

Impact of the Global Financial Crisis on the Mainland and Hong Kong

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Introduction

- ◆ Impact on the Mainland Economy
- ◆ The Chinese Economy in a Post-Financial Crisis World
- ◆ The Renminbi-U.S.\$ Exchange Rate
- ◆ Impact on the Hong Kong Economy
- ◆ The Recovery
- ◆ Concluding Remarks

Impact on the Mainland Economy

- ◆ Is 8% economic growth achievable?
- ◆ Yes, despite the difficulties in the export sector, there should be sufficient aggregate demand to sustain a rate of growth of 7-8%.

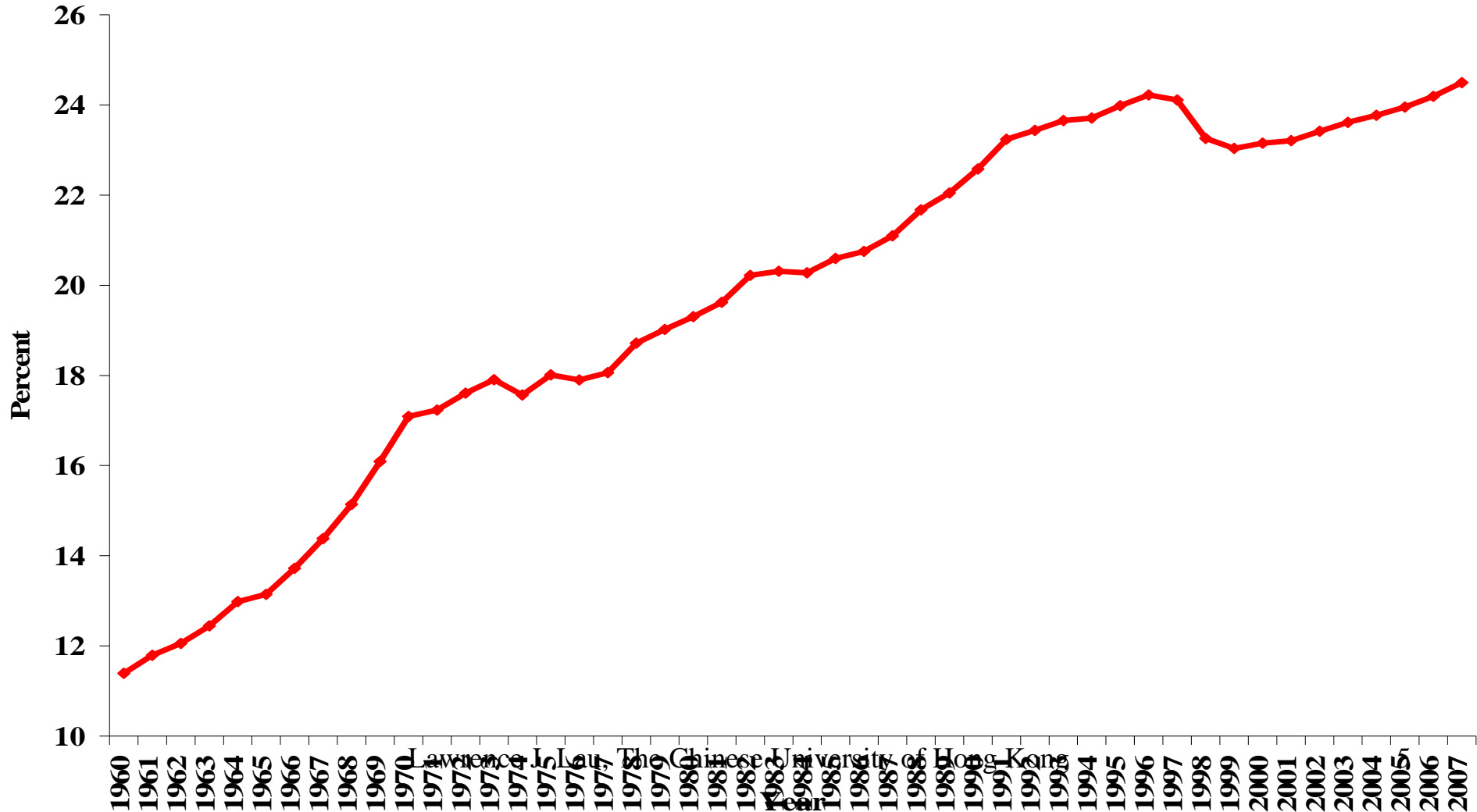
The Partial De-Coupling Hypothesis

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 and within East Asia from Japan to China.
- ◆ In 1960, East Asian GDP, comprising of the GDPs of ASEAN (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China (Mainland only), Japan, and South Korea) was less than 12 percent of World GDP. Today, East Asian GDP accounts for approximately a quarter of World GDP.

East Asian Share of World GDP, 1960-present

East Asian Share of World GDP, 1960-present



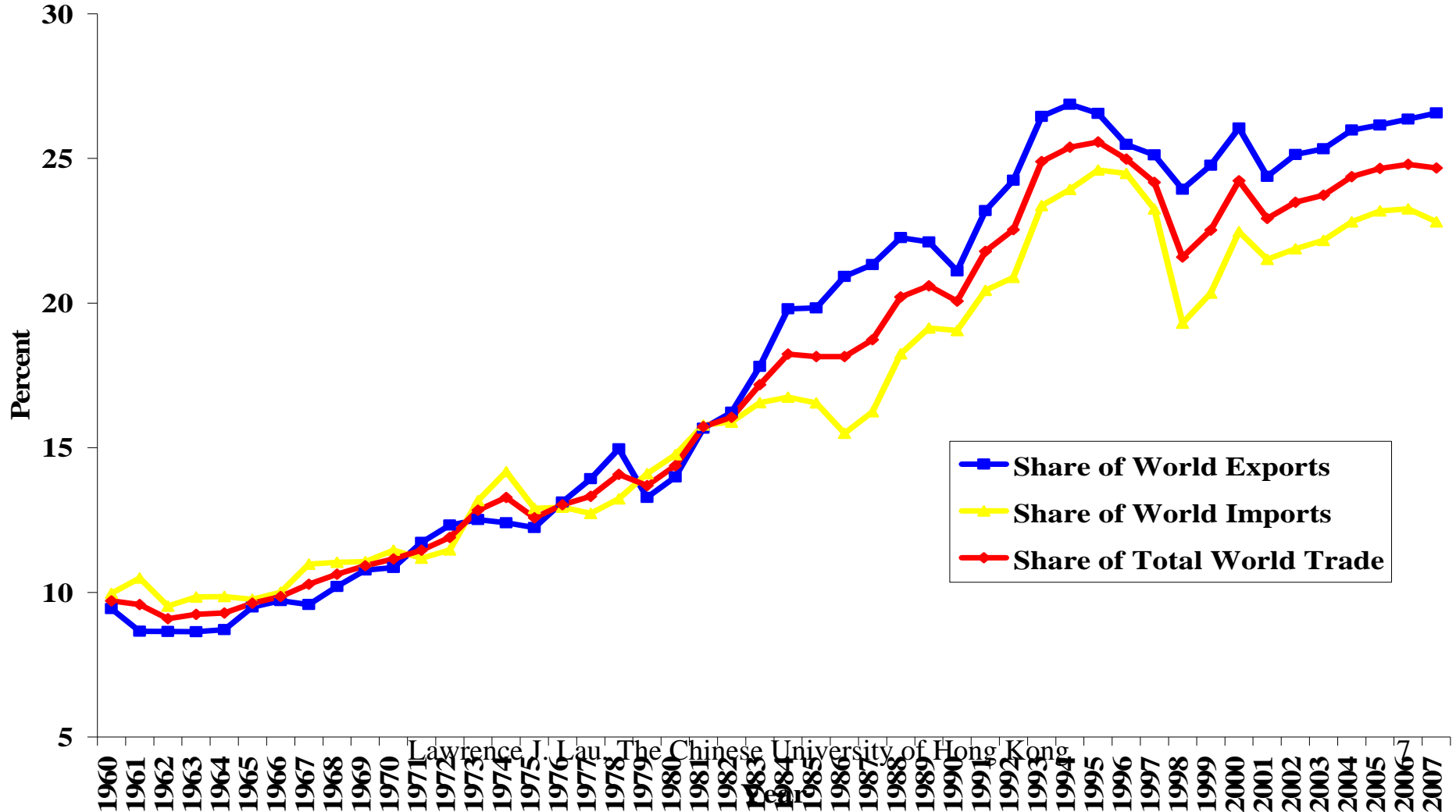
The Partial De-Coupling Hypothesis

The Shifting Economic Center of Gravity

- ◆ East Asian shares of world exports, imports, and international trade have also grown from approximately 10 percent in 1960 to a quarter in 2007, paralleling the growth of East Asian share of world GDP.
- ◆ Because of the rapid economic growth of China and the rest of East Asia outside of Japan, 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. Approximately half of East Asian trade is among East Asian economies. This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe.

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

East Asian Share of Total World Trade, 1960-present



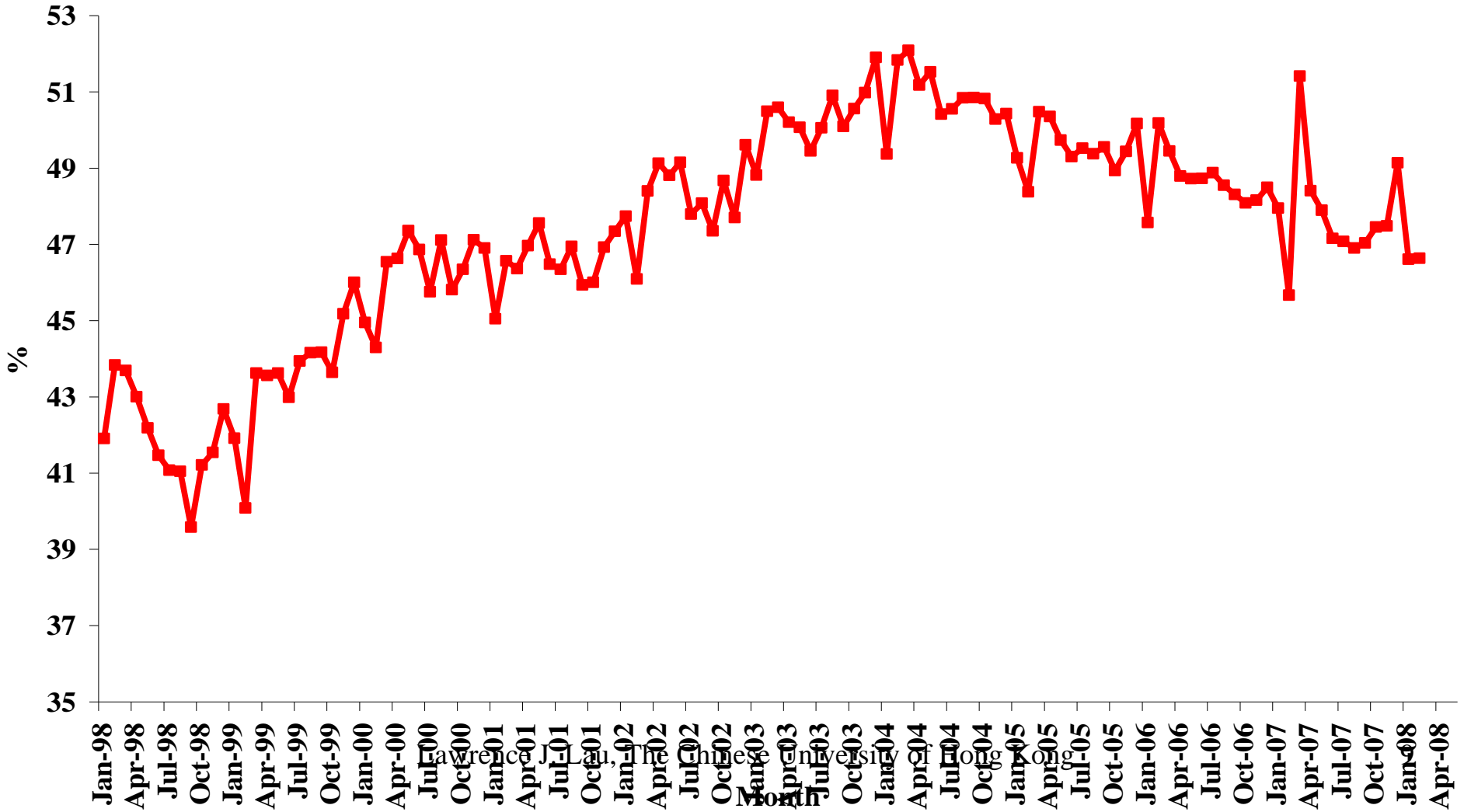
The Partial De-Coupling Hypothesis

The Changing Pattern of World Trade

- ◆ 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.
- ◆ The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality.
- ◆ This is what gives credence to the idea of partial “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. However, China and East Asia are not large enough to turn around the whole world.

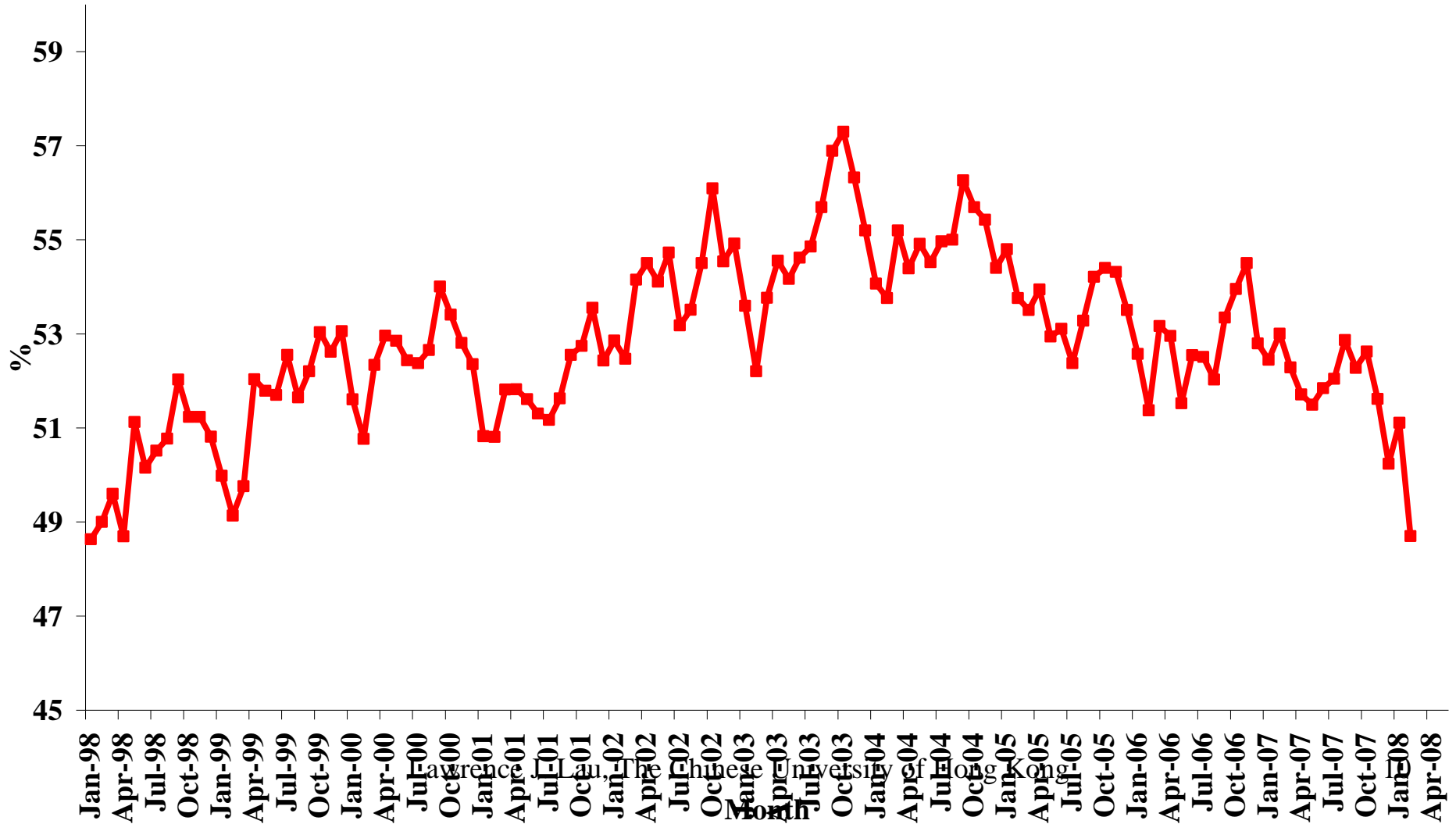
The Share of East Asian Exports Destined for East Asia

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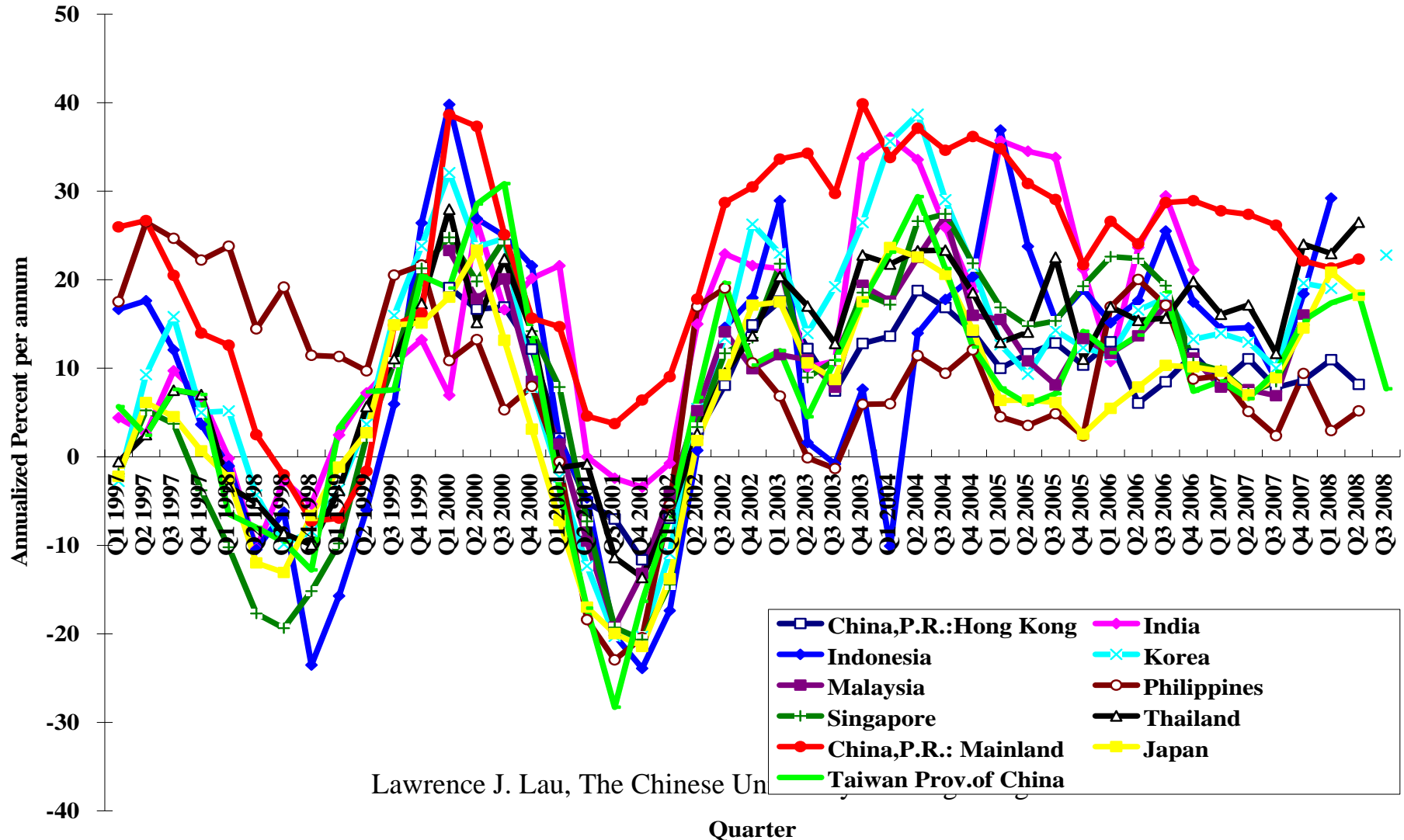
The Share of East Asian Imports Originated from East Asia

The Share of East Asian Imports Originated from East Asia



Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

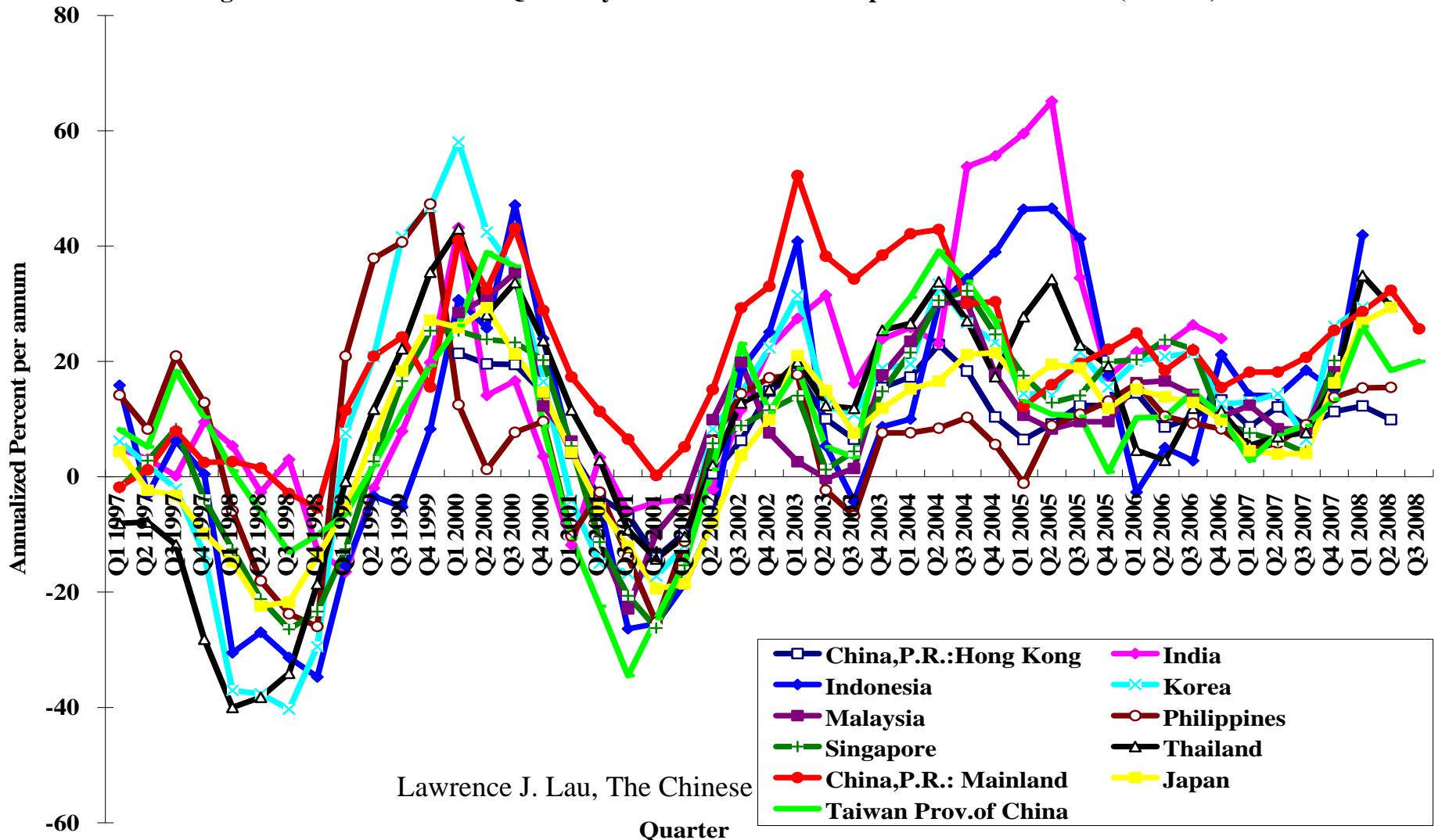
Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)



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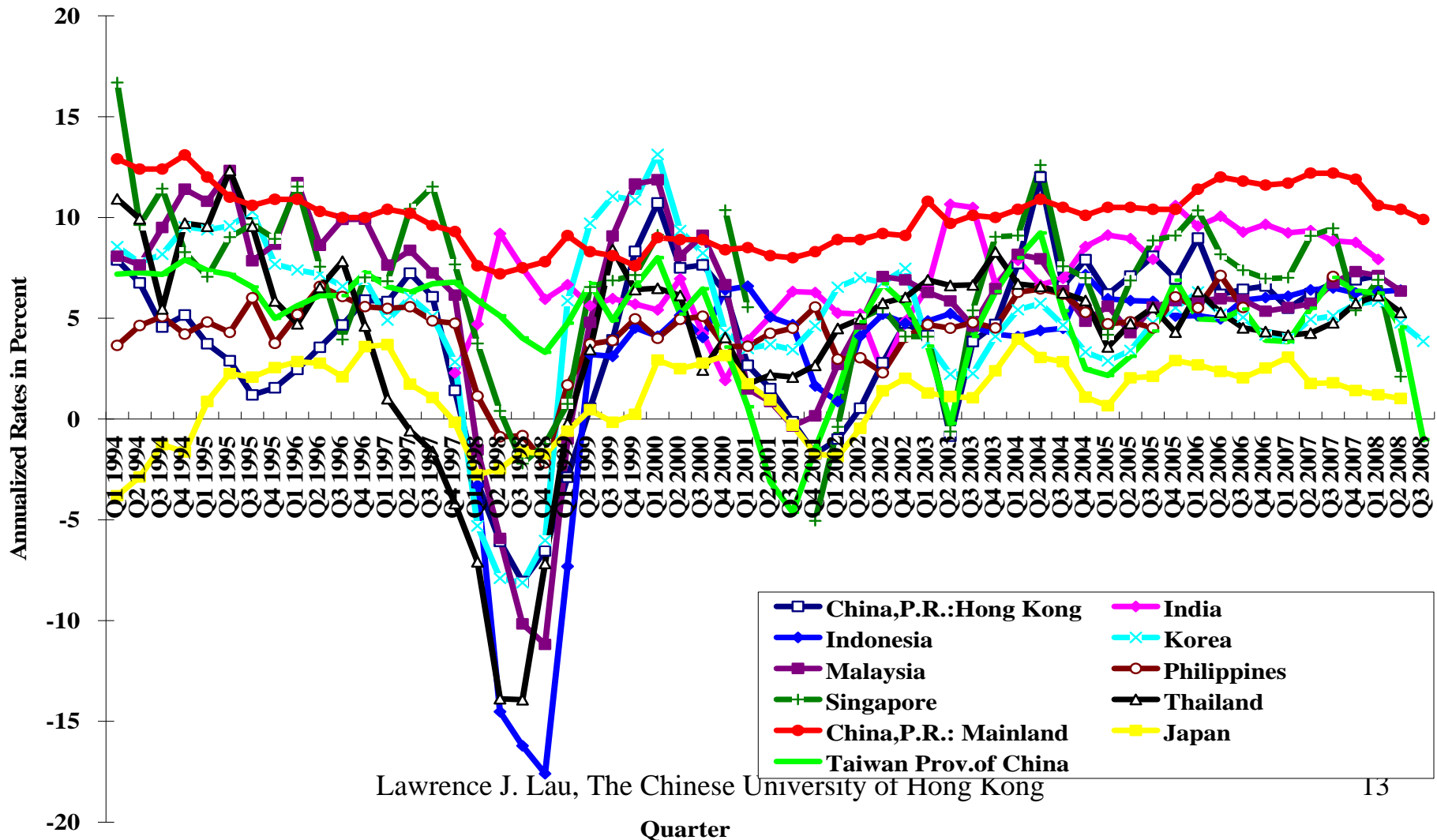
Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

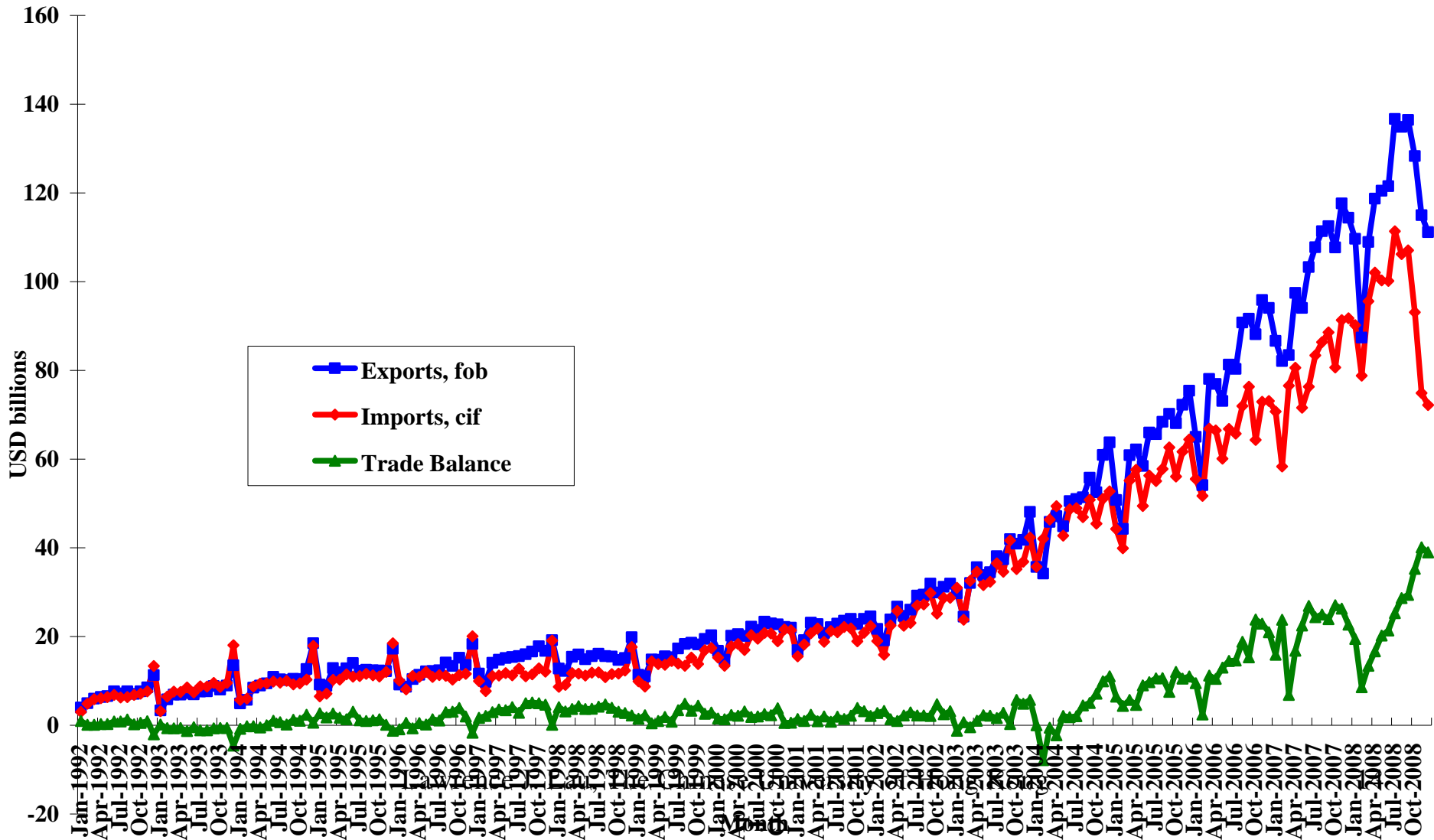
Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



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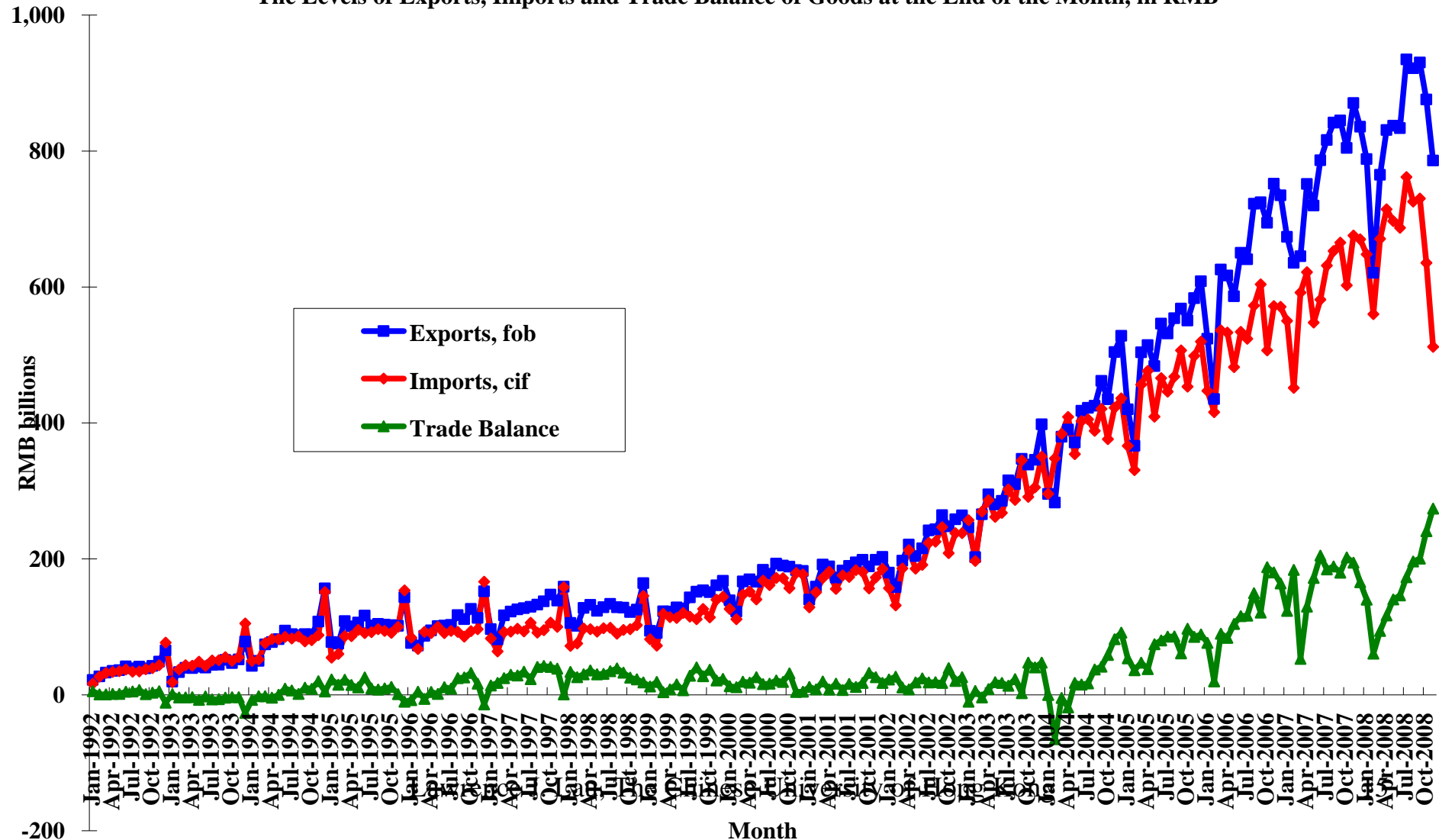
Chinese Exports, Imports and Trade Balance, US\$, Monthly Data

The Levels of Exports, Imports and Trade Balance of Goods at the End of the Month, in U.S. Dollars



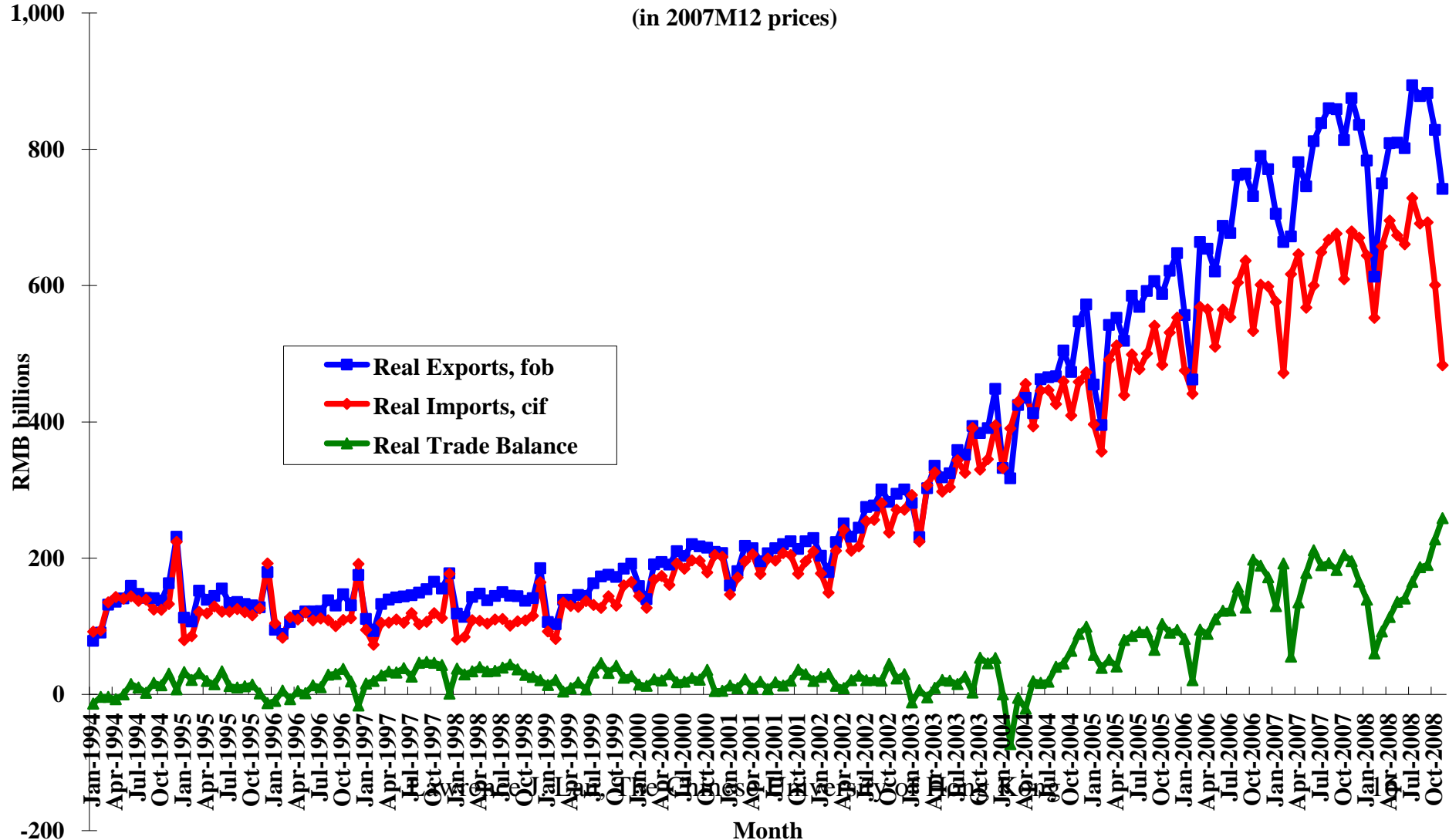
Chinese Exports, Imports and Trade Balance, Yuan, Monthly Data

The Levels of Exports, Imports and Trade Balance of Goods at the End of the Month, in RMB



Chinese Exports, Imports and Trade Balance, 2007 Yuan, Monthly Data

The Real Level of Exports and Imports of Goods at the End of the Month, in RMB
(in 2007M12 prices)



The Impact of the Economic Recession in the U.S. on Chinese Exports

- ◆ 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% in real terms, 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.
- ◆ If the indirect domestic value added of Chinese exports to the U.S. is also taken into account, a 10% real decline in Chinese exports to the U.S. may result in a decline of Chinese GDP of no more than 0.5%.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ Chinese exports to the World constitute approximately 35% of Chinese GDP; however, the direct domestic value added content of Chinese exports to the World. is also quite low, averaging 20.0%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 7% (35% times 20% = 7.0%).
- ◆ 7.0% of GDP is quite significant (almost one whole year's real economic growth) and will result in hardships if completely lost. However, even if Chinese exports to the World. falls by 10% (which is considered unlikely), it will cause Chinese GDP to fall by only 0.7%, which is tolerable, especially if the remaining 93% of the Chinese economy continues to grow. If the indirect domestic value added of Chinese exports to the World is also taken into account, a 10% decline in Chinese exports may result in a decline of Chinese GDP of no more than 1.5%.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ The decline in export orders received by Chinese exporters of almost 50% year-over-year since September took almost everyone by surprise. It is true that export orders have been expected to decline and have been declining, but not to this order of magnitude.
- ◆ Why was there such a large, precipitous decline? This was principally caused by the importers in the U.S. and elsewhere having their access to bank credit frozen. Importers cannot get their bankers to issue letters of credit to the Chinese exporters, or if they can, these letters of credit may not be accepted by the Chinese commercial banks. For those importers with impeccable reputation whose orders would be accepted by Chinese exporters even without a letter of credit, such as Hewlett-Packard, Nike and Wal-Mart, the problem is with the ability to finance their inventory with bank loans from their U.S. banks. As the availability of such credit dwindles, they also reduce their orders and wait until the inventory is exhausted. The net result is a huge reduction in orders for Chinese exports.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ It is, however, important to realize that this is not the result of a reduction in the expected demand for Chinese exports of this magnitude, but the result of the credit freeze in the U.S. It is also not the result of Chinese exports being too expensive, and thus a devaluation of the Renminbi and/or an increase in the proportion of Value-Added-Tax (VAT) rebate on exports are also not likely to be effective.
- ◆ According to the historical experience of the U.S. economy, real personal consumption is a much smoother series than real GDP or real personal income. Since 1949, the worse quarterly decline (at annualized rates) of personal consumption was 12% and since 1952 was less than 10%.
- ◆ Imports of consumption goods would therefore be expected to decline with personal consumption, but probably no more than double the rates of decline of real personal consumption. For Chinese exports, which consists of mostly daily consumption goods targeted at the low-price market, the effect should be much smaller, as consumers switch from high-price to low-price items in an economic downturn.

The Chinese and East Asian Economies in a Post-Financial Crisis World

- ◆ The Continuing Shift in the Economic and Financial Center of Gravity
 - ◆ U.S. and Europe gradually lose their pre-dominance.
 - ◆ There is a relative redistribution of wealth in favor of East Asia.
- ◆ New Global Financial Architecture and Regulatory Regime
 - ◆ The global financial system will have to be restructured to limit the spillover effects.
 - ◆ The global financial markets will be reorganized and reoriented, with new, hopefully safer products.
 - ◆ The use of leverage, which used to be a substitute for savings, will be greatly reduced.
 - ◆ Short-term capital flows, which is a principal source of contagion, may be more tightly regulated and monitored; this is especially the case for commercial banks which face not only maturity mismatch but also currency mismatch.

The Chinese and East Asian Economies in a Post-Financial Crisis World

- ◆ Cash and Savings are King
 - ◆ Savers will own the world—East Asian economies have high saving rates.
- ◆ While East Asia accounts for 25% of World GDP, China is only 10% of the World economy, compared to the Euro Zone and the U.S. of approximately 25% each. East Asia and China are probably able to keep their economies growing, albeit at reduced rates; but they will be unable to turn around the economic situations facing the U.S. and Western Europe.

The Impact of the Economic Recession in the World on Chinese Exports

- ◆ So the expectation is that the export orders would bounce back in a quarter or two, that this decline in export orders is only temporary and basically represents a delay or postponement of the demand by a quarter or two for Chinese exports, as opposed to a permanent reduction. Thus, the decline in Chinese exports, when averaged over a whole year, should not exceed 20%. In terms of GDP, the impact should be a reduction on the order of 1.5%, a significant but still tolerable amount.

The Impact of the Economic Recession in the World on Chinese Exports

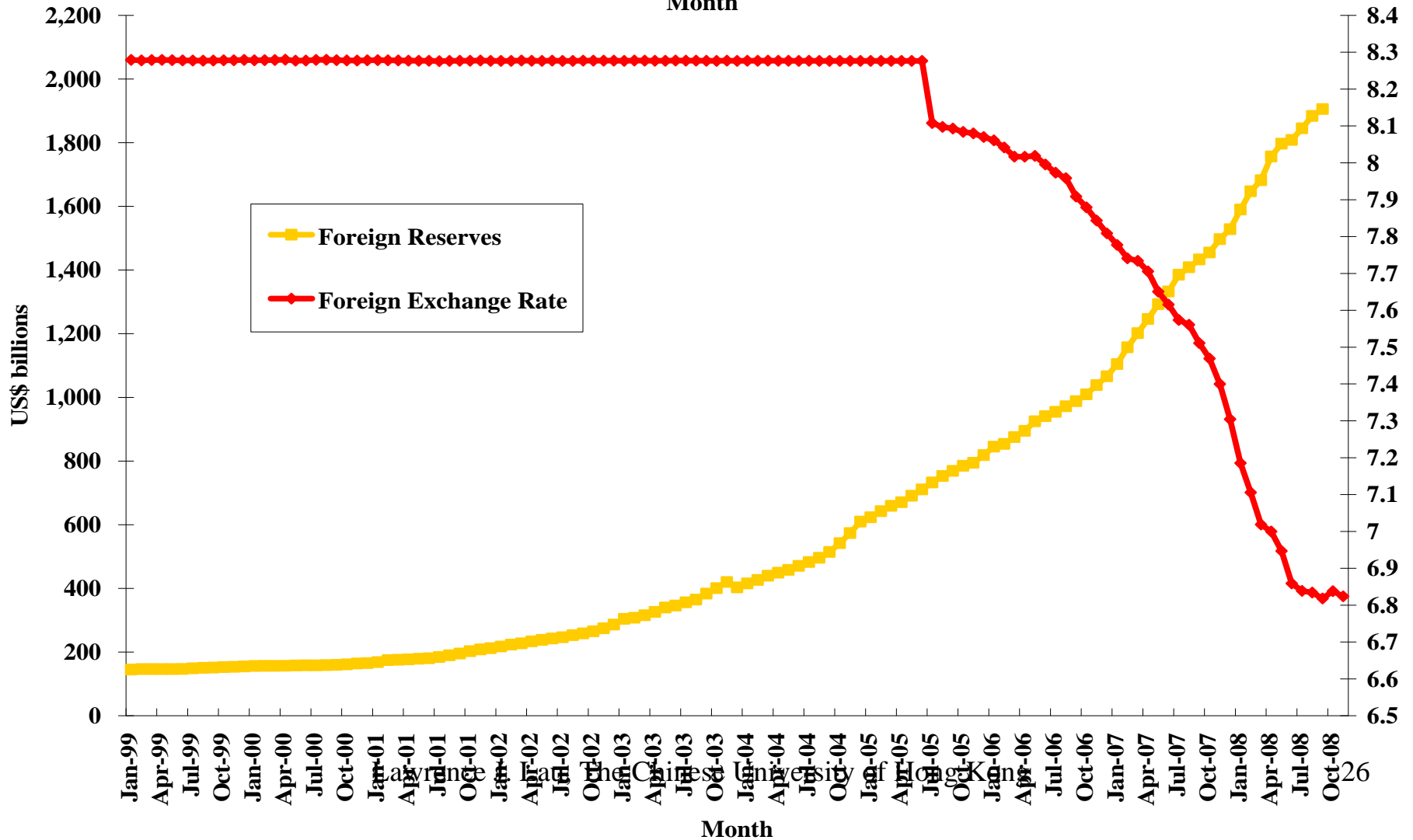
- ◆ The Chinese Government can however shorten the delay or postponement of demand by allowing the Chinese commercial banks to finance the exports of long-term seasoned exporters to their long-term customers so that they can ship their goods on a consignment basis and allow payment terms of 6 months after receiving the goods. This will allow Chinese export enterprises to continue their production with minimal interruption and layoffs of workers. To make this happen, the Chinese Government may need to guarantee these loans in whole or in part, possibly through the Export-Import Bank of China—otherwise the Chinese commercial banks may not be willing to extend such credit to the Chinese exporters.

The Renminbi-U.S.\$ Exchange Rate

- ◆ The near-term expectation is that it will be relatively stable—neither appreciating nor devaluing.
- ◆ Everyone in the world has an interest in trying to restore stability in the markets—the fewer changes, the better.
- ◆ A revaluation of the Renminbi would require the selling of US\$ assets (including bonds and notes) and the buying of Renminbi by the People's Bank of China—it will help neither the U.S. nor China.
- ◆ However, as the Renminbi becomes much more acceptable, especially in East Asian economies, it may gradually supplant the U.S. Dollar as the currency of denomination in international trade.

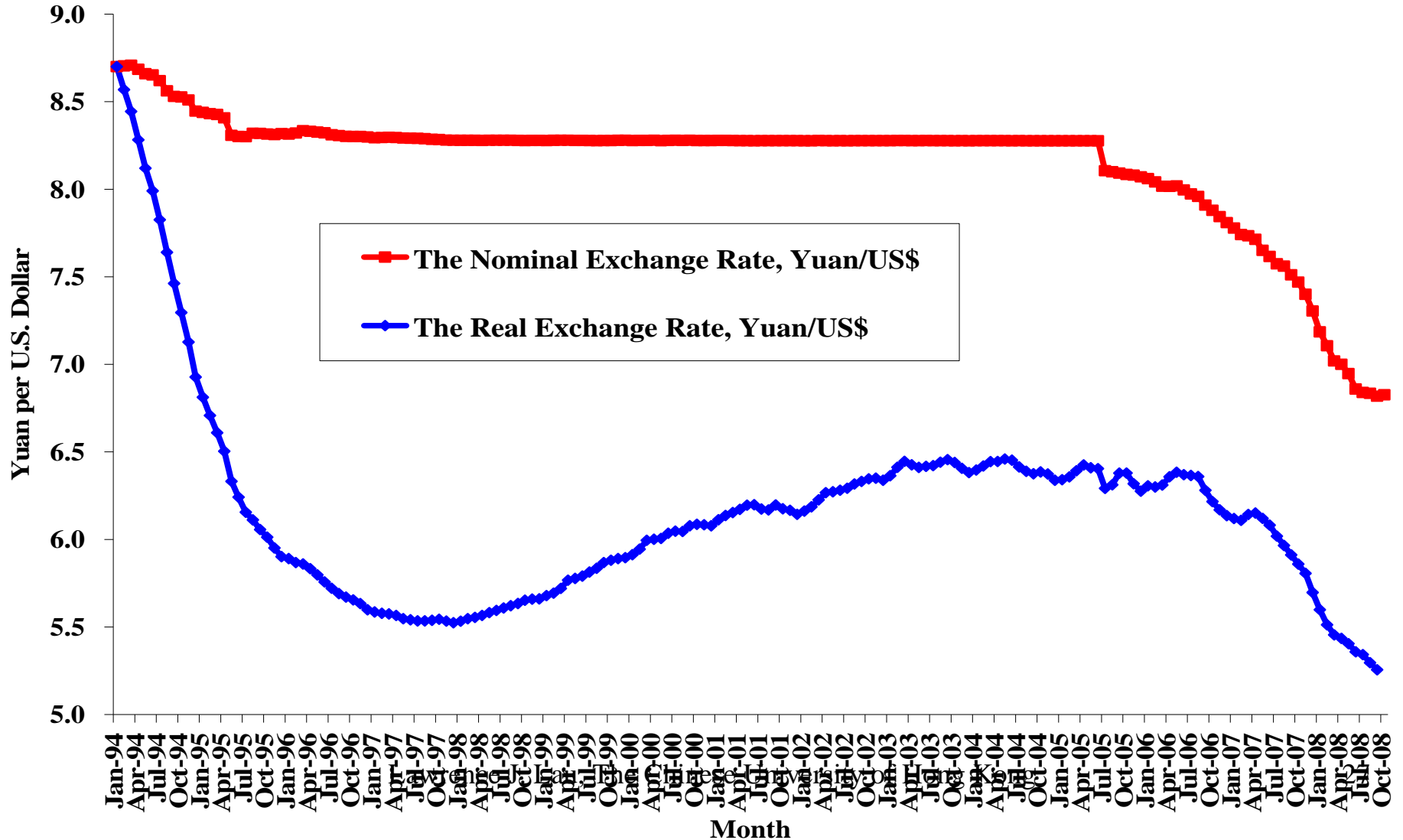
Foreign Exchange Reserves and the Yuan/US\$ Exchange Rate

The Level of Foreign Exchange Reserves and Exchange Rate (Yuan per US Dollar) at the End of the Month



The Nominal and Real Yuan/US\$ Exchange Rates

The Nominal and Real Exchange Rates (1994 prices), Yuan/US\$



Concluding Remarks

- ◆ The charts on the rates of growth of exports, imports and real GDP of the East Asian economies show that while the exports and imports of China have fluctuated just like all other East Asian economies, the rate of growth of the Chinese real GDP has remained quite stable, unlike those of the other East Asian economies.
- ◆ 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 still manage to grow independently of the U.S. and Europe.

Concluding Remarks

- ◆ 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.
- ◆ 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.

Concluding Remarks

- ◆ The situation facing the Chinese economy was much more adverse back in 1998, during the East Asian currency crisis, with the Chinese Government then having far less resources. But the Chinese economy managed to do all right then (and refrained from devaluing the Renminbi, and thus earned the gratitude and respect of the other East Asian economies). Today the Chinese Government has far more resources and instruments at its disposal to cope with a negative external environment—It has much higher official foreign exchange reserves (almost US\$2 trillion compared to approximately US\$100 billion then), large and rising fiscal surpluses, and a much more effective social safety net. The Chinese economy should be able to grow at between 7 and 8 percent in 2009. And that should be good news for the other East Asian economies.
- ◆ And if the Chinese economy can grow at 7-8 percent in 2009, the Hong Kong economy should also be able to manage a positive real rate of growth for the entire year of 2009.