing many countries to diversify away from their reliance on trade with the United States. China will continue to face many difficult challenges in 2017, including the continued obsolescence

of its core manufactured goods, rapid technological change, the advent of ever more sophisticated manufacturing technology, and the continued flight of financial and human capital from the country. Another alarming issue is that China's outbound investments are mostly long-term real estate speculations that are financed largely by short-term debt instruments. The resulting mismatch of asset/liability durations, together with a poor understanding of underlying asset valuations and an obsession with 'trophy' properties and a 'must-win' attitude, combine to create a potential time bomb, which could eventually destroy China's financial health. The most likely way for China to overcome this challenge will be for it to redirect its resources to build stronger relationships with neighboring countries. In the end, China will likely take a friendlier approach to manage its neighbors and court them to foster stronger trade partnerships. As China's president Xi Jinping remarked at the recent World Economic Forum in Davos, "China's economy has entered what we call a new normal, in which major changes are taking place in terms of growth rate, development model, economic structure and drivers of growth. But the economic fundamentals sustaining sound development remain unchanged." U.S. companies will need to develop new strategies in order to maintain competitiveness and develop opportunities in China's changing economy and to successfully handle any changes or disruptions in U.S. trade policy.

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