ARTICLE FOR THE EDGE

CHINA'S OUTLOOK: UPSIDE IN NEAR TERM BUT WHAT OF THE LONG TERM?

What a difference a decade makes. The last time the world economy exited from a recession, in 2010 after the global financial crisis, China's share of global output was roughly 10%. Today it is around 18% while its share of world imports today is around 10%, up from about 8% in 2010. China matters a lot more today: As it moves out of the pandemic ahead of the rest of the world, its economy will out-perform and so help to consolidate the global rebound more quickly than we anticipated. There are some risks to this optimistic scenario but they appear to be more long term in nature. The prospects in 2021 for Southeast Asia are therefore likely to be boosted by China's trajectory.

Near term: fair chance of upside surprise

We see the Chinese economy growing well above 8% this year, powered mainly by robust exports. In fact, the expansion could be even faster if exports and domestic demand turn out to be far better than expected – something which looks tantalisingly possible:

In fact, there is accumulating evidence to suggest that global demand is gaining momentum at an impressive pace. As China is the world's biggest exporter, its economy will be an outsized winner from this rebound.

- The latest OECD composite lead indicator which predicts economic expansion in the world's biggest economies is now just above its pre-pandemic level, suggesting strong growth ahead.

- Recent data on Korean and Taiwan exports shows global demand surging more strongly than expected. Given Korean and Taiwanese exposure to information technology, this tells us that the tech cycle is particularly vibrant. This is very important – it means that COVID or no COVID, the huge opportunities that new technology offers are so compelling that businesses are going ahead with investment projects. That will help Chinese exports of electronic gadgets and high-tech components.

- The purchasing manager index (PMI) for Europe's manufacturing sector has surged to a record high. More surprisingly, the service sector PMI also rose despite the high level of COVID infections and ensuing restrictions on activity. This also tells us something quite salient for how we look at the global economy – businesses and consumers are now better at adapting to the pandemic, so their production and spending behaviour is less damaged by pandemic fears and restrictions.

- In the US, consumer confidence is soaring. The Conference Board consumer confidence index leapt to 121.7 in April from March's 109.0, boosted by the large fiscal stimulus and the rapid pace of vaccinations. Companies are also rapidly increasing their orders for capital goods. As more countries overcome the initial delays in vaccine roll-outs and come to grips with the new wave of infections, we are likely to see consumer and business confidence improving markedly across the advanced economies. For example, after a slow start, Europe's vaccination rate is now rapidly improving.

Yes, it is true that the COVID virus has been a remarkably mischievous one and has tripped up many an optimistic prediction. The horrors being witnessed in India today have also made many observers wary. Even taking all this into account, we are confident that, as vaccines are rolled out and economic agents learn to better adapt to the pandemic, the pandemic-related risks can be better contained.

Currently, China's economy has bounced back mainly on the back of exports. Consumer and investment spending are doing better but are not particularly vigorous yet. However, we do see the domestic mood lifting soon. China was slow to inoculate its population against COVID but it is now accelerating its vaccination programme. The celebrations of the 100th anniversary of the founding of the Chinese Communist Party in July are just around the corner – the country's leaders will certainly want to see a more enthusiastic citizenry as that date approaches and will pull out the stops to boost morale. Moreover, it is also not likely that the central bank will throttle back on monetary support out of concerns for financial stability as some had feared earlier – the authorities have made clear that their policies will be carefully calibrated and remain supportive of economic recovery.

For these reasons, we think that consumers will soon step up spending. The marginal propensity to consume – how much consumers spend out of a rise in income – had fallen to 61.4% in the first quarter from 65.2% in 2019. We think a rebound to more normal levels is likely in the second half, and that will help fire up domestic demand. Moreover, this is the first year of the 14th Five Year Plan – as the projects of the Plan start being implemented, companies will feel more encouraged to step up their capital spending as well. Recent data show industrial sector profits expanding vigorously which means that once confidence returns, the revival in investment spending could be quite strong.

Risks exist but appear more long term in nature

There are a number of pitfalls that could hurt the Chinese economy but there is little evidence that these risks will materialise soon.

First, there are some hints that domestic politics may not be as untroubled as it appears. The censoring of a newspaper article that former prime minister Wen Jiabao penned as a tribute to his mother was intriguing. Wen managed to include in his homage to his mum wording that seemed to indirectly criticise President Xi Jinping. Wen is too astute and experienced a political hand to not have known that his comments would be seen in this light. Wen's article comes after several other lower-level insiders criticised Xi openly last year. There was also an odd incident last year when a proposal by Prime Minister Li Keqiang to encourage street hawking as a means of job creation was roundly criticised in Chinese media. Criticisms of the top leaders are unusual, and certainly so in the case of state-controlled media. Li, once seen as a rival to Xi, has been kept on a tight leash in recent years so it was not surprising that the incident sparked speculation that Li was being cut down to size.

So, it appears to us that something is not quite right in high-level Chinese politics. As the 20th Party Congress in November 2022 approaches, there could be more infighting. Xi may well be dominant and able to set the pace in Chinese politics but there is opposition to his ways which suggests that a major misjudgement he makes could crystallise that opposition and unsettle Chinese politics.

Second, it is clear that Xi's view of China's private sector is not the benign one of his predecessors Jiang Zemin and Hu Jintao. This is evident in the rough treatment being accorded to Jack Ma and his companies as seen in the huge fine imposed on Alibaba and the increasing pressure on his Ant Financial group. That this extends beyond Ma to other big names in China's corporate world is evident in the investigation by the State Administration for Market Regulation of alleged monopolistic practices by Meituan. The abrupt resignation of Colin Huang, the founder of the fast-growing e-commerce giant Pinduoduo also got tongues wagging. Pony Ma, the founder of the social media giant Tencent, recently proposed tougher rules for internet companies like his in what some observers felt was an attempt to accommodate the increasing demands of the Chinese state on the private sector.

There is little doubt that there is growing pressure on China's private sector. Some of this is entirely reasonable. After all, the big tech companies had established near-monopolistic control over key parts of the new economy and China is not the only country which is seeking ways to rein big tech in. But if these moves presage a stronger state role in the sector and a suppression of entrepreneurial energies, then the risks to China's longer term growth would grow more serious.

A third challenge is demographics. The Financial Times has revealed that the reason for the delay in announcing the findings of China's latest nationwide census is the discovery that provincial authorities may have been inflating population data. It now seems that China's population may have already started to decline. If true, that means that the demographic headwinds to China's economic growth have appeared much earlier than expected. Growth could be slower, and the burdens on the state budget to support the elderly higher than anticipated. The government may also feel compelled to bring in changes such as a later retirement age which may be unpopular.

Conclusion: what does this mean for the rest of us?

If Chinese economic growth surges in the second half to well over 9% as is possible, our region would benefit strongly.

First, the trade channel would be re-activated: demand for exports of manufactured goods such as electronic components and other intermediate goods would accelerate. The demand for commodities will also tend to swell. At the same time, prices of commodities that are tied to the economic cycle such as the thermal coal, rubber, copper and nickel that Indonesia exports, would enjoy an upswing.

The pickup on the services side, however, may not be so impressive since it is unlikely that Chinese tourists will be flying to Southeast Asia's beaches, casinos and malls any time soon.

The boost to trade would be all the greater if signs of a surging Chinese economy helped to rouse business confidence globally and so accelerate the recovery in business spending.

Second, as China puts its pandemic crisis well behind it, confidence will grow and we are likely to see more Chinese capital flow to the region. The Belt & Road Initiative could be revived with more projects announced. Chinese companies are becoming more interested in Southeast Asia's growth potential so there is likely to be more Chinese foreign direct investment into the region – as well as more mergers and acquisitions. It is possible that the Chinese authorities would encourage such a movement by further liberalising its capital account.

Of course, on the flip side, much stronger growth could inspire concerns of an earlier tightening of monetary policy by the US Fed and that could spur outflows of capital from emerging markets. One suspects, though, that the Fed will be careful to carefully manage market expectations so that we do not get a repetition of the taper tantrums of 2013.

Third, as China's economy outperforms expectations, its currency would tend to strengthen again. That could help bolster other Asian currencies as well.

The longer term impact that China would have is much more murky. While recent history has taught us not to under-estimate the Chinese policy makers' capacity to deal with challenges, the combination of political and demographic difficulties could well test even the highly competent Chinese technocrats. While hoping for the best, Southeast Asia should be alert and prepare itself to absorb potential shocks if China suffers a reversal of fortunes.

Prepared by Manu Bhaskaran
CEO, Centennial Asia Advisors