

# The U.S.-China Trade Friction and the Chinese Economy<sup>1</sup>

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The Chinese economy is now facing great difficulties in sustaining growth. There are two main causes. First, there is a need for internal adjustment within China's domestic economy. The second is the ongoing trade friction between the United States and China.

First, I will outline the issues behind the necessity for internal adjustment. For the past 20 to 30 years, China has achieved economic growth, but we have recently entered a new phase. Past growth was based on three points. First, the government implemented policies that assisted economic development to maintain high growth rates. Second, China became the world's foremost processing plant with the introduction of foreign capital, most of which was used to promote foreign exports. Third, low cost labor processed a large volume of low-quality products.

Rapid economic growth of these three driving forces, powered by foreign capital, exports and coastal regions leading the way, brought regional disparities to China, which in turn forced the need for significant adjustment in the method of achieving growth. As for the kind of adjustment needed, the first is quality growth, that is to say, a shift towards the encouragement and promotion of innovation. This is because past growth has led to environmental pollution problems and regional disparities. Second, to create a higher-level growth structure, China should transform its foreign capital- and export-dependent growth model.

Since regional disparities in development are disadvantageous for China's economic development, the government has emphasized high-quality development, correction of regional disparities and increased domestic demand for the past two years. In other words, the government stopped the pursuit of high growth rates and came to adjust structures with a high degree of pollution and high energy consumption. As for regional disparities, a series of measures have been taken to promote the development of the Central and Western regions.

China, once a processing giant and the heart of East Asia's production network, relied on external markets, mainly those in the United States. This created a trade imbalance. As a result, after the Trump administration was inaugurated, the U.S. changed to a national protectionist policy, triggering a trade war and an increase in tariffs on China. On top of this, the emergence of new competitors put China under further pressure. Other countries such as Vietnam, Southeast Asia and India offered low labor costs. Compared to these countries, labor costs in China have increased, which resulted in the movement of foreign capital to other countries for production.

These changes in the internal and external environment have led to structural industrial problems in China, especially in labor-intensive export processing industries in coastal regions who face difficulties such as structural unemployment. Although it no longer seeks high growth rates, the Chinese government is expressing concerns about future developments.

So, how can the situation be improved? Looking at the overall situation in 2019, conditions are still good. That is because GDP growth exceeded at least 6%, with a final figure of 6.1%. It is hard to be optimistic about trends such as the slow growth in the fourth quarter, but from an overall perspective, structural adjustments have generated more than \$100 billion of foreign capital and 13 million jobs. Reaching the total economic volume of \$1 trillion in 2000 and a GDP per capita of \$10,000 within 20 years were significant changes.

Although China's actual economic growth rate is under debate, 5.5 to 6% is said to be a reasonable estimate. That is because China needs to maintain a certain growth rate. Its urbanization rate exceeds 60%, and current employment issues must be resolved. Also, moderate economic growth is linked to corporate confidence, influencing its willingness to invest for the future.

As for regional disparities, although Guangdong Province and Jiangsu Province in southern China have a large impact on exports, they maintain overall growth and are making progress in structural adjustments. The Central and Western regions also experienced high growth rates and structural transformation, but conditions have not improved in the Northeast region, where the impact of regional disparities is most noticeable.

So, where does the biggest threat to China lay? First, there is the problem of debt. To maintain growth, the government expanded its investment, eased its monetary policy, and continued to increase its debt. Also, the production volume per unit generated by the amount invested has been decreasing.

Second, there is the issue of employment. Since private companies account for 80% of China's industry, a negative impact on private processing exporters can trigger an employment problem. Although the overall employment situation is good, the low income of private processing exporters is alarming. Some sectors and regions, such as processing centers in small and medium cities in coastal areas, are facing difficult conditions. It will be necessary to adjust structures over the next ten years. However, with no major crisis to this point, there is hope that all will remain stable. This is because the government intervenes strongly, and

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state-owned banks are playing an important role in providing loans.

Next, I will describe the U.S.-China trade friction, an area of keen interest. What is the cause of the trade friction? To begin from the conclusion, U.S.-China trade is in a state of structural imbalance. With export processing centers concentrated in China, there was an export surplus in China and an import deficit in the U.S., which in turn accelerated the U.S. trade imbalance. As a result, the Trump administration adopted protectionism and raised tariffs.

On the other hand, trade friction is not only an issue of economics, but behind it, a problem of politics and policy. The U.S. fears that China's total economic volume is increasing rapidly, thus becoming a superpower and its direct competitor. And when the total volume of economy increases, so does its military power. Using its military capabilities, the "Belt and Road" initiative and more, China is gaining more influence on other countries and regions of the world in multiple ways. In other words, if China is not restricted, the U.S. will consider itself to have lost out. In terms of science and technology, as seen in the example of regulation of Huawei, China's development opportunities are being narrowed.

What will lead to a resolution in the U.S.-China trade friction? It seems impossible to thoroughly resolve this issue in a short period of time. However, it can be appreciated that both the U.S. and China recognize that unilateralism is not the answer, and that any solution to this issue will require negotiation.

On January 15, the first phase of negotiations between the U.S. and China was concluded with an agreement, and a second phase was entered. The issue of trade imbalances was mentioned during the negotiations, and the U.S. urged China to import agricultural products. Also, institutional friction is present. The U.S. recognizes that China will not keep its commitment to modifying systems. On the other hand, by using the negotiations, China is in part independently modifying some aspects of its systems. For example, before the conclusion of the agreement, China declared the opening of its financial and investment markets. China's approach is likely to last for a long time. The continuation of these negotiations can be viewed positively.

On the other hand, the impact of trade friction is significant for Japan and ROK, both active in the supply chain. China's exports to the U.S. are declining, but trade with other countries is on the rise. Imports may have declined, but a 5 to 6% increase in exports has been maintained. That said, Japan's economy has been hit hard, and companies have struggled to find suitable replacements for relocating production in countries other than China. Taiwan's Foxconn has also relocated its production base to India, but with no environmental improvements in the supply chain or other areas, it will take more than a decade to realize ideal conditions.

So, what should China do? First, it must continue negotiations with the U.S., and keep applying pressure on the U.S. to not implement unilateral policy measures in East Asia. The next step is to build a Free Trade Area in East Asia in haste. Rudimentary agreement on the Regional Comprehensive Economic Partnership (RCEP) in East Asia will be reached by 15 countries, and it

is scheduled to be signed in 2020. Since India has not yet met the requirements for participation, it is preferable to construct an open economic zone in 15 countries except India, at first.

What of this open economic zone? It will create a growth structure within East Asia that is not solely reliant on export processing. This agreement will be formed promptly, and at the same time, a free trade zone between China, Japan and ROK will be formed. This negotiation has been ongoing for ten years, so gradual results should be produced. It is hoped that in 2021, a political decision higher in level than that of RCEP will be made, resulting in the completion of a China-Japan-ROK Free Trade Agreement.

In addition, if China joins the Trans-Pacific Partnership (TPP), it can create development opportunities that do not rely on the U.S. and maintain regional growth. In other words, there are a lot of problems, but regional cooperation is important. Also, the aim is not to eliminate the U.S., but to continue to apply pressure on its unilateral policies, otherwise the problem of trade imbalances cannot be resolved.

As is well known, the U.S. trade imbalance is a domestic problem. For U.S. companies to survive, it is advantageous to produce in low-cost markets or markets like China where consumption is rapidly increasing. Thus, the U.S. should coordinate its own policies and spend on internal regional imbalances.

China has the largest total economy in East Asia, and it continues to grow. India follows, and for the first time in history, we are experiencing two large economies in East Asia. The U.S. is currently the leading economy, but East Asia shows true potential. Looking at growth in 2019 under China's structural adjustments, growth in the high-tech sector was 8%, which is faster than the overall growth rate and other general manufacturing sectors. The development of the high-tech sector, i.e. big data, telecommunications, etc. is dramatically faster, and the technology enables electronic trading, and most Chinese now lead cashless lives. This situation also drives consumption and lowers costs. Soon the issuance of data money will be promoted, and the use of 4G and 5G technologies will likely make China the center of technological innovation.

With these technological innovations and large-scale potential consumer markets, the medium-term growth rate in the East Asia region over the next decade will be significant. In the past, East Asia, and especially China, Japan, and ROK in Northeast Asia, have been the driving force behind the global economy. China's economy accounted for most of that growth, but it was dependent on investment and technology from Japan and ROK. The next stage will see China itself as the center of technological innovation, and its new economy that has networked and digitalized the entire region of East Asia will lead the way.

The new economic structure emphasizes energy-saving and cost-effectiveness. A new generation of artificial intelligence, big data, and space technology will create an integrated open region and an open world. From this point of view, it is vital to continue to open the entire world multilaterally. East Asia is linked to the whole world. Though China's trade with the U.S. has declined, figures with Europe, Africa, Latin America, among others, are all on the rise, and its economic structure is expanding. To achieve

economic benefits, China will open the regional production network we have built to this point, stop protectionism, create and open a free trade zone and economic functions of China and India, the region's two largest economic bodies, and ASEAN, among others.

Now, though, we should focus on two issues: the balance of growth and the distribution of social income. It is necessary to look at this point in the development process of the region. China emphasizes a new method of growth centered on the "Belt and Road" initiative for this reason. For China to prosper, it must first construct its transportation infrastructure, rather than focusing on openness policy. China needs to change the past model of growth, such as opening markets, using foreign capital, and processing exports, and aim to implement cooperative policies so that more balanced growth can occur in the region. In other words, we should pay attention to the construction of a comprehensive environment for development, cooperation and growth, and not necessarily aim for the implementation of zero tariffs or zero barriers at once. Over the next year or two, China may encounter some volatile phases in its regional economy, but I am quite certain of its growth.

This is because of the major changes in economic relations

between Japan and China. China was once overly dependent on the Japanese market, but now Japan depends on China's economy. China's domestic demand reached 60% in 2019. These structural adjustments also create many inconsistencies. In particular, small and medium-sized private companies are facing difficulties. That is because, unlike large companies, they require full coordination. China has established support policies such as lending to the private sector and guaranteeing the economic environment, but these measures are still insufficient for companies.

To summarize the above, the Chinese economy experienced the following model changes; there was a shift from quantity to the development of quality, a shift from foreign demand to domestic-led demand, and a shift from low-cost labor force to dependence on innovation. If China is successful in making these adjustments in 20 years without facing a major crisis, it will be tremendous. The U.S.-China trade friction is not only an issue of economics, but behind it, a problem of politics which cannot be resolved easily. Under these circumstances, it is important for China and East Asia to strengthen regional cooperation and resolve current multilateral issues together.

[Translated by ERINA]

## Appendix

In response to the spread of the new coronavirus, we add the following comments from Mr. ZHANG Yunling, made after this speech.

1. The new coronavirus outbreak will affect China's economy in 2020. The growth rate for the first quarter is expected to fall below 5% or less, and the annual growth rate is expected to be below the original forecast of 6%. However, to maintain economic growth, the government will take special measures later in the year, including monetary and fiscal policies.
2. The spread of the new coronavirus poses a new challenge for regional cooperation. East Asia is densely populated, increasing the risk of various viruses spreading and serious damage to the region. Regarding regional cooperation, it is important to strengthen cooperation in non-traditional security fields such as natural disasters and infectious diseases, while emphasizing the establishment of cooperative mechanisms for prevention and management.