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China's macroeconomic policy trifecta and challenges to the governance of the global trading system

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CIGI Papers No. 236 – January 2020

China's Macroeconomic Policy Trifecta and Challenges to the Governance of the Global Trading System

Mark Kruger



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About the Author

Mark Kruger is a CIGI senior fellow. Mark began his career at the Alberta Petroleum Marketing Commission in Calgary, Alberta, in 1982. He joined the Bank of Canada (BoC) in 1989 as an economist in the Monetary and Financial Analysis Department. He moved to the International Economic Analysis Department in 1992, where he held a number of positions including assistant chief responsible for international financial policy and emerging market issues. He served as a senior advisor to the Canadian executive director at the International Monetary Fund from 2003 to 2006. From 2006 to 2013, Mark headed the Economic and Financial Section in the Canadian Embassy in Beijing. In September 2013, he returned to the BoC as a senior director in the International Economic Analysis Department. In June 2019, Mark retired from the BoC and began to work as a Shanghai-based consultant on economic and financial issues related to China.

About Global Economy

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Acronyms and Abbreviations

AmCham	American Chamber of Commerce in China
FDI	foreign direct investment
G20	Group of Twenty
IMF	International Monetary Fund
IP	intellectual property
IPRs	intellectual property rights
OECD	Organisation for Economic Co-operation and Development
PBoC	People's Bank of China
USTR	US Trade Representative
WTO	World Trade Organization

Executive Summary

The trade war could not have come at a worse time for China. GDP growth has been on a downward trend, driven by a shrinking working-age population and slowing investment spending from very high rates. More recently, the elevation of de-risking the financial system to a key policy objective has led to a credit crunch. Even though a ceasefire has been called in the trade war, lingering uncertainty will dampen aggregate spending until a peace treaty is signed. Thus, Chinese policy makers are currently undertaking a precarious policy balancing act. They are trying to maintain steady growth while promoting financial stability and managing protectionist pressures. Unfortunately, policies directed at attaining any one of these objectives make hitting the others more difficult.

To put the trade war in simple terms, the United States is concerned about the size of its bilateral trade deficit with China and it worries that China's industrial policies give it an unfair advantage in international trade and investment. The United States has lost patience with China and does not believe that the World Trade Organization (WTO) can effectively constrain China's behaviour. To some extent, however, the frustration of the administration of US President Donald Trump is at odds with the facts on the ground, which show that the business environment for foreign firms is slowly improving and that the bilateral trade deficit has long stabilized as a small percentage of the United States' GDP. Moreover, the United States' distrust of the WTO goes well beyond its conflict with China. Repairing the damage done to the governance of the international trading system will be difficult. Yet, as the world's largest trader, China has the most to lose from a breakdown of the WTO and it behooves China to take a leadership role. It can help ensure moving beyond a ceasefire to a lasting peace by demonstrating that its strong state-owned sector is not incompatible with an open trade and investment regime.

Introduction

China has many economic strengths. While GDP growth has slowed, it is still relatively rapid. China is an international creditor and what liabilities it has are largely denominated in renminbi. Despite these strengths, Chinese policy makers are currently undertaking a precarious policy balancing act — they are trying to simultaneously attain three macroeconomic objectives. However, policies designed to attain any one objective reduce the chance that the others will be met. At the same time, the United States is no longer supporting the WTO, which is tasked with setting the rules for how international trade should be conducted. This creates a tremendous amount of uncertainty for China, which is the world's biggest exporter.

This paper is organized as follows. The first section describes the three elements of China's macroeconomic policy “trifecta,”¹ the second section looks at existential threats to the WTO and the third section concludes by offering recommendations on the types of policies that China might pursue to achieve its macroeconomic goals and take a leadership role in WTO reform.

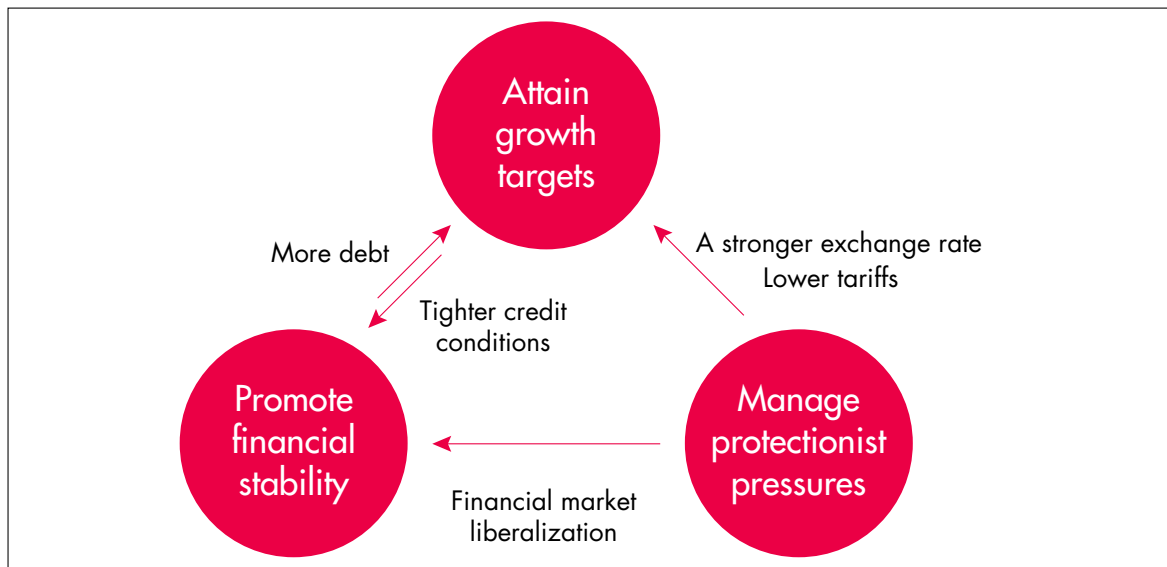
China's Macroeconomic Policy Trifecta

China's macroeconomic policy trifecta is illustrated in Figure 1. Its three objectives are: meeting targets for GDP growth; promoting financial stability; and managing protectionist pressures.

It is easy to see how attaining any one objective makes hitting the others more difficult. Meeting the growth targets could imply allowing firms and governments to increase their borrowings to take advantage of incremental investment opportunities. However, this additional debt could imperil financial stability. Conversely, the tighter credit conditions needed to promote

1 The term “trifecta” comes from parimutuel horse race betting. It describes a bet in which one must pick the horses finishing first, second and third in exact order. It is an extremely difficult bet to get right. However, the payoff is huge for those lucky handicappers who are able to do so.

Figure 1: China's Macroeconomic Policy Trifecta



Source: Author.

financial stability make it more difficult for the economy to grow rapidly. Managing protectionist pressures could involve accepting a stronger exchange rate or lowering tariffs. However, these measures would tend to dampen growth. Similarly, managing protectionist pressures could involve accelerated financial market liberalization. More open financial markets would be good for both economic growth and financial stability in the long run. However, there is a risk that, if poorly sequenced, large two-way capital flows could, in the near term, result in high exchange rate volatility and undermine domestic financial stability.² It is for this reason that Governor of the People's Bank of China (PBoC) Yi Gang, in his first public speech, said it was important to “put equal emphasis on the opening up of the financial sector and prevention of financial risks” (CNBC 2018).

Let's now look at each one of China's macroeconomic objectives in more detail.

Meeting GDP Growth Targets

China has long had the objective of doubling the level of real GDP between 2010 and 2020. Figure 2 shows the progress in meeting this objective. Here, the level of Chinese real GDP is indexed to 2010 = 100. Through 2018, the level of real GDP stood close to 80 percent higher than the 2010 starting point. Growth needs to average six percent in 2019 and 2020 for the target to be met. Since growth averaged 6.7 percent over 2016–2018, one would suppose that, in normal times, this should be an easy objective to meet. However, these are not normal times.

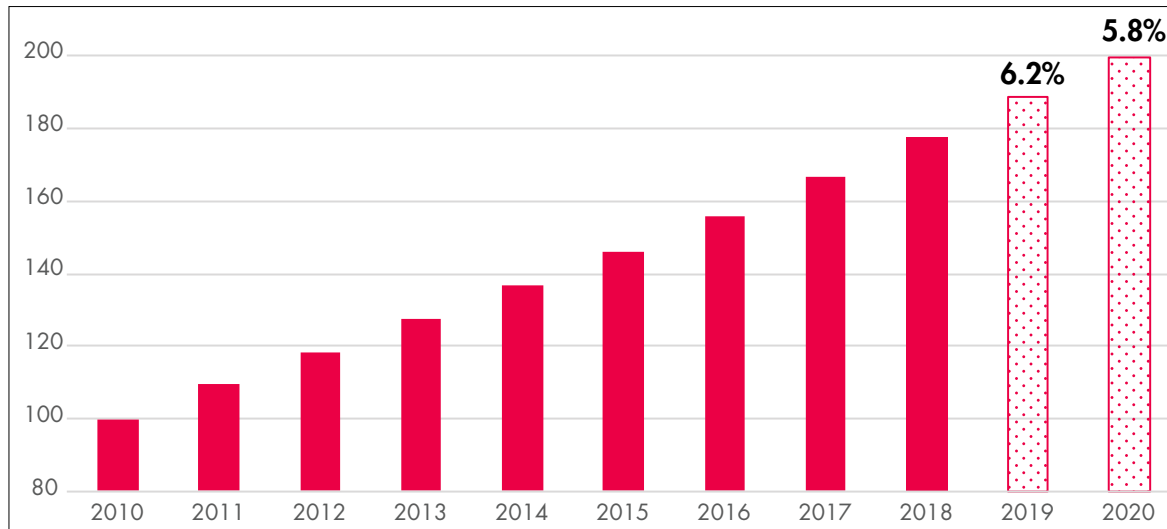
In its 2019 Article IV report, the International Monetary Fund (IMF) warns that if the United States raises tariffs to 25 percent on remaining Chinese imports, China's GDP growth could fall by around 0.8 percentage points (IMF 2019).

China has both the fiscal and monetary space to manage a shock of this magnitude. It has contingency plans in place for additional spending on housing, farming, rural connectivity and regional development. In addition, the one-year government bond rate is far from zero and banks still hold about 10 percent of their deposits as reserves with the PBoC

Nevertheless, execution of these countermeasures implies further expanding either public or private sector balance sheets and some roll back of the progress of achieving financial stability.

2 A more liberal capital account regime could result in China having to intermediate a potentially huge amount of capital inflows. A back-of-the-envelope calculation suggests that if the ratio of China's international liabilities to GDP were to converge to that of the Group of Twenty (G20) average, excluding China, over a 20-year period, capital inflows would rise by close to US\$500 billion per year. This would represent a doubling of inflows from their current level. For details see Mark Kruger and Gurnain Pasricha (2016).

Figure 2: Chinese Real GDP Growth Target



Data source: National Bureau of Statistics of China.

Promoting Financial Stability

The key risk to China's financial stability is illustrated in Figure 3. It shows China's total debt-to-GDP ratio, which includes the liabilities of households, governments and firms. The total debt-to-GDP ratio essentially doubled since the global financial crisis. At three times GDP, this debt-to-GDP ratio is not particularly high for a major economy. China ranks somewhere in the middle of the G20 countries in this regard. However, China is relatively highly indebted, given that it is an emerging market economy. Indeed, all of the G20 countries that are more indebted than China are advanced countries. However, as noted above, China benefits from some advantages that most other emerging market countries do not have: its economy is growing relatively rapidly; it is an international creditor; and almost all of its borrowings are in renminbi.

The financial stability concern is more with how fast debt has been accumulated and the quality of these credits, rather than the level of the debt itself. Moreover, much of the new debt was contracted through the shadow banking system in which counterparty risk was opaque and liquidity risk was elevated.

President Xi Jinping has taken the promotion of financial stability seriously. He has reiterated that preventing financial risks is one of China's "three major battles" (*san da gongjianzhan*), along with environmental remediation and poverty

reduction.³ China is targeting a steady and gradual reduction in the debt-to-GDP ratio and has taken measures to rein in the shadow banking system. As Figure 3 shows, progress has been made in stabilizing the debt-to-GDP ratio in the last year and a half. But, with GDP growth slowing and pressures building for a policy response to the trade tensions, it remains to be seen if the progress in promoting financial stability can be maintained.

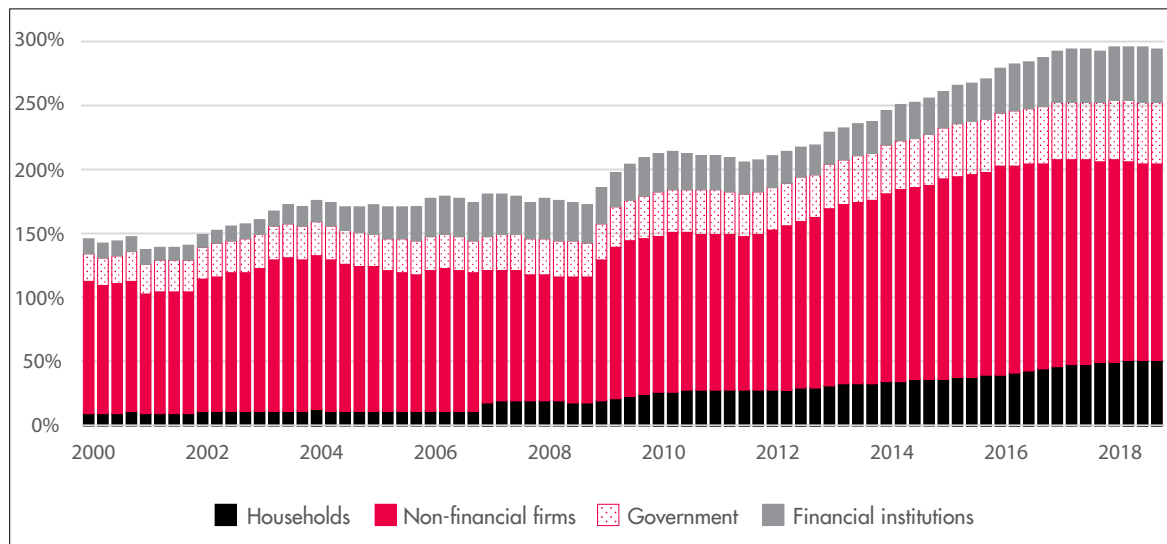
Managing Protectionist Pressures

The United States has a set of wide-ranging concerns vis-à-vis Chinese economic policy. The bilateral trade deficit, perhaps because it is easily measured, has prominence of place. This paper will not discuss the reasonableness of focusing on a *bilateral*, rather than the *overall*, trade deficit. Nor will it analyze countries' overall trade positions with respect to their savings-investment imbalances and the myriad factors that determine a country's savings and investment. This section will focus on statements made by US Trade Representative (USTR) Robert Lighthizer in his 2017 *Report to Congress On China's WTO Compliance*.

Lighthizer says, "Since China joined the WTO, the U.S.-China trade imbalance has grown

3 Xi originally referenced the three major battles in his Report to the 19th National Congress of the Communist Party of China on October 18, 2017. A *South China Morning Post* article in December 2017 referred to the "top three economic battles" (Wu 2017).

Figure 3: China's Debt-to-GDP Ratio



Data source: Institute of International Finance.

exponentially.... A trade relationship that is neither natural nor sustainable” (USTR 2018, 4).

The US-China bilateral balance in goods and services is depicted in Figure 4. It shows that the United States’ deficit has, indeed, ballooned from US\$81 billion in 2001, when China joined the WTO, to just over US\$380 billion in 2018. However, the world has not stood still over this period. Importantly, the US economy has continued to grow. As Figure 4 shows, when expressed as a percentage of US GDP, the bilateral goods and services deficit has remained remarkably stable at just under two percent over the last 10 years. A modest and stable trade deficit, as a share of the US economy, does not appear to be unnatural or unsustainable. It is also worth mentioning that this deficit, expressed as a percentage of China’s GDP, has shrunk dramatically — from close to nine percent in 2005 to just under three percent in 2018.

There is a strong sense among US policy makers that the bilateral deficit is, in part, the result of an undervalued currency. Indeed, in August 2019, the US Treasury designated China as a currency manipulator that was trying to “gain an unfair competitive advantage in international trade” (US Treasury 2019). This was the first time since 1994 that the US Treasury has called China out for manipulating its currency. However, the United States’ assessment is not widely shared. For example, the IMF Article IV report cited above says there is little evidence of foreign currency

intervention by the PBoC. Moreover, despite a modest, 2.5 percent depreciation against the US dollar between mid-2018 and mid-2019, the renminbi was broadly stable on a multilateral basis. The Fund’s Mission Chief for China, James Daniel, speaking on a conference call just after the release of the report, was quoted as saying that the Chinese exchange rate was “broadly in line with fundamentals,” not significantly overvalued or undervalued (Kearns and Tian Tong Lee 2019).

Of course, the United States’ concerns go far beyond the bilateral trade deficit and centre, more broadly, on Chinese industrial policy. In the following paragraphs, the statements made in the USTR’s report will be contrasted with the results of the 2019 survey undertaken by the American Chamber of Commerce in China (AmCham). The AmCham is a non-profit, non-governmental organization, whose membership includes the major US businesses operating in China, such as Apple, Cisco and J.P.Morgan. The 2019 *China Business Climate Survey Report*, which was undertaken in late 2018, was based on 317 responses.

Lighthizer states: “The Chinese government has continued to pursue and expand industrial policies that promote, guide and support domestic industries while simultaneously and actively seeking to impede, disadvantage and harm their foreign counterparts” (USTR 2018, 4).

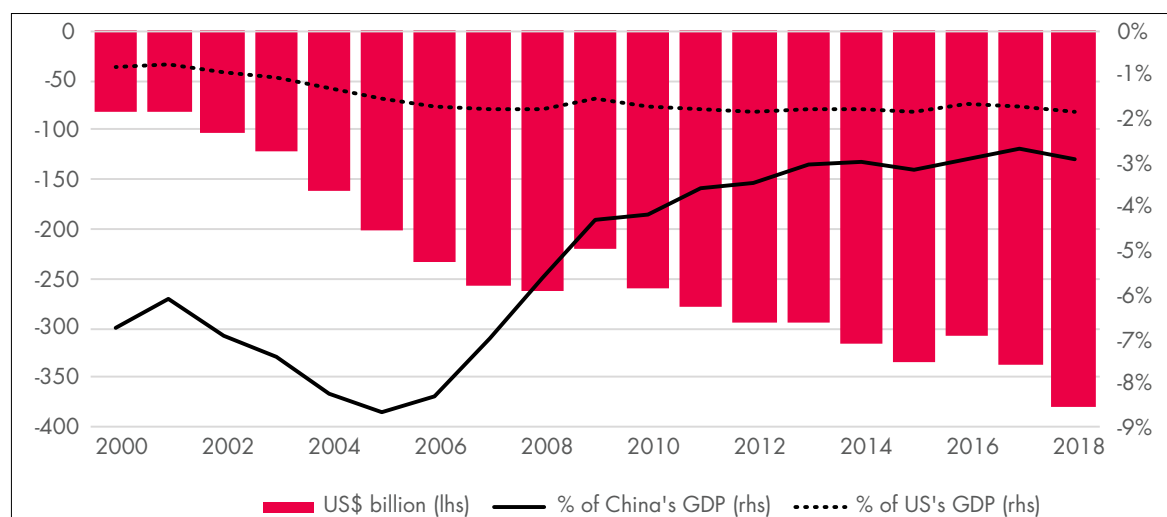
To what extent are Chinese policies actually impeding, disadvantaging and harming foreign companies?

AmCham asks its members how foreign companies are treated relative to local companies. Their responses for 2016–2018 are shown in Figure 5. In 2018, 44 percent said that foreign companies are treated unfairly. This is clearly not a good state of affairs — neither for foreign companies nor for the long-run competitiveness of the Chinese

economy. However, the share of companies that feel unfavourably treated has been falling over time and is down 11 percentage points from 2016. In 2018, about half of the respondents said that they were treated the same as domestic firms. Surprisingly, eight percent say that they were being treated *even better* than domestic firms. These results indicate that while the situation is not great, it is getting better.

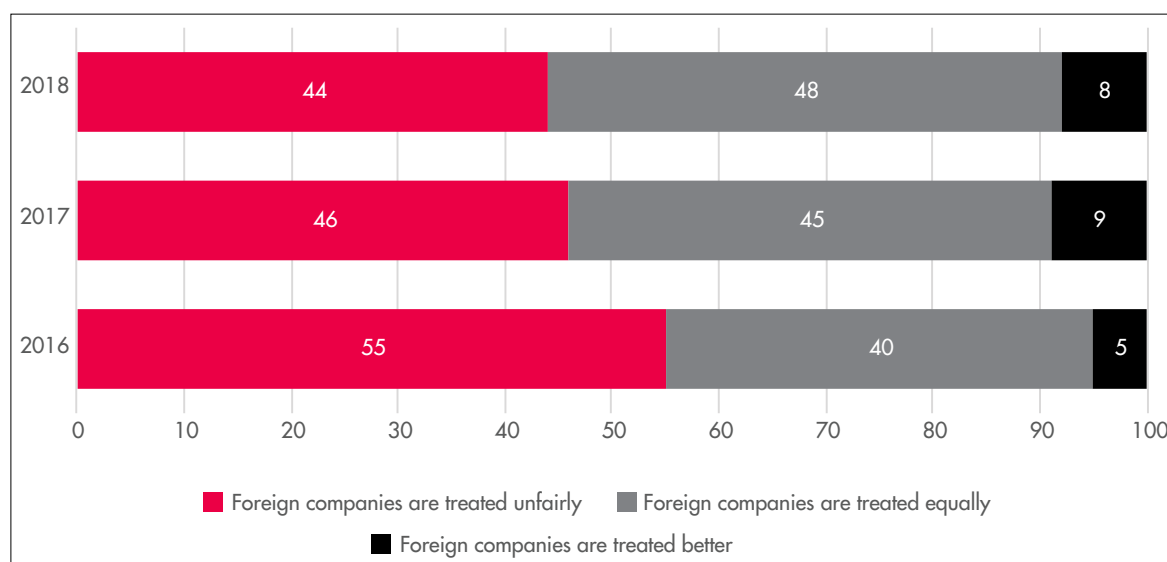
One of the United States' key concerns is forced technology transfer. According to

Figure 4: China-US Bilateral Goods and Services Balance



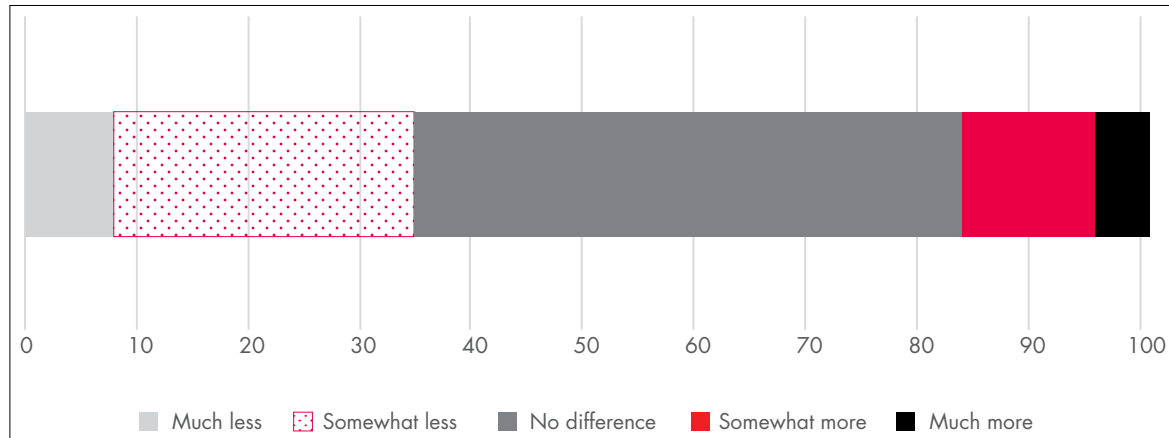
Data source: IMF International Financial Statistics, IMF World Economic Outlook.

Figure 5: How Are Foreign Companies Treated Relative to Local Companies?



Data source: AmCham China (2019).

Figure 6: How Much IP Do You Share with Your Chinese Partner, Compared with Those in Other Countries?



Data source: Ibid.

Lighthizer, “The Chinese regulatory authorities... require or pressure foreign companies to transfer technology as a condition for securing investment or other approvals” (ibid.).

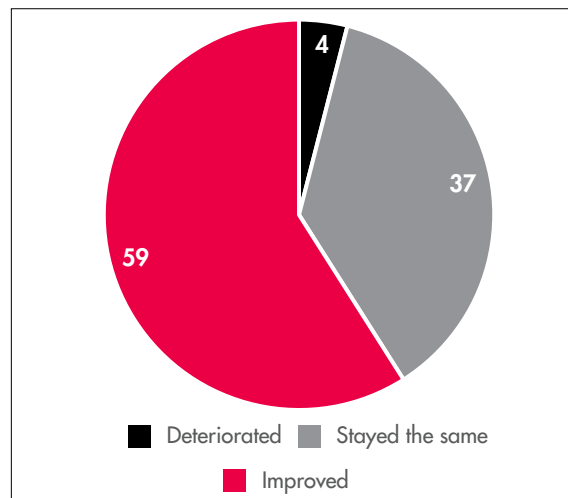
AmCham asks its members how much intellectual property (IP) they share with their Chinese partners, compared with partners in other countries. Figure 6 shows that 17 percent of the respondents say that they share “somewhat more” or “much more” with their Chinese partners, while 35 percent say they share “somewhat less” or “much less.” Almost half say that there is no difference. Taken together, these responses indicate that either forced technology transfer does not appear to be a big problem *in aggregate* or that the American firms are able to manage the pressures to transfer IP.⁴

Another key US concern is the protection of IP. Lighthizer notes, “China continues to pursue myriad policies that require or favor the ownership or development of IP in China.”

AmCham asks its members how the enforcement of their IP rights (IPRs) has evolved over the last five years. Figure 7 shows that 59 percent of the respondents say enforcement has improved. Only four percent say it has deteriorated and 37 percent say it has remained the same. Here, too, the picture is improving, even if the starting point does leave something to be desired.

⁴ Work by Dan Prud’Homme and Zhang Taolue (2019) outlines recent significant changes in China’s IP system, including policies aimed at ameliorating the concerns of foreign firms.

Figure 7: In the Last Five Years, China’s Enforcement of IPR Has:

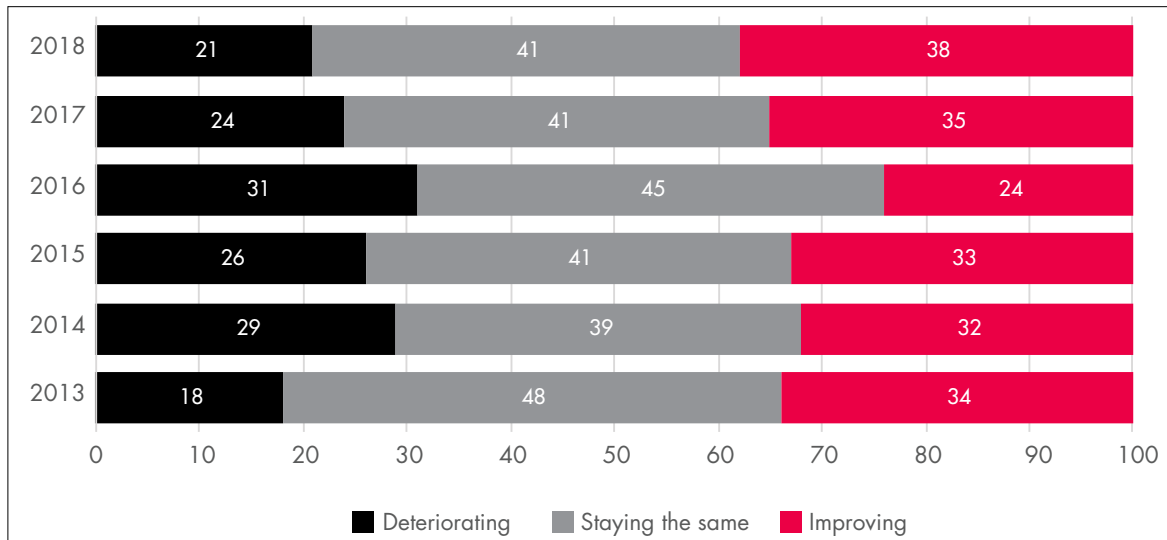


Data source: Ibid.

In contrast, Lighthizer believes things are getting worse: “Over the past five years...the state’s role in the economy has increased, *as have the seriousness and breadth of concerns* facing U.S. and other foreign companies” (ibid.; emphasis added).

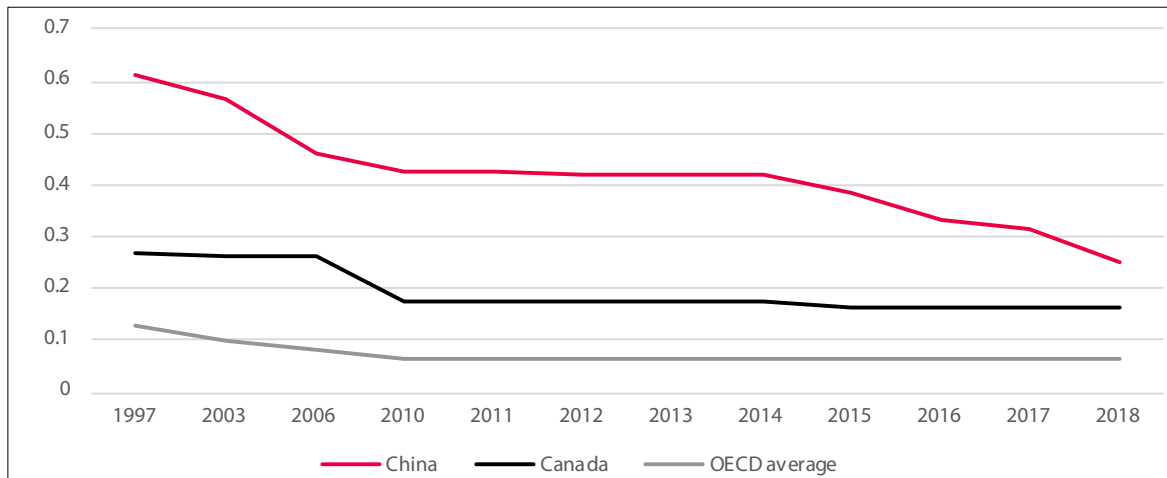
For a number of years now, AmCham has asked its members about the quality of the investment environment in China. The results for the last six years are shown in Figure 8. While just over one-fifth of the respondents say that the investment environment is deteriorating, almost two-fifths say that it is improving. Moreover, this ratio of

Figure 8: How Is the Quality of China's Investment Environment?



Data source: Ibid.

Figure 9: FDI Restrictiveness



Data source: OECD (2019).

responses has remained fairly stable over time, providing a contrasting view to that of Lighthizer.

The Organisation for Economic Co-operation and Development (OECD) provides an interesting perspective on this question as well. It constructs a foreign direct investment (FDI) index for its members as well as for other major economies. The OECD index is composed of foreign equity limitations, discriminatory screening or investment approval mechanisms, restrictions on the employment of foreigners and other operational restrictions. The time series of this index is shown

in Figure 9. China's FDI regime is restrictive — in fact, it ranks sixty-third out of the 68 countries surveyed (Canada ranks fifty-fifth). Nevertheless, China has made tremendous progress in reducing the restrictiveness of its investment regime in absolute terms over time. In particular, since 2014 the restrictiveness of China's FDI regime has fallen by as much as the distance between Canada (the black line) and the OECD average (the grey line). Thus, the OECD data reinforces the trend suggested by the AmCham survey responses: the business environment for foreign firms is slowly improving.

The Challenges to the Governance of the Global Trading System

Given the trends discussed above, it is disturbing that Lighthizer says, “Furthermore, it is now clear that the WTO rules are not sufficient to constrain China’s market-distorting behavior” (ibid.).

In fact, it seems that China does take the WTO very seriously. As author and journalist Paul Blustein has pointed out, while the United States has, in several cases, ignored or skirted negative WTO rulings, China dislikes being branded a rule breaker and it has a commendable track record of complying when it does lose a WTO case (Blustein 2017).

Layered on top of the United States’ concerns with China’s industrial policy is its ambivalence toward the WTO, in particular, its Appellate Body. Robert McDougall, a former Canadian delegate to the WTO, notes that these concerns are not new and date long before the Trump administration and even before the emergence of open rivalry between the United States and China (McDougall 2018).

Jennifer A. Hillman, an American who served on the WTO’s Appellate Body, has written that the United States is not actively engaged in trying to fix the problems it perceives and that “Mr. Lighthizer appears to prefer blowing up the entire system” (Hillman 2018). She notes that when the WTO’s General Council met in December 2018, the European Union and 11 countries — including China, Canada, Mexico and South Korea — proposed changes to the body’s dispute settlement system to respond to the United States’ complaints. They hoped their suggestions would convince the United States to allow vacancies on the appellate panel to be filled. Instead, the United States rejected all the changes while refusing to put forward proposals of its own, and it has blocked the reappointments of appellate judges.⁵

The Appellate Body will be able to continue work on existing cases for a year or two because members whose terms have expired are

allowed to continue to work on cases they have started. But since December 2019 the Appellate Body has been unable to take on new cases, effectively gutting the appellate system.

What Can China Do?

As noted above, China’s economic agenda is a full one. The following are suggested priority policy recommendations designed to improve the chances that China will make its policy trifecta and improve the governance of the global trading system.

The growth target is largely a matter of pride. From a macro-economic standpoint, the difference between doubling the level of GDP and having it only increase by 98 percent is small. However, failing to meet the target could reflect poorly on the government’s economic stewardship and would have a political cost. It is reasonable to expect the Chinese leadership will pull out all the stops to achieve this long-standing objective. Given the weak global outlook and declining investor confidence in China, this might entail additional stimulus. Looking across the sectors depicted in Figure 3, the central government’s balance sheet is the strongest. Thus, it seems reasonable that China should respond to a potential shortfall in the growth target with central government, on-the-budget fiscal support, as this would minimize the impact on domestic financial stability.

Managing the protectionist pressures is challenging because the objective is much more complex than meeting the growth targets. As noted above, the United States appears to have two complaints with China: the size of the bilateral trade deficit and the need to level the playing field for foreign firms operating on the mainland.

Most economists agree that policy makers should not focus on bilateral trade deficits as they are the outcome of myriad economic factors including comparative advantage, relative savings, and investment rates and currency valuations. Still, China has to demonstrate that it is trading fairly and has not erected unreasonable trade barriers. For example, it needs to show that its sanitary and phytosanitary measures truly reflect public health and safety concerns. China also needs to demonstrate

5 Jennifer A. Hillman is a professor at Georgetown Law Center, a former member of the WTO’s Appellate Body and a former ambassador and general counsel in the Office of the USTR.

that it is not benefitting from an undervalued currency. The view of the IMF is key here.

In terms of levelling the playing field, there is no question that the business environment for foreign enterprises in China is difficult. According to the firms surveyed by AmCham, the top challenge faced by American firms is “inconsistent regulatory interpretation and unclear laws and enforcement” (AmCham China 2019, 8). To manage the trade pressures, China needs to redouble its efforts to make its trade and investment regime transparent and open.

It is encouraging that China has recently taken positive steps in this regard. Its creation of a negative list for investment does help promote transparency. Moreover, its revisions to this list in July 2019 will allow for more access in agriculture, mining and infrastructure. The new foreign investment law comes into effect in January 2020. It will provide for equal treatment of foreign and domestic firms and explicitly prohibit forced technology transfer. During the summer of 2019, China liberalized access to its financial sector by allowing foreign firms to take controlling stakes in Chinese banks, life insurance companies and asset management companies. These ownership limits are to be eliminated in 2020.

The prospect for sustaining a rules-based regime for international trade is daunting. Still, as the world’s largest trader, China has the most to lose from a breakdown of the WTO and it behooves China to take a leadership role and help fill the gap in global governance. China regards its initiatives such as the Belt and Road and “building a community with a shared future” as contributions to global economic governance. However, to take a leadership role in reforming the WTO, China needs to do more to convince the United States, and others, that its industrial policy does not distort international trade.

For example, China is fully within its rights to have a large state-owned sector. Indeed, it has been able to usefully harness state-owned capital in a classic, Keynesian, counter-cyclical fashion to stabilize economic activity. Moreover, China has tried to clamp down on the privileges of state-owned firms in various ways, including through revising the competition law and promoting the concept of competitive neutrality. However, it needs to demonstrate that state-owned enterprises do not provide components

to exporters at preferential prices, which could give rise to unfair commercial advantages.

Richard Haas, the president of the US Council on Foreign Relations, calls the United States’ foreign policy “The Great Abdication” as it is no longer supporting the global institutions that set the rules for how international relations are being conducted (Haass 2017). As the United States steps back, the world needs China to step up.

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