China Watch

A China Business Report prepared by David Mahon
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When opposing warriors join in battle, he who has pity conquers.

Lao Zi, 5th century BCE

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Uncontainable

If Trump's tariffs on Chinese goods reach 60% in 2025, China's annual GDP growth may fall by between 0.5% and 1% to reach 4%, as Chinese exporters lose US markets and are forced to reduce domestic investment and employment, and to complete manufacturing outside the country. China will likely not experience the true impact of tariffs until 2026, assuming it takes 12 months for Congress to approve them and longer to apply. But if Trump imposes tariffs on China through executive orders, impacts could be felt sooner.

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As with Washington's past attempts to contain China, some effects will be temporary and many of the tactics ineffectual. China has suffered most from US tariffs and sanctions in its technology sector, but even this has become stronger due to the need to be more self-sufficient, now surpassing global competitors in most categories. China makes over half the world's robots; five out of ten apps downloaded on US phones are now Chinese; and even after sanctions, Chinese electric vehicles are cheaper than US EVs.

> *'Can someone ask Biden to kindly sanction the Chinese men's football team?'*
>
> Joke circulating on social media

Americans will feel the inflationary effects of tariffs on basic household items such as toys, sporting equipment and appliances, but also on computers, biotech and pharmaceutical products, and electric vehicles. Trump's voodoo economics will cost American households between USD 3000 to 4000 a year at a time when consumer credit card defaults have exceeded those of the Great Recession. Trump and Biden both failed to reduce the US deficit through their tariff policies over the last eight years, and the most protected sectors — such as hypersonic technology, batteries, and advanced radio-frequency communications (5G and 6G) — became less efficient and less innovative.

China's Consumer Price Index will probably be flat over the next 12 months and the renminbi may fall against the US dollar to RMB 7.5 or RMB 7.6 by the end of 2025. The renminbi is unlikely to fall further, for sources in the Chinese Government are adamant they intend to resist depreciating the currency to offset increased export prices in America. China depends heavily on imports of a wide range of raw materials and components which most of its trading partners trade in US dollars.

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Extensive tit-for-tat tariff retaliation is also unlikely, for the Chinese Ministry of Finance and the People's Bank of China understand that counter-tariffs can be acts of economic self-harm. China can, however, respond with crippling effect if it chooses to accept the cost of tactical tariffs. China controls supply chains representing 60% of worldwide production of critical minerals and 85% of their processing capacity. Were it to deny the US market supplies of lithium, cobalt, gallium, germanium and other rare earth elements, it would cause a crisis in the American technology and defence sectors. Even after eight years of determined effort, the US has failed to diversify supply of these vital minerals.

Exports no panacea

Exports supported the Chinese economy during the low-growth years of the pandemic and helped to balance out the weak demand of the last 24 months, but they are not the single key to China's future growth and stability. Despite the fact China's exports grew almost 7% in 2024, the strength of the Chinese economy is its large, varied internal market which has been Beijing's primary focus when formulating stimulus policies.

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The external economic pressure that China is now enduring is forcing the government to pay greater attention to boosting domestic demand sustainably without the luxury of delaying reforms in a more robust trade environment. If Washington increases tariffs on Chinese goods in 2025 and cracks down harder on Chinese technology firms, there will be even more pressure on the Chinese Government to undertake deep structural changes, such as fiscal and urban residency reform, and formulating greater support for the private sector. The government is already working to make these changes, but middle-class householders and foreign investors will not be infinitely patient.

Taxes and corruption

Beijing must now back its pro-private sector policy announcements of the last two years with action, and one tool at its disposal is tax reform. The accumulated taxes and levees on Chinese companies are higher than those faced by most of their Western competitors. In lower-tier cities and rural counties, from which so much future growth and urban migration must come, companies still face endemic rent seeking and corruption.

> *'When we were building our business and the county was poorer, we got strong support from the local government. Back then officials had to show they were meeting growth targets set for them by the province. Now things have improved, and some of the better officials have rotated out to more developed counties. The new people often come to us for cash, eat in local restaurants without paying, and generally extract what they can from us. Businesses in Kunming don't have to put up with this extent of corruption, and in more developed cities like Beijing and Shanghai it is even rarer.'*
>
> Yunnan entrepreneur

For all the substantial gains Beijing has made fighting corruption and alleviating poverty in China's lower-tier cities and rural regions, it has more work to do. In both developed and developing China the solutions to economic ills are the same. The government would release underlying economic potential if it lowered company taxes throughout the country and fought harder against bureaucratic rent seeking. Allowing hawkers, small stallholders and pavement restaurants to return to the streets and alleys of the more developed cities (many banished over the last 10 years in a drive for urban social sanitisation) would also help lift economic growth and consumer confidence, while alleviating migrant poverty and youth unemployment.

Pace and substance

The economies of China's coastal provinces continue to improve, although consumer confidence is still recovering more slowly than the government had hoped. Beijing launched a raft of stimulus polices over the last three months, most targeting local government debt restructuring and bond issuance, injecting capital into the major banks and expanding infrastructure projects. Beijing needs to act swiftly to implement policies which will improve consumer confidence, for the pace of policy implementation is as crucial in winning public trust as their substance.

Since 1949 Chinese people have been largely willing to 'eat bitterness today' in the hope of a sweeter future tomorrow. China's middle class, which now exceeds 500 million people according to recent state data, wants to see results in their own working lives and feel confidence that their children's futures are secure. Optimistic economic stories in the state media will not substitute for job security, wage growth and reductions in income disparity.

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Welfare phobia

It is possible that China's senior leadership sees some motivational benefit in the present discomfort and anxiety of the middle class. For Beijing views Western decline as the part-product of a lack of need to struggle and may fear the populations of China's coastal cities have become too comfortable and are losing their edge. Many have lost a degree of need, as they are wealthy by any global standards; but the risk of further deflating their confidence while trying to re-ignite a lost motivation is great.

Anything resembling Western style welfare is an anathema to the Chinese Government and therefore they have not taken the logical, non-inflationary steps of increasing subsidies for essential services such as education. The state is supposed to provide education free of charge, but in fact schools require an array of extra fees and levees from households, and an alarming minority of teachers and headmasters are corrupt. The government needs to improve schools outside first-tier cities in particular, the quality of which drops as affluence diminishes.

Having demonstrated how well it can reform industrial policy, Beijing clearly has the ability to craft and apply regulations to stimulate consumption.

The Chinese economy has always been hard to qualify, but more so in a time of radical transition. Commercial analysts struggle to assess newer sectors accurately, tending to understate their growth. Economic forecasters tend to look at the negative social ramifications of factors such as China's aging population more than the investment and employment opportunities they will generate. When considering real estate oversupply, economists focus on present supply and demand imbalances, often failing to consider the magnitude of the potential urbanisation of the hundreds of millions in China's small towns and villages who will absorb housing oversupply as they migrate to increasingly larger urban areas. The other side of this opaqueness is the underreporting of the depth of unemployment in lower-tier cities, and the rise in real estate foreclosures.

The greater of two evils

It is hard to imagine a Trump presidency delivering many benefits to China, but one unintended boon may be the de-escalation of tensions in the Taiwan Strait and the South China Sea.

Trump demonstrated in his last term that the deployment of the US military in foreign wars is his anathema, reinforcing this principle throughout his recent campaign. Trump may spur some economic growth in the US, although probably more in the capital markets than for working people. And his geopolitical indifference may lower pressure in some of the more distressed regions of the world where the US is an increasingly insecure arbiter.

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If the US steps back from Taiwan, it will be because Trump fears the ramifications of escalation, and not because of any desire for peace in the region. Trump has shown time and again that he is enamoured with the theatre of diplomacy and not with its reality, such as his recent threats to invade Panama to control the canal, probably while believing he will never have to. It is also possible that in the unstudied, crass nature of Trump's decision making he will deepen conflicts and unwittingly seed new ones. The net results of his presidency are more likely to be a greater degree of chaos in the world, weaker global institutions, more protectionism and a shrinking global economy.

Although China's leadership is better prepared for Trump's second presidency than it was for his first, it is deeply uncomfortable with his inconsistency and unpredictability. But whoever had won the White House in November would have focused on US primacy above all else over the next four years and not favoured a more balanced approach on China.

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Historians will reflect with incredulity on the Washington-led (the US is 4% of the world's population) attempts to contain the aspirations of 20% of the world's people, largely on the justification that China's leaders dared to follow their own development models rather than those of the West.

> *'There is no point in confronting Trump directly. Some say America wants a war. Maybe so, but we don't, and we should not allow ourselves to be drawn into one. Taiwan is always very sensitive but we can resolve it peacefully later in a less volatile time. We should focus on relationships we know we can improve and improve the world's perception of China. China's tensions with Indonesia are fewer now that we have agreed to exploit the fishing, oil and gas resources together. Vietnam will always dispute the islands we took back in 1979 but at least each side's position is clear and economic co-operation is the priority. We have come to an agreement of sorts with India to establish better protocols so our border troops have fewer chances of clashing. We must invest in soft power in the region now. We can do this through diplomacy better than we have in recent years.'*
>
> Chinese trade official in Beijing

Sloping playing fields

China's challenge is not entirely different than that of most countries in dealing with a disruptive United States in an insecure world. It needs to look to its own economic and social integrity, the robustness of its institutions, and its primary interests so it does not react to an increasingly eccentric president and his poorly qualified cabinet.

Some Chinese observers may perceive the forces against China in the US as irreversible, but this would not be correct. As the US market suffers from Trump's economic follies and isolationism, consensus for a rapprochement with China motivated by economic expediency may build. Trump's electoral victory is irrefutable, but his majority is slim and moderates in his own party will eventually regain traction, just as the Democrats should recover a measure of unity after their defeat. The Chinese Government needs to find new ways of revealing itself to the world if it wishes to demonstrate that China seeks to build economic strength at home rather than hegemony in the region. A good start would be at China's own borders in making a concerted effort to develop better relations with its most complex and fraught relationship after the US: India.

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Chinese leaders seem to seldomly examine their own recent economic history to understand how Western politicians and regional adversaries can mobilise their populations against China so easily. In a world of uneven commercial playing fields, the Chinese Government has sanctioned some particularly steep tilts in its own favour in the past. It is no defence to simply refer to Europe and the US' extensive subsidies and tariff barriers, for after China joined the WTO it only applied its principles selectively. Decades of favouring SOEs and the larger, well-connected private companies over foreign companies left many foreign investors and governments resentful and sceptical of China's claims of fair treatment and equal market opportunities.

Admittedly the situation has changed in the first decades of this century. Now foreign and Chinese private companies arguably struggle together equally against regional favouritism, SOE dominance (especially in some sectors), and common issues of unnecessary government red tape. Chinese courts in more developed cities increasingly treat foreign and Chinese alike. As Chinese regulators improve the commercial environment for domestic companies to strengthen the Chinese economy against outside coercion, foreign companies will also benefit. China relaxed visa requirements for both foreign businesses and tourists late last year in an urgent move to attract foreign engagement. This was not so much for the cash visitors might bring and the increased chances of business investment, but more for creating greater opportunities for transfers of technology and know-how, and simple but vital personal contact with other cultures.

In 2025, China can deliver real economic growth. In the last quarter of 2024 retail sales rose 5%, investment in manufacturing increased by 9% and private sector investment 11%. Vehicle purchases, both retail and wholesale, increased 25% and the government will probably report GDP of 4.8% for 2024.

Under internal pressures and exterior threats, China's economic future must be characterised by more than growth alone. Beijing is launching reasonable policies to restore confidence. It remains to be seen if it will be able to sell them with greater clarity and simplicity to the Chinese people, and apply them more swiftly. Beijing also needs to find new ways to build understanding within the US and Europe that it is not trying to take the West's place in the world but to work alongside it peacefully, competitively and profitably. ☯