

ARTICLE

For professional investors

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Lost in translation: a low point in the US-China relationship

- China wants to avert a trade war, but does it need what Trump wants to sell?
- Chinese policies are making steps toward a more open economy
- As China focuses on financial sector stability, expect more fintech regulation

Meeting several financial leaders, government officials, and think-tank analysts from the United States and China, Victoria Mio and Fabiana Fedeli tried to find the answer to one key question: How can the US-China relationship be fixed?

In the past few months, the clash of Xi's 'China Dream' and Trump's 'Make America Great Again' has created turmoil in the US-China relationship. Meanwhile, China is gradually opening up the domestic economy by allowing, among other things, more foreign investment in the financial sector, and is containing debt expansion via increased regulation in areas such as shadow banking and fintech. Will this be sufficient to mend the relationship with the US?

Significant changes in US-China relationship

Our meetings made us realize that there is a significant change in the US-China relationship. There is great polarization of opinions in the US when it comes to China and Trump exacerbates it. Overall, the consensus among US policy makers is to take on a tougher stand. What triggered this, however, is not a worsening in China's behavior but rather the realization of how pivotal and powerful the country has become in the global context.

In the past, the US political elites held the view that as long as China integrated more into the world trade system, the Chinese economy would become more market-oriented, implying that state control would reduce, and ideologically China would draw closer to the



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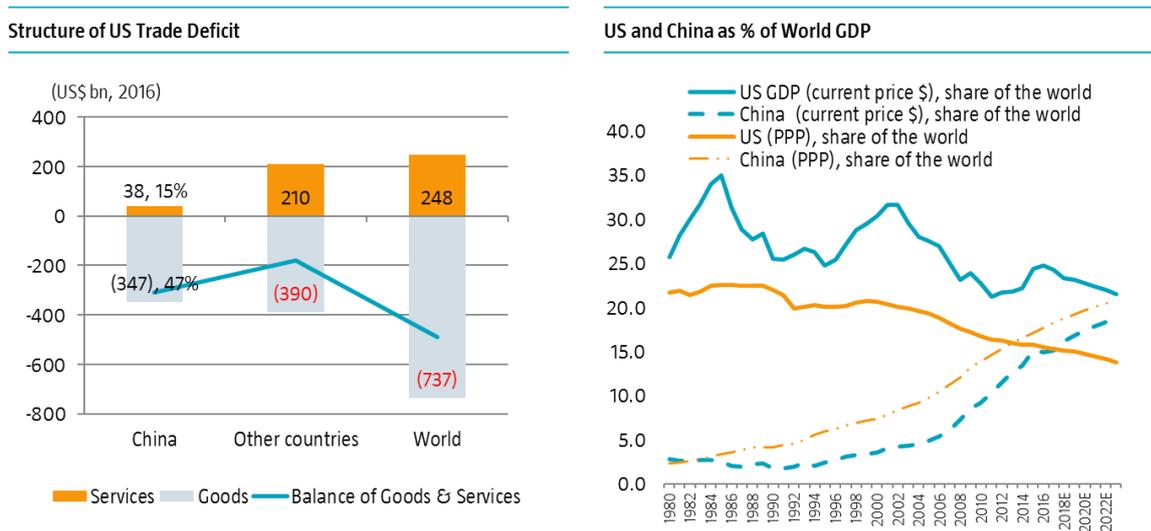
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'US-China
relationship
warrants
reassessment'

western world. However, the consolidation of power by President Xi has changed the perception and approach of the western world towards China. The might of China's size and power in the world has increased, while its ideology has not drawn closer to the US. The One Belt One Road (OBOR) and Made in China 2025 strategies are perceived by the US as China challenging the established world economic and political order.

The US merchandise trade deficit with China (47%) is high relative to its GDP share and the service surplus (15%) is low. The relative sizes of the US and China are also at a critical moment, as shown in Figure 1. We need to evaluate a long-term problem: can China and the US escape the Thucydides Trap? Professor Graham Allison of Harvard Kennedy School has popularized this term to explain the likelihood of conflict between a rising power and a currently dominant one. This is based on the famous quote from ancient Greece's historian and general Thucydides: "It was the rise of Athens and the fear that this inspired in Sparta that made war inevitable." This issue has been acknowledged by Chinese President Xi Jinping, who said "We all need to work together to avoid the Thucydides trap – destructive tensions between an emerging power and established powers ... Our aim is to foster a new model of major country relations."

Figure 1 | US-China trade relationship vs change in sizes of US-China GDP



Source: US Census Bureau, IMF, Credit Suisse

Managing US-China trade frictions

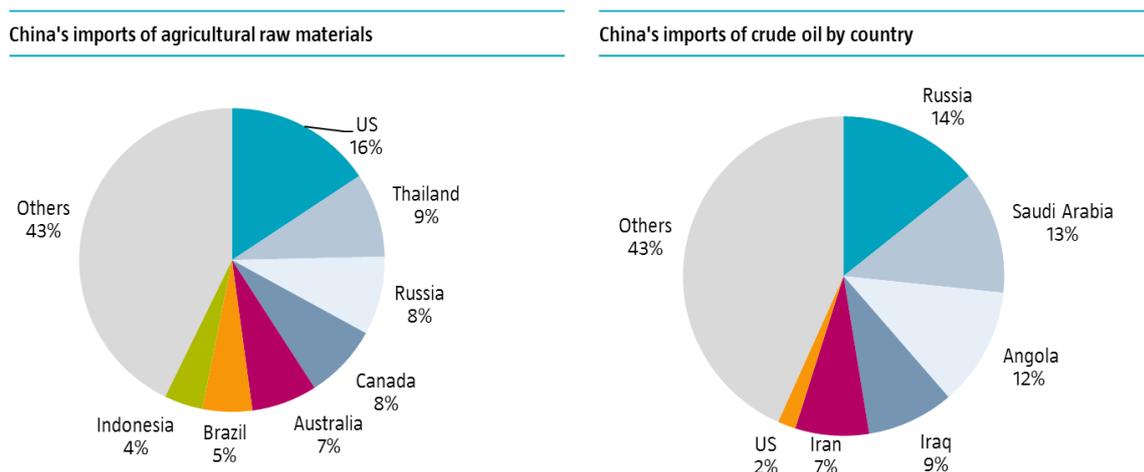
The most recent trade frictions between the US and China are one manifestation of how delicate the balance of power has become. The key issue is, is it at all possible for China to give President Trump what he wants? Following Vice-Premier Liu He's trip to the US in May 2018, a joint announcement stated that China will significantly increase purchases of US

goods and services and deepen cooperation on bilateral investment and intellectual property protection. However, questions remain on how China could increase imported goods from the US by the 'requested' USD 200 billion without purchasing more IP-sensitive goods, which the US does not want to sell due to security concerns. During one of our meetings, the CEO of a Chinese bank jokingly said, "When we open up the auto industry, I will still want to buy a German car, not an American truck." Both sides seem to lack any concrete idea on how to do this, and the discussion will continue.

China will likely opt for a gradual shift to US products in its incremental imports, such as beef, LNG and automobiles, but this is unlikely to fill the trade deficit. Hence, the trade frictions between the two countries are more likely to drag on. Importantly, the potential surge in imports from the US could lead to increasing competition for economies with leading market shares in the aforementioned sectors.

On 15 June, the US announced additional duties of 25% on USD 50 billion worth of Chinese imports. This is the equivalent of 0.1% of China's GDP, and affected exports account for 2.2% of China's total exports. Shortly following the US announcement, China followed up with tariffs "of the same scale and same intensity". At the moment, the direct macro impact on China and the US is limited. However, we should be prepared for further escalation.

Figure 2 | China's imports of agricultural products and crude oil from other countries



Source: UN Comtrade, Mizuho

Opening up China's financial sector and prospects for foreign flows into China

Services exports could provide a solution to the current frictions, by off-setting the trade deficit with an increase in the services surplus. Currently travel and education contribute over half of US services exports to China and growth remains strong and sustained. During our meetings, Chinese officials reaffirmed their commitment to stay on the path of liberalization

and promoting globalization, and laid out some implementation actions that could allow for further penetration of foreign services in the country:

- Promote globalization: China pledged to support global cooperation and the multilateral trading system, making globalization more open, inclusive, balanced and beneficial to all.
- Widen market access: China will relax foreign shareholding limits in the financial services sector, and the joint venture shareholding requirement for foreign firms in the auto sector.
- Improve domestic investment environment: China will complete the revision of the foreign investment negative list, and implement a management system based on national treatment and the negative list by the end of June 2018.
- Enhance IP rights protection: The State Intellectual Property Office will intensify enforcement of laws and enhance the protection of intellectual property rights in China.

As always, the Devil is in the detail, and there are three issues with the above points. First, in contrast to the Chinese government's proclamations of economic openness, the foreign share in banking and insurance has fallen in China, also due to an unclear regulatory environment and increased reach and competition of domestic players. Second, expanding the US services surplus while keeping a wide trade deficit will not benefit President Trump's constituencies, and will therefore not be a satisfying *quid pro quo* for the US administration. Third, the growth in the US services surplus with China is likely to be slowed down by geographical distance, culture and language difference.

Yet, the steps undertaken by the Chinese administration are undeniable. In the Boao Forum in April 2018, China announced 11 measures in its financial sector to create broader access for foreign financial institutions. Since then many US financial institutions have committed to grow their market presence. While some US financial executives during our meetings labelled the steps as "too little too late", others expressed optimism that the opening up of the domestic markets, the inclusion of A-shares into the MSCI, and the opportunity to hold a controlling share above 50% in local subsidiaries are all the ingredients that are going to fuel the next phase of growth for foreign players willing to invest in China for the longer term.

New trends in financial regulation: US de-regulation vs Chinese re-regulation

In March, a new financial regulatory system was formed in China to improve regulation and risk control. Instead of following the US or British models, Chinese authorities created a hybrid, China-style system. The new system consists of the State Council Financial Development and Stability Commission at the top, the central bank being responsible for prudential macro-economic management, and the China Bank and Insurance Regulatory Commission (CBIRC) and the China Securities Regulatory Commission (CSRC) as the financial regulators. The CBIRC is the result of the merger of two pre-existing regulators, and should

allow for more consistent and hence effective action when it comes to regulating the sprawling Chinese financial sector and contain shadow banking.

During our meetings, Chinese officials also emphasized the policy steps made to stabilize the macro leverage ratio. For example, the recently announced asset management regulation aims to bring down leverage in the financial system by reining in inter-bank and off-the-balance-sheet activities. The Asset Management rule to remove implicit guarantees for investors by 2020 is another key step.

Fintech: China's regulatory challenges

One key challenge for the Chinese regulators is represented by the financial institutions that are embedded within large conglomerates via complex cross-ownership structures. Good examples of this are some financial holding companies, such as Anbang, but also internet companies such as Alibaba, Tencent, Baidu, and JD. These structures are complex and post a number of risks to the financial system.

In particular, financial institutions within conglomerates could create systemic risk to the economy, given their ability to hide financial leverage and the fact that their size has grown exponentially and continues to grow. Chinese regulators are evaluating a number of options, which range from following the principle of 'substance over form' (i.e., if a conglomerate engages in financial operations, it should be considered a financial company in its entirety and be regulated accordingly) to a breakout of financial subsidiaries within conglomerates.

While we do not know which option will be chosen, the likelihood of increased regulation of such conglomerates is very high and this should be taken into account when forecasting their future profitability and scope of action.

Major risks remain

Our meetings showed that the protectionist tone of the Trump administration has hardened and trade frictions between the US and China are likely to drag on. In the near term, we need to monitor the trade conflicts between the US and China very closely, as both sides are likely to maintain a strong stance and some damage (to specific sectors in certain countries) could be caused along the way. Moreover, as China improves the accountability of its financial system, there will inevitably be undesirable consequences. For example, increased corporate bond defaults, which some foreign investors worry could cause systematic risk. While we expect that defaults could rise amid a reduction in non-standard financing, but remain idiosyncratic rather than systemic, we do believe that risks from the global macro backdrop remain. In particular, geopolitical tension such as those between China, the US, South and North Korea could affect the region.

As for the North Korea situation, the recent Trump-Kim Jong Un summit hints to a normalization. That said, given the volatile nature of the main personalities involved, any further development needs to be monitored.

Implications for China's macro-economic and market outlook

We maintain our Chinese growth forecast of 6.5% for 2018 and our positive stance on the Chinese equities markets. Growth is still resilient, as consumer confidence remains strong, supported by higher income and property prices, industrial production remains robust and profits have improved. Chinese corporate earnings momentum decelerated in the first quarter of this year, but remained strong at 15.6% yoy.

The political and economic relationship between China and the US has changed dramatically, and any expectation of a quick settlement of the disputes would be unrealistic. We may rather see a series of dynamic moves back and forth from both sides. The stakes at risk in a trade war are high for both countries, which means that we are likely to see negotiations ahead, but the process will not be straightforward. Both President Xi and President Trump are likely to maintain a tough stance to further their domestic agendas: Xi to push through tough reforms and Trump to help his party win the mid-term elections. The market will likely focus on the potential winners or losers in the energy, auto and tech hardware spaces. Should a trade war truly escalate, we expect the Chinese government to loosen policies somewhat in order to hedge downside risks.

Robeco has a number of strategies investing in China, both at a global level, such as Emerging Markets Equities and Emerging Stars Equities and a at a regional level, including Chinese H-share and Chinese A-share strategies.

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