

China Economic Update April 2024

Is China headed for a new trade war?

NAB Group Economics

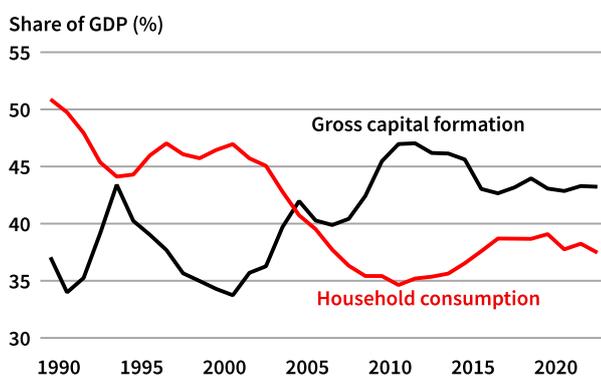


Recent months have seen growing scrutiny on China's trade policies. The US and various European Union governments have accused Chinese producers of attempting to address its industrial overcapacity by dumping its goods in global markets. Weakness in China's domestic consumption, growth in industrial output and rising export volumes and falling prices make a reasonable case for accusations of overcapacity and potentially dumping (with the latter having a higher burden of proof). Failure to effectively address these concerns could trigger a fresh trade war.

China's investment-led growth has led to overcapacity

There have been long running concerns around China's industrial and broader economic policies. Various policy measures were implemented early in its development stage to limit household consumption and encourage savings, providing a low cost pool of resources to fund investment – echoing the growth models used by Japan and South Korea. That said, both Japan and South Korea successfully transitioned away from investment towards consumption once they had established a sufficient capital stock, whereas China's investment (as a share of GDP) far exceeded the levels of these countries and has remained at elevated levels. This trend was exacerbated during the COVID-19 pandemic, where fiscal support was directed towards businesses rather than households, contributing to further expansions in production capacity, while domestic demand has remained comparatively subdued.

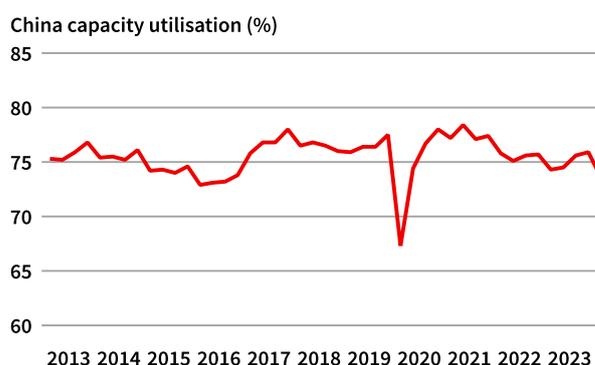
Consumption and investment China's investment share of GDP has remained persistently high



China's industrial capacity utilisation data is relatively short running – starting in the first quarter of 2013. These

data show that utilisation rose to a peak of 78.4% in mid-2021 (around the time of peak goods demand during the COVID-19 pandemic), before subsequently retreating – down to 73.6% in Q1 2024. As a rough guide, 80% utilisation is often seen as a normal level in advanced economies. China's utilisation has remained consistently below this level and this is sometimes attributed to obsolete capacity remaining installed but idle, rather than being formally decommissioned. It is also unclear as to whether the methodologies of capacity utilisation in China and other countries are directly comparable. This suggests that the direction of China's capacity utilisation is more important than its level.

Capacity utilisation China's CapU has trended down since its 2021 peak



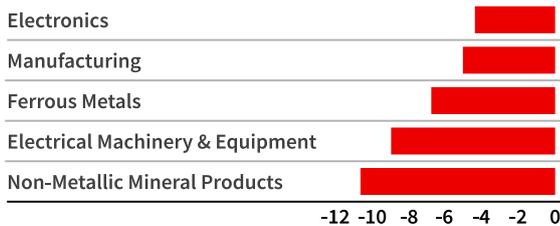
It is worth noting that there was considerable divergence in the change in capacity utilisation over this period. The largest declines were recorded in non-metallic minerals – down by 10.6 percentage points – electrical machinery & equipment (8.9 percentage points lower) and ferrous metal production (6.8 percentage points) – with the first and third closely tied to the downturn in construction, as these categories include cement, glass and steel (among

others). The electrical machinery & equipment sector includes solar panel and battery manufacturing, where analysis by BloombergNEF suggests that China’s capacity in these sectors is more than double current global demand, while capacity additions in coming years are expected to maintain this trend through to 2027.

Changes in capacity utilisation

Steep falls in CapU in a few key sectors since 2021

Change in capacity utilisation (Q1 2024 vs. Q2 2021)



The recent ramp up in China’s exports has raised tensions

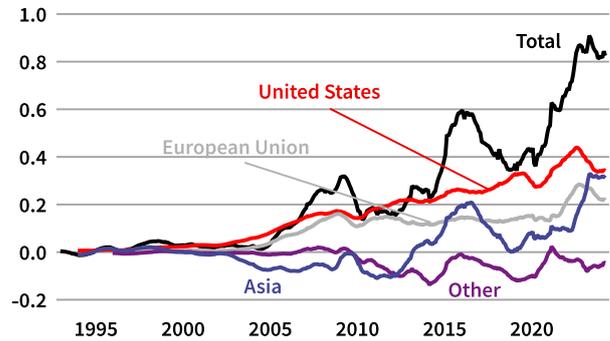
China’s trade surplus with the rest of the world expanded rapidly following the start of the COVID-19 pandemic – rising from a low of US\$361 billion (on a twelve-month moving average basis) in February 2020 to around US\$909 billion in April 2023. Partly this reflected disruptions to other suppliers as a result of the pandemic, along with strong demand for medical equipment, furniture and electronics, as consumers worldwide adjusted to pandemic arrangements. Export prices also rose from late 2020 through late 2023 (in year-on-year terms).

While China’s trade surplus with both the United States and the European Union rose strongly from this trough to peak, the increase was larger in Asia – led by a surge in exports to Taiwan, South Korea and Indonesia. Indeed, China’s trade surplus with Asia continued to climb even as its surpluses with the US and EU were starting to retreat, and it has remained at high levels since early 2023.

China’s trade surplus

Surpluses with the US and EU remain elevated; surplus with Asia has soared

China trade surplus (US\$ trillion, 12 month rolling sum)



Simply looking at trade in US dollar terms can overlook physical trade flows – which is important when it comes to accusations of dumping. China’s total export volumes accelerated from mid-2023 onwards – despite the impact of restrictive monetary policy in a broad range of key advanced economy export markets. A broad range of sectors showed strong growth over this period – from relatively low value added products such as leather goods and clothing to higher value ones such as machinery & transport equipment – with motor vehicle exports surging in recent times.

Export volumes

China’s recent surge is counter to the rest of the global trend

Export volumes (% yoy 3mma)



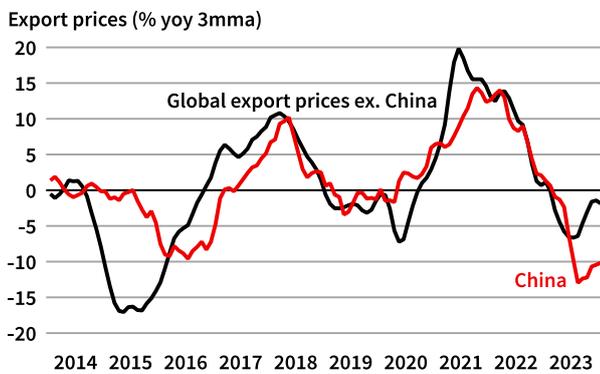
Given the weakening in global demand, the increase in China’s export volumes has coincided with falling export prices. Data for US dollar denominated export prices (collated by the CPB) dates back to 2001, with year-on-year prices falling at its fastest pace in August 2023 (at around 14.4% yoy) with subsequent months showing declines trending close to 10% yoy.

Detailed Chinese currency denominated data showed comparatively larger price declines in sectors such as chemicals, basic metal products and textiles, clothing and footwear – with these commonly being relatively lower value added products. Despite the strong increase in machinery & transport equipment export volumes,

price declines in this sector have been below the aggregate measure.

Export prices

Surging Chinese export volumes has driven its prices much lower



Conclusions

At a high level, the combined factors of soft domestic consumption, growth in industrial output, rising export volumes and falling prices (when compared with other countries) makes a reasonable case for accusations of overcapacity and potentially dumping. It is more difficult to make a clear case regarding dumping, as under WTO trade rules this has a high burden of proof (requiring evidence of discriminatory pricing and an impact on domestic industry in importing countries) and is done so on a product-by-product basis, rather than in aggregate. Overcapacity reflects a long running failure to provide policy support to boost consumption, exacerbated by industrial support during the pandemic.

In recent times, criticisms by trade officials in the United States and European Union have focussed on higher value added exports – alleging that overcapacity in sectors such as solar panels, electric vehicles and batteries was driving producers to dump excess production into global markets. That said, the steepest falls in export prices observed in recent months has tended to be in lower value added products.

This is where we are limited by the data – we don't have disaggregated export volume data by country, meaning that we are unable to determine if the pattern of export volumes differs considerably between countries. This means that while prices have fallen more rapidly for low value added goods, the criticisms of the US and EU may also have merit.

Falling prices for China's exports result in some policy conflicts in advanced economies, particularly between shorter and longer term ambitions. In the short term, declining export prices means that China is exporting deflation to the rest of the world – an important impetus

to getting inflation back to central bank targets. Similarly, advanced economy governments are seeking to expand the penetration of green technology into the energy and transport sectors, which can be done relatively cheaply using Chinese technology. However, this may come at the cost of domestic firms that these governments may wish to champion. For example, the European Solar Manufacturing Council has warned the EU that without emergency support more than half of the industry's capacity faces closure.

In the near term, this may be enough to see trade measures imposed by both the European Union and United States – which could see retaliation by China. Republican Presidential candidate Donald Trump has threatened further measures – including a 60% across the board tariff on Chinese imports and a 100% tariff on motor vehicle imports from any country – echoing the policy measures that triggered a trade war between the US and China during his first term in office in 2018.

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