

COUNCIL *on* FOREIGN RELATIONS

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INSIGHTS FROM A CFR WORKSHOP

Economic and Geopolitical Fallout From China's Slowing Growth

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*In November 2015 the Council on Foreign Relations' Maurice R. Greenberg Center for Geoeconomic Studies and Asia Studies program held a workshop on the potential economic and geopolitical fallout of China's slowing growth. The workshop, hosted by CFR Senior Fellows Michael A. Levi and Elizabeth Economy, was made possible by the support of the Carnegie Corporation of New York. The views described here are those of workshop participants only and are not CFR or Carnegie Corporation positions. **The Council on Foreign Relations takes no institutional positions on policy issues and has no affiliation with the U.S. government.***

INTRODUCTION

In 2010, when China’s economy was expanding at an annual rate of more than 10 percent, the world pondered the ripple effects of what many observers thought would be another decade of spectacular Chinese growth. Five years later, reality has caught up with the Chinese miracle, and the world is recasting its question: What will China’s economic slowdown mean for the globe, especially if growth continues to decelerate?

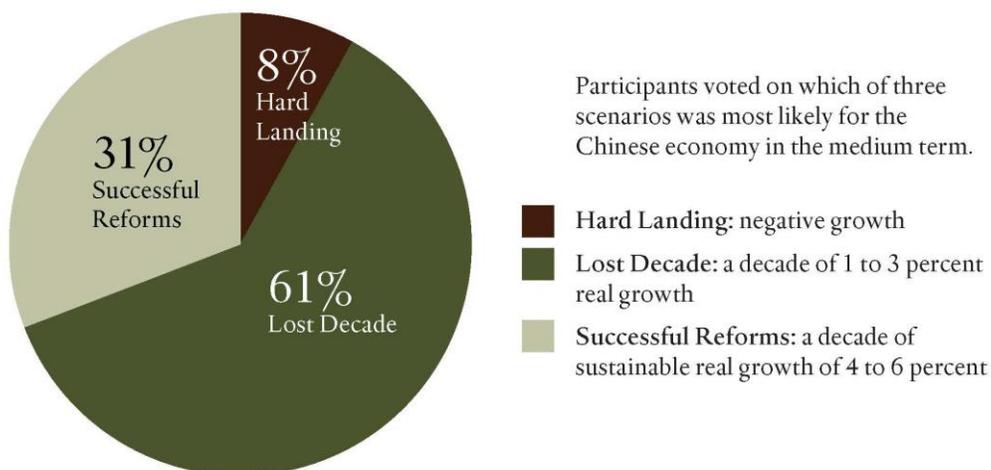
To explore possible answers, the Maurice R. Greenberg Center for Geoeconomic Studies and the Asia program at the Council on Foreign Relations convened a workshop in New York City with roughly forty participants with backgrounds in economics, finance, government, political science, and military affairs. The group debated the prospects of a prolonged economic slowdown in China and attempted to forecast the fallout—for the global economy, geopolitics, and China’s ambitions and clout—if the Communist Party’s goal of “medium-to-high growth” through 2020 turns out to be unachievable. This report summarizes the discussion’s highlights.

WHERE THE CHINESE ECONOMY IS HEADING

Workshop participants generally viewed “medium-to-high growth”—which Beijing defines as 6.5 percent per year—as a tall order. Achieving it will require more government stimulus of the sort that has already spawned rampant industrial overcapacity and saddled the economy with untold levels of nonperforming loans and other debt. Though China has the resources and, many analysts believe, the will to deploy a new wave of stimulus, Beijing will get less return on its money than in years past and court higher risk of a crisis of confidence in the country’s financial system.

There was broad consensus among workshop participants that one of three scenarios will play out. The most common forecast was that China will avoid a hard landing but fall short of implementing necessary reforms, sentencing it to something similar to Japan’s “lost decade” of the 1990s, with

Experts’ Forecast for the Chinese Economy



Source: Survey of workshop participants.

SIGNALS OF CHANGE

What indicators should the world watch?
Workshop participants debated the yardsticks.

GDP. Higher gross domestic product (GDP) is usually better. But several participants argued that high GDP figures over the next several quarters would be a *negative* sign because it would imply Beijing is resorting to stimulus measures that will further distort supply and demand and aggravate a credit bubble.

Wage and income growth. Other participants said to watch wage and income growth rather than GDP. A substantial downturn in these would hurt efforts to rebalance the economy away from manufacturing to services.

Fiscal deficits. Skyrocketing central government spending would be a harbinger of crisis, one participant argued. Another disagreed, saying deficits could be a sign China is shifting from overreliance on bank debt to safer sovereign debt.

Bankruptcies. Some participants maintained a spike in bankruptcies and consolidation in overbuilt industries, such as steelmaking, would be a positive sign for reform.

average real growth rates around 1 to 3 percent. A less common, but still frequent, forecast predicted that China will successfully implement and enforce a full complement of financial, fiscal, and state-owned-enterprise reforms. Although these reforms would trigger bankruptcies and the loss of millions of jobs at first, they would put China on track to sustain 4 to 6 percent growth well into the 2020s. The least common projection was the oft-discussed “hard landing”—a crisis so acute it will cause the economy to contract.

CHINA SNEEZES, THE WORLD BRACES FOR A COLD

The hybrid nature of the Chinese economy—heavily integrated with the world through free trade, but isolated in other ways by its restrictive financial system—means global reverberations will be felt unevenly as Chinese growth shifts into lower gear.

The Commodities Hangover

Two significant effects of China’s slowdown have already been widely felt: steep declines in the prices of metals, energy, and other commodities that China devoured to feed its now flagging construction boom, and softening Chinese demand for imported machinery and construction equipment from developed economies.

Prices for metals, including iron ore, copper, and nickel, as well as coal and steel, have fallen sharply. Though prices for some commodities may be bottoming out, it will probably take years for them to recover as China works to reduce excess production capacity and rekindle demand, and as other countries struggle to fill the gap. The slowdown has also contributed to lower oil prices and to cheaper prices for some agricultural goods, such as soybeans. Workshop participants saw no scenario in which China’s demand for industrial commodities could stage a major comeback. China’s demand for machinery will also remain soft, hurting imports of finished goods from Europe and the United States.

Follow the Money

The fate of the yuan’s exchange rate with the dollar and other currencies is harder to predict, but the consequences are greater for those countries whose exports compete with China’s. China’s economic slowdown has increased downward pressure on the yuan. Chinese are pulling more capital out of the country because of fewer appealing investment opportunities at home and

because of persistent political uncertainty (a national anticorruption campaign, for example, has been running for three years and has netted many wealthy party members along with their relatives and business allies). The pressure on the yuan is fueling some speculation that China's central bank will balk at spending hundreds of billions of dollars, as it has done recently, to prop up the yuan's value on currency markets and opt instead to let its value fall against the dollar—but this was far from a universally shared view among workshop participants.

Several participants warned of potential knock-on effects of the yuan becoming cheaper. Given the implications of a competitive shift for exporters such as Germany, Hong Kong, India, Indonesia, Italy, Japan, Malaysia, Mexico, the Philippines, Singapore, Spain, and South Korea, further decline in the yuan's value could trigger devaluations elsewhere. Several participants warned that investors and governments did not have a strong grasp on how competing currency devaluations might unfold and what their consequences for the global economy might be.

CHINA'S GEOPOLITICAL AMBITIONS AMID SLOWER GROWTH

There are no true economic winners from a dramatic Chinese slowdown, noted one participant, but there is one political winner: the United States. Chronically lower growth might rob China's development model of some of its mystique. In this respect, at least, the United States would enjoy a boost in relative prestige in Asia, as long as the United States exhibited wise leadership, built a healthy economy of its own, and avoided getting bogged down by conflicts around the world.

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SURPRISE WINNERS

China's slowdown is not bad news for everyone. Workshop participants identified potential winners.

Net importers of commodities—particularly countries with weak current account positions such as **Turkey**—are benefitting from cheaper prices.

English-speaking “gateway” metropolises, including **London, Los Angeles, New York, and Sydney** have seen an influx of capital from Chinese seeking to preserve their wealth by buying property.

For the **United States** as a whole, the impact is mixed: consumption is benefitting from cheaper fuel, but investment in oil production is suffering, especially in Texas and North Dakota.

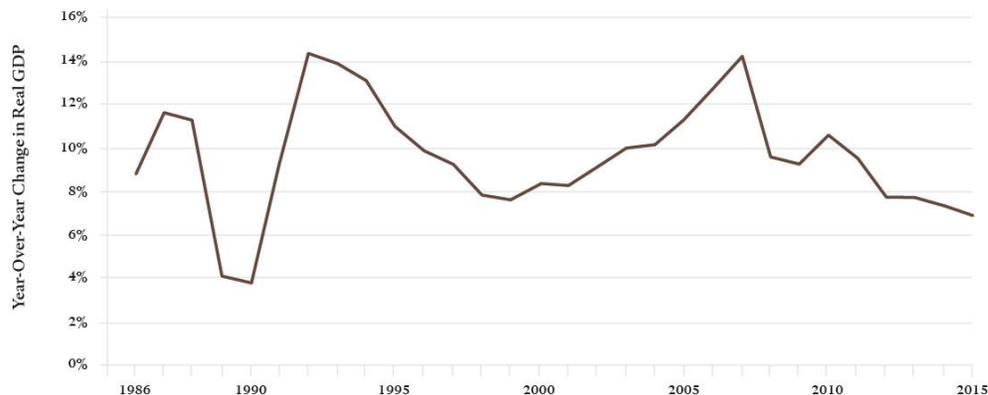
India and Vietnam might profit from lower input costs and less competition for manufactured goods exports, but many participants were skeptical that either country would seize the opportunity.

Participants wondered if, as its growth slows, China might become more bellicose. The workshop fleshed out some geopolitical scenarios that, at first glance, may seem counterintuitive, but that make sense when considered in the context of the Communist Party's paramount goal of retaining power.

Lower Chinese Military Spending? Don't Bet on It...

Analysts and policymakers should probably ditch the assumption that as China's economic growth diminishes, so will its military spending and territorial ambitions. That is highly unlikely, several

China's GDP Growth From 1986 to 2015 as Reported by the Chinese Government



Source: National Bureau of Statistics of China.

participants argued. Even with a slowdown, China has the resources and motivation to continue growing its military budget much faster than its neighbors and the United States. The Communist Party's legitimacy rests in part on its promise to bring about "the great rejuvenation of the Chinese nation"—a concept that includes asserting sovereignty over contested islands, airspace, and expanses of ocean in the South and East China Seas. President Xi Jinping has amply demonstrated his intention to pursue this goal, in part by accelerating the transformation of the People's Liberation Army into a world-class fighting force with operations well beyond Asia.

...But Beijing Is Unlikely to Wage War if the Economy Crashes

By the same token, analysts should probably discard the notion that a crash of the domestic economy would provoke a Chinese military adventure abroad in order to distract Chinese people from upheaval at home. This "wag the dog" scenario may gain currency with screenplay writers and conspiracy buffs, but it is not borne out by history. Although it is true that strife-torn countries often get embroiled in external wars, it is rarely because their leaders set out to generate a diversionary activity for their restive populace.

Indeed, most workshop participants argued that if China were beset by an acute internal crisis, the Communist Party would almost certainly refocus its energy and resources inward. The leadership and its security apparatus, including components of the military, would have their hands full protecting against social instability, tamping down the activities of Uighur and Tibetan separatists, and maintaining the cohesiveness of the party itself. To launch a foreign war in an atmosphere of domestic public grievance would be particularly dangerous for Beijing. If China sustained a defeat at the hands of the Japanese or U.S. navy, the leadership would compound its reputation for economic mismanagement with one for military ineptitude—a potentially lethal cocktail for the ruling party.

Balancing Nationalism With Neighborliness

A soft economy should increase the importance to Beijing of maintaining a peaceful regional environment so that China can grow its trade and investment with its neighbors. The paradox for Chinese rulers is that, having deliberately steeped their population in nationalistic propaganda and training for so long, they now face rising public expectations to make good on sovereignty claims in the

East and South China Seas. This situation has left Beijing with limited room to accommodate its Asian neighbors and the United States. Indeed, China's campaign to assert sovereignty over regional skies and seas has already damaged its diplomatic relations with neighbors. In discussing how China's leaders could balance their desire for regional stability with their nationalistic aims in the East and South China Seas, one participant raised the possibility that Beijing might try to split the difference by directing its ire against one neighbor in particular—probably the Philippines, or perhaps Vietnam—while seeking to reduce tensions with other neighbor

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ALL ROADS LEAD TO BEIJING

Chinese foreign policy is not just military. Indeed, concluded participants, the economic slowdown may arguably motivate Xi to accelerate, rather than soft-pedal, efforts to expand China's economic and political influence.

China Will Buy Clout Despite a Softer Economy

It is no secret that Beijing, while continuing to benefit greatly from multilateral organizations and norms that were spearheaded by Washington in the decades following World War II, aspires to reshape some of those same institutions and, in some cases, build and lead parallel ones. Workshop participants largely agreed that slower Chinese economic growth will not halt these ambitions; in some cases, it is accelerating them. For example, China's One Belt, One Road directive commits more than a trillion dollars over many years to infrastructure projects that, if the plan works, will form a cohesive economic "belt" across the Eurasian continent and a maritime "silk road" through southern Asia to the Middle East. This plan is now receiving greater emphasis from Chinese leaders, not less. Even a so-called hard landing seems unlikely to divert China from its current course of long-term expansion of its international economic commitments, as one participant noted, particularly as China seeks an outlet for its excess industrial capacity.

Several participants in the workshop forecast that China's ambitions may ultimately be limited by a scarcity of overseas projects into which hundreds of billions of dollars could be sensibly invested. Some local populations and governments will also resist ceding too much economic influence to Beijing, as evidenced by Myanmar's surprising decision to wriggle out of China's tight embrace a few years ago by halting several high-profile China-funded infrastructure projects.

China's geopolitical strategy and goals, however, will remain active and operational in an era of slower Chinese growth. China will be the world's second-largest economy even with slower growth, and it will continue to influence the globe's fortunes significantly—for good and ill—under any economic scenario that might unfold.