21 November 2019

Postcard from China

From trade war to US-China decoupling

- **Below are our key impressions from a week of travelling in China. While views are divided, most people expect the trade war to calm down over the next year. However, focus is moving beyond the trade war and towards US-China decoupling. In our view, this could have a big impact on corporate supply chains and it is a rising concern among the Nordic companies to which we talked.**
- **There are still worries over the short-term picture for the economy. On the medium-term outlook, views vary a lot but, generally, we sense some concerns about China's economic path and find ourselves more optimistic than consensus.**
- **Our impression from talking to many Chinese officials and business people is that China is quite confident it can navigate through the headwinds from the US. We hear often the view that this will prove positive for China because it strengthens the commitment to do what it needs to do to continue modernisation.**
- **Green development, opening up and innovation were popular phrases among Chinese officials and academia. They also highlighted quality over quantity.**
- **On a trip to Xi'an we witnessed that the Go West strategy is alive and kicking, with a heightened focus on opening up further. Lower costs, less competition and improving connections to the world market were highlighted as advantages compared with the coastal cities.**

Our bi-annual fact finding trip in China this year took us to Beijing and Xi'an and participants from Danske Bank were Chief Analyst Allan von Mehren, Chief Representative of our Beijing office Mathias Boyer and research analyst in Beijing Adie Zhang.

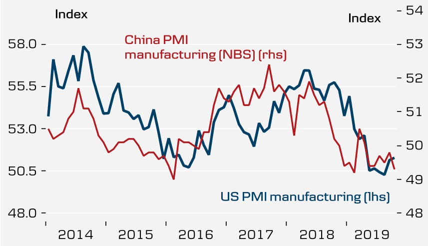
Trade war to be replaced by US-China decoupling

Our trip started in Beijing, where we met with a seasoned investors, analysts, academia and Nordic businesses. We also hosted a seminar with the Danish China Chamber of Commerce on the issue of future US-China decoupling.

The main talking points in China today are, not surprisingly, the US-China trade war, the outlook for US-China decoupling and the state of China's economy.

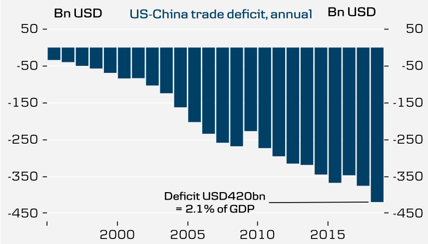
To start with, on the trade war, the mood is generally that some sort of solution to the trade war will be found over the next year but that the US-China friction will be far from over. Most people expect a phase one deal this year and some see the scope for a bigger phase two deal next year, mostly because Donald Trump is likely to need a renewed boost to the economy ahead of the US election next year. A trade deal could add that boost, as the main drag on the US has been the dark clouds of uncertainty from the risk of an all-out economic war. The path to end the trade war is expected to be bumpy, though, but ultimately some solution should be found. However, if Trump is re-elected, it is not unlikely the trade war could reignite again in 2021.

US and China have both felt the pain from the trade war



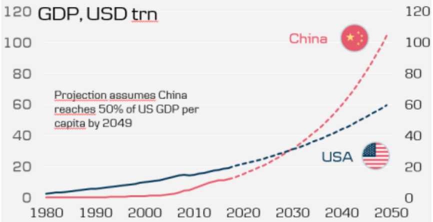
Source: Macrobond Financial, Markit

US-China trade deficit set new record in 2018



Source: Macrobond Financial, Danske Bank

US in relative decline, China on the increase



Source: IMF, Danske Bank

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While worries over the trade war are ebbing somewhat, there is rising concern about the prospect of a US-China decoupling involving a continued tech war. The steps to restrict China's access to US technology have been more aggressive and broader than most had expected at this stage. Export controls, restrictions on Chinese investments, visa challenges for Chinese students and a possible need to lay off Chinese workers in US tech companies indicate a 'whole-of-government' approach to confrontation by the White House, with strong bipartisan support from Congress. The trust between the two countries has taken a very big hit.

The rhetoric on the US side has reached new heights of confrontation lately, not least the most recent comments from Secretary of State Mike Pompeo who makes a clear distinction between the Chinese people, whom the US wants to prosper, and the Communist Party, which Washington describes as hostile to US values and working to undermine democracy. China's response has been unusually sharp in return. There is a growing sense in the Chinese government that the goal of the US is a system change in China. On the US side, the narrative is of a China that wants to dominate the world when it is big enough to do so and is currently simply pretending to want a multipolar world. **With this kind of confrontation, it seems like to us that restoring trust between the two powers is more or less impossible.**

China's sputnik moment

The question is no longer a matter of if, but rather how far and how fast, the US and China will decouple. Two opposing forces are in play on the US side of the equation. On the one hand, the national security community will push for a wide degree of decoupling and a further 'whole-of-government' approach with more significant export controls and possibly financial sanctions on China to stem China's rise. On the other hand, the force pushing against this is commercial interests, as widespread export controls would have a significant cost for US tech firms. For the big chipmakers, China accounts for between 30% and 65% of their revenues (see chart). Apart from dealing a blow to their profits, it would also undermine the very revenues they need to fund R&D spending in the race with Chinese tech firms. Other US companies in general would also suffer from a tougher confrontation, as Chinese consumers could increasingly turn their backs on US products. Therefore, essentially, it is a battle between the US defence ministry and the CIA on one hand and the Treasury and Commerce Department and a strong business lobby on the other.

On the Chinese side of the equation, national security interests are set to drive rising demand for full transparency on western companies and increasing use of Chinese components. However, in the short term, we expect this to balance with China's goal to attract further foreign investments. However, few doubt that the effect of the US confrontation is that **China will double its investments in technology**, with the aim of becoming independent of the US. The US **export controls on Huawei have been described as China's sputnik moment**, as it became clear that China would be in a tech race with the US and was behind on certain key technologies

A China tech expert at our event about US-China decoupling believed that over time China would be able to develop its own tech capabilities and become independent of US technology but that this is more a five- to 10-year journey than a one- to two-year game. We believe China will also push for increased financial independence from the US, as the White House can wield significant power as long as the USD is the world's main reserve currency. A digital currency from People's Bank of China may come in the not too distant future, which may be an effort to create more channels of payment that do not involve USD.

Mike Pompeo on China

'Look, we have a long-cherished tradition of friendship with the Chinese people.

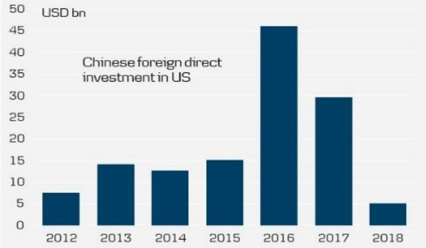
But I must say that the communist government in China today is not the same as the people of China.

We're finally realising the degree to which the Communist Party is truly hostile to the United States and our values'

Secretary of State, Mike Pompeo, 30 October

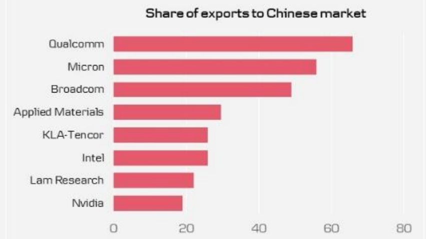
Source: Hudson Institute

Chinese investments in the US have collapsed following US restrictions



Source: Rhodium Group

Chinese market is key for US chip makers



Source: IMF, Danske Bank

Trade war as a strategic gift to China

During our trip, we met with a range of Chinese people, from local government officials in Xi'an, to professors and business people. Our impression from these talks was that (1) China is quite confident that it will prevail in the long term. The trade war and tech war are hurting the economy in the short term but this will not derail China's growth, even if the pace is a bit slower. One businessperson put it this way: China has had some years drinking champagne but we are not afraid of having to drink sparkling water instead for some time. We are used to struggle and can handle that. The US, in contrast, will not want to give up drinking champagne but it will have to if it continues down the current path. This is another way of saying that China's pain threshold is much higher than that of the US and that the US will eventually feel the cost of its current actions.

We heard several times from Chinese people that the **current headwinds were good for China. This is because they make it easier to cut through vested interests, as it is clear to everyone that China has to work hard to get to the next level of modernisation** and strengthens the feeling that a push for further opening up and reform is necessary. This reflects the view among some Chinese observers that the trade war is actually a strategic gift for China.

Concerns about the growth picture linger

The current economic slowdown is clearly a talking point and concerns continue to linger among Western observers in China. Data currently point in all directions with Caixin PMI and some other indicators suggesting a rebound, while other data such as industrial production and retail sales still point to a downbeat picture. There are some signs that the auto sector is set to recover in 2020 but the strength from housing is fading. **Views are divided on the need for further stimulus** but our sense is that consensus is looking for a bit more easing. Our own view is still that we will see a moderate recovery in 2020 on a de-escalation of the trade war, stimulus kicking in further and a slight pickup in the auto sector.

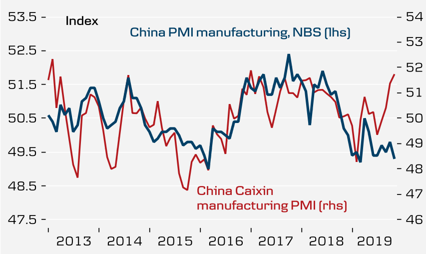
The outlook for the CNY is generally seen as very dependent on the development in the trade war, as the renminbi has traded very much in sync with the ebbs and flows in the negotiations. If the trade war fades further in 2020, we believe it will underpin a further decline in USD/CNY (which is our own baseline scenario).

Green development, opening-up and innovation in focus

The officials we spoke to repeated frequently three areas in particular. First, 'green development' is now very high on the agenda and achievement in this area is an important key performance indicator (KPI) among local governments leaders. It is important because China tends to move fast through collective mobilisation of resources, when it sets a goal in a new area. We witnessed the drive for green development up close on our train ride from Beijing to Xi'an where trees filled field after field, with many of them planted not long ago. The result has been more rainfall and a big decline in the problem of sand storms, which previously could leave Beijing and other cities in a thick fog of sand from time to time.

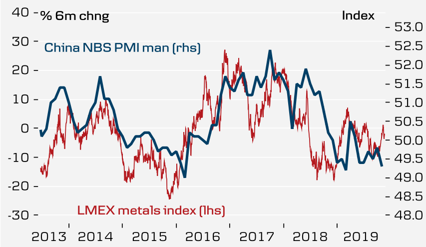
The second buzz phrase we heard a lot on the trip was more 'opening up'. One answer from China's leaders to the current headwinds from the trade war seems to be another push towards opening up. More free-trade zones have shot up over the past few years and investments have opened up in more areas. The latest example came over the past week, with the news that Germany's Allianz has become the *first fully foreign owned insurance company* in China. The opening up has several purposes. The first is to attract more investments that create jobs and another is to foster more competition to force Chinese companies to become

Mixed PMI data leave uncertainty over true economic picture



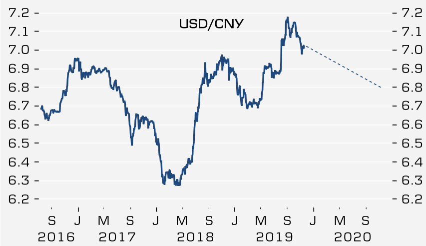
Source: Macrobond Financial, NBS, Markit

Metal prices point to moderate improvement but no big turnaround



Source: Macrobond Financial,, LMEX Danske Bank

USD/CNY trade in sync with trade war waves – we look for further decline



Source: Macrobond Financial, LMEX, Danske Bank more efficient. Protectionism of domestic companies in some areas is unlikely to go away fast but in other areas, opportunities for foreign companies are improving.

A third phrase we heard a lot in China was innovation, which is encouraged across many areas, not only in the technological area but also in governance and ways to strengthen incentives. Local leaders are competing with other cities and provinces for promotion and fostering innovation is another of the KPIs on which local leaders are evaluated. While the government system under Xi Jinping instils some degree of fear, it is balanced to some extent by the encouragement to find innovative solutions and rewarding of this.

Go West strategy alive, tough competition drives development

That competition is a key driving force behind China's development became evident when we visited Xi'an, a city of 13 million people in Western China, 1,200km from Beijing. It is most famous for being home to the Terracotta Army created under the rule of Emperor Qin Shi Huang as part of his tomb. He is one of China's most famous emperors, as he united the nation after the so-called Warring States period around 240BC.

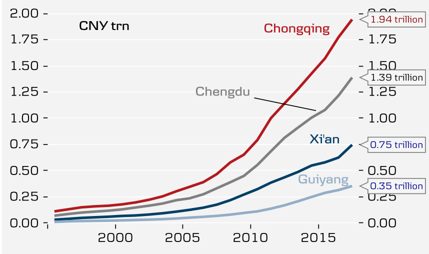
In Xi'an we met with an investment-promotion bureau of a new export free-trade zone area, the ministry of commerce of the Shaanxi province and professors and Chinese business people. They were eager to present Xi'an as a favourable city in which to invest and mentioned it was in hard competition with other Western China cities such as Chongqing and Chengdu. The local government leaders that show the most success on the KPIs of green development, poverty reduction and attraction of investments are likely to win promotion to higher levels in government or the CPC.

Highlighted advantages of investing in Xi'an rather than in the east coast were (a) cheaper labour, (b) less competition than on the coast and (c) a central location making it a nice hub for companies. Improved connectivity to Europe following the Belt and Road Initiative (BRI) has also benefited Western China. The labour cost is around 60% of the labour cost on the east coast and the cost of land and residential housing is cheaper. Train transport to Europe is rapidly increasing and the transport time has fallen to around 15 days, half the time of transport by sea (but also double the price).

The Go West strategy in China is thus alive and improving the infrastructure in Western China has been an important part of the strategy on top of creating more free-trade zones.

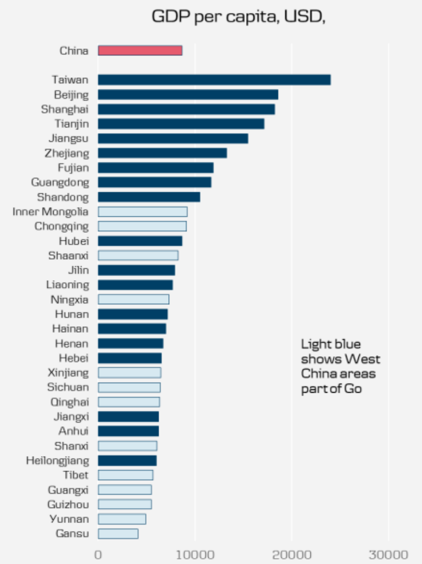
To sum up, as usual our trip was a fruitful experience, reminding us that China is much more than Beijing and Shanghai and that a lot more is going on than the trade war and short-term business cycle swings. Not least, talking to Chinese officials and business people gives a different perspective from the one we tend to get through the usual sources.

Xi'an GDP vs other Western China cities



Source: Macrobond Financial, NBS, Markit

Western China still has gap to Eastern China



Source: IMF, Danske Bank

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Expected updates

None.

Date of first publication

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