ECONOMIC VIEWPOINT

#1 BEST OVERALL FORECASTER - CANADA

China and U.S. Protectionism

Should We Expect a Sharp Slowdown in China's Economy?

The United States is ratcheting up the tariffs on imports from China. This is a serious threat to China's economic growth. China can hardly expect to win by countering these U.S. tariffs. Devaluing the yuan could be a solution, but it would not come without risk and without causing other problems. China could instead seek to develop other exports markets to offset potential losses in the U.S. market. It could also speed up the changes that would further stimulate domestic demand. But this comes with its own set of challenges, mostly because such adjustments take time to implement.

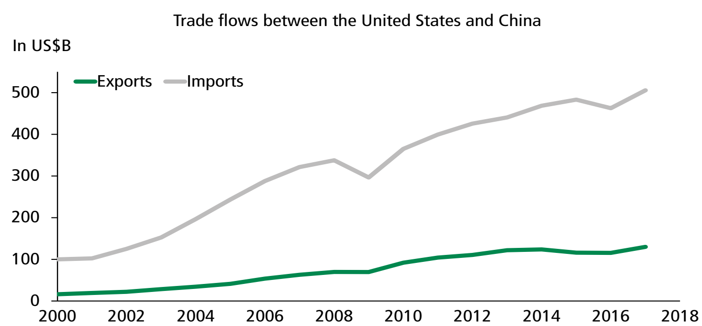
Protectionism Continues to Escalate

China is bearing the full force of U.S. protectionism. In February, the United States introduced tariffs of up to 50% on washing machines and solar panels. This measure was especially aimed at China. Steel and aluminum were next in March, with tariffs of up to 25% and 10%, respectively. In July, the United States decided to focus squarely on China, slapping a 25% tariff on US$34B worth of Chinese goods. The escalation continued in August with US$16B in new tariffs and into September with a 10% tariff levied on US$200B in goods. These last tariffs could in fact rise by 25% early next year. More announcements could follow, meaning that almost all the goods imported from China could be subject to U.S. tariffs.

In retaliation, China has slapped several tariffs of its own on U.S. imports. China, however, cannot possibly counter these blows to the same degree, given the asymmetrical nature of trade between the two countries. After the last salvo of US$200B in tariffs on Chinese goods, China finally hit back in September with tariffs of 5% to 10% on only US$60B of U.S. goods. According to U.S. data, the United States imports just over US$500B in goods from China, about three times the value of U.S. exports to China (graph 1).

China's trade surplus with the United States amounts to approximately 2.5% of China's GDP. Despite China's use of tariffs to retaliate, it's hard to imagine how the country will stop this surplus from eroding in the next few years, as this could crimp China's economic growth. There will be a strong incentive to find other solutions.

GRAPH 1
Trade between the United States and China is far from balanced



Sources: Datastream and Desjardins, Economic Studies

Devaluing the Yuan: Not a Risk-Free Solution

Devaluing the yuan could be a solution. This would help keep China's products competitive on the U.S. market. This solution is not perfect, however. For example, all of China's trading partners would be affected. As a policy, the devaluation of China's currency could over time compel other countries to adopt their own protectionist measures against China.

Since mid-June, China's currency has lost about 8% of its value against the greenback (graph 2 on page 2); this should partially offset the impact of the tariffs announced since last spring. The yuan's depreciation is somewhat less steep on average, against the currencies of China's major trading partners. The yuan's effective exchange rate shed about 6% over the same period.

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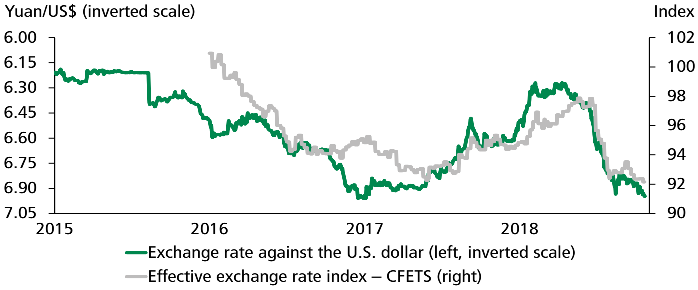
GRAPH 2
The yuan has lost about 8% against the greenback since mid-June

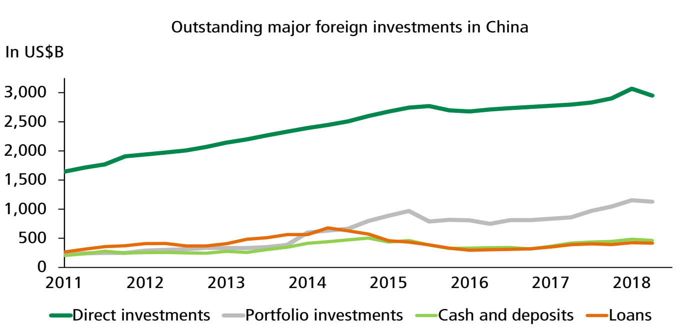


CFETS: China Foreign Exchange Trade System
Sources: Datastream and Desjardins, Economic Studies

We should point out, however, that the recent decline in the yuan is not necessarily the result of a voluntary devaluation of the currency to boost the competitiveness of China's exports. It is perfectly normal for a country's exchange rate to adjust to changes in the economic conditions. Weaker economic growth outlooks and expectations that China may adopt a more flexible monetary policy may amply justify the yuan's slide in the last few months.

In addition to the risk of broader retaliatory measures, changes in capital flows would be another obstacle preventing the Chinese authorities from deliberately slashing the yuan's value. Foreign investors could heavily withdraw their assets from China should they anticipate highly volatile exchange rates (graph 3). More liquid investments, such as portfolio investments, are usually quicker to transfer from one country to the next. These investments have already been declining since the year's second quarter. Direct investments, which are held over the long term and are generally less liquid, are also down. China's residents may also want to massively withdraw their assets from the country. They may have to contend with strict rules limiting capital outflows, however.

GRAPH 3
The yuan's volatility could see foreign investors flee



Sources: State Administration of Foreign Exchange and Desjardins, Economic Studies

A capital flight would be a threat to China's economic growth, making it far more difficult to finance business investment as well as consumer and government loans. China has huge reserves of foreign assets, which could meet its capital needs (graph 4). That said, dipping too heavily into these reserves could make China more vulnerable to other potential shocks.

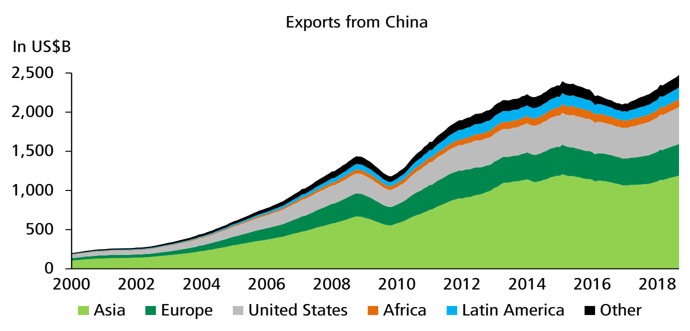
GRAPH 4
China has more than US$3,000B in reserves

Sources: Datastream and Desjardins, Economic Studies

Finding Other Markets

Instead of devaluing its currency, China could bank on new markets for its exports, about 20% of which are currently destined for the U.S. market (graph 5). The challenge may seem feasible, especially considering that there would probably be no need to find alternative markets for all of these products.

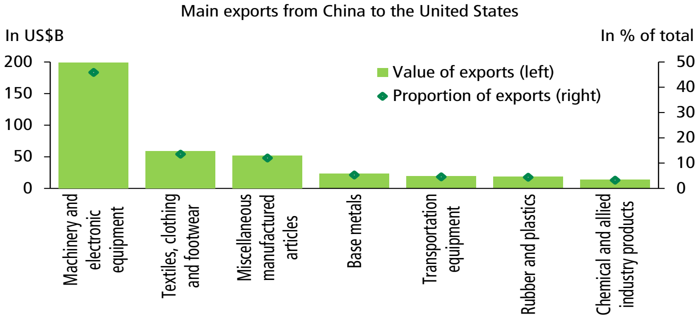
GRAPH 5
About 20% of China's exports head to the United States



Sources: Datastream and Desjardins, Economic Studies

Despite the tariffs in effect and potential tariffs, the United States should keep importing a certain quantity of goods from China. The machinery and electronic equipment category alone accounts for almost 50% of China's exports to the United States (graph 6 on page 3). This includes computers, televisions and smartphones—consumer goods that are rarely built on U.S. soil

GRAPH 6
China mostly exports machinery and electronic equipment to the United States

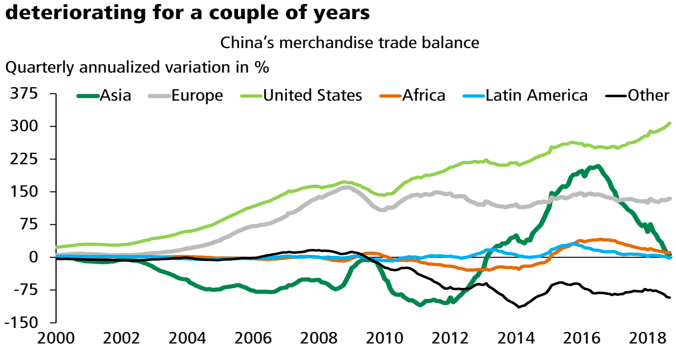


Sources: Datastream and Desjardins, Economic Studies

and thus difficult to substitute. Textiles, clothing, footwear and other clothing accessories come in second place. Here again, finding local products to replace Chinese imports could prove difficult. The same could be said for several goods in the miscellaneous manufactured articles category, which includes toys. However, the United States may turn to other countries if it can't find alternatives to Chinese imports.

Several Asian countries, which can export goods similar to China's, would be well-positioned to take advantage of the situation. Nevertheless, these countries may need to invest to boost or adapt their output capacity. That said, ramping up investments and exports would stimulate economic growth in these countries, and have positive effects on the entire region, including China. In other words, China could lose market share to the United States but gain ground in Asia. This would help reverse the trend in recent years that has seen China's trade balance with other Asian countries narrow (graph 7). Adjustments to China's production apparatus may be required to meet these countries' demand for imported products. China could also increase trade with other world regions, such as Africa and Latin America. Exports to Europe could rise too, especially

GRAPH 7
The trade balance between China and the rest of Asia has been deteriorating for a couple of years



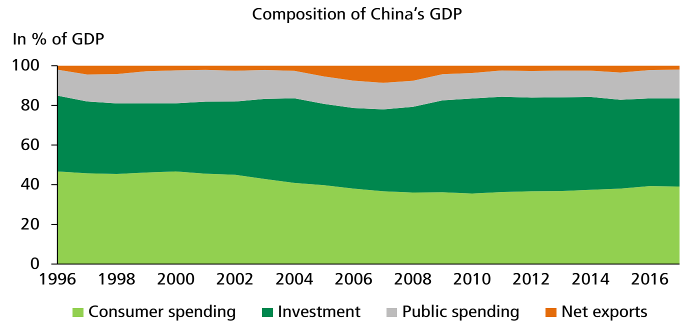
Sources: Datastream and Desjardins, Economic Studies

in response to the weaker yuan. But China already has a sizable trade surplus with Europe. If China seeks to increase this surplus significantly, this could fuel new trade tensions.

Why Not Domestic Consumption?

China has another option to offset the potential drop in its exports to the United States. It could look inward instead and boost domestic demand, especially in terms of household consumption. While the weight of consumption often exceeds 50% or 60% of the gross domestic product in many countries, in China it represents just under 40% (graph 8). Clearly, there is potential on that front.

GRAPH 8
Consumption's share of the Chinese economy is still struggling to rise



Sources: Datastream and Desjardins, Economic Studies

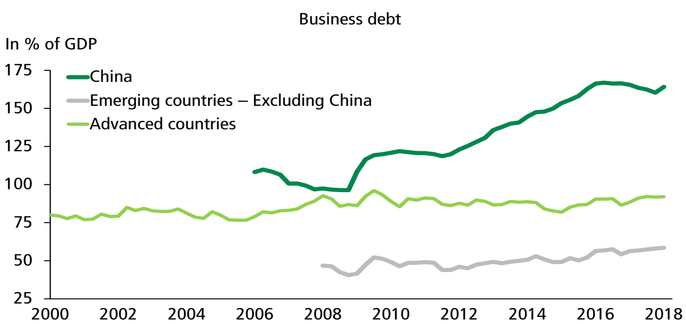
To encourage consumption, however, China would have to review the economic development model it has leaned on these past decades. China's success resulted from policies that spurred investment, often to the detriment of consumption. Supporting high investment takes a lot of money, and this money can either be borrowed from abroad of from households. China depends on the population's deep-rooted propensity to save.

We might add that the situation in China encourages people to save. Social security measures in China are few and insufficient to convince households to loosen the reins on saving for retirement or life's vagaries or necessities. Moreover, interest rates on deposits are low, meaning that people have to save even more to reach their long-term goals. Interest rates on savings could stay at low levels since there are still few alternatives in China for investing money. The country's stock and bond markets are still relatively small, and their strong volatility does not make them attractive compared to the security offered by bank deposits. Turning to foreign investments is also difficult, as several restrictions still limit capital flows.

All in all, several reforms could help kick-start consumption growth in China. For one, the government could enhance its social programs. Solutions could also be found to increase the return on savings and expand investment possibilities for Chinese households. However, these are not the types of reform that can be implemented overnight.

Even if China made every effort to accelerate consumption, doing so could create other problems. For example, we have to wonder what would happen to the companies used to finding cheap financing in a snap. Several of them could experience financial difficulties. The stakes are even higher now that China's businesses have a debt ratio far beyond the average posted in advanced countries (graph 9). This is an argument for a gradual approach. What's more, economic instability could turn into political instability, a scenario China's authorities would no doubt like to avoid.

GRAPH 9
Chinese business debt far exceeds the average in advanced countries

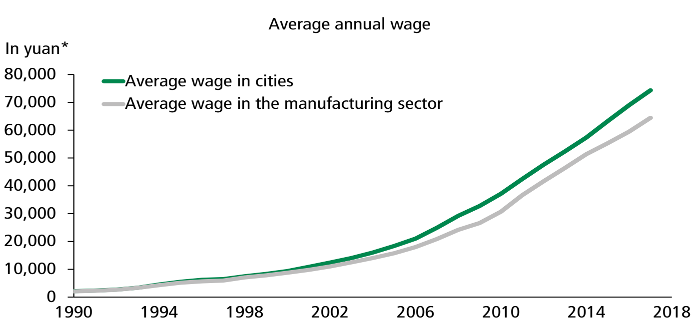


Sources: Bank for International Settlements and Desjardins, Economic Studies

Increase Income by Going Upmarket

Income growth would be another way to jump-start consumption. Wages in China are clearly moving up (graph 10), but this does not seem to be enough to push households to allocate a bigger share of their income to consumption.

GRAPH 10
Wages continue to rise in China

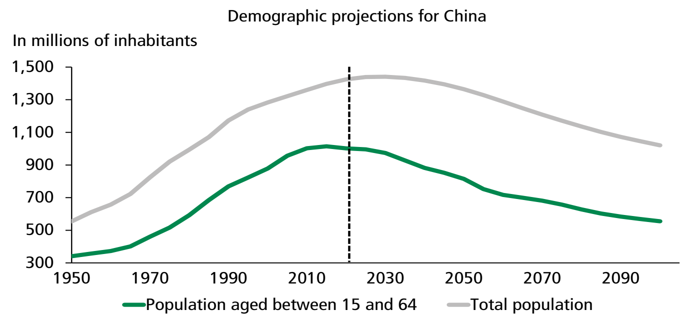


*1,000 yuan equal about US$145.
Sources: Datastream and Desjardins, Economic Studies

The challenge with income growth is that it stems from economic growth and, more specifically, from labour productivity. China has positioned itself well on the international markets by producing low-cost and labour-intensive goods. It has made high productivity gains, mostly by reallocating its labour force from low-productivity agriculture to high-productivity manufacturing. This mechanism cannot last indefinitely, however. Even without U.S. tariffs, China's competitiveness would eventually decline due to its shrinking rural, under-used labour pool. Not to mention the unfavourable demographic projections for China (graph 11).

The trade tariffs introduced by the United States are therefore

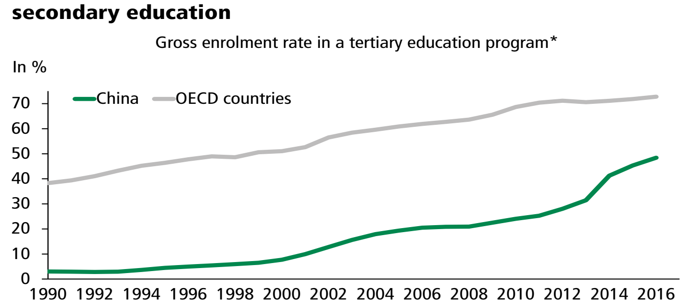
GRAPH 11
The population between the ages of 15 and 64 is starting to drop in China



Sources: United Nations and Desjardins, Economic Studies

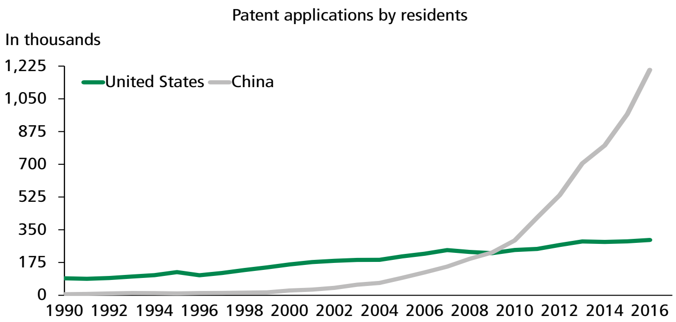
an incentive to speed up the transformation that will need to take place sooner or later. China must increase its productivity in ways that do not involve labour movements, and this could be achieved by accelerating the development of an economy that focuses on producing higher value-added goods. China's quick progress in education is an asset for this transition, although the country still trails the education rates in advanced nations (graph 12). The dramatic rise in patent applications in China is also encouraging (graph 13 on page 5). China is no longer a country that just assembles and exports goods—it is also becoming a place where products are designed and developed.

GRAPH 12
A growing number of Chinese people are pursuing post-secondary education



OECD: Organisation for Economic Co-operation and Development; * Total enrolment in tertiary education, regardless of age, expressed as a percentage of the population old enough to pursue official tertiary education.
Sources: World Bank and Desjardins, Economic Studies

GRAPH 13
The Chinese file more patents than Americans



Sources: World Bank and Desjardins, Economic Studies

That said, this is yet another transformation that cannot take place overnight. It is part of a longer term vision, whereby China would reduce its reliance on exports and develop its own consumer society.

In the End, China Still Has Some Leverage

In short, while the rise in U.S. protectionism is an important issue for China's economy, we should not necessarily expect Chinese growth to plummet in the next few years.

The truth is, China still holds several cards to mitigate the effects of U.S. trade tariffs. The first is to let its currency adjust without falling into the trap of a competitive devaluation. China could then seize the opportunity to review its trading position in the world. The loss of market share in the United States could be partially offset by making gains in other countries. China's trade composition could also be reviewed over time. This would be consistent with a gradual economic shift toward higher value-added products. In terms of consumption, the potential also seems high. However, there is a good deal of uncertainty in this scenario. This will especially hinge on Chinese authorities' willingness to implement the required reforms.

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