BIG TROUBLE IN BIG CHINA

By Matthew Rizzo

All of the rhetoric surrounding the current Trump tariffs has focused directly on how U.S. commerce will be affected. There has been little to no discussion of the effect the tariffs will have on other economies. China, who seems to be the main target of the new tariffs, will be greatly affected.

China's export advantage is at risk

China's 2018 GDP growth is estimated at 6.6% which is slightly down from 6.9% in 2017. This reflects a stricter regulatory environment and softer external demand. A trade war with the U.S. could further hinder global demand for Chinese products due to increased cost in raw material type imports; for instance, steel which affects numerous Chinese industries such as real estate and manufacturing. With China already experiencing greater labor costs leading to decreased profits, these increased costs are causing Chinese exports to be less price competitive. This does not even include provisions for new tariffs.

China's debt reduction policies

China has been amassing a large amount of debt since the 2008 crash at both the government and corporate levels to the tune of 37% and 136% of GDP, respectively. While corporate debt to GDP has stabilized, nonfinancial sector debt increased faster than nominal GDP. Although the Chinese government's debt to GDP seems low, Chinese State-Owned Enterprises or SOEs have turned to shadow banks or Local Government Financing Vehicles ("LGFV") to bridge the gap for funding shortfalls set forth by the central Chinese government. At high interest rates, this funding is all off-balance sheet and this snowball of debt cannot be measured by the Chinese government. The central Chinese government is also being hurt by the continued depreciation of the yuan versus the U.S. dollar as well as other currencies. This makes China's external debt more expensive to service which increases China's default risk. The U.S. tariffs against China further exacerbates the debt situation due to the fact that SOEs and Corporations may need quantitative easing. This will cause the Chinese government to abandon their debt reduction policies and take on more debt, which will create a general uneasiness for countries that hold Chinese paper.

With business defaults happening in China due to crippling amounts of debt, the trade war with the U.S., and the risk of Chinese default due to continued depreciation in value of the yuan, China simply cannot afford to ignore the impacts of the Trump tariffs.

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