# The Sky is not Falling (II)
# 天塌不下来 (二)

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# Preview

- Introduction
- China and the World
- The Macroeconomic Situation
- The External Environment
- The Asset Markets
- Maintaining Price Stability
- Concluding Remarks

# Introduction

- Approximately ten years ago, at the height of the East Asian currency crisis, I wrote an article, "The Sky is not Falling," basically saying that the Chinese economy will be able to emerge from the crisis more or less whole. China at the time decided not to devalue the Renminbi even though every other East Asian economy, except Hong Kong, had done so. This was helpful not only to China itself, but also enabled the relatively fast recovery of the other East Asian economies, and earned their gratitude and respect.
- Today, the external environment facing the Chinese economy is similarly negative, though in a totally different way. It is a major financial crisis in the United States the magnitude of which has not been seen since the Great Depression of 1929. I would argue that despite the economic slowdown and possible recession in the U.S. and perhaps in some of the Western European countries, the Chinese economy will also be able to manage to continue to grow based on its internal demand alone. Thus, once again, "The Sky is not Falling."

# Introduction

- China has made tremendous progress in its economic development since it began its economic reform and opened to the world in 1978. China is currently the fastest growing economy in the World—averaging approximately 10% per annum over the past 30 years.
- Between 1978 and 2007, Chinese real GDP grew fifteen-fold, from US$228 billion to US$3.42 trillion (2007 prices) (4th largest economy in the world) and real GDP per capita grew more than ten-fold from US$236 to US$2,571. By comparison, the U.S. GDP (approx. US$13.84 trillion) and GDP per capita (approx. US$45,671) were respectively 4 and 18 times the comparable Chinese figures in 2007.

# Introduction

- Despite its rapid growth, China is still a developing economy in terms of its real GDP per capita. An economy is generally considered to be developed if its GDP per capita exceeds US$10,000 (if we take into account inflation, this threshold probably should be raised).
- It will probably take another 20-25 years before China joins the ranks of developed economies, and a further 20-25 years before China reaches the same level of real GDP per capita as the United States (some time around the middle of the 21st Century).

# The Chinese Real GDP and Real GDP per Capita: Past, Present and Projected Future

| | 1978 | 2007 | 2020 |
|---|---|---|---|
| | US$ | (2007 prices) | |
| Real GDP (trill.) | 0.228 | 3.42 | 8.00 |
| Real GDP/capita | 236 | 2,571 | 5,500 |

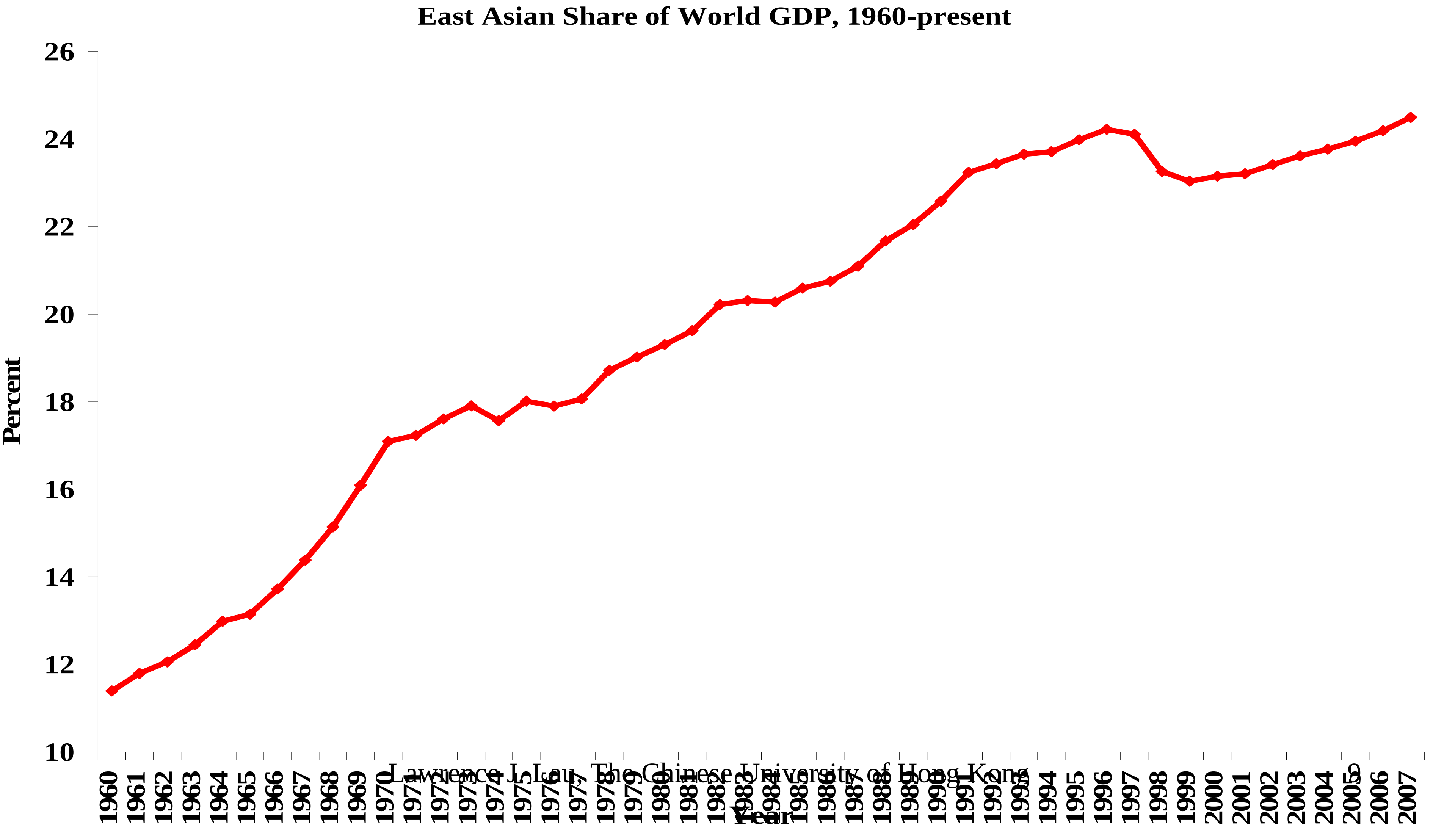
# Introduction

- Chinese economic growth during the past 30 years has been underpinned by three factors:
- (1) A consistently high domestic savings rate greater than 30 percent on average and occasionally approaching 45 percent—this means, among other things, the Chinese economy does not depend on foreign capital or foreign loans;
- (2) An unlimited supply of surplus labor—as long as the primary sector produces approximately 10% of the GDP but employs almost 40% of the labor force, there is no shortage of and no upward pressure on the real wage rate of entry-level unskilled labor;
- (3) A huge domestic market of 1.3 billion consumers with pent-up demand for housing and transportation and other consumer goods, enabling the realization of significant economies of scale based entirely on internal demand.

# Introduction

- Moreover, Chinese economic growth has not been at the expense of the Rest of the World. It has not been a zero-sum game. Almost every country has benefitted from China's economic progress and its opening to the world. For example:
  - The consumers in the developed economies are able to enjoy low and stable prices for their everyday light-manufactured consumer goods.
  - China has become the most important importing country for and runs a trade deficit with almost every country and region in East Asia, including Japan.
  - China has become a major donor of development aid and assistance to developing countries, especially those in Africa.

# East Asian Share of World GDP, 1960-present

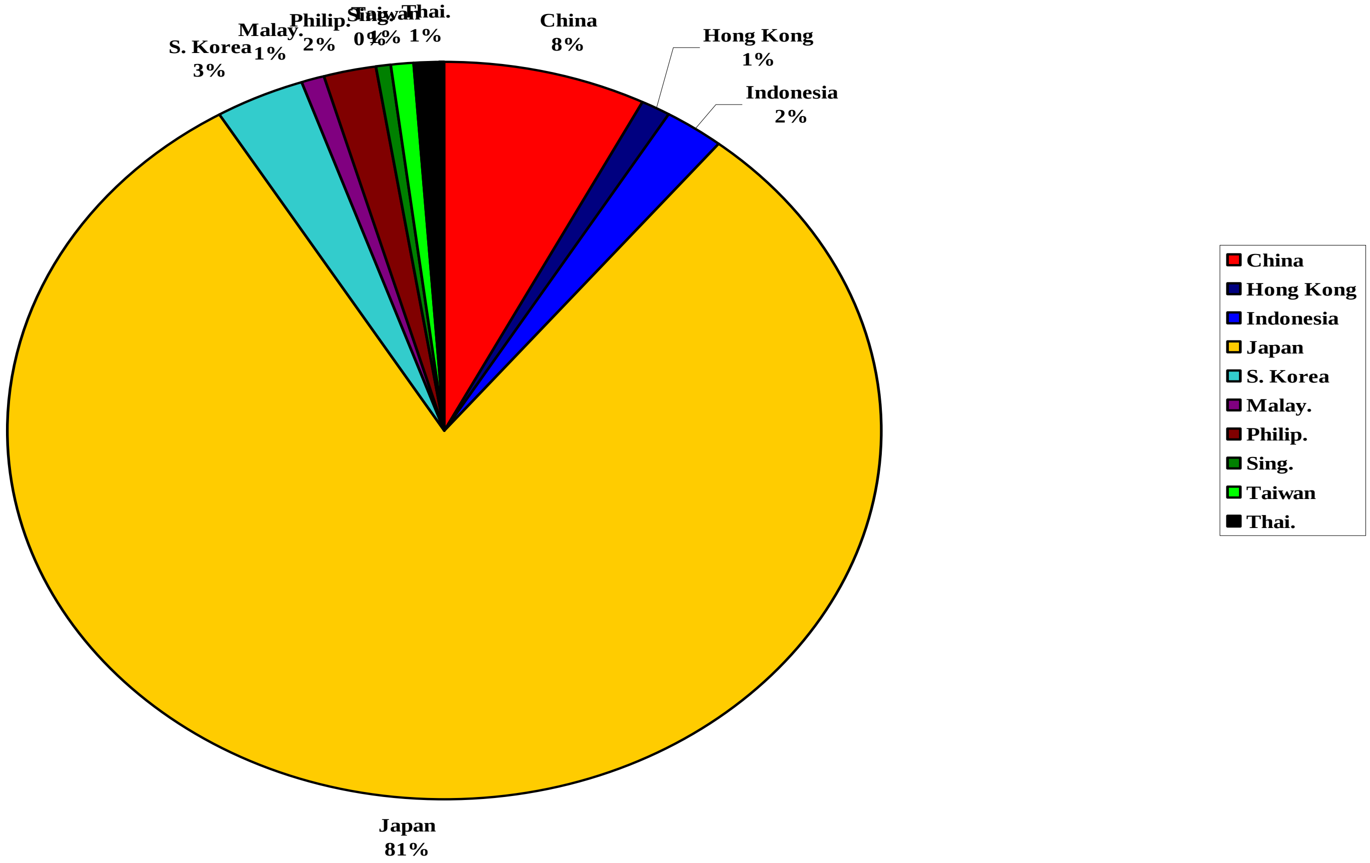


# The Chinese Economy in the World: The Shifting Economic Center of Gravity

- The economic center of gravity of the world has been gradually shifting to East Asia from the United States and Western Europe.
- In 1960, the GDP of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was approximately 40% of US GDP, with Japan contributing more than 80% of total East Asian GDP, followed by China (Mainland only), with not quite 8%.
- In 2006, the GDP of ASEAN + 3 was approximately comparable to that of US GDP, with Japan contributing a little more than a half of total GDP, followed by China (Mainland only), which contributed somewhat more than 20%.
- South Korea, and Hong Kong, Macau, and Taiwan combined, contributed between 10% and 15%.
- ASEAN + 3 is also comparable to the Zone Euro in terms of the order of magnitude of its GDP.

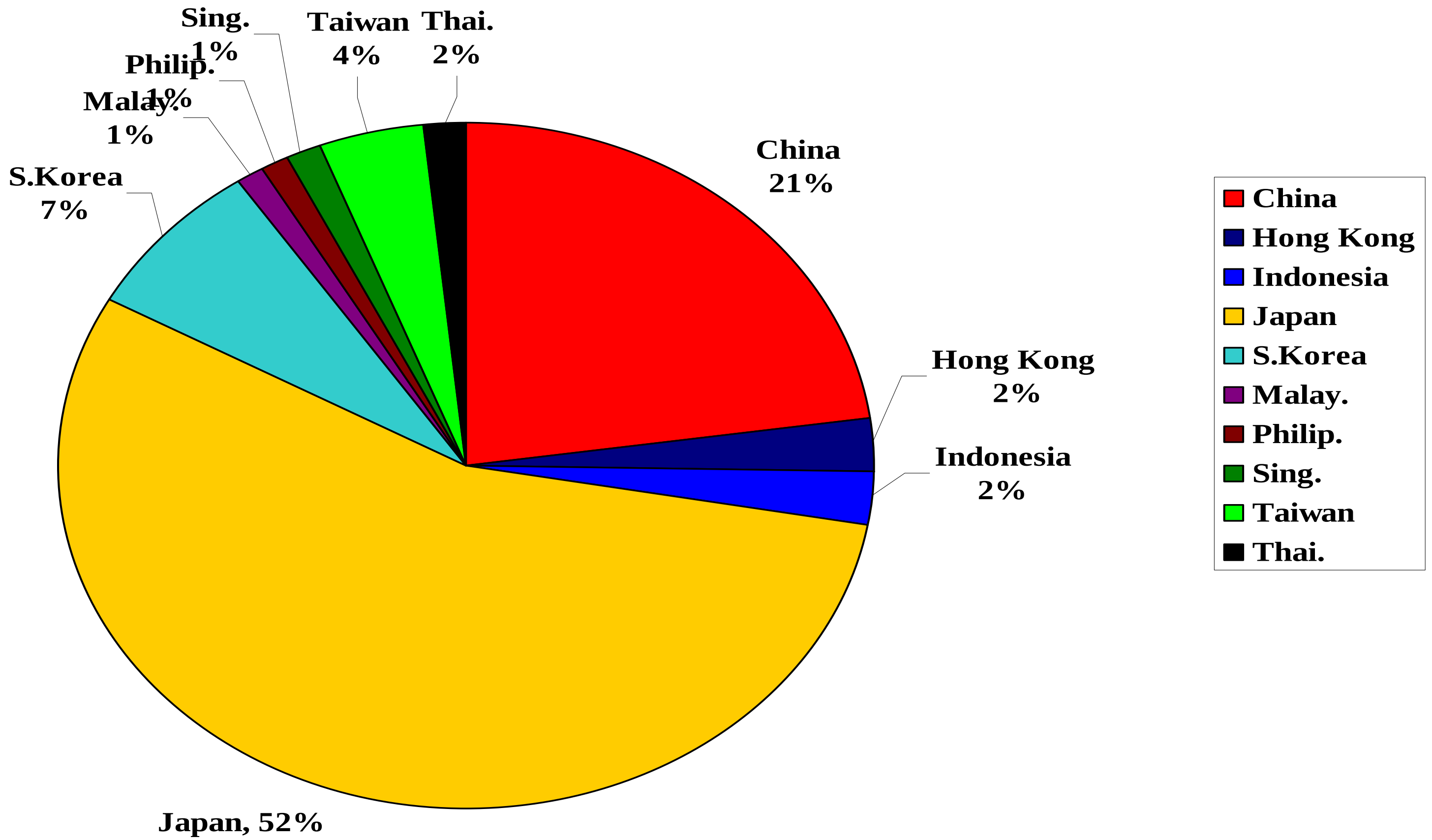
# Composition of East Asian GDP, 1960

**Figure 2.1: Composition of East Asian GDP, 1960**



# Composition of East Asian GDP, 2006

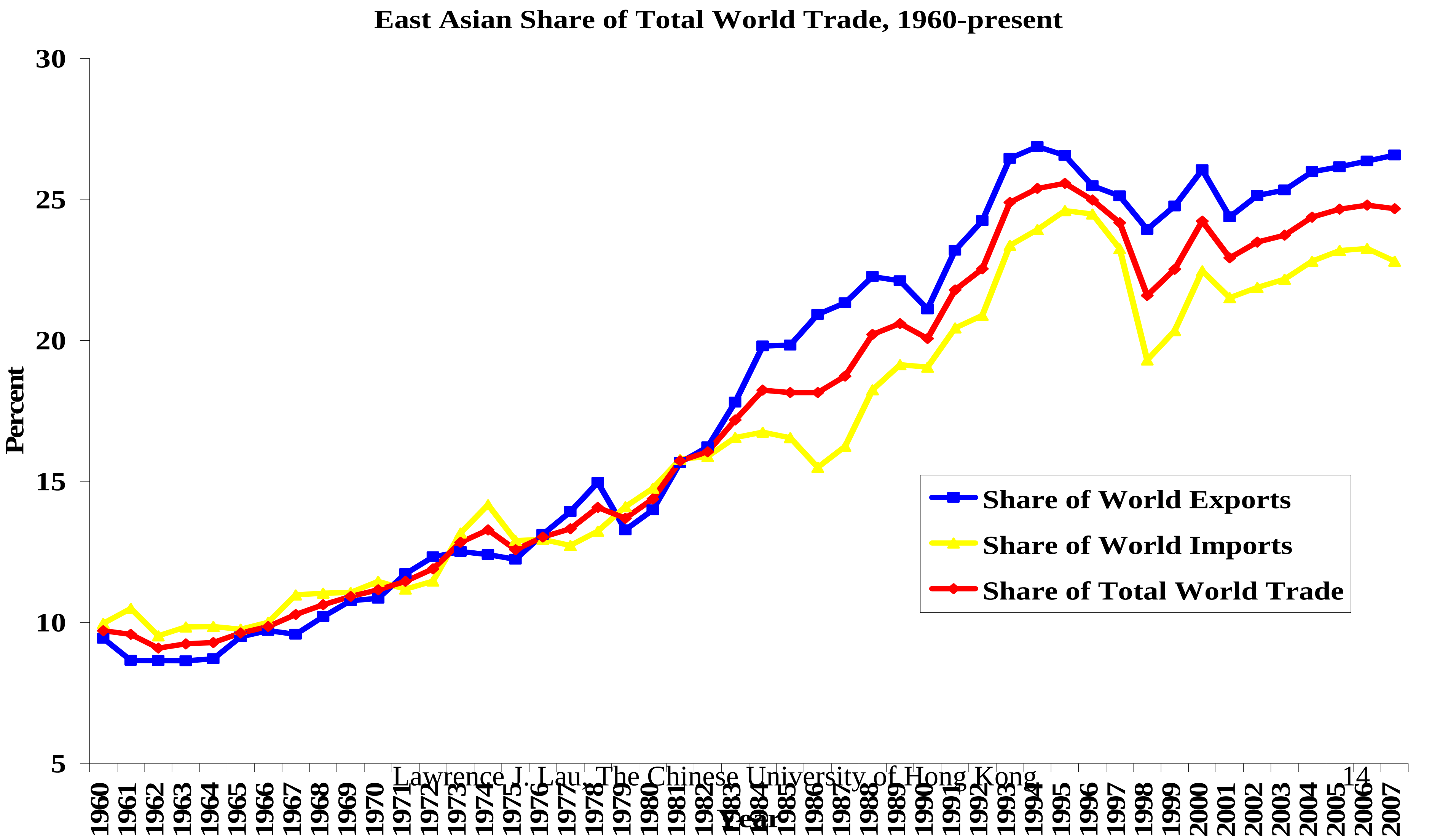
**Figure 2.1: Composition of East Asian GDP in 2006 (in 2000 prices)**



# The Shifting Economic Center of Gravity

- These figures and percentages are sensitive to the exchange rates used for the conversion, but the general conclusions that (1) The contribution of East Asia to total World GDP has increased significantly; (2) The contribution of East Asia other than Japan to East Asian GDP has also increased significantly; and (3) Japan remains for the time being the leading economy within East Asia in both aggregate and per capita terms are reasonably robust to exchange rate changes.
- However, given the trends in current rates of economic growth, ASEAN + 3 will probably surpass the United States in terms of aggregate GDP with China perhaps contributing the highest proportion of the total by 2010.
- This is what gives credence to the idea of "de-coupling" of the world economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the U.S. and elsewhere.

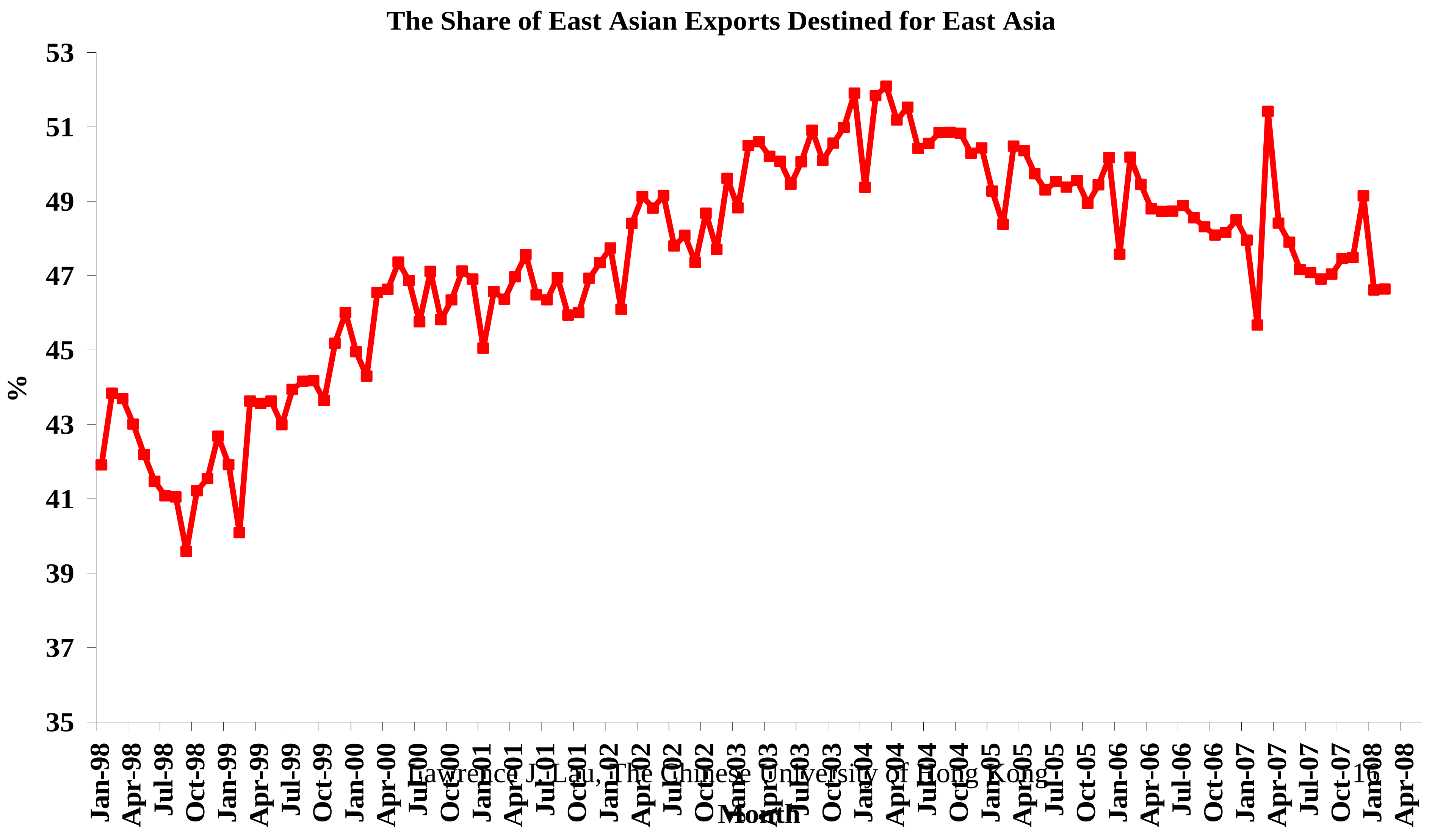
# The Rising Ratio of East Asian Trade in Total World Trade, 1960-present



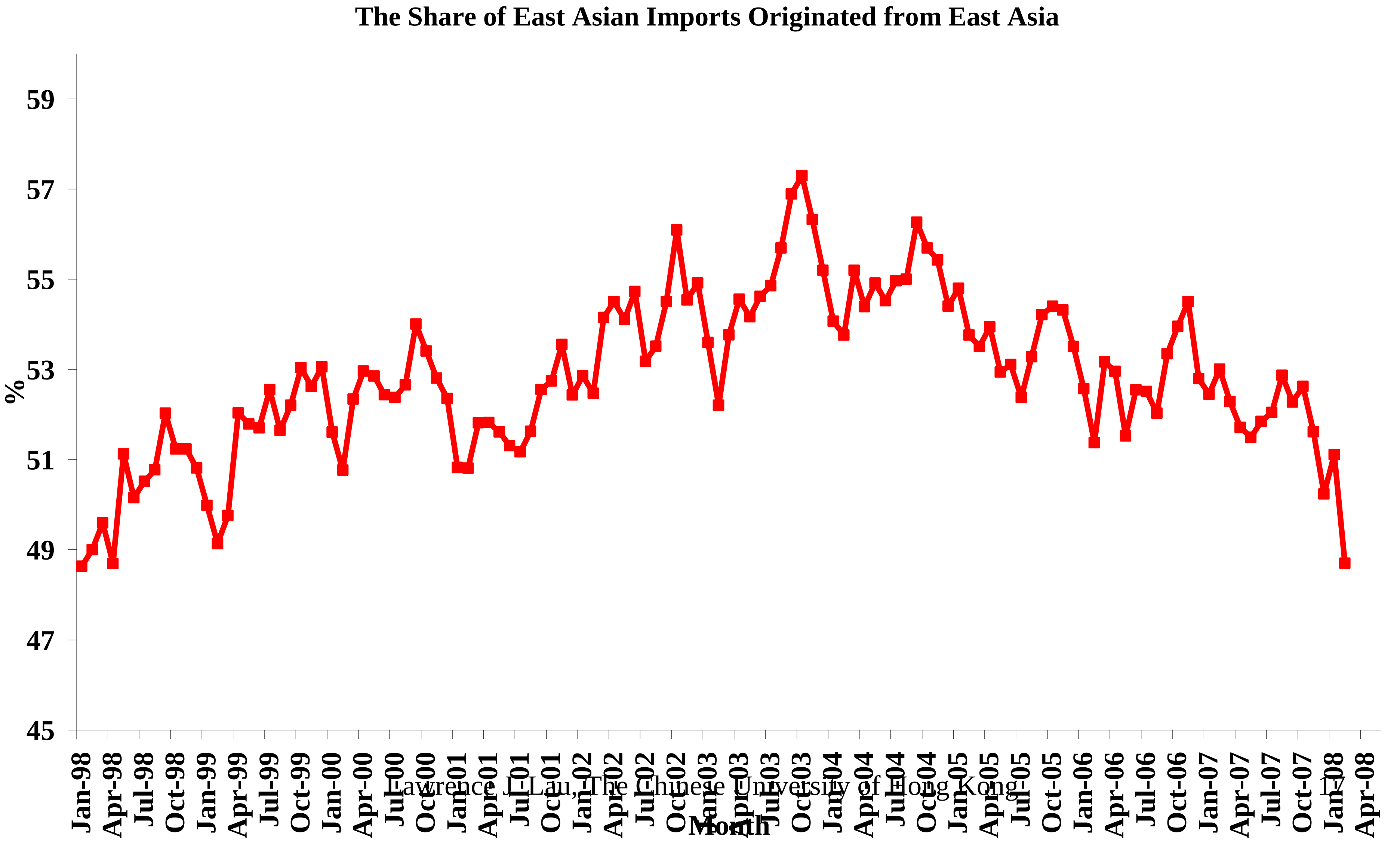
# The Chinese Economy in the World: The Changing Pattern of World Trade

- Because of the rapid economic growth of China and the rest of East Asia, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States.  This is a sea change compared to say thirty years ago.
- Interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined.
- China has overtaken Japan to become the largest exporting country in East Asia.  China has also overtaken Japan to become the largest importing country in East Asia and the most important export market for almost all East Asian economies and runs trade deficits vis-à-vis almost every one.
- The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality.

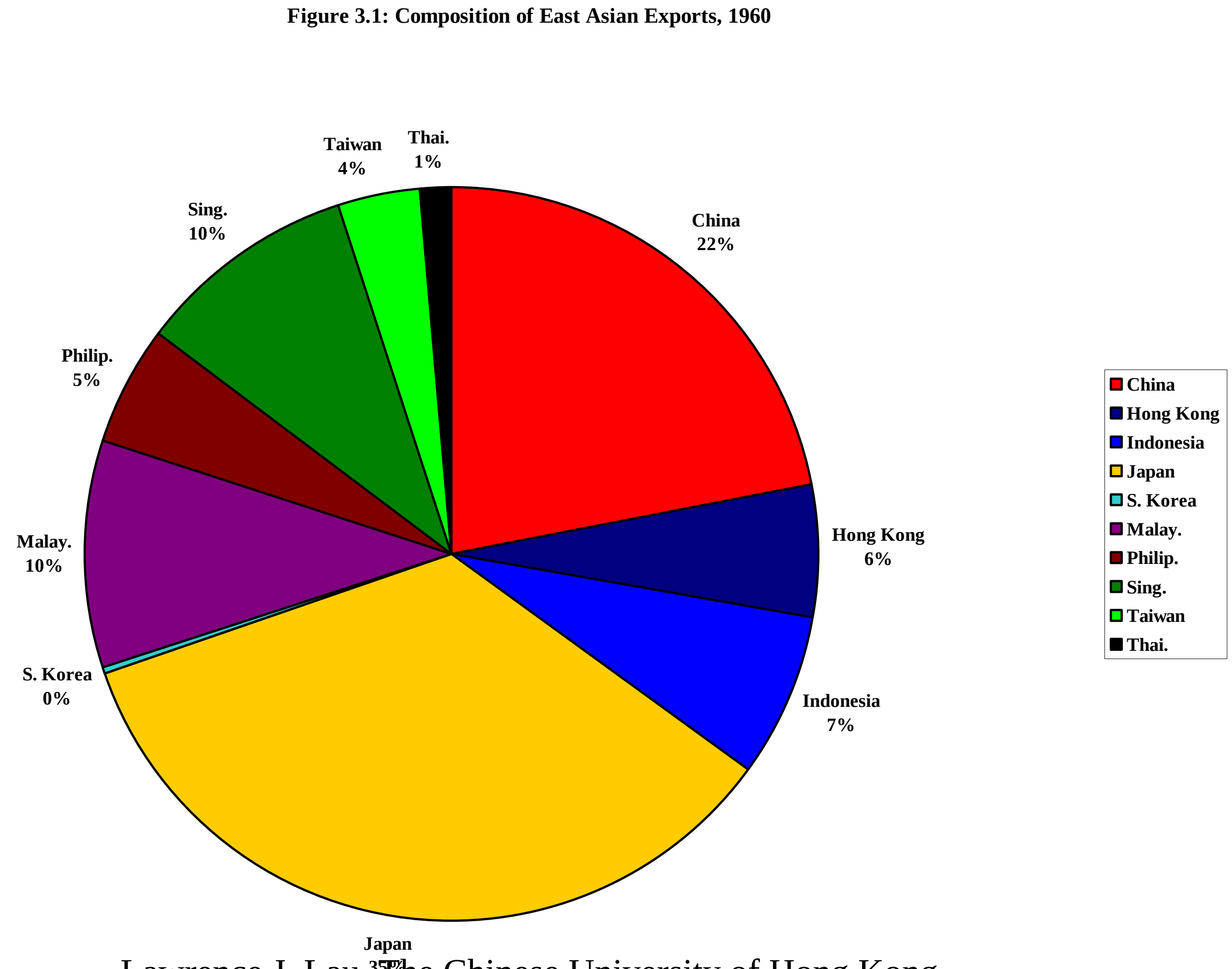
# The Share of East Asian Exports Destined for East Asia, 1960-present



# The Share of East Asian Imports Originated from East Asia, 1960-present

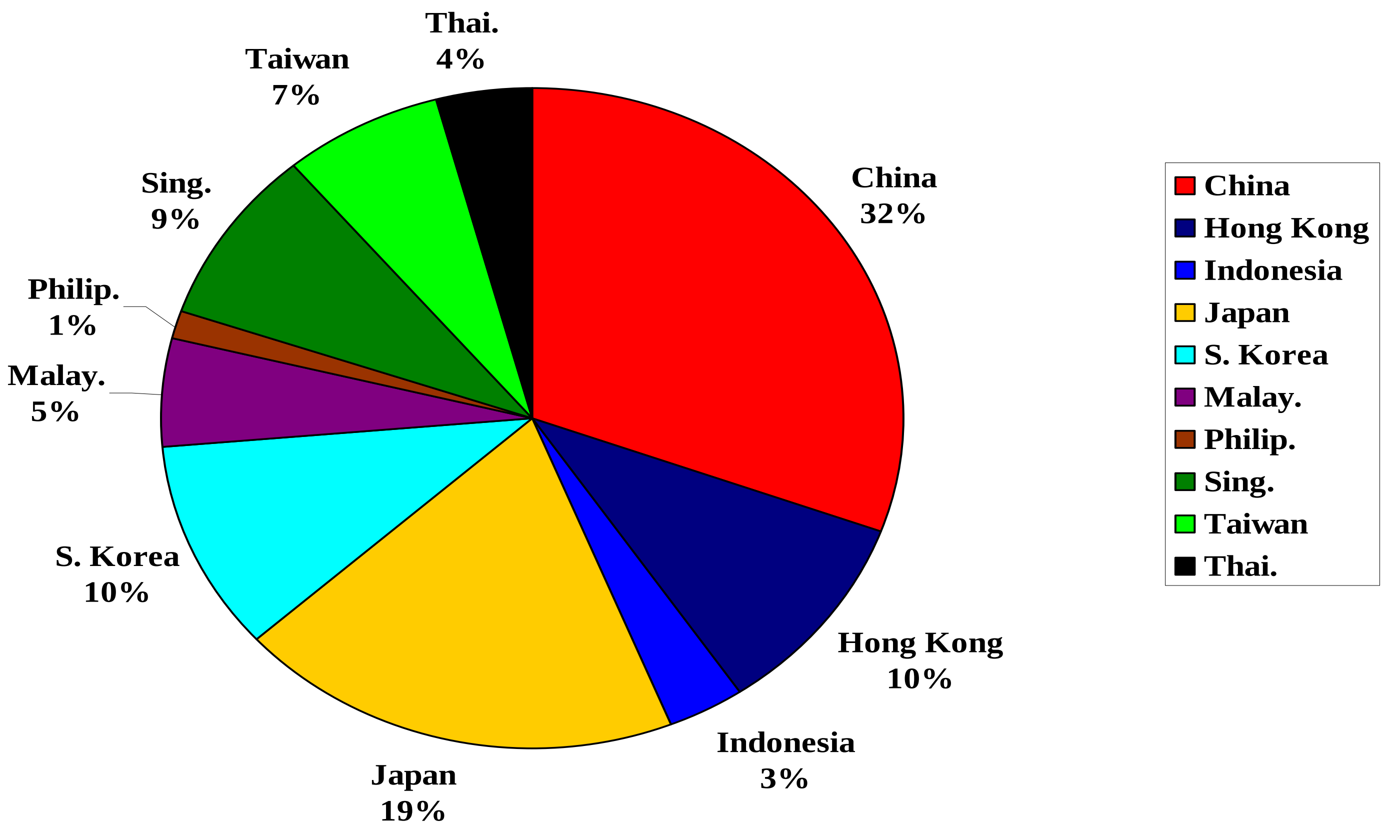


# Composition of East Asian Exports, 1960



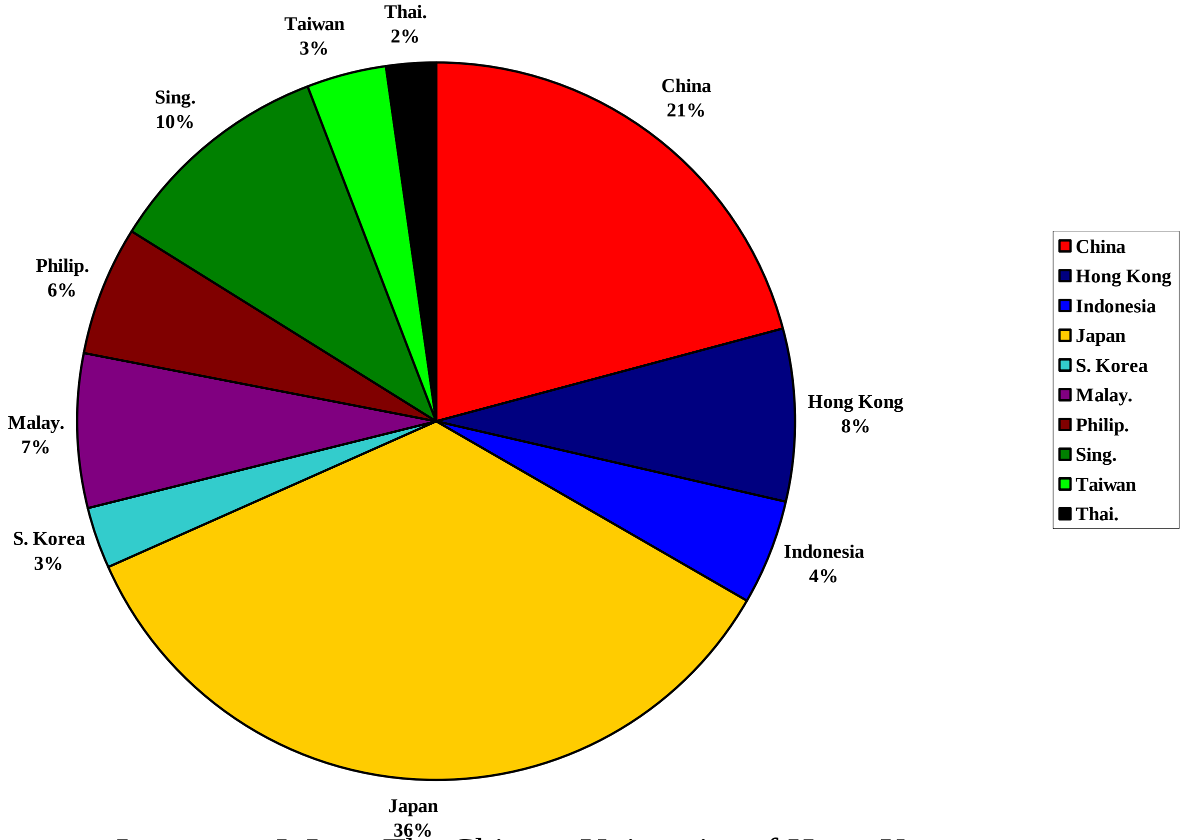
# Composition of East Asian Exports, 2006

**Figure 3.1: Composition of East Asian Exports, 2006**



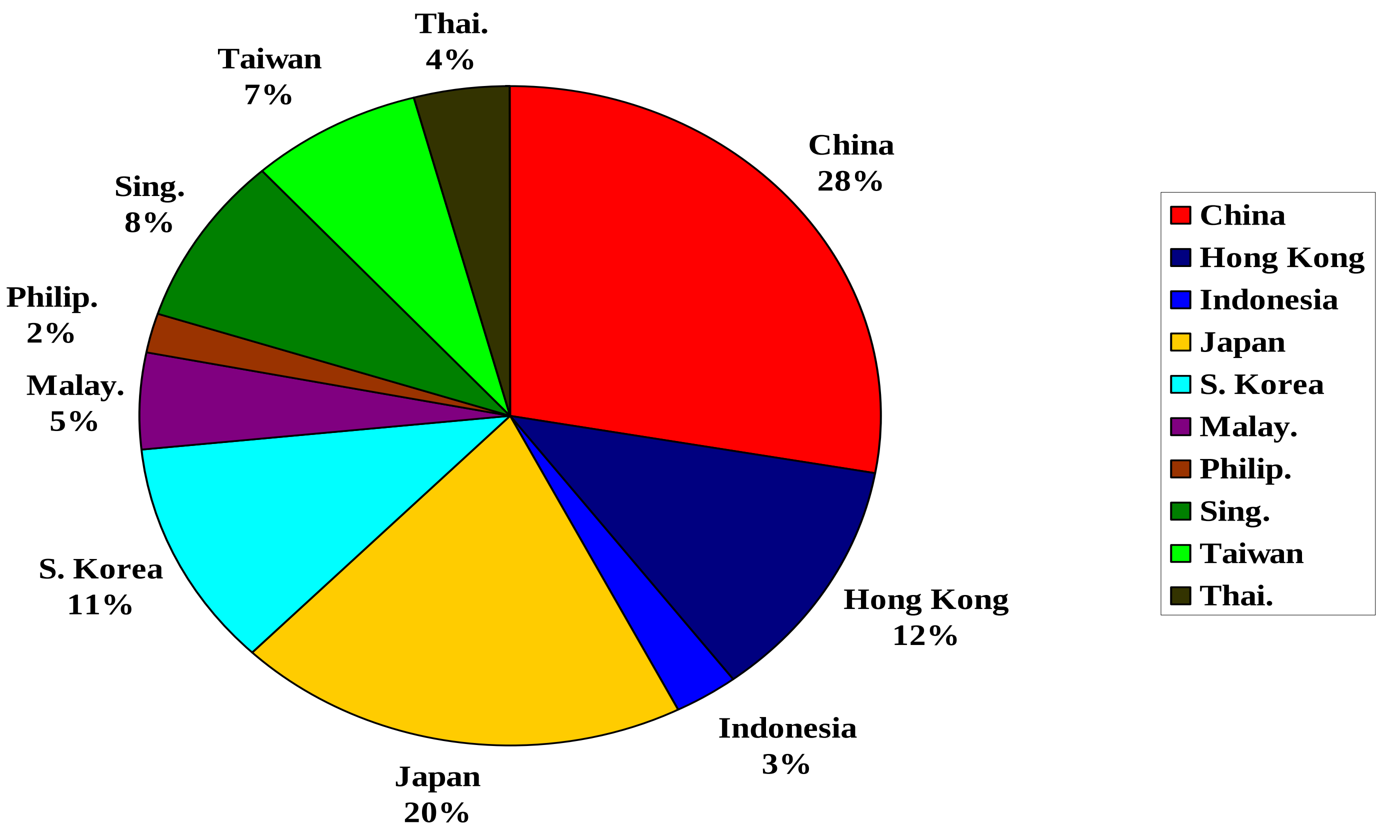
# Composition of East Asian Imports, 1960

Figure 3.3: Composition of East Asian Imports, 1960

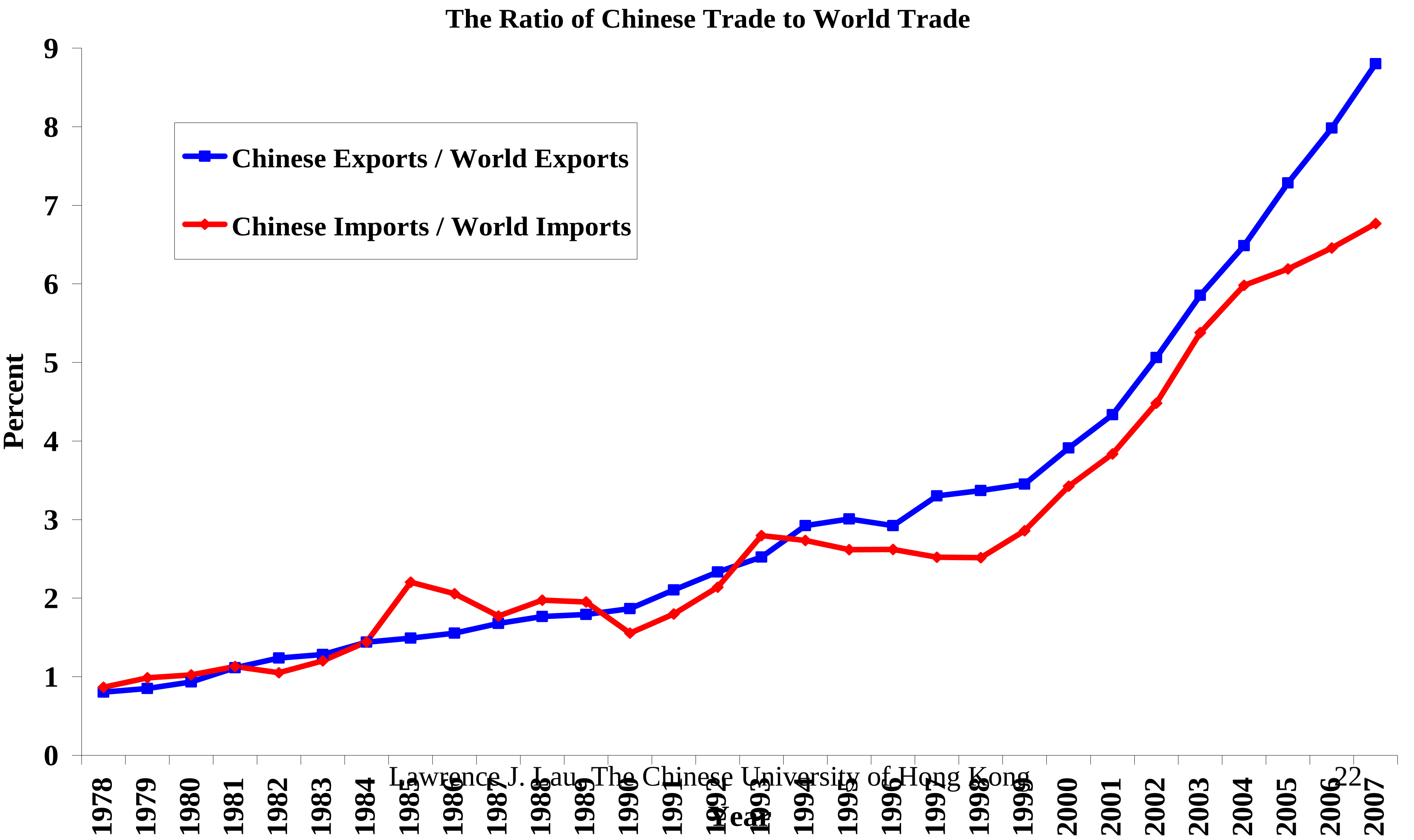


# Composition of East Asian Imports, 2006

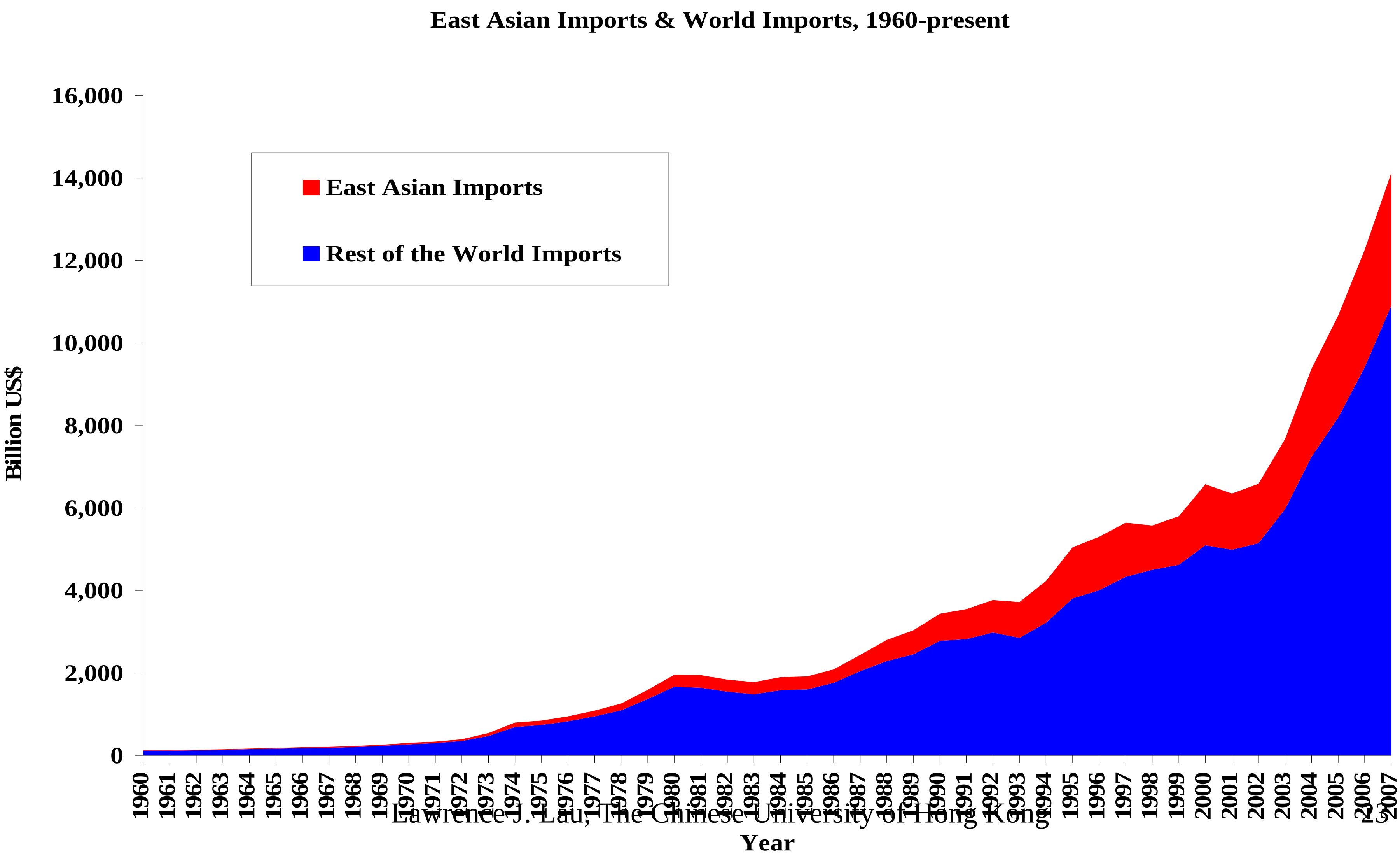
Figure 3.3: Composition of East Asian Imports, 2006



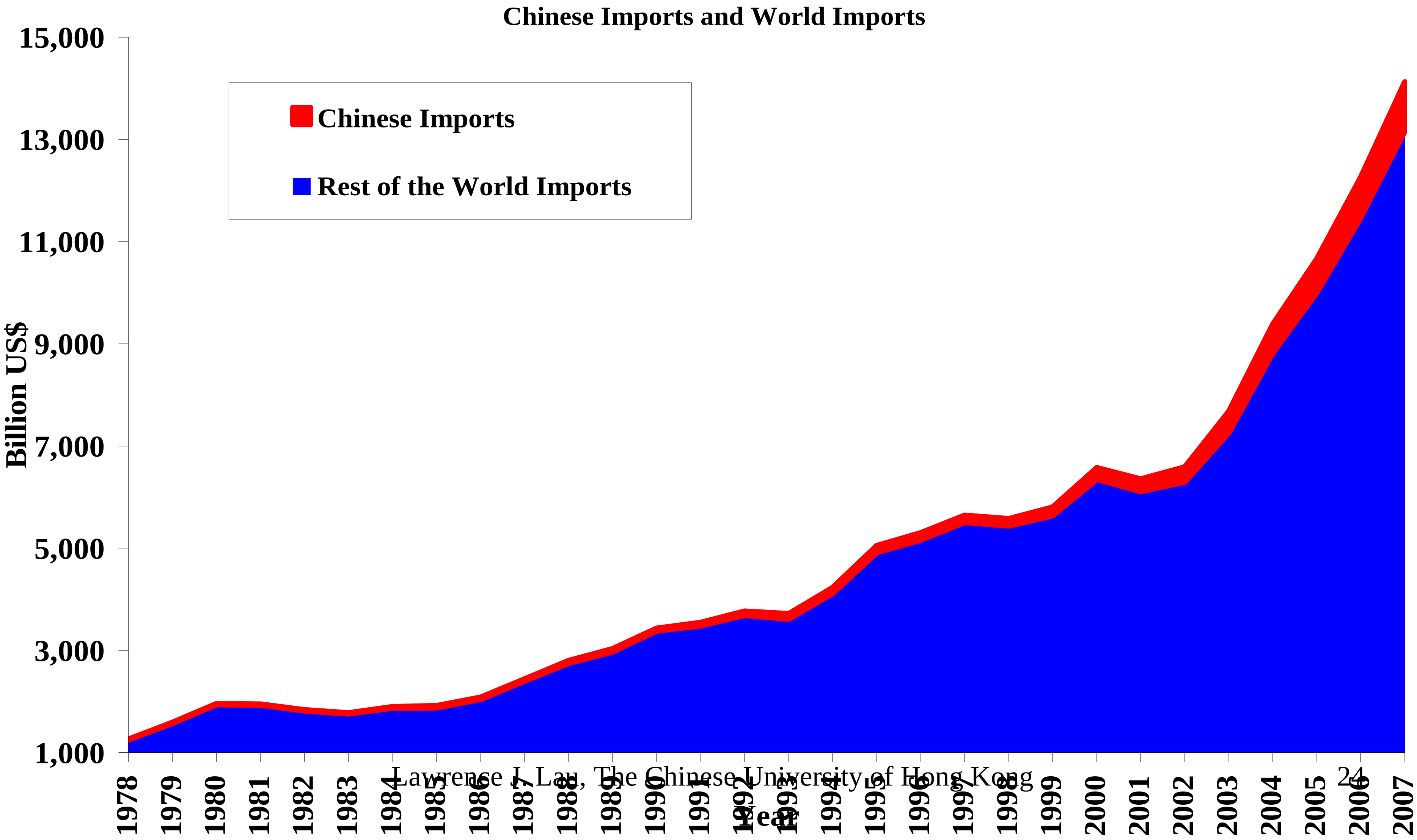
# The Rising Ratio of Chinese Trade in Total World Trade



# East Asian Imports & World Imports, 1960-present



# Chinese Imports and World Imports



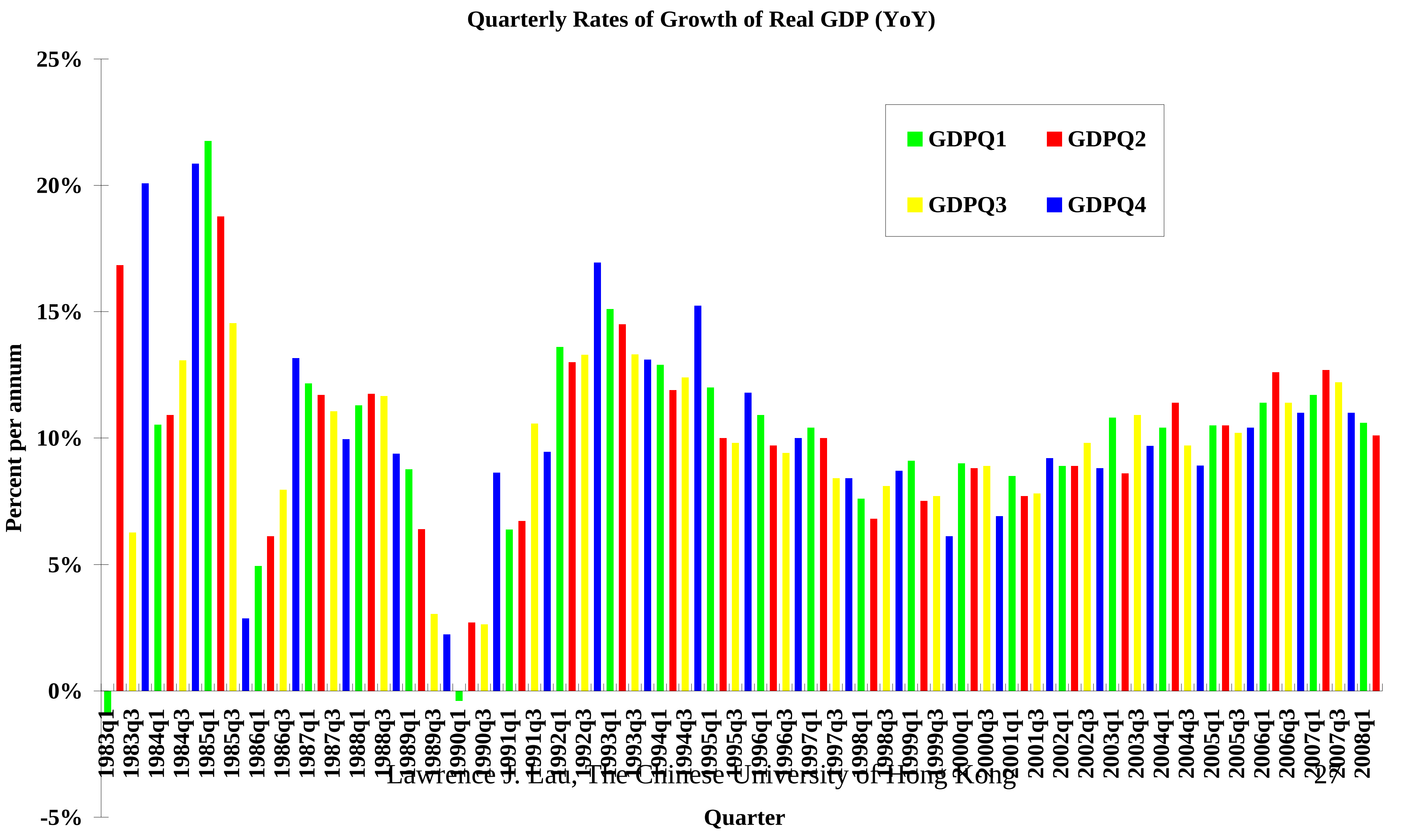
# The Macroeconomic Situation

- The Chinese economy has begun to slow, albeit rather slowly. However, there is reason to believe that the real rates of growth have been somewhat over-estimated because of the difficulties in measuring real value added in real estate development.
- Exports are likely to continue to slow because of the economic recession in the U.S. and the possible slowdown elsewhere in the World and because of other factors such as the revaluation of the Renminbi, the new labor law, the intensified enforcement of environmental regulations and the unification of the tax rates for domestic and foreign-invested enterprises.

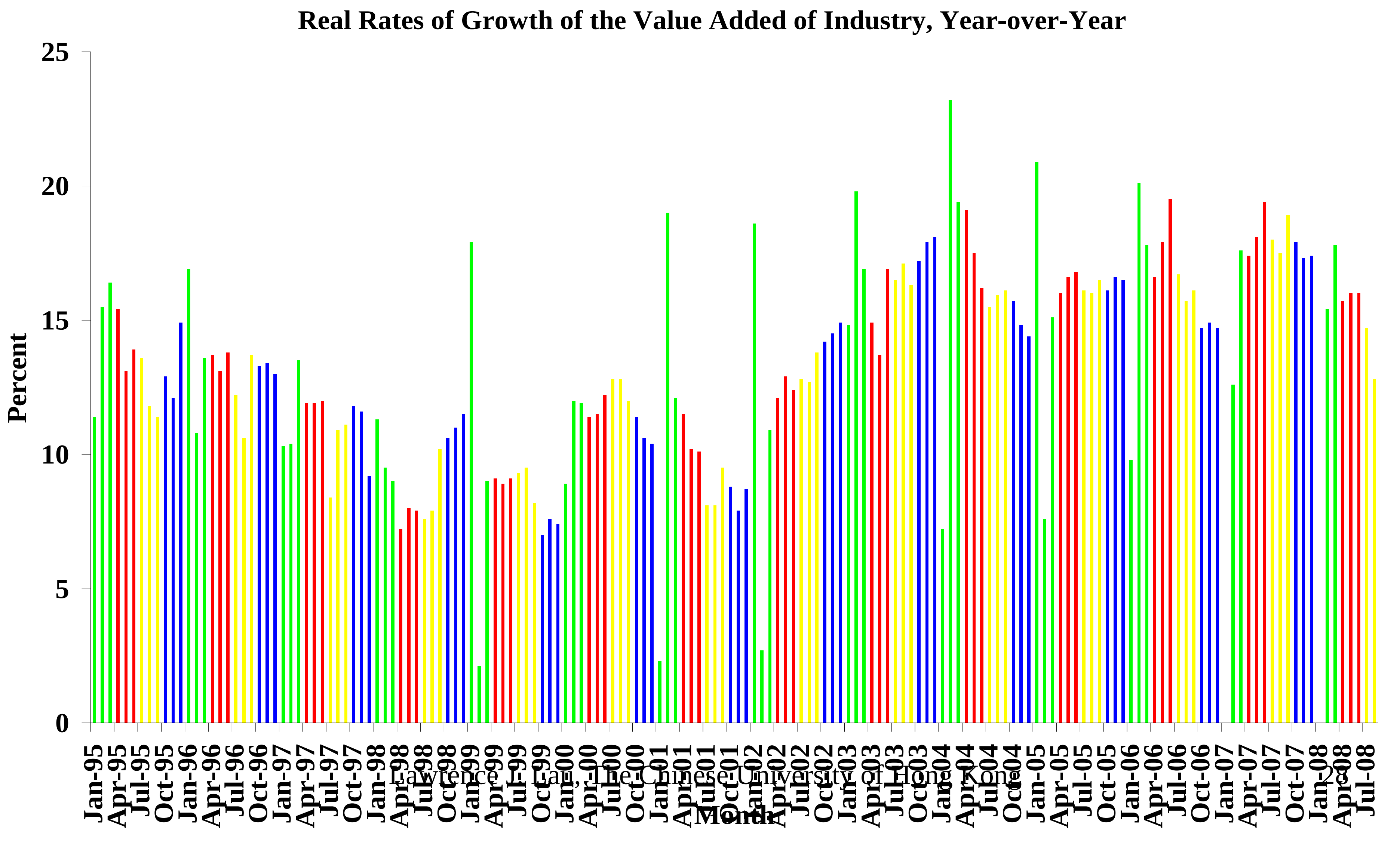
# The Macroeconomic Situation

- However, the reduction of the overall Chinese trade surplus is positive because it helps to decrease the inflow of foreign exchange (hot money). If trade is balanced, then there is no net increase in the inflow of foreign exchange. In addition, a zero or negative trade surplus will alter the expectation that the Renminbi will continue to appreciate, and that will in turn further decrease the speculative inflow of foreign exchange (hot money). With hot money inflow reduced or stopped altogether, China will be able to better control its money supply and conduct its monetary policy.
- China should continue to try to increase its imports, especially from the United States. Agriculture and high-technology products are areas where substantial progress can be made. There is also an opportunity for China to import old ships, with the sharp slowdown in international trade, to be scrapped, as a replacement for ore imports in the production of steel. And this will enable the development of mini-steel mills in China.
- There are many opportunities for the expansion of Chinese domestic demand through infrastructural investment, especially in the earthquake-affected regions, and environmental clean-up and protection. Education and medical care and upgrading of facilities are other possibilities. All of these investments contribute to the achievement of a harmonious society.

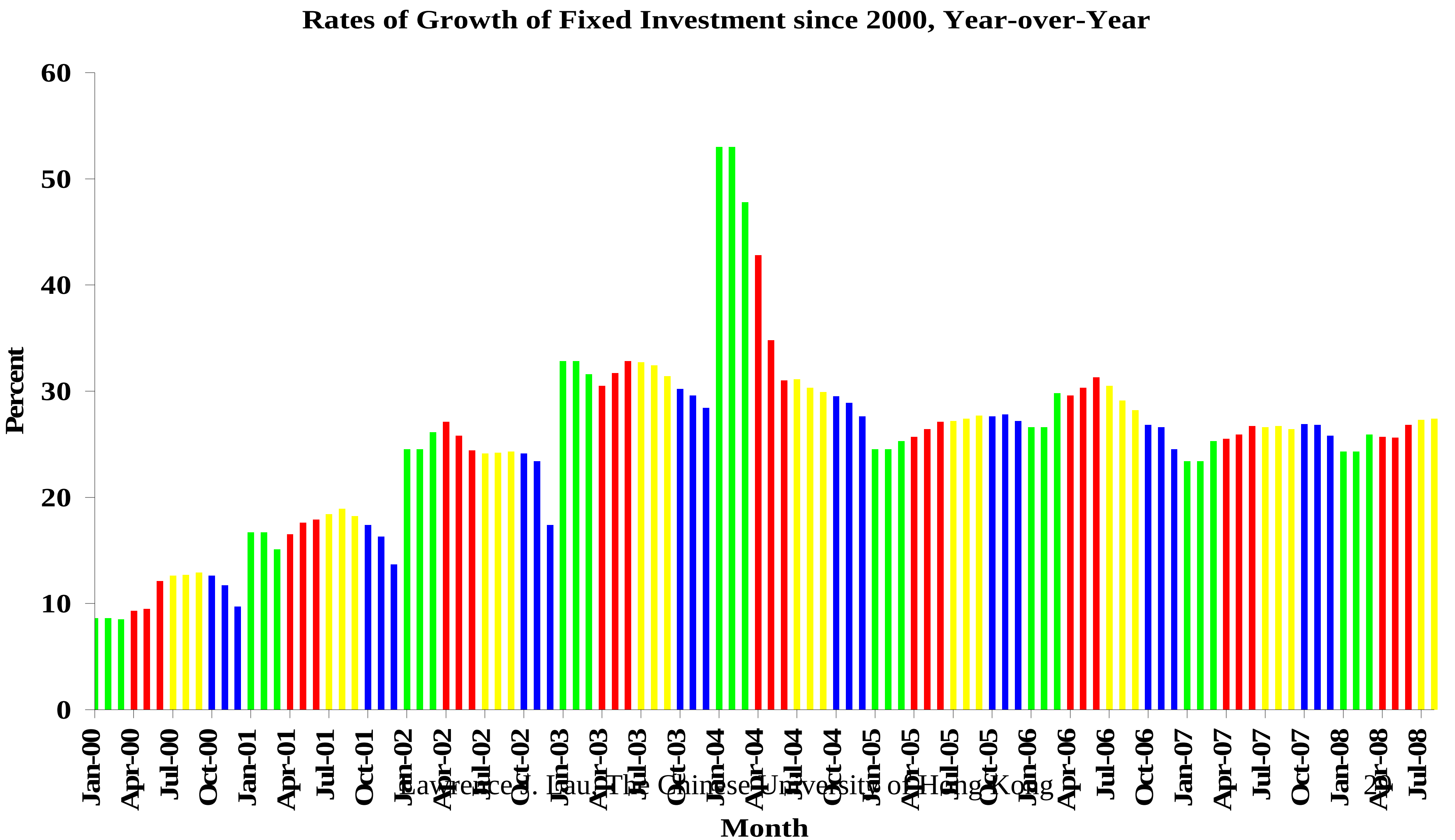
# Quarterly Rates of Growth of Real GDP



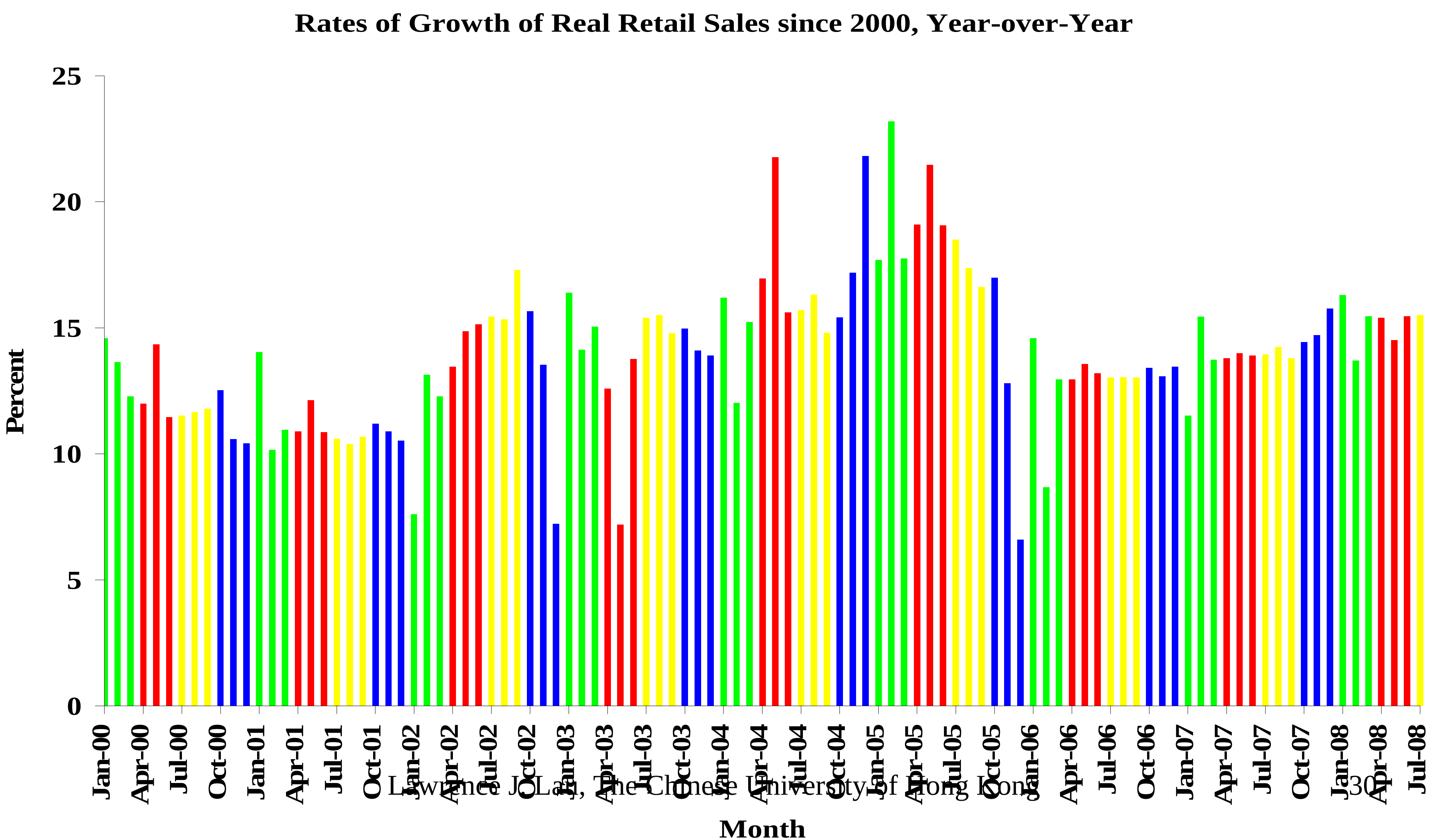
# Monthly Rates of Growth of Value-Added of Industry



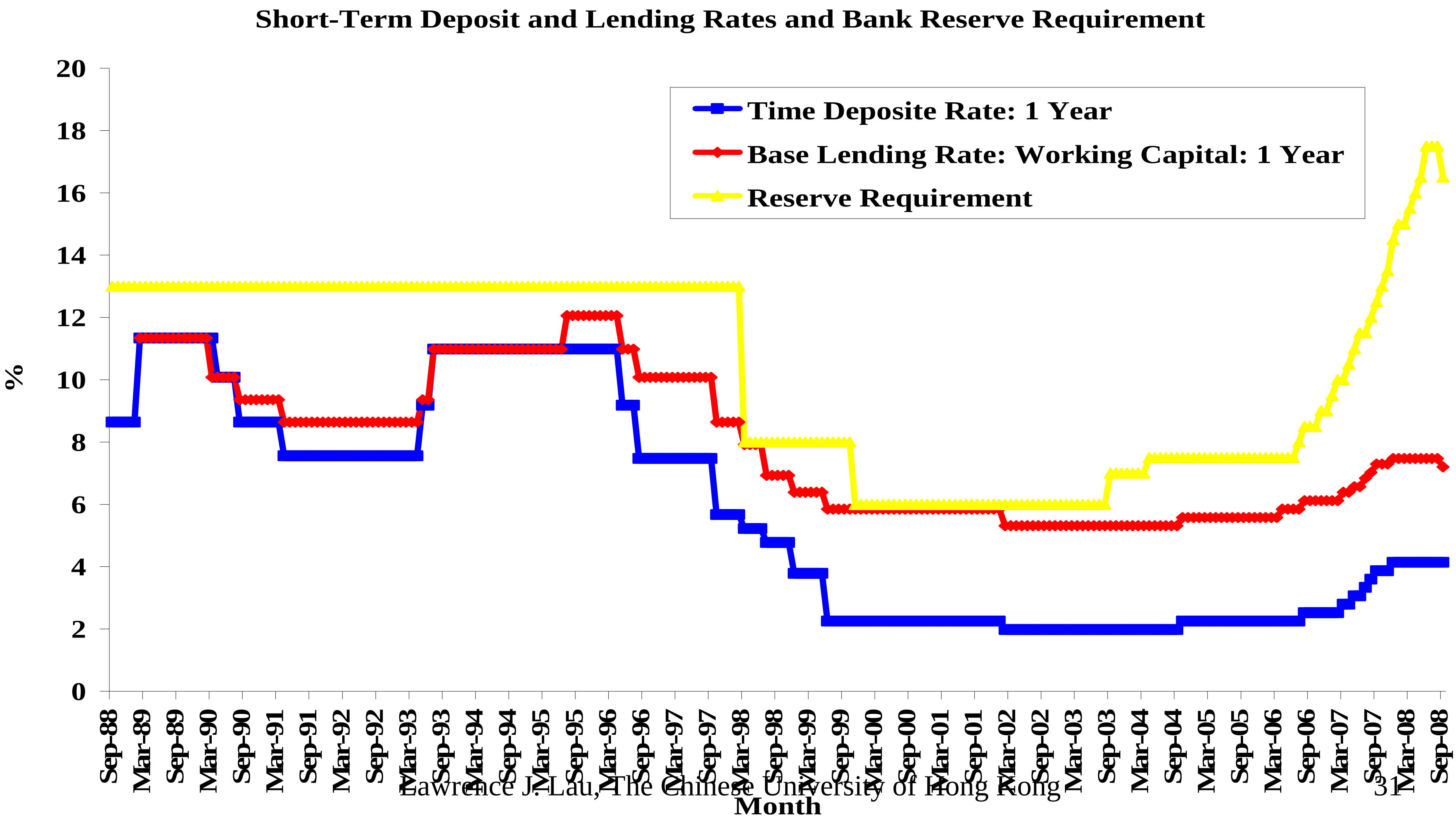
# Monthly Rates of Growth of Real Fixed Investment, Y-o-Y



# Monthly Rates of Growth of Real Retail Sales, Y-o-Y



# Short-Term Deposit and Lending Rates and Bank Reserve Requirement



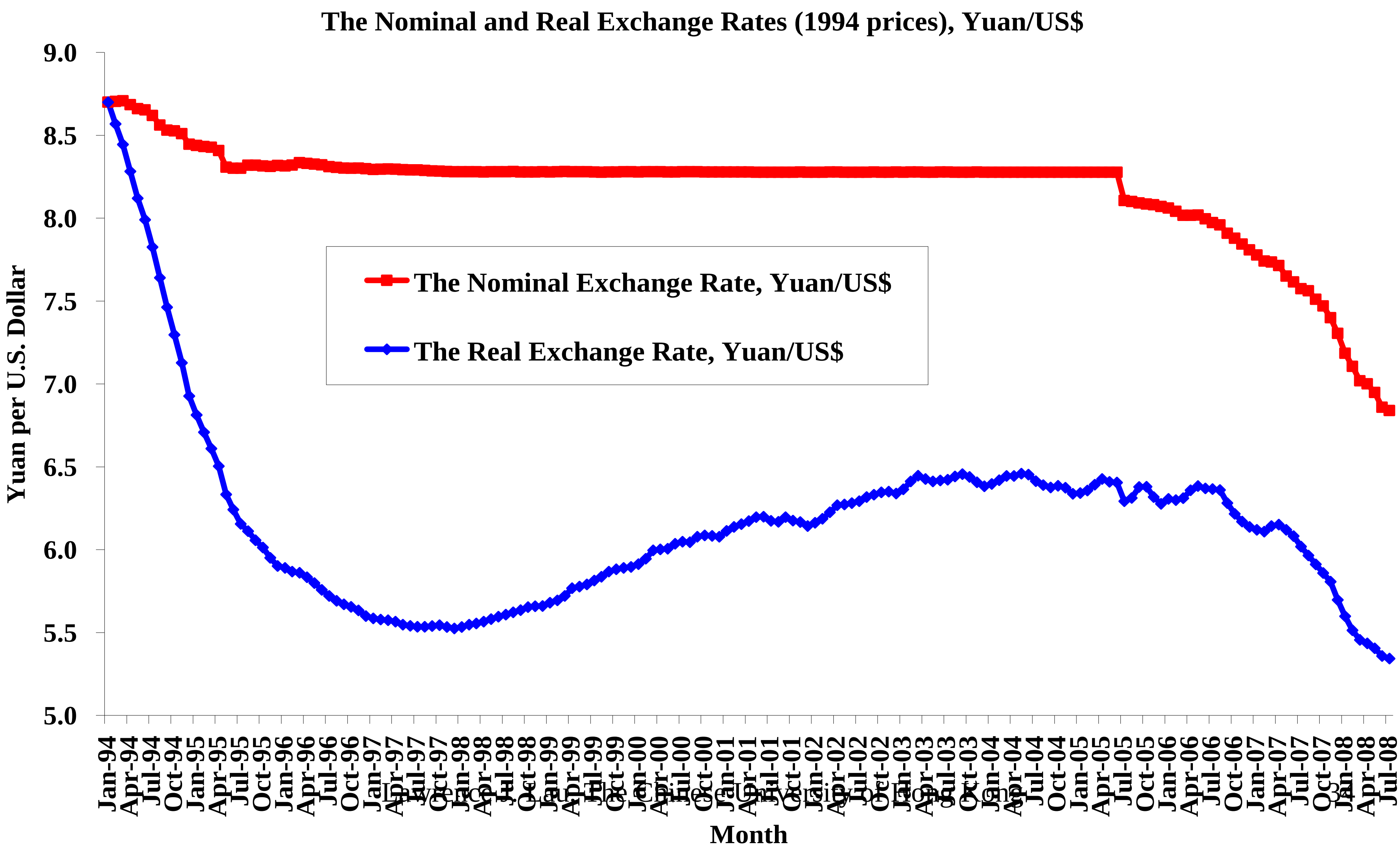
# The Macroeconomic Situation

- The Chinese fiscal situation remains healthy, with large annual increases in government revenue at rates much higher that those of real GDP.  And the banks are flush with cash.  Long-term bonds can be issued by the Government to finance infrastructural projects.
- A slowdown of the economy to 8% per annum is not a bad thing—it is still among the highest rates of growth in the world.
- However, the central government must take care of the subsistence needs and the retraining and reemployment of workers who become unemployed because of the slowdown in the export sector.
- It is best to let the asset markets—stock and property markets—to adjust by themselves.  The key objective of the central government should be to encourage long-term investment and owner-occupied housing, but not short-term speculation.  Policies should be crafted to achieve these objectives.

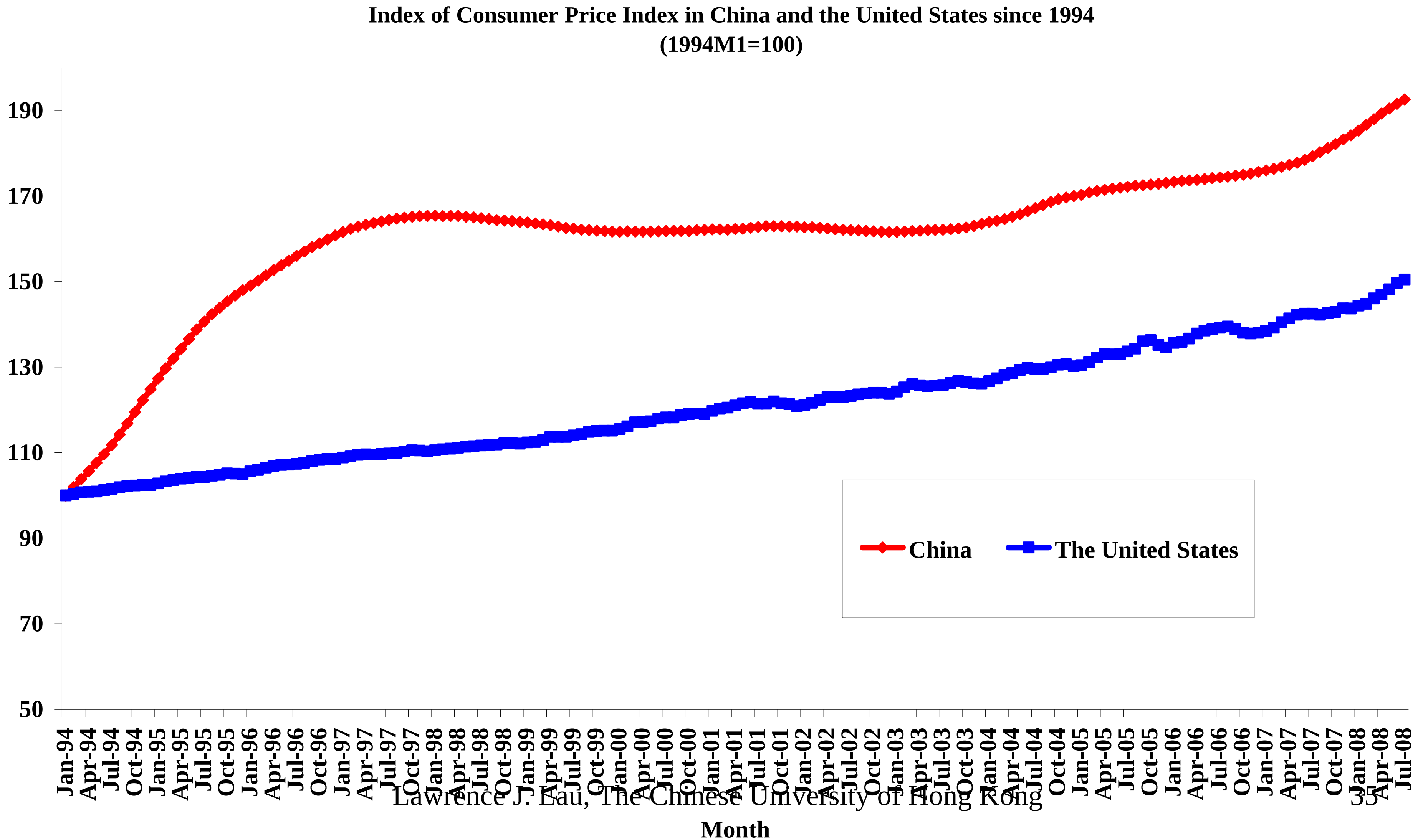
# The External Environment

- The U.S. financial crisis is now more or less under control, but there may be a few more failures of large financial institutions. Recovery in the U.S. housing market will take at least a couple of years. In the meantime, the U.S. is unlikely to press for a weaker Dollar.
- The world price of oil has begun to return to more normal levels. China can help accelerate its decline by committing to energy conservation and environmental protection policies which are beneficial to both China and the World. The world price of oil, in real terms, is not significantly different from the price of oil prevailing in the 1980s.
- With expected slowdown in the U.S. and in Western Europe, China should rely on its own resources to stimulate its internal demand. It can also provide support for other East Asian economies. De-coupling is real and can be made even more significant through appropriate policies.
- China can provide help to the U.S. and speed up its recovery by increasing its imports from the U.S. (including agricultural commodities) as well as by financing U.S. non-financial corporations during its current credit crunch.

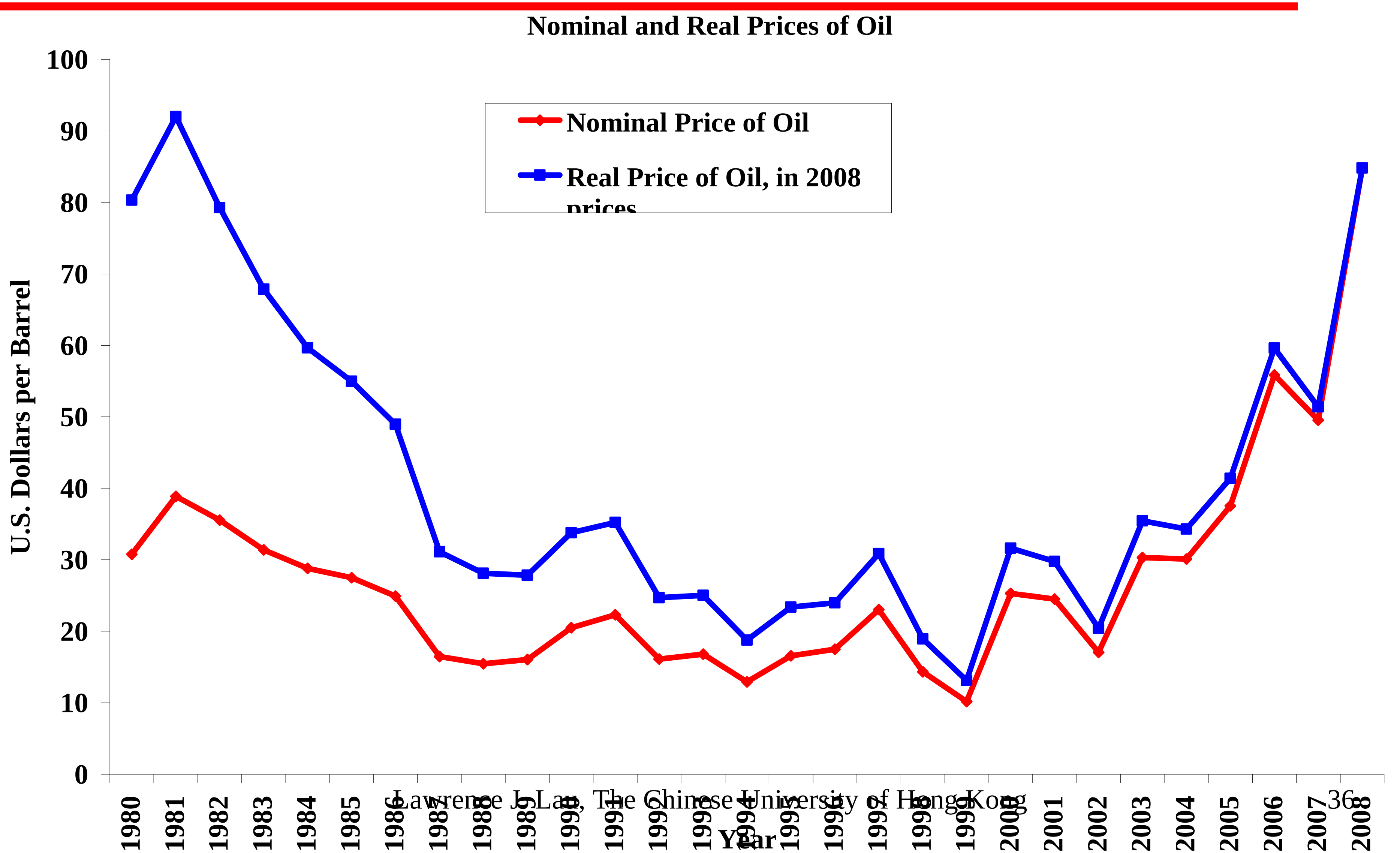
# The Nominal and Real Yuan/US$ Exchange Rates



# The Consumer Price Indexes of China and the United States



# The Nominal and Real Prices of Oil (2008 prices)



# The External Environment—De-Coupling

- In general, the phenomenon of “decoupling” is expected to be operative.  Chinese economic growth is largely unaffected by external developments, including a possible economic recession in the United States.  The other so-called BRIC countries—Brazil, Russia and India—are even less dependent on exports.  Brazil has recently discovered huge oil reserves and should be entering a new era of rapid economic development, financed by its new found oil wealth instead of foreign loans.  Russia has already been benefiting from the high world price of oil and is not a major exporter of manufactured goods and hence will be relatively unaffected by external developments.  India is also not a major exporter, except in computer software, and its economic growth is mostly internally driven.

# The External Environment—De-Coupling

- The BRIC countries can be expected to maintain their rates of growth, more or less, the rest of the world, including developing East Asia, should be able to manage.
- During the East Asian currency crisis of 1997-1998, the impact of simultaneous downturns and upturns on the part of East Asian economies was amply demonstrated. So that so long as they continue growing together, by creating demands for one another's exports, their collective growth can be sustained. The high domestic savings rate found in almost all of the East Asian economies is a major advantage of East Asia which makes it more or less independent of capital inflows from developed economies and hence de-coupling much more possible and likely.

# The Impact of the Economic Slowdown in the U.S.

- The U.S. demand for imports will likely decline with the reduced household consumption, or at a minimum the rate of growth will decline.
- Such decline will have a negative effect on the rate of growth of Chinese exports to the U.S. and hence on Chinese GDP, but the effect is expected to be marginal.
- The overall economic slowdown in the U.S. will last another year or two, until more positive expectations are restored for both firms and households.
- Despite its current near-term strength, in the longer term horizon of 3-5 years, the U.S. dollar will weaken relative to other reserve currencies as the net inflow of capital, especially that of direct and portfolio investment, is reduced.

# The Impact of the Economic Slowdown in the U.S.

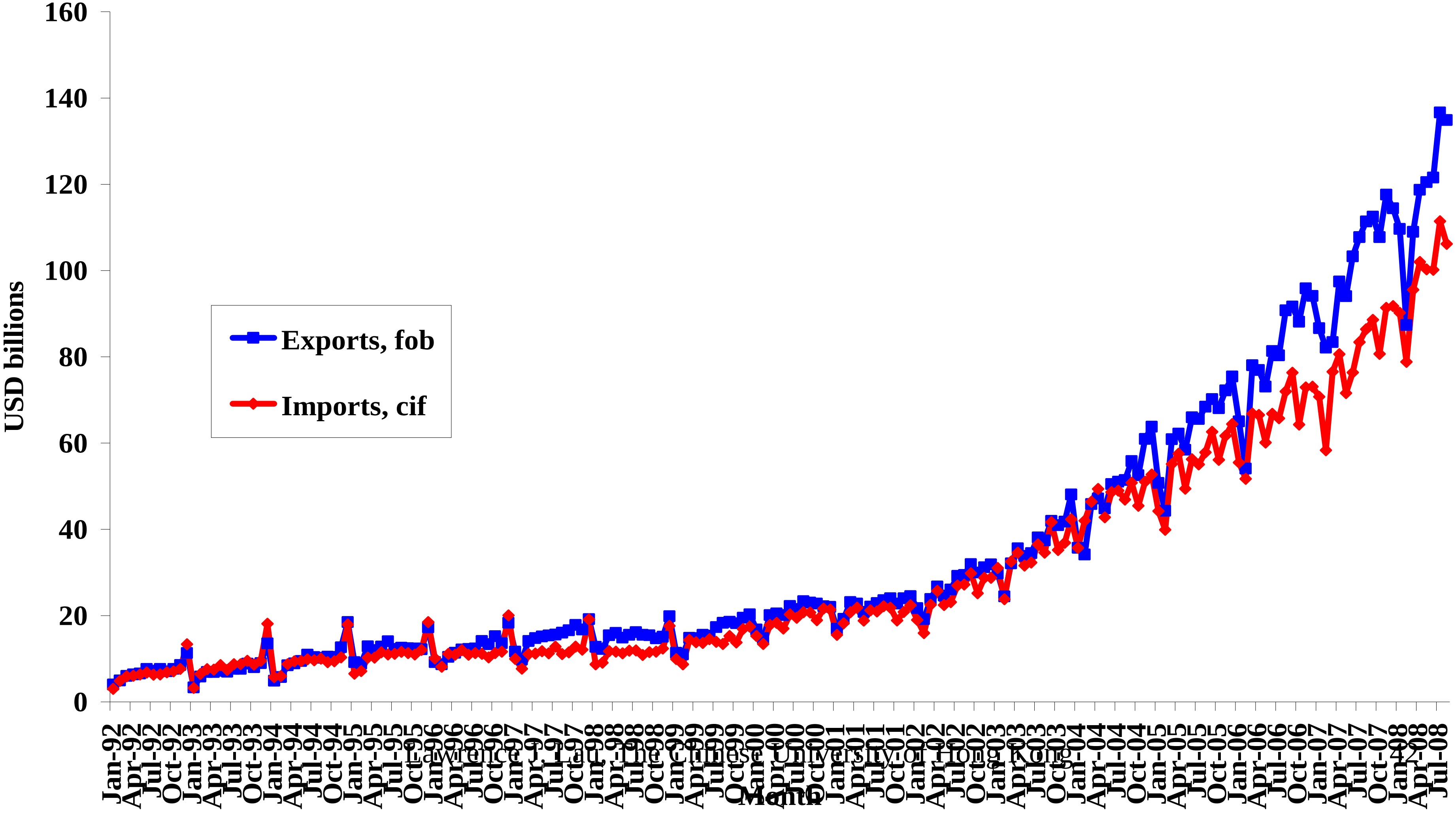
- Chinese exports to the U.S. constitute between 8% (Chinese estimate) and 12% (U.S. estimate) of Chinese GDP; however, the direct domestic value added content of Chinese exports to the U.S. is quite low, averaging 17.7%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 2.2% (12% times 18% = 2.16%).
- 2.2% of GDP is reasonably significant and will result in hardships in some localities if completely lost. However, even if Chinese exports to the U.S. falls by 10% (which is considered unlikely), it will cause Chinese GDP to fall by only 0.22%, which is clearly tolerable, especially if the remaining 97.8% of the Chinese economy continues to grow.

# The Impact of the Economic Slowdown in the U.S.

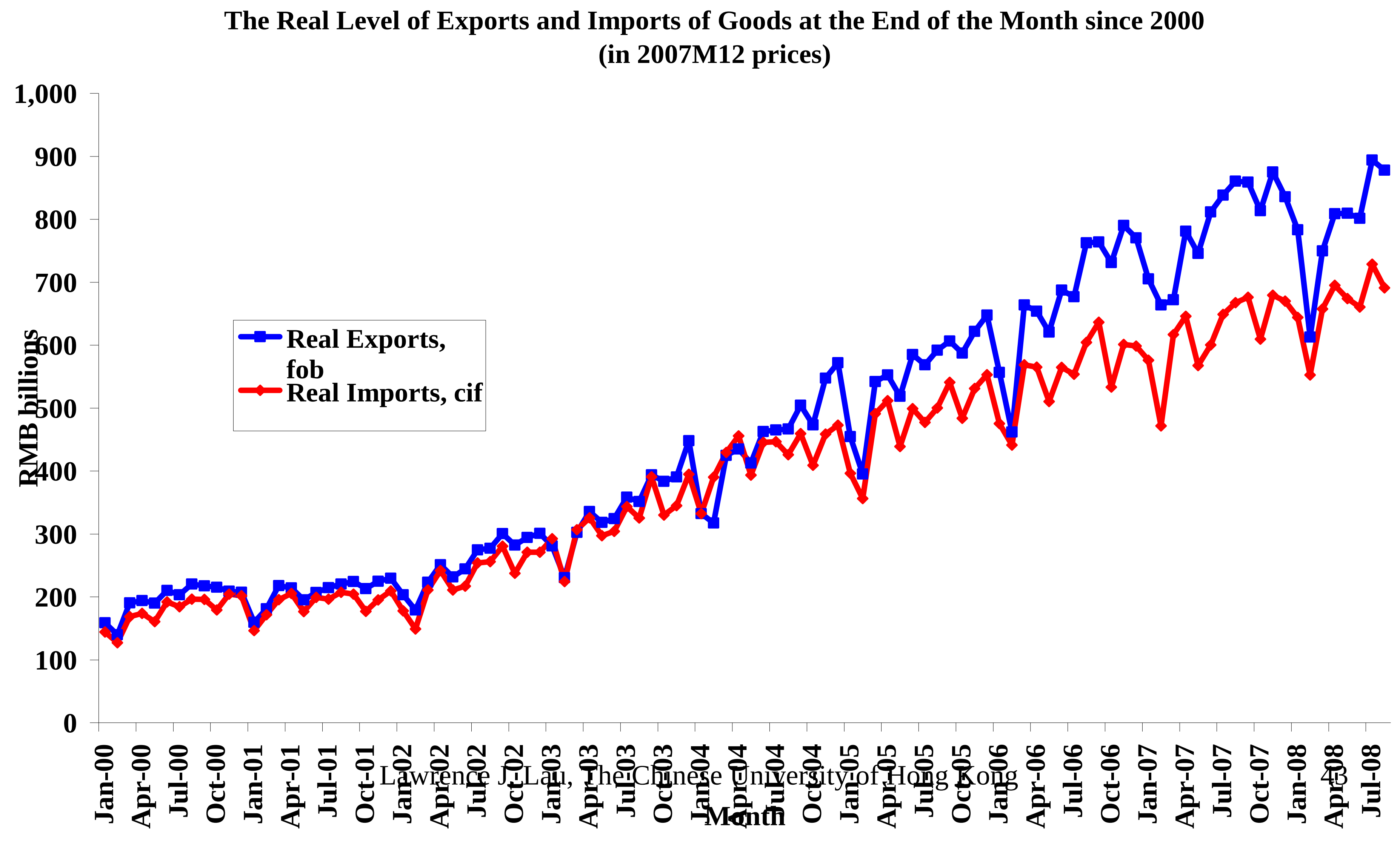
- If the indirect domestic value added of Chinese exports to the U.S. is also taken into account, a 10% decline in Chinese exports to the U.S. may result in a decline of Chinese GDP of no more than 0.5%.
- However, the impact may be quite severe on certain localities where most of the economy is dependent on exports, e.g., the cities of Dongguan and Shenzhen in the Province of Guangdong, and Suzhou in the Province of Jiangsu, where the value of exports is greater than the local GDP. Measures must be put in place in these localities to take care of expected lay-offs of workers as a result of the slowdown in export demand.

# Chinese Exports and Imports in US$

**The Level of Exports and Imports of Goods at the End of the Month, in U.S. Dollars**



# Real Chinese Exports and Imports in RMB (2007M12 prices)

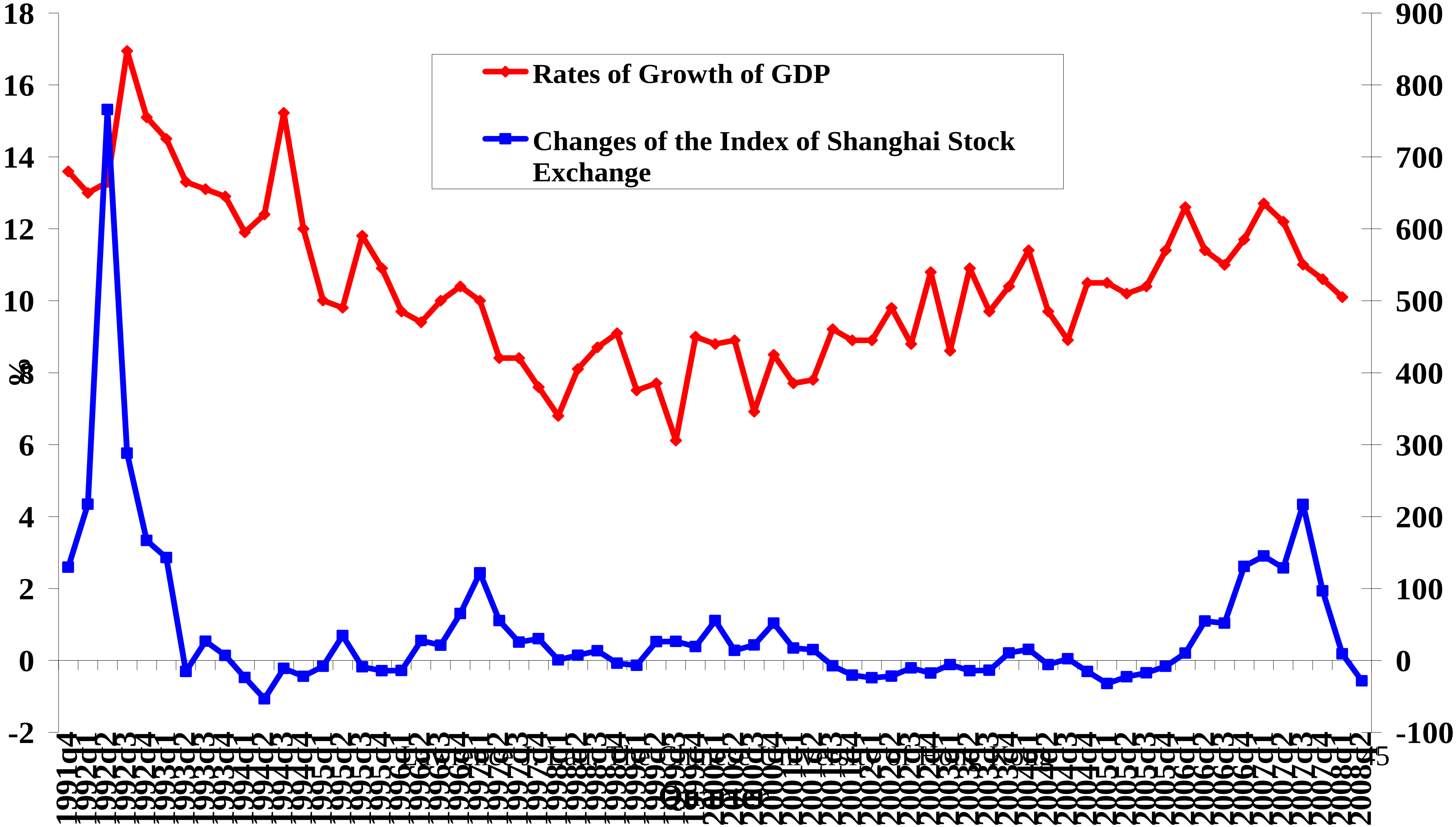


# The Impact of the Asset Markets

- If we look back, the 30 year period of successful economic performance in China since the beginning of the economic reform and opening to the world is almost completely independent of the Chinese stock markets or the Chinese property markets. The Chinese stock markets have been prosperous only within the last couple of years.
- The situation facing the Chinese economy is much more adverse back in 1998, with the Chinese Government then having far less resources. But the Chinese economy managed to do all right then (and earned the gratitude and respect of the East Asian economies). Today the Chinese Government has far more resources and instruments at its disposal.

# Quarterly Rates of Growth of GDP and the Index of the Shanghai Stock Exchange

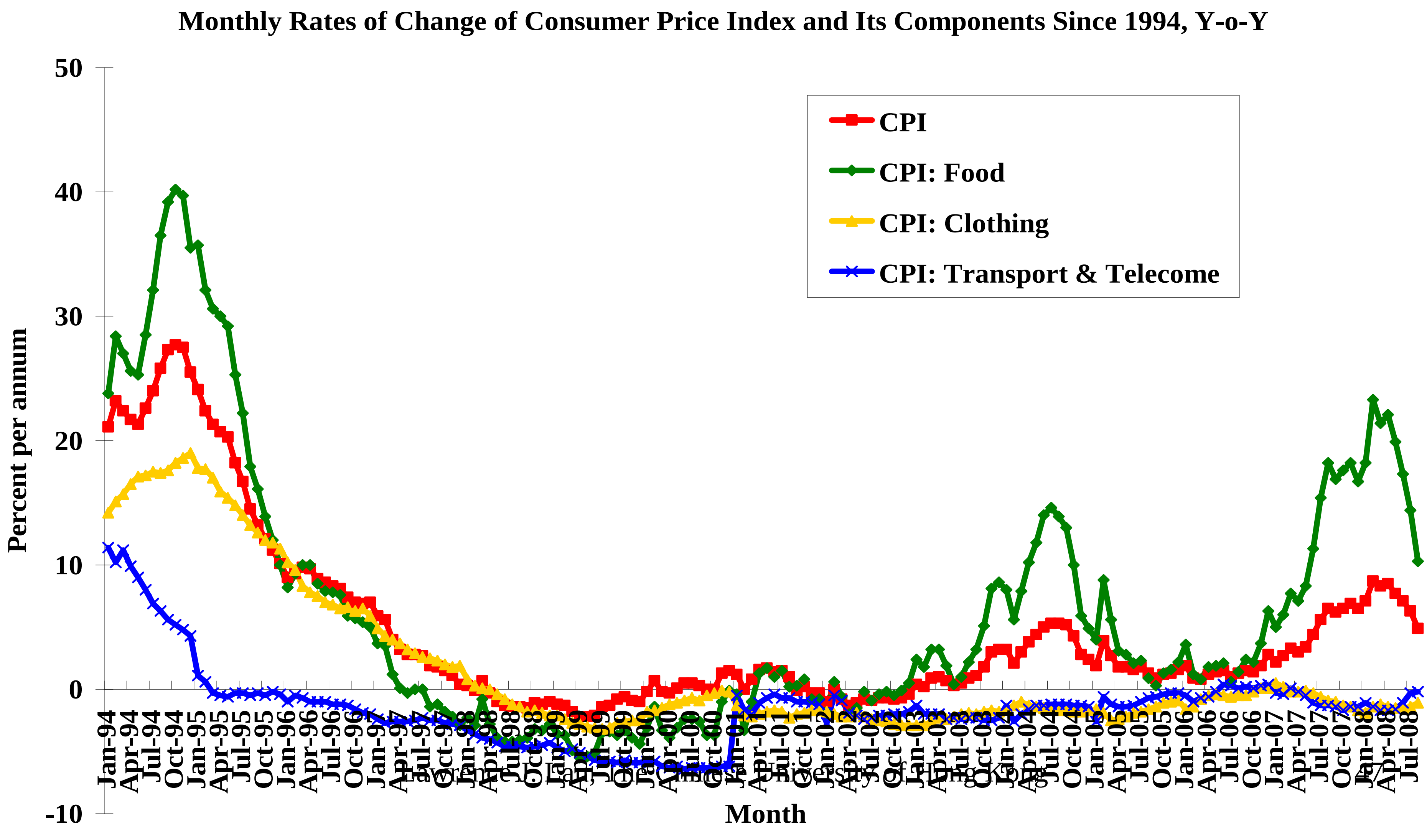
Quarterly Rates of Growth of GDP and the Shanghai Index, Year-over-Year



# Maintaining Price Stability

- The rate of inflation has slowed significantly, as expected. This is the time to try to adjust the domestic prices of energy commodities such as coal, gas and oil, as well as the retail prices for electricity, gas and transportation fuel, while introducing differential pricing policy to protect the low-income households.

# Monthly Rates of Changes in the Consumer Price Index & Components



# Concluding Remarks

- The experience of the East Asian Currency Crisis in 1997 shows that the downturns were sharp when they occurred simultaneously but the upturns were also rapid and sharp when all economies recovered together. This also shows that the East Asian developing economies as a group can grow independently of the U.S. and Europe.
- The de-coupling of global economic growth is a new phenomenon. But with the rapid economic growth of not just East Asia, but also the other BRIC economies (Brazil, Russia and India), the world should be able to manage even as the U.S. economy slows down and goes into a recession.

# Concluding Remarks

- China is at the present time much better prepared to cope with a negative external environment—it has more resources (much higher reserves, large fiscal surpluses, a much more effective social safety net).
- There is a great deal of scope for China to exercise its leadership in important initiatives that can be beneficial for all East Asian economies and for the world. The key is to ensure that the resulting outcomes are win-win for all.
- Continuing economic integration of the East Asian economies is inevitable—East Asian economies now trade more with one another than with either United States or Europe and are likely to continue to do so, especially given the economic problems being faced by the United States.