THE REAL ECONOMY

SPECIAL GLOBAL EDITION: CHINA OUTLOOK 2018

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING
ABOUT THE AUTHORS

Our thought leaders are professionals with years of experience in their fields who strive to help you and your business succeed. Thought leaders who have contributed content to this issue include:

Joe Brusuelas, Chief Economist, RSM US LLP
TABLE OF CONTENTS

China Outlook 2018 ................................................. 4
US Capitol Corner .................................................. 7
China and the US, by the numbers ................................ 12
Over the past four decades, the economic and trade relationship between the United States and China has been dramatically transformed, growing from about $2 billion in 1979 to approximately $612.5 billion in 2017. This places it among the most important bilateral economic relationship in the international economy. Now, however, that relationship is fraught with tensions due to differentials in growth, trade frictions and enforcement of trade rules along the technological frontier.

Trade frictions and associated political noise often overshadow that deep and broad economic relationship that supports growth in each country and across the global economy. Any discussion of bilateral interaction must put the economics and trade frictions in the proper context to understand the costs and benefits associated with this relationship.

The scale and scope of changes in the Chinese economy and population are breathtaking. Each year the single largest human migration takes place around the Chinese New Year. This year, for example, almost 400 million people will travel home in China by train. By comparison, the entire U.S. population is 327 million. Thus, it is fair to say that as China modernizes its economy, there are going to be multiple dislocations in price, supply and demand across the international economy. How those are managed at a political and commercial level will drive the direction and deepening of that relationship going forward.

The scale of that change is the major reason that, despite deepening commercial ties, tensions within the economic relationship with the United States are rising amid a complex set of economic and financial interactions. First and foremost, these tensions revolve around the ongoing transition of China toward a free-market economy that is at once advanced yet incomplete. American businesses simply do not have access to the Chinese market in the same way that Chinese businesses have in the United States. That, along with enforcement of trade rules on intellectual property, is likely to be the defining feature of the economic relationship between China and the United States in the years ahead.

The following provides a quick and accessible overview of the frictions, costs and benefits between the two economies amid a quickening pace of economic integration.

**US jobs and China**

U.S. trade with China supports about 2.6 million jobs. While much of the discussion on the link between China and the United States concerns job losses in the manufacturing
sector, particularly among those without a high school education, this is often a fact that is lost amid the political noise. The modernization of the Chinese economy, and the development of its middle class, will support a growing number of jobs over the next decade as U.S. businesses tap the growing services and luxury markets. At the current pace, the Chinese middle class will outnumber the entire U.S. population by 2030. New markets, especially those aligned with life sciences and technology, will support a growing number of high-paying U.S. jobs.

**Frictions: Bilateral deficits and enforcement of trade and intellectual property rules**

The majority of the noise surrounding the Sino-U.S. relationship has been around the size of the trade deficit, which in 2017 was roughly 1.75 percent, or $347 billion. This is an erroneous way to define the economic relationship. The trade deficit simply reflects U.S. consumption that is outpacing the ability of domestic suppliers to meet it. Meanwhile, something often overlooked amid the focus on the goods deficit is that the United States has a $30.8 billion surplus in the upscale services sector.

The services sector, in general, and intellectual property, in particular, are where there will be significant trade frictions going forward (see US Capitol Corner, page 7). The Trump administration has said it is considering using its “Super 301” powers under the 1986 U.S. Trade Omnibus Act against China over noncompliance with rules governing intellectual property covered by the World Trade Organization. Due to the U.S. surplus, China’s intention to enter and compete in upscale services, life sciences and technology markets, not agriculture or industrial goods, are likely to define the immediate future of bilateral economic interaction.

**Global supply chains: Catalysts for integration**

Evidence from data compiled during 2000–2015—the most intense period of China’s economic modernization—implies that countries that are geographically closer to China and participate in commodities trade tend to grow faster than those that do not. The construction of global manufacturing supply chains, mostly located in east and Southeast Asia, contribute to U.S. growth, too. These supply chains have resulted in an increase in productivity, profitability and competitiveness for U.S. businesses such as Apple, Texas Instruments and Marvel Technology that define the new economy. Even older businesses like GM, Ford and Boeing are slowly integrating their global production of products into those supply chains.

Like the development of the integrated North American supply chain that serves the production of autos and civilian aircraft, the higher revenues and profits that arise from these supply chains increase the fixed business
investment and hiring that follow in their wake. If one includes the indirect effects of U.S. contribution to those supply chains around Asia, the net deficit between the United States and China falls by approximately 25 percent, which underscores our core view about an overemphasis on the bilateral deficit as the defining feature of the economic relationship.

**China supporting global and US growth**

One of the most understated facts about China over the past two decades is that it has accounted for about 30 percent of all global growth, compared to the U.S. contribution of 16 percent. Even if one looks at the contribution of the United States and the European Union combined the overall contribution of China to global growth is greater than both. In fact, the top five countries in terms of growth since the turn of the century—China, Cambodia, India, Vietnam and Indonesia—averaged 7.2 percent per year, in contrast with the 1.8 percent in the United States, 1 percent in the eurozone and 0.7 percent in Japan.

The benefits from closer integration between the two economies are largely located in the following areas: China absorbs about 7.5 percent of all U.S. exports, which is equal to approximately 1 percent of U.S. gross domestic product. Income from U.S. investment in China totaled approximately $9.8 billion in 2015, or about one-half of 1 percent of total U.S. corporate profits, according to the Bureau of Economic Analysis. Through the end of 2016, U.S. foreign direct investment stood at $92.5 billion, up 9.4 percent from one year earlier. That investment is largely organized around manufacturing, wholesale trade and nonbank holding companies. Chinese foreign direct investment in the United States stood at $27.5 billion in 2015, up 63.8 percent from a year earlier. The major recipients of that investment were in manufacturing, real estate and depository institutions.

**Services and US surpluses**

One little known, and overlooked, aspect of the trade and investment relationship is that the United States runs a $30.8 billion-dollar trade surplus in the services sector and overall sales of U.S. affiliates in China. The 2017 memorandum of understanding reached between President Donald Trump and Chinese President Xi Jinping pointed toward the opening of Chinese markets to biotechnology products, credit rating services, electronic payment services and bond underwriting settlement services, all areas where the United States lead is expected to boost the exports of services and products that will narrow the politically sensitive bilateral deficit over the medium to long term. Just as important, U.S.-owned affiliates in China had $55.2 billion in sales through the end of 2015, compared with the $5.7 billion of sales of Chinese affiliates owned in the United States.

The Sino-U.S. economic relationship is complex and predicated on a growing global supply chain across a diverse universe of products, services and investments. The ability of the two countries to negotiate the problems surrounding the implementation of rules governing intellectual property, and the ability of the Chinese fiscal and monetary authority to manage the debt and deleveraging cycle that is in its early stages, will define the next quarter-century of China-U.S. economic relations.
Over the past three decades, economic interaction between the United States and China has increased significantly. During that span, American diplomatic policy attempted to frame a strategic and economic relationship around channeling the tremendous untapped potential of China’s people and its economy into what Washington and Brussels refer to as the “liberal international order.”

That liberal international order—best defined as the institutions, multilateral trade treaties and international law that provide a loose governance framework for global economic and strategic interaction—is in the process of undergoing tremendous change.

Transformation is being driven by conditions, mostly brought about by the differing growth rates in individual economies, resulting in tensions that will present challenges to the core components of this so-called liberal international order.

Meanwhile, a new bipartisan consensus has formed in Washington around how both to challenge and accommodate the rise of China amid the evolution from a unipolar global system to that of a multipolar international system. This will result in both greater tensions and opportunities during the years ahead.

China’s modernization represents one of the most dynamic and transformative events since the arrival of the United States on the global economic scene in the mid-19th century. One side of the emerging bipartisan consensus that has formed in Washington explicitly acknowledges that fact and has no interest in containment. In fact, policymakers taking this view openly acknowledge and wish to support China’s emergence as one of the five economic pillars of the global economy: North America, European Union, Northeast Asia, Indo-Asia, and the emerging markets and frontier economies.

One of the more remarkable aspects of this new consensus is Washington’s willingness to acknowledge the triumph of China’s economic initiatives and innovations. China’s winnings at the economic table, especially in manufacturing, are substantial, hard earned and deserving of respect. The point of view emerging from this new consensus calls for China to take those winnings and focus on internal development and global economic cooperation. Consider that since the year 2000 alone, China’s economic growth is equivalent to adding another Germany and France to the global economy. The development of
global supply and value chains over the past three decades around China’s prodigious manufacturing output should not be underestimated. They point toward a modest form of global economic integration that cannot and should not be reversed. In fact, this integration has added to America’s own economic growth.

Despite the recent intensification of trade tensions between the United States and China, international trade and investment over the past three decades have benefited both sides.

For the United States, China has opened the door to new opportunities. The United States runs a trade services surplus of $30.8 billion and overall services trade has increased ninefold since 2001.

While the United States runs a goods deficit of $347 billion with China, U.S. exports to China account for more than 8 percent of all American global exports and include the second-largest market for agricultural exports. Moreover, the acceleration of petroleum exports and potential opportunities to export liquefied natural gas to China all represent a new and tremendously profitable direction for U.S.–based energy firms, despite growing tensions around the bilateral relationship. During the next 12–15 years, U.S. export growth will likely outpace that of Chinese imports as China’s middle class expands, ultimately narrowing the bilateral trade deficit. Demand for services will translate to growth in high value-added areas such as technology, life sciences and energy.

Moreover, U.S. foreign direct investment in China for the year 2016 amounted to $92.5 billion, an increase of 9.4

**MIDDLE MARKET INSIGHT:**
About 75 percent of the trade deficit with China is within the manufacturing and electronics sectors, both of which are key employers within the middle market.

The orderly opening of the Sino economy has conferred enormous advantage to those economies that trade with China and whose geographic proximity places them near China’s emerging trading and financial centers. Expanding growth rates in many countries in both North and South Asia are a direct result of that economic development. Even those countries geographically distant from China benefit from its growth policies. The Organisation for Economic Co–operation and Development estimates that, despite the nongeographic proximity of the United States to China, 4 percent of the value of exports from Asian countries to China can be attributed to the United States. In fact, if one adds indirect exports via other Asian countries, the value of U.S. exports to China’s increases by 25 percent.
percent over 2015 spread out among economic sectors such as manufacturing, wholesale trade and banking. In return, China’s foreign direct investment in the United States was $27.5 billion, up 63.8 percent from a year earlier, and clustered in areas such as manufacturing, real estate and depository institutions. Not surprisingly, sales of U.S.-owned affiliates in China were valued at $55.2 billion, and sales of China-owned affiliates in the United States were $5.7 billion.

So given the broad and deep economic and trade relationships, why have tensions increased?

In the United States, three factors are primarily to blame. Foremost is the loss of manufacturing jobs over the past two decades. While most manufacturing jobs lost during that time are related to the technological revolution in the United States, job losses among those without a high school education have been substantial and are directly linked to China’s ascension after its admittance into the World Trade Organization. Consequently, the turn to economic populism and protectionism in the United States is not just a passing development.

Second, the degree of reciprocity for U.S. firms operating inside China, and that country’s lack of openness will determine the extent to which competition turns to economic conflict. China’s development has proceeded to the point where it benefits from a quicker pace of economic liberalization, access to foreign goods and a greater degree of flexibility in its currency valuations. It is possible now for China to confidently move forward across a wider range of social issues that will only deepen and broaden its development within the existing global economic framework.

Third, and most important, the emerging U.S. bipartisan consensus that has formed in Washington will likely be predicated on drawing a red line around enforcement of existing intellectual property laws. Competition over the balanced development of the global framework that emerges from the economics of artificial intelligence and machine learning will also be key. It is important to note that the willingness of Washington to cede ground around manufacturing over the past 30 years will not be repeated going forward. The low-hanging fruit of economic development has been picked, and now is when the hard work of organizing a global economic framework governing advanced technology begins.

It is here where Washington is in broad agreement with Chinese Premier Li Keqiang, who recently stated that it is important for China’s economy that the country enhances protection of intellectual property rights. Li made the
case that inadequate protection of intellectual property rights had contributed to the decline in Chinese private investment—not just from global investors but also in China itself. That is a potential point of convergence between the interests of American and Chinese investors and their governments. It is critical that this policy takes root. If it does not, then Washington will move to take action.

If the lack of enforcement on intellectual property rights continues, then it is highly probable that Washington will turn to the use of what is referred to as its “Super 301” powers under the U.S. 1986 Omnibus Trade Act to impose deep and far-reaching sanctions on Chinese goods and services. This will likely result in an economic targeting of Chinese firms in technology, telecommunications and life sciences, as well as access to the deep capital markets of the United States.

In 2016, while China generated only 9 percent of artificial intelligence (AI) startups globally, the cash volumes of its investment represented 48 percent of worldwide dollar volumes, compared with 38 percent that originated in the United States. Given that the total global dollar volume attributed to China in 2016 was 11.3 percent, China’s development in AI has not gone unnoticed in Washington.

China’s rapid immersion into the AI field has directly contributed to the nascent consensus by the United States that they must draw the line on the enforcement of existing agreements where it has a comparative advantage, as well as in emerging economic sectors organized around science where technology transfers are going to occur.

Perhaps the most important development on the timely issue of China’s role in AI is its level of equity investment in the United States. American–backed equity investment flowed into 20 AI startups in China in 2017; conversely, Chinese–backed equity investments in the United States supported 31 AI startups. It appears that both sides have a deep and abiding interest in the protection of existing intellectual property laws. Given the critical nature of this area of economic and financial development, the alternatives to cooperation are simply unthinkable.

The Chinese challenge to American economic predominance is unavoidable. It is far better to discuss this challenge than to sit back and hope for the best. Fortunately, the long tradition of intellectuals guiding policy in China, and the desire on the part of U.S. policymakers to avoid making the mistakes of both the recent past and historical instances of miscommunication and miscalculation that have led to conflict, imply that both countries can avoid misunderstandings about each other’s actions and intentions.
Chinese growth decelerating toward sustainable path

A look at Chinese monthly gross domestic product on a year-ago basis implies still strong and robust growth that is moderating toward a more sustainable path. We expect the economy to grow at a 6.5 percent pace in 2018 driven by the transition to a growth model based on consumer spending and robust demand for exports.

Chinese credit impulse: Debt limiting efficacy of credit impulse

Bloomberg’s China credit impulse—which is calculated on a 12-month flow of total social finance, net of equity issuance plus local government bond issuance divided by the four quarter rolling sum of nominal gross domestic product (GDP)—implies a modest deleveraging following the successful infrastructure investment program in 2017. Absent that stimulus, overall GDP would have likely slowed to 5.7 percent for the year.
China copper and steel prices: Critical domestic commodity prices likely to slow in 2018

Prices of critical commodity such as steel, copper and iron ore have all moderated through the first two months of 2018. Moderating growth and slower pace of residential investment, as well as, financial deleveraging will likely weigh on domestic prices throughout the remainder of the year.

Chinese electrical demand: Likely to moderate in 2018

Chinese electrical demand, which is often used as a simple proxy for overall economic activity, eased to 4.8 percent through the final three months of 2017, down from 7 percent one year ago. In our estimation, this modestly understates the true pace of domestic growth because of the overrepresentation of the manufacturing sector. However, given demand from abroad for intermediate and finished goods, this proxy will likely remain solid this year.
U.S.-CHINA TRADE SUPPORTS 2.6 MILLION JOBS IN THE UNITED STATES

China is the 3rd largest destination for American goods and services

China’s economic growth since 2000 is roughly equivalent to adding another Germany and France combined to the global economy

U.S. tourism to China is up to 2.6 million individuals in 2015, up from 230,000 in 2000

Global supply chain development

The OECD estimates that 4% of the value of exports from Asian countries to China can be attributed to the United States

If one adds indirect exports via other Asian countries, the value of U.S. exports to China increases by roughly 25%

Roughly 75% of the trade deficit with China is in the electronics and manufacturing sector

Diplomatic interaction: April 2017

China agreed to open its markets to U.S. beef, biotechnology products, credit rating services, electronic payment services, and bond underwriting and settlement. United States agreed to open its markets to Chinese cooked poultry and welcomed Chinese purchases of U.S. liquefied natural gas.
GOOD AND SERVICES TRADE (2016)

UNITED STATES exports to CHINA
- SERVICE EXPORTS: $54.2 BILLION
- GOODS EXPORTS: $115.6 BILLION

CHINA exports to UNITED STATES
- SERVICE EXPORTS: $16.1 BILLION
- GOODS EXPORTS: $426.6 BILLION

The United States runs a Trade Service Surplus of $30.8 BILLION
U.S. Exports of Services are up 908% since 2001

TOP EXPORT CATEGORIES ARE
INTELLECTUAL PROPERTY, TRAVEL AND TRANSPORT

The United States runs a goods deficit of $347 BILLION
U.S. exports to China account for over 8% of all American global exports
China is the 2nd largest export market for U.S. agricultural products

INVESTMENT

U.S. foreign direct investment (FDI) in China was $92.5 BILLION IN 2016
AN INCREASE OF 9.4% FROM 2015
U.S. FDI led by manufacturing, wholesale trade and nonbank holding companies

China FDI in the United States was $27.5 BILLION IN 2016
UP 63.8% FROM 2015
China FDI led by manufacturing, real estate and depository institutions

Sales of U.S.-OWNED AFFILIATES IN CHINA were $55.2 BILLION in 2015
Sales of CHINA-OWNED AFFILIATES IN THE UNITED STATES were $5.7 BILLION
CHANGE IN GROSS DOMESTIC PRODUCT PER CAPITA NOMINAL (2000–2015, USD$)

Source: RSM US, Bloomberg
GROSS DOMESTIC PRODUCT GROWTH (COMPOUND ANNUAL GROWTH RATE, 2000–2015)

Source: RSM US, Bloomberg
U.S. GOODS EXPORTS TO CHINA

- **$15 BILLION**
  - Grain, seeds and fruits

- **$15 BILLION**
  - Aircraft

- **$12 BILLION**
  - Electrical machinery

- **$11 BILLION**
  - Machinery

- **$11 BILLION**
  - Vehicles

U.S. GOODS IMPORTS FROM CHINA

- **$129 BILLION**
  - Electrical machinery

- **$97 BILLION**
  - Machinery

- **$29 BILLION**
  - Furniture and bedding

- **$24 BILLION**
  - Toys and sports

- **$15 BILLION**
  - Footwear

U.S. AGRICULTURAL EXPORTS TO CHINA

- **$1 BILLION**
  - Soybeans

- **$1 BILLION**
  - Coarse grains

- **$949 MILLION**
  - Hides and skins

- **$713 MILLION**
  - Pork and pork products

- **$513 MILLION**
  - Cotton

U.S. AGRICULTURAL IMPORTS FROM CHINA

- **$1.1 BILLION**
  - Fruits and vegetables

- **$328 MILLION**
  - Fruit and vegetable juices

- **$213 MILLION**
  - Snack foods

- **$205 MILLION**
  - Fresh vegetables

- **$152 MILLION**
  - Tea
For more information on RSM, please visit rsmus.com.
For media inquiries, please contact Terri Andrews, National Public Relations Director, +1 980 233 4710 or Terri.Andrews@rsmus.com.

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM® and the RSM logo are registered trademarks of RSM International Association. The power of being understood® is a registered trademark of RSM US LLP.

© 2018 RSM US LLP. All Rights Reserved.