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What the U.S. Stimulus Package Means for China

By Torsten Weller, China Policy Analyst

- Biden's USD 1.9 trillion stimulus package will further boost Chinese exports to the US
- But a stronger dollar could also increase costs for commodities and foreign investment in China
- The world's two largest economies remain deeply interconnected and neither will be able to develop without the other

Summary

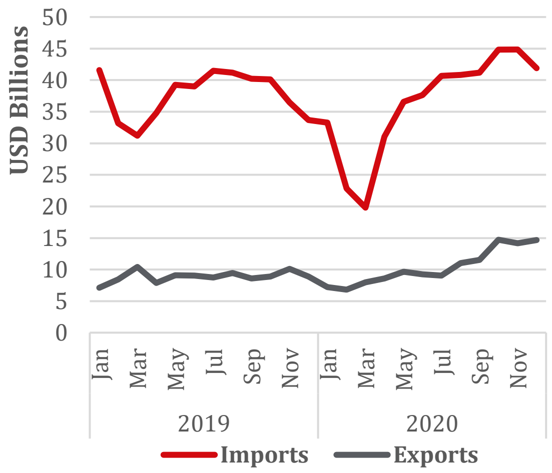
US President Joe Biden has achieved his first major legislative success, after signing a huge USD 1.9 trillion stimulus package into law on March 11th. The bill includes direct payments of up to USD 1,400 to American households, giving a big boost to their disposable income. The Biden Administration has since also published a USD 2 trillion infrastructure programme, which – if passed – would further pump the US economy.

For China, this US spending spree is generally positive, but it also poses new challenges. On the plus side, Chinese exporters will benefit from increasing demand from US customers. Last year's CARES Act, which injected USD 2.3 trillion into the US economy, also helped boost imports from China. Despite punitive tariffs now imposed on over 66% of Chinese imports[1], goods shipments from China into the US were 20% higher in the last quarter of 2020 than in the same period in 2019. China remains the US's largest source of foreign products, with nearly 19% of all goods imports coming from the country.

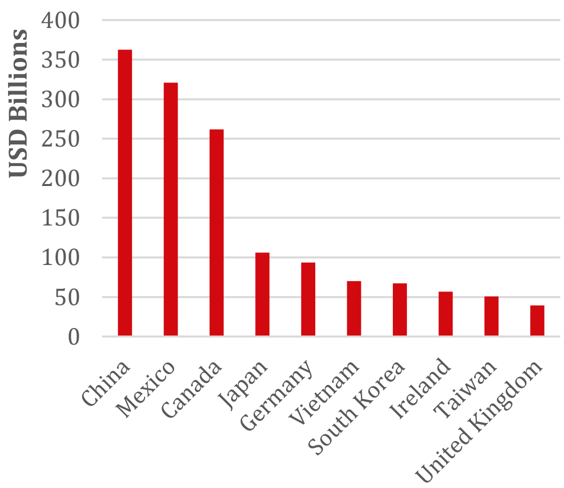
Yet while a booming US economy will likely drive Chinese imports higher again this year, it will also put upward pressure on the dollar. This could increase capital costs for Chinese businesses and make dollar-denominated imports – especially commodities – more expensive.

Graph - US-China Trade in 2020

Monthly Chinese Imports and US Exports to China since 2019 (in USD bn)



Main Import Sources for US in 2020 (in USD bn)



Source: US Census, OEC ©CBBC

[1] https://www.piie.com/research/piie-charts/us-china-trade-war-tariffs-date-chart

The knock-on effect of the US stimulus will in turn pose broader questions about China's economic reform strategy. A persistently strong export sector coupled with more expensive imports could force Chinese leaders into a rethink of their plan to shift the economy towards a consumption-driven growth model. It could also force China's central bank, the People's Bank of China, to speed up liberalisation of the renminbi.

What the US stimulus means for Chinese exporters

The US remains the biggest market for Chinese exporters. Last year, 19.3% of all Chinese goods exports went to American customers, up from 18.7% in 2019 [2]. The US's recently enacted stimulus, and the planned infrastructure bill, could further increase this share, especially as other major markets, such as the European Union, look set to recover much more slowly from the pandemic.

What's more, the US stimulus's main beneficiaries – lower income groups and the unemployed – are more likely to spend the extra cash on consumer goods, and less inclined to invest it in stocks or real estate. US households spent around 15% of the money they received under last year's CARES Act [3] directly on consumption, with many using the cash to save or pay down debt; that proportion is likely to be higher this time around [4].

Even though less than 10% of US consumer spending goes to businesses abroad, China remains the largest beneficiary. 16% of all US spending goes to China, compared to 12% for the Euro Area and 10% for Canada, according to a 2019 study by the Federal Reserve Bank of San Francisco[5].

Another factor which is helping sellers from China is the growing reliance on e-commerce during the pandemic. In 2020, US sales through e-commerce websites such as Amazon grew 44% year-on-year, according to research by Digital Commerce 360, a data research organisation[6]. Many of the country's largest online retailers source their products from China: 42% of sellers on Amazon, which remains the largest e-commerce platform, were based in China[7].

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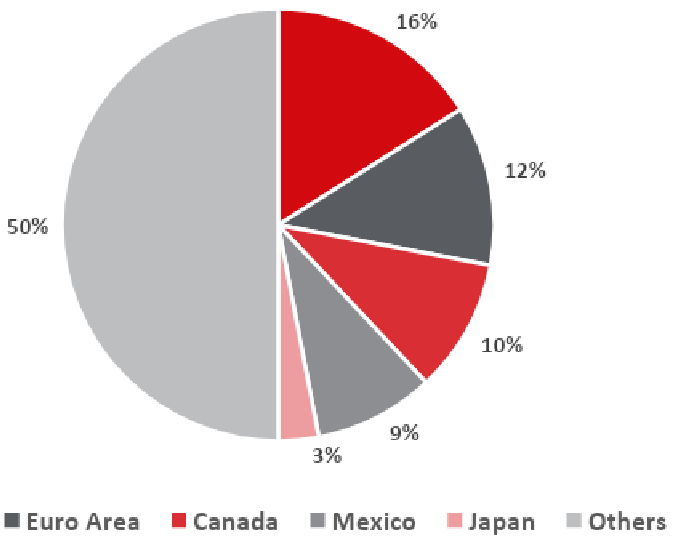
[2] https://oec.world/en/visualize/tree_map/subnational_chn/export/chn/show/all/2020/
[3] https://repec.bfi.uchicago.edu/RePEc/pdfs/BFI_WP_2020109.pdf
[4] https://www.project-syndicate.org/commentary/us-stimulus-inflation-threat-reflects-outdated-economic-model-by-james-k-galbraith-2021-03
[5] https://www.frbsf.org/economic-research/publications/economic-letter/2019/january/how-much-do-we-spend-on-imports/
[6] https://www.digitalcommerce360.com/article/us-ecommerce-sales/
[7] https://www.marketplacepulse.com/marketplaces-year-in-review-2020#china

Graph – Adjusted Total Spending on Imports to US by Source Country in 2019



Source: FRBSF ©CBBC

New Challenges

While President Biden's stimulus bill could be a boon for Chinese exporters, it also creates new challenges for Chinese policy makers.

Even though the future path of the US dollar remains the subject of heated debate, many analysts and investors now expect a strengthening of the world's reserve currency[8]. This could spell trouble for China in numerous ways.

First, a stronger dollar would divert global investment flows away from emerging markets towards US assets. A stronger dollar could particularly affect global index funds: Research has shown that a 10% rise in the dollar's trade-weighted index has on average led to a 30% drop in the MSCI's emerging market index[9].

Chinese markets have especially benefited from a weak dollar: Last year, foreign investors poured nearly £300 billion into Chinese bonds and stocks, according to data collected by Bloomberg[10]. Chinese institutions sold nearly £135 billion worth of bonds to buyers from abroad last year, with investors attracted by relatively high yields and the promise of China's financial opening.

Yet this advantage is now in jeopardy. Yields of Chinese and US 10-year bonds have already begun to converge, making Chinese debt less attractive. Recent defaults of dollar-denominated bonds, such as that by Tsinghua Unigroup in December 2020, have further dampened investors' risk appetite[11].

A stronger dollar this year could further reduce the attractiveness of Chinese bonds and make it harder for Chinese firms to attract international capital.

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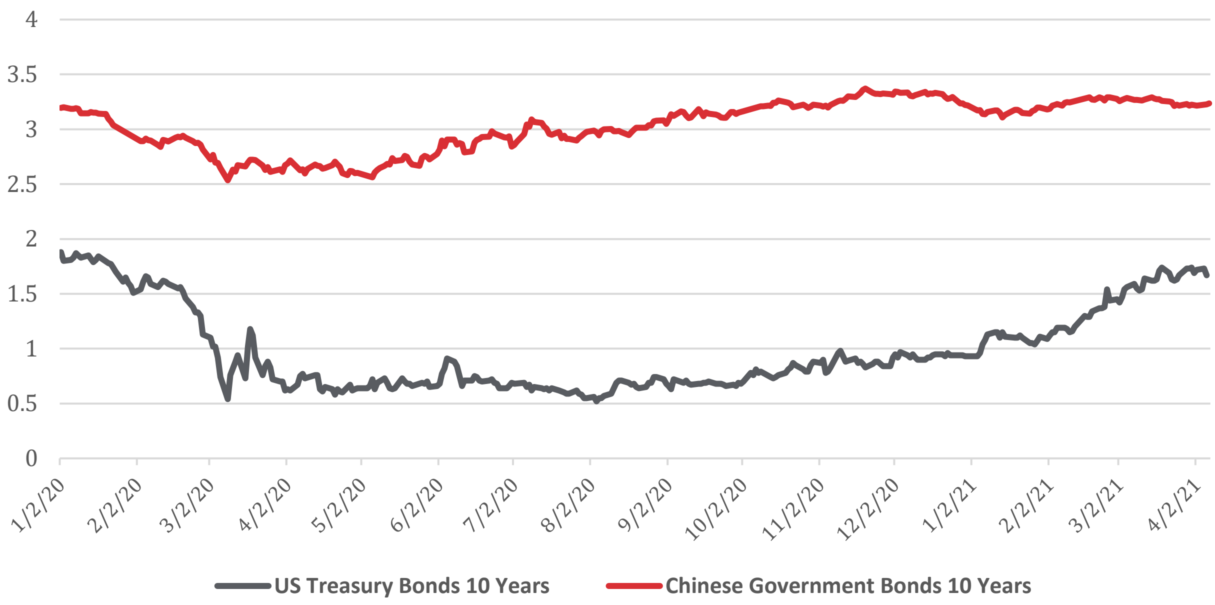
[8] https://www.forex.com/en/market-analysis/latest-research/what-does-bidens-stimulus-plan-mean-for-the-us-dollar
[9] https://www.investorschronicle.co.uk/news/2021/02/19/biden-threat-to-emerging-markets/
[10] https://www.bloomberg.com/opinion/articles/2021-03-10/hot-money-rushed-into-china-during-the-pandemic-will-it-get-cold-feet
[11] https://asia.nikkei.com/Business/Markets/China-debt-crunch/Tsinghua-Unigroup-s-bond-default-Five-things-to-know

Graph - Yields on 10-Year Government Bonds since January 2020 (in %)



Source: U.S. Department of the Treasury; China Foreign Exchange Trade System ©CBBC

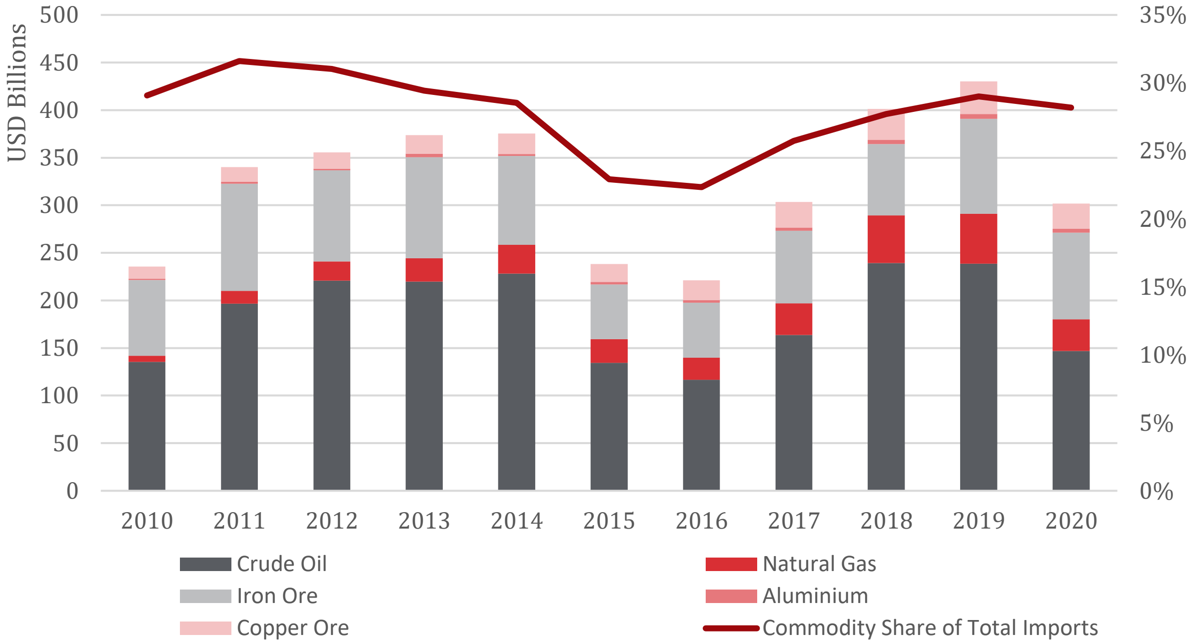
Another side-effect of a strong dollar is that commodities – which are traded in US dollars – become more expensive in local currency terms. This especially affects China, whose resource-hungry economy heavily depends on imported raw materials.

For example, China imports 60% of its iron ore used by the country's gluttonous steel mills[12]. In 2020, these imports amounted to $90.4 billion, with $54 billion's worth (~60%) coming from Australia[13]. This is even more noteworthy as China has been embroiled in a trade dispute with Canberra. The spat has led to Chinese import bans on Australian wine and other products – but not iron ore.

Varying price levels notwithstanding, the share of minerals and metals in China's total imports has remained stubbornly high. After an initial drop in the mid-2010s it has risen again, to over 28% last year. A significant increase in commodity prices could therefore have ripple effects throughout the entire Chinese economy, leading to higher inflation and company shut-downs.

[12] https://www.cnbc.com/2020/12/16/as-china-australia-trade-tensions-rise-beijing-needs-iron-ore-alternative.html
[13] https://oec.world/en/visualize/tree_map/subnational_chn/import/chn/all/show/2020/

Graph – China's main commodity imports 2010-2020



Source: UN Comtrade, OEC ©CBBC

A hike in import prices could also impact China's ambitious drive for self-sufficiency in high-tech industries. Ironically, Beijing's plan to develop a domestic semiconductor industry has actually led to a surge in imports of integrated circuits and related equipment. Since 2015, the dollar-value of integrated circuits imported by China has been higher than the country's oil imports, reaching a value of USD 278 billion last year. By comparison, crude oil imports were only worth USD 147 billion.

A price increase caused by a stronger dollar, coupled with higher financing costs, could sound the death knell for many of China's fledging semiconductor projects.

What about the China's reform strategy?

The interdependence between the Chinese and US economy has important implications for China's own reform strategy.

China has long sought to rebalance its economy away from export-oriented industries towards domestic consumption. This strategy has been further underscored by China's new 'Dual Circulation Strategy' and constitutes one of the key targets of the 14th Five-Year Plan.

Yet as Michael Pettis and Michael C. Klein pointed out in their book '*Trade Wars are Class Wars*[14]', rebalancing an export-driven economy is easier said than done, especially if the export sector remains one of the key growth drivers. This became especially obvious during last year's pandemic, when China's export-oriented industries recovered much faster than the domestic retail sector. A booming US economy would further discourage Beijing from transferring resources from exporters towards domestic consumers, and make it harder to raise income levels towards high-income status.

Another weak spot is the reliance of China's high-tech sector on foreign capital and imports. While the long-term goal of self-reliance is to reduce the country's dependence on foreign technologies and to create high-value adding jobs, in the short term it requires vast amounts of investment and intermediate goods, such as integrated circuits.

A stronger dollar could make both ingredients more expensive. This would not only threaten many of the over 50,000 new semiconductor producers in China -- many of which have only minimal chances of surviving in a highly competitive environment to begin with -- it could also put pressure on Chinese producers to rely on cheaper and already mature foreign alternatives, thus further slowing down China's drive for indigenous innovation.

The significance of Biden's stimulus package for China's economy highlights just how interdependent the world's two largest economies are and how difficult it will be for Beijing to change the country's economic growth model.

CBBC View

A strong export sector is a nice problem to have, but Beijing will have to address the challenges caused by a stronger US economy if it wants to implement its own ambitious reform agenda. Several reforms will be crucial to counter the risks of a stronger dollar.

First, continuing reform and opening-up of China's financial sector. Beijing will need to improve the quality of financial assets for foreign investors. This does not only require more openness and market access but also higher transparency and better legal protection in case of defaults. Speeding up the liberalisation of related service sectors – such as accounting, audit, and legal services – could also help boost investor confidence.

Second, less imports of raw materials. A lot of commodity imports are driven by oversized sectors, such as state-owned steel mills, and domestic infrastructure projects. Limiting the scope of these industries and investments is already a top priority and enforcement will probably become more urgent as costs continue to rise. Beijing's green development agenda and tougher environmental rules will be used more widely to curb overcapacity and demand for foreign commodities.

[14] Klein, M.C. & Pettis, M. (2020*), Trade Wars Are Class Wars. How Rising Inequality Distorts the Global Economy and Threatens International Peace,* New Haven: Yale University Press

Finally, China might also make further steps to liberalise its currency. Although Beijing's reluctance to allow free capital flows remains the biggest obstacle to a complete removal of capital controls, a strong dollar coupled with a rising current account surplus could force Chinese regulators to allow the Renminbi to adjust more freely to global foreign exchange markets.

About the author

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