



China Watch

# PREPARING FOR TRADE WAR ESCALATION

China Team

## Politics

- The trade war is Xi's biggest test as leader
- The trade fight challenges the system
- Beijing appeals to nationalism as it prepares for trade war escalation

## Economics

- Economy stabilising despite seasonal noise and trade uncertainty
- Beijing can and will maintain growth through the trade war
- Consumption is a risk to growth, but support is imminent

## Markets

- Swine fever and bumper harvests will weigh on soybean prices
- US farmers risk a permanent loss in China soybean market share
- 2017 could mark peak US soybean exports to China

## Politics: China's red lines

- **The trade war is Xi's biggest test as leader**
- **The trade fight challenges the system**
- **Beijing appeals to nationalism as it prepares for trade war escalation**

**The trade war with the US leaves Xi Jinping facing his biggest challenge** since he took over the leadership of China in 2012-13. Although he has left the negotiating to his lieutenant, Liu He, the way in which Xi has personalized the power structure and centralized it on himself during the past seven years means that the outcome of the confrontation with the Trump administration will have a major – perhaps decisive – effect on his authority. And this is bolstering the Chinese resolve to limit any trade deal to liberalizing changes that it sees as being in its interests while strictly curbing more far-reaching concessions that could have systemic impact, hamper its technological modernization and, not least, play badly with public opinion.

**As a result, China views the confrontation through a political lens** and as a fight against foreign interference in its economic model. The connection with the domestic system means the conflict will impact on the prospects for domestic reform as well as on China's global relationships and its desire to lessen its dependence on economic ties across the Pacific. The bigger the political price China feels it is being asked to pay, the more elusive and more limited its concessions for an agreement will be.

While Beijing would welcome a resolution of the trade dispute, Xi has to be careful about what concessions he authorizes. He holds power precisely because of the way in which he has built up the Communist Party machine he heads, marginalizing the government and putting the political movement at the centre of decision-making. This process, which he launched after becoming General Secretary of the Party, would be severely weakened if he allowed a resolution of the trade dispute to chip away at the Chinese economic model fostered by the Communist Party. But the model, underpinned by its political links, is at the core of the unfair competition denounced by the US as the latter identifies the People's Republic as a strategic rival.

**Although Donald Trump remains fixated on the deficit and "big, beautiful tariffs"**, the breakdown in the latest negotiations points to the more fundamental issues identified by American negotiators. It also highlights the lack of trust on either side that has steadily built up with China's failure to live up to many of the commitments undertaken when it joined the WTO in 2001.

In the latest stand-off, the US wanted China to write changes such as limits of state subsidies into its national laws. China regarded that as an unacceptable interference in its domestic affairs. Instead, the most it was ready to offer was to monitor and implement the changes through state regulatory bodies. But the US saw that as a potentially fatal weakening of the oversight mechanism it seeks and insisted China was reneging on undertakings reached in the previous round of talks. To which the Chinese responded that this was all part of the negotiating process, saying that the talks had been conducted in English and that it was later that they had obtained Chinese-language version of the English text, which did not accord with their understanding of what they had agreed and which was accordingly revised when shown to Xi Jinping. Then they joined in the tit-for-tat accusations by charging the Americans with having suddenly changed the terms of agreement reached at the end of last year to increase the volume of Chinese exports.

The US desire for China to reorganize its economy in order to cut away at state involvement, subsidies and the dominance of the Communist Party State is anathema for Xi and the leadership around him. Quite apart from raising the spectre of a repetition of pre-Communist “national humiliation” at the hand of foreigners, such a systemic shift would undermine the basis on which the Party exercises its monopoly political power.

**The remorseless promotion of the cult of Xi as the Party chief** leading China leaves him little room to manoeuvre towards what might be interpreted as a set-back at Trump’s hands. He has shown himself an adept political tactician in outmanoeuvring domestic rivals and consolidating his own power. But now he faces major challenges even without the trade war – notably in steering economic stabilization and modernization at a time of slowing growth while dealing with major demographic and ecological challenges as well as seeking to reduce wealth inequalities. Above all, he needs to deliver on the promise that he and the Party had set the country on an unstoppable path of national strengthening and rejuvenation.

Although Xi appears to firmly control the centre of political power and has put a number of trusted subordinates in provincial posts, Chinese hawks have flapped their wings in calling for a tougher line towards the US. Meanwhile, anecdotal evidence suggests that a combination of factors – such as rising living costs, restrictions on private companies, the tightening of censorship and capital account controls – have dented the leadership’s popularity among the urban middle classes. But support appears to remain strong among less well-off city dwellers and rural residents because of spending on healthcare and pensions, an anti-poverty campaign, the anti-corruption drive and a crackdown on village mafias as well as continuous propaganda campaigns.

After biding their silence on the trade war for months, official media wheeled into action this week with a strong nationalist message. A state television video called the trade war “an important unifying juncture in China’s development” through which the country must “stand firm, be confident and rise through hardships”. The outspoken tabloid *Global Times* wrote of a “people’s war” and a posting by the *People’s Daily*, the main Party newspaper, declared “Talk – fine! Fight – we’ll be there! Bully us – wishful thinking!”

That narrative is likely to become more common as the leadership seeks means of rallying popular support amid decelerating growth. But Xi’s greater concern must be about his power base within the Communist Party. He can accept economic reforms – as long as they are contained and controlled within the Party State ring. But having spent the last seven years consolidating Party power and promoting the equation “Communist Party = China = Xi”, he would risk seriously destabilizing his authority if he were seen to be switching course to buy off Trump.

## Economics: L shaped recovery

- Economy stabilising despite seasonal noise and trade uncertainty
- Beijing can and will maintain growth through the trade war
- Consumption is a risk to growth, but support is imminent

Seasonality is driving the narrative around China's economy in 2019. An unusually prolonged China New Year shutdown in February boosted March data and kicked off the "green shoots" rhetoric. April numbers, which declined relative to March, quickly shifted the headlines to "losing steam". Looking through the seasonality, [we see](#) the economy stabilising. Fiscal frontloading is supporting an L shaped recovery led by infrastructure investment.

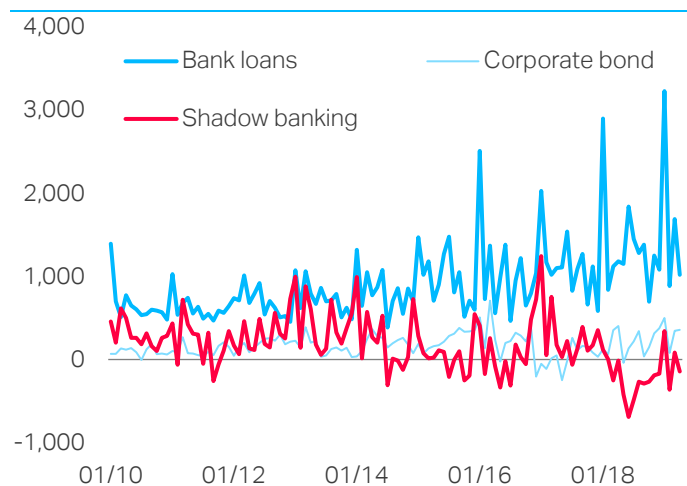
**The L-shaped trajectory remains on track, despite the trade war.** Even under a no deal scenario, Beijing has the wherewithal to stabilize growth. [We expect](#) China to tailor stimulus measures to the magnitude of trade friction. The risk is an additional ballooning of debt weighing on longer-term sustainability, rather than a substantial lowering of the 2019 growth outlook.

**The Q1/19 Politburo meeting dampened the markets' expectation of a credit blow-out.**

The statement issued after the April session reintroduced the term "structural deleveraging", which brings the political rhetoric into line with our [forecast](#) of measured credit easing for 2019. Beijing is allowing on-balance sheet lending to increase (banks and bonds), while cracking down on shadow banking (see the left-hand-side chart below). Calibrated monetary expansion in Q1/19 leaves room for credit growth to ramp up in response to the trade war. The authorities will need to reverse the change in rhetoric and increase credit growth if US-China relations deteriorate further.

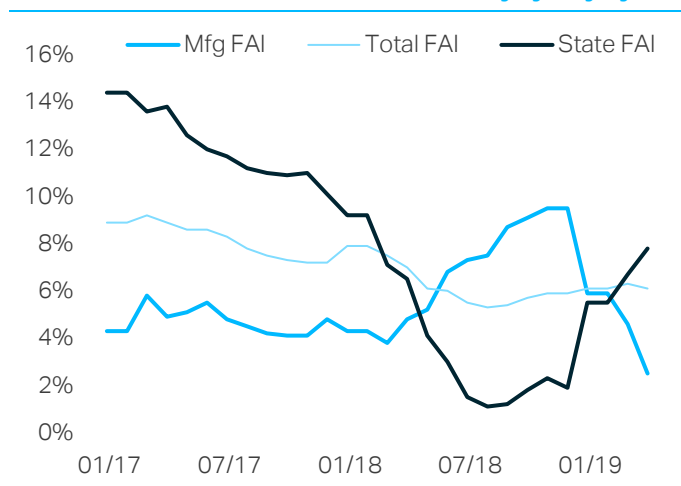
**Fiscal frontloading puts a floor on growth.** [The massive Q1/19 deficit](#) expansion stabilized business and consumer sentiment and is now tracking through to a modest improvement in activity. Record local government bond issuance led a sharp rebound in state investment, and a pick-up in infrastructure linked industrial production and commodity imports. Government investment was the key growth driver for headline FAI growth, state investment grew at 7.8% yoy in April vs 5% yoy for private and 6.1% for total FAI.

Incremental TSF (RMB bn)



Sources: CEIC, TS Lombard.

State investment leads the recovery (ytd yoy %)



Source: CEIC.

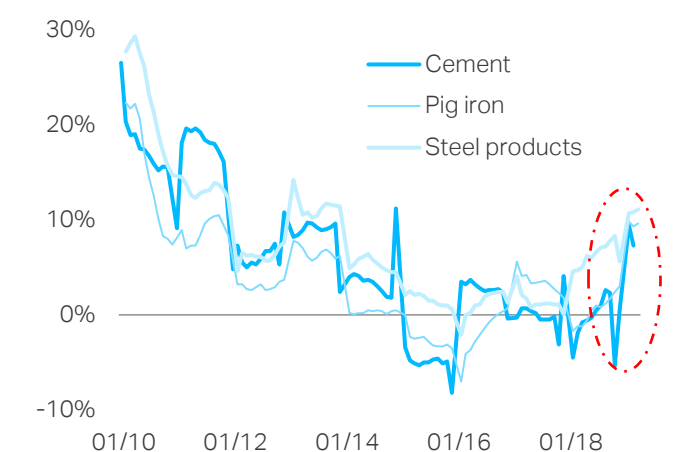
**Industrial commodity output rebounds.** Production of the big three infrastructure inputs – steel, iron and cement – maintained strong growth in April, indicating that underlying infrastructure activity continues to pick-up. Output of cement declined on a monthly basis owing to the exceptionally high level of production in March. However, cement production ytd grew at a four-year high. Because the material is difficult to store, sustained increases in production are a reliable indicator of strong construction activity. Our measure of imports of commodities and industrial supplies has turned positive after recording in March the first negative growth since 2016. We expect fiscal front-loading and window guidance to boost infrastructure investment to 8% yoy over the next six months.

**The private sector struggles.** As forecast, falling PPI and industrial profits are weighing on manufacturing investment, which recorded its lowest ever ytd yoy growth number. Manufacturing investment will remain weak in 2019 as PPI struggles to inflate and trade friction hits business confidence. In terms of manufacturing output, the picture is mixed. Auto production collapsed, down 16% yoy. However, mobile phone and related intermediate product output recovered in a sign that the semiconductor cycle is beginning to bottom out.

**Autos continue to weigh on consumption.** Retail sales recorded their lowest-ever growth in both real and nominal terms last month (see the right-hand-side chart below). Declining vehicle purchases, which account for 28% of total retail sales, were responsible for almost the entire slowdown. All major consumption categories, except autos, registered positive growth. As we noted last year, vehicle sales continue to suffer from the successive tax cuts that brought forward auto demand. The broad uptick in retail sales (absent autos) is testament to improvements in the core consumption drivers – consumer sentiment, disposable income, and access to credit. We expect the latter two to remain positive through 2019, while consumer sentiment is largely contingent on the trade war.

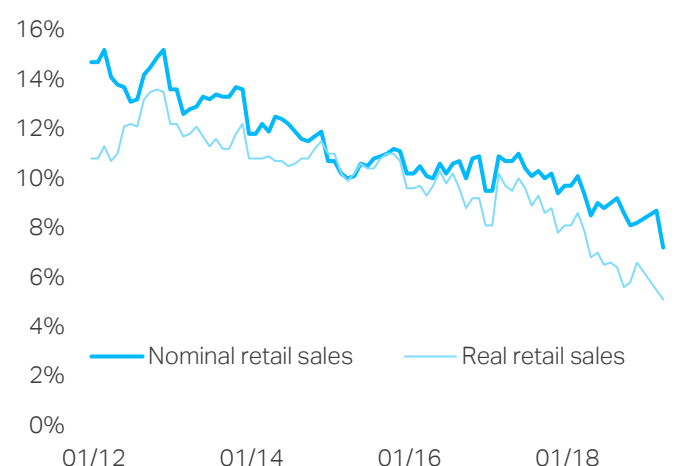
**Consumption contributed 76% of GDP growth in 2018.** The authorities are acutely aware of the importance of consumption to economic activity and the risk that falling sentiment poses to retail sales. Our recent conversations in Beijing have confirmed the central government's strong intention to support consumption growth. A leaked copy of an internal policy draft from the NDRC contained guidance on promoting consumption upgrades of autos, home appliances and consumer electronics in 2019-20. The combined weight of the three product categories in the retail sales index is 38%; thus, the likely pick-up in auto and appliance sales in H2/19 will boost overall retail sales and support GDP growth.

### Industrial output recovers (ytd yoy %)



Source: CEIC.

### Consumption support required (yoy %)



Source: CEIC.

## Markets: Winning the ag trade war

- **Swine fever and bumper harvests will weigh on soybean prices**
- **US farmers risk a permanent loss in China soybean market share**
- **2017 could mark peak US soybean exports to China**

Soybeans – the poster boy product of the trade war – will not stage a price recovery in 2019. African swine fever (ASF) and large crops in China, South America and US will weigh on soybean prices through 2019 and into 2020-21.

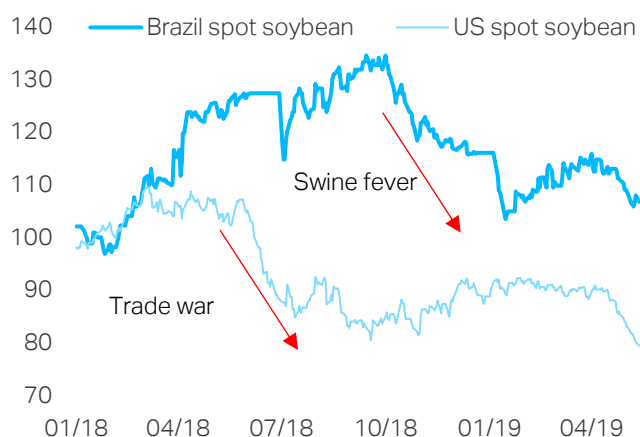
**ASF will depress soybean demand.** ASF first broke out in northern China in August 2018 and has now spread to all provinces. There is no cure for the disease and the size, concentration and interconnectedness of the Chinese market all make containment difficult. Estimates of the extent of ASF spread and the number of pigs killed vary dramatically: 100 million pigs killed (23% of the total herd) is the upper bound mentioned by various Chinese and foreign commentators, while the USDA estimates a 13% decline in the swine herd in 2019. We believe that the USDA estimate is overly conservative and we forecast that pork production could drop by 30%, with a concomitant decline in soybean demand. USDA put the global soybean trade loss due to ASF at 19 mmt in 2018/19, equivalent to 40% of projected US soybean exports.

Markets are already reflecting a substantial reduction in purchases. Even the prices of South American beans, which had traded at a distinct trade war premium, have fallen as the disease has spread. The Brazil premium over US beans reached a high of 274 US cents/bushel in October 2018, it is now at 85 cents, up from a one year low of 23 cents in March, as Chinese orders for late 2019 boost South American prices.

**The supply side is weighing on prices, too.** The Ministry of Agriculture reports Chinese production of soybeans will increase by 5% in 2019. The rise in production comes after the MoA launched an aggressive subsidy programme to induce farmers to plant soybeans during the trade war. The South American harvest, currently under way, is on track to register another strong crop. In the US, the impact of flooding has done little to dent the soybean surplus: stocks are at record high and analysts are forecasting another 900 mn plus bushel carryout in 2019-20.

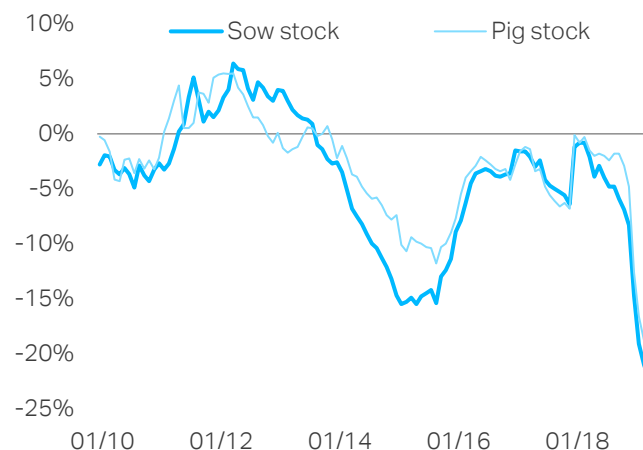
**The prolonged decline in the Chinese swineherd is a headwind for 2020 bean prices.** As noted above, ASF is incredibly difficult to contain or eradicate – Russia has been battling ASF for

### ASF and trade war drive soybean prices (index)



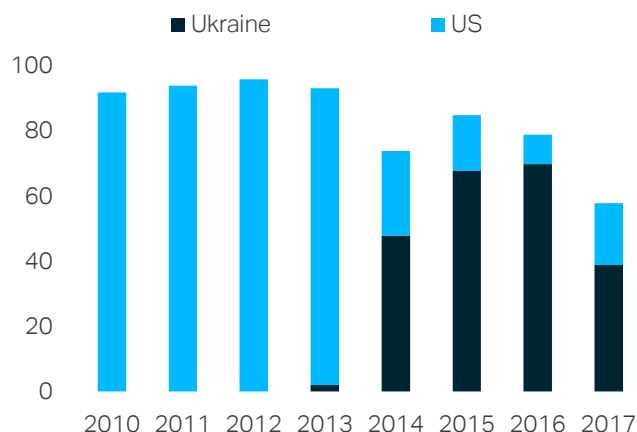
Sources: Bloomberg, TS Lombard.

### Swine herd collapse (yoy %)



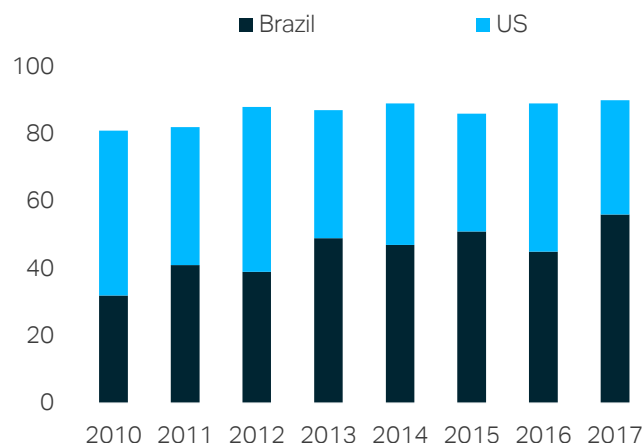
Source: CEIC.

### China corn import market share (%)



Sources: OEC, TS Lombard.

### China soybean import market share (%)



Sources: OEC, TS Lombard.

the last 10 years, to no avail. Moreover, as [we noted](#) last year, the combination of trade war-induced soy price gains and ASF-infection risk has led many farmers to slaughter costly breeding swine rather than risk forced culling (see right-hand-side chart below). The decline in sow numbers to record lows means that herd recovery will be a slow process. At present, infection risk has made producers reluctant to restock and banks unwilling to lend, further prolonging the recovery to full herd strength. We estimate recovery to the 2017 level of pig numbers and soybean consumption will take more than two years.

## Agricultural decoupling

**The trade war risks permanent soybean losses for US farmers.** Beijing is acutely aware that China is a net food importer. Feeding more than 1 billion people is a national security nightmare with which the Party has grappled since its inception. In recent years, diversification of food import sources, particularly away from the US, has become a core feature of government agricultural policy. Corn imports provide a concrete example of China's efforts. Until 2014 US corn supplied more than 90% of the China import market. After a number of landmark agreements signed between China and Ukraine in 2014, imports of Ukrainian corn surged (see left-hand-side chart above) and now account for an average 70% of Chinese annual corn imports.

Soybeans are, of course, a much larger import category, which means that reducing purchases from the US to zero is impossible in the near term. However, the trade war will accelerate an ongoing diversification process. In the last eight years, the US share of Chinese soy imports has shrunk by 15 ppt (even as total volumes have grown). Since the start of the trade friction, Chinese investments in smaller supplies such as Russia and a host of African nations have increased as Beijing looks to future sources of soybeans. In the near term, our contacts in Brazil report that China is extending its soybean supply coverage through mid-autumn (when the US will be harvesting its crop). It is increasingly clear that China is going to favour South American soybeans once again this year.

Given our assumptions about falling Chinese soy demand, the trade war and state incentives to buy non-US soybeans, it is possible that US soybean exports to China peaked in 2017. Only if a trade deal contains specific dollar quantities for annual soybean imports will it materially change the outlook on soybean prices and agricultural decoupling.

## Authors



**Jonathan Fenby**  
Chairman, China Team  
and Managing Director,  
European Political  
Research



**Rory Green**  
Economist, China and  
South Korea



**Bo Zhuang**  
Chief Economist and  
Director, China Research