Impact of the Global Financial Crisis on the Chinese Economy

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- The Impact of the Economic Recession in Developed Economies
- The Partial De-Coupling Hypothesis
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Introduction

- The financial earthquake has affected all of the developed economies, especially the United States. While North America and Europe have gone into economic recession, it is not an ordinary recession, because it is accompanied by a serious breakdown of the capital and credit markets and bankruptcy, insolvency and illiquidity of many major financial institutions.
- Fortunately, in East Asia, despite the steep decline in the stock markets, the financial institutions remain relatively sound and financial stability is not seriously threatened.
- However, East Asian exports to North America and Europe has slowed, and export orders have fallen precipitously since mid-September, following the failure of Lehman Brothers, to the order of 50%, on an year-over-year basis. This has caused derivative declines in the demands for shipping, transportation, logistics and storage services.

The Impact of the Economic Recession

- The overall economic slowdown and recession in the U.S. and in Europe, caused by the global financial crisis, will last at least another year or two (probably longer in the U.S.), until more positive expectations are restored for both firms and households and the U.S. mortgage loan default/negative equity problems are straightened out.
- U.S. home prices still have some way to fall, and the rate of growth of real GDP turned negative in 2008Q3 and is likely to continue through at least the first couple of quarters of 2009, and the unemployment rate has reached a new high of 7.6%, the highest level since 1994.
- The U.S. demand for imports will likely decline with the reduced household consumption. 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.
- Despite the current near-term strength of the U.S. Dollar, caused in part by the repatriation of U.S. investment overseas to the U.S., in the longer term horizon of 3-5 years, it is likely to weaken relative to other reserve currencies as the net inflow of capital to the U.S., especially that of direct and portfolio investment, is reduced.

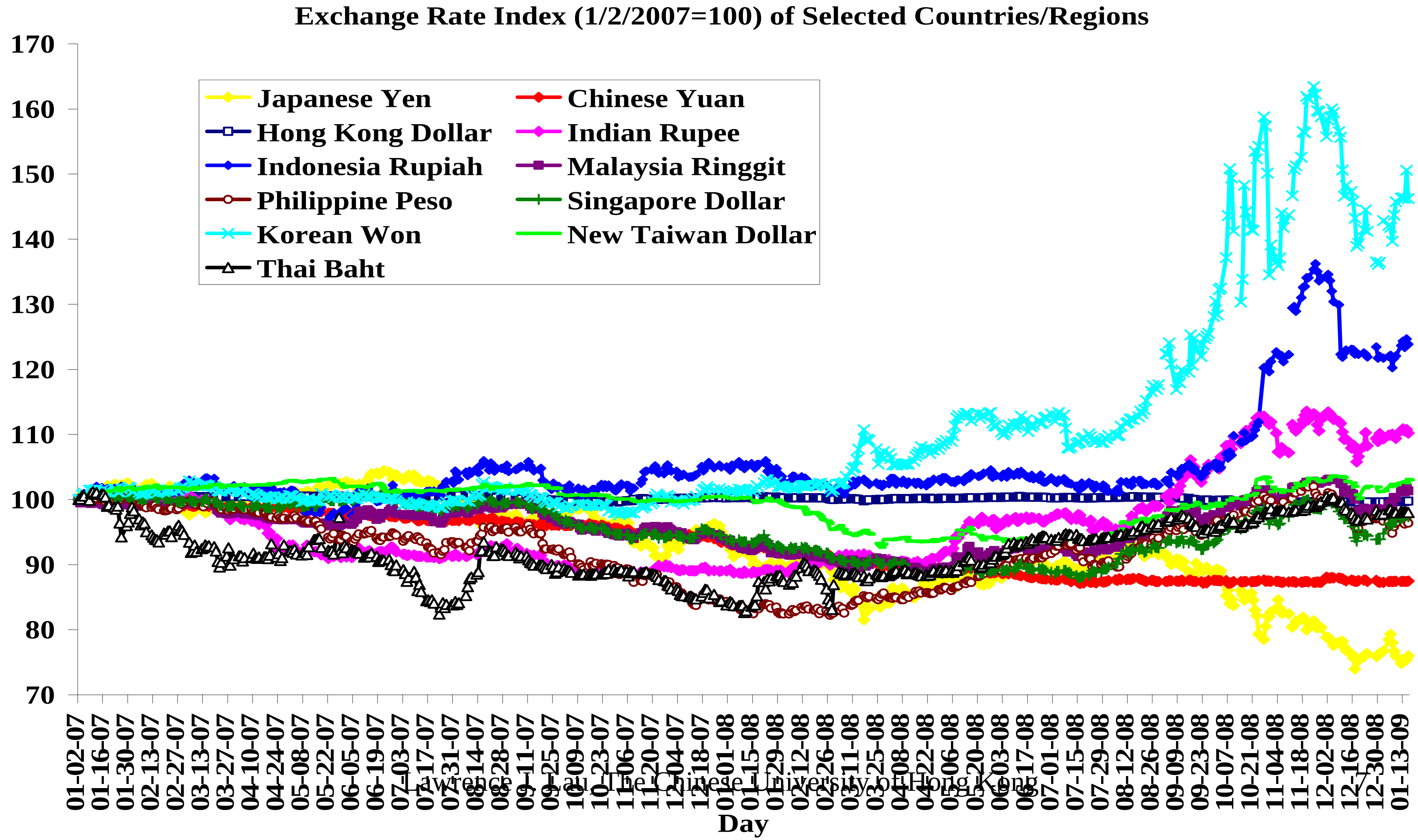
Impact on East Asian Economies

- Since mid-September, 2008, when Lehman Brothers failed, there has been a precipitous decline in export orders received by East Asian firms across the board—by as much as 50 percent.
- Concurrently, there has also been a sharp decline in the East Asian stock markets, driven mostly by selling by overseas investors in need of cash.
- Between mid-September and December, the East Asian currencies, with the exception of the Japanese Yen (which appreciated significantly), the Chinese Yuan and the Hong Kong Dollar (both of which held steady), have all declined in value relative to the US$. The strengthening of the US$ was mostly due to the repatriation of the capital of the U.S. investors.
- But the East Asian stock markets and exchange rates have begun to stabilize since December. The exchange rates have even begun to appreciate relative to the US$.
- The stabilization of the East Asian stock markets and exchange rates indicates that the exodus of overseas capital from East Asia has largely come to an end—money that can and wants to leave has left.

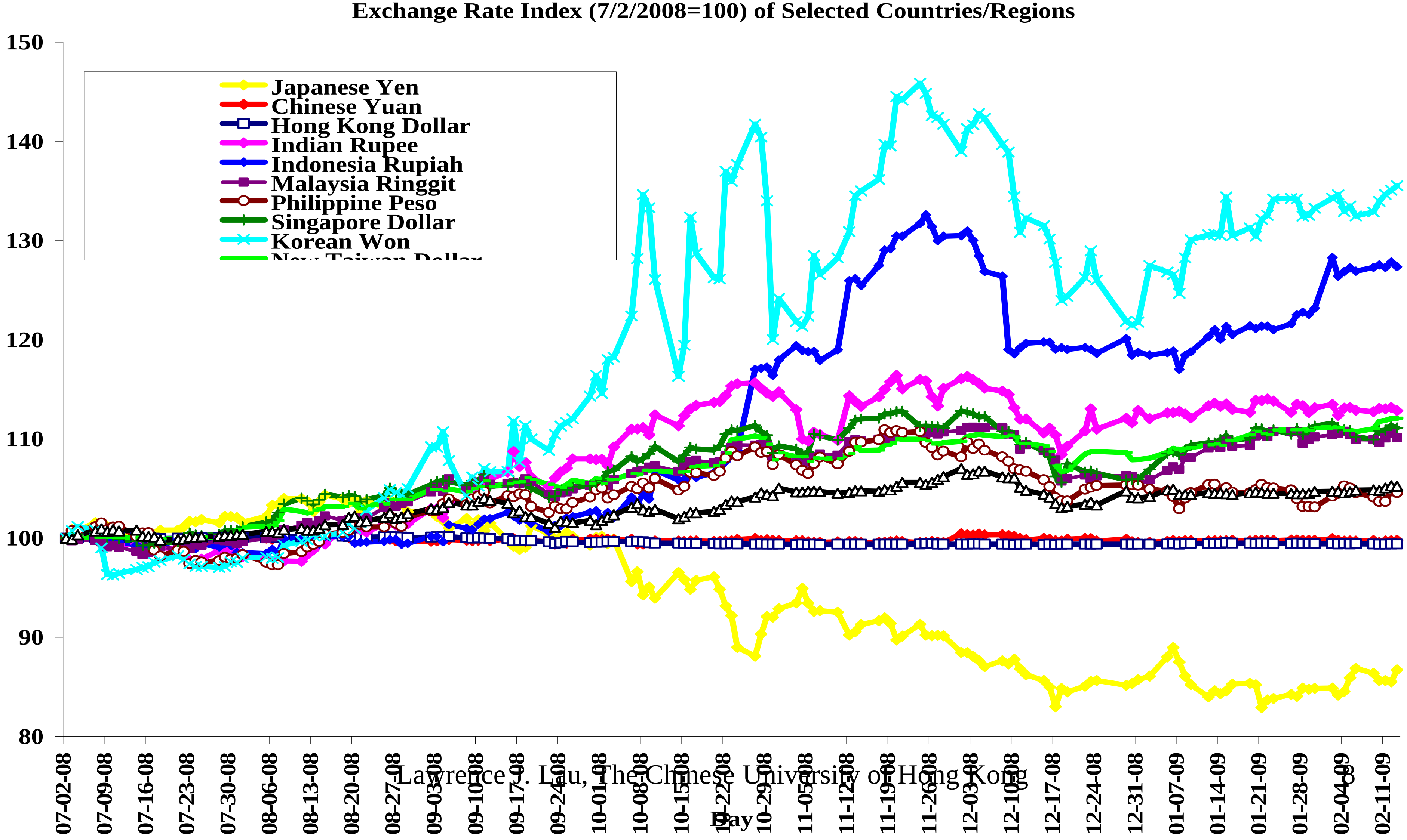
Impact on East Asian Economies

- The declines in the East Asian stock markets were due primarily to three reasons: repatriation of capital back home by foreign investors; de-leveraging; and loss of confidence by both domestic as well as foreign investors (irrational panic).
- Initial public offerings and other financial transactions such as mergers and acquisitions have dried up.
- The reduction in wealth (even unrealized) also has had a negative impact on domestic consumption and investment.
- There has also been a significant decline in visitor arrivals, especially from North America and Europe. But outbound visitors from China have continued to increase moderately.
- All this means a decline in the rates of growth of real GDP and a rise in the rates of unemployment in many East Asian economies.

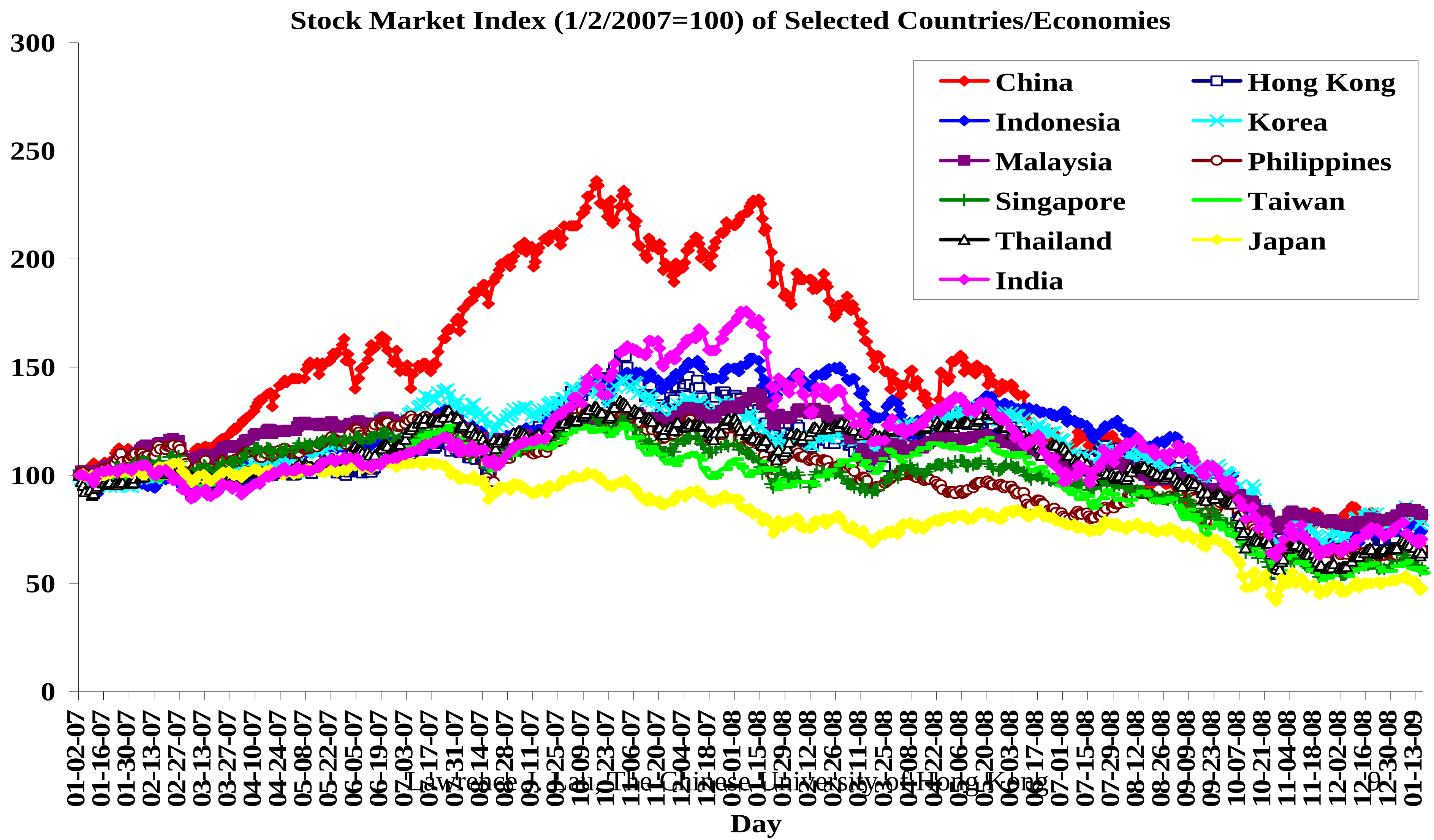
Exchange Rates of Selected East Asian Economies (1/2/2007=100)



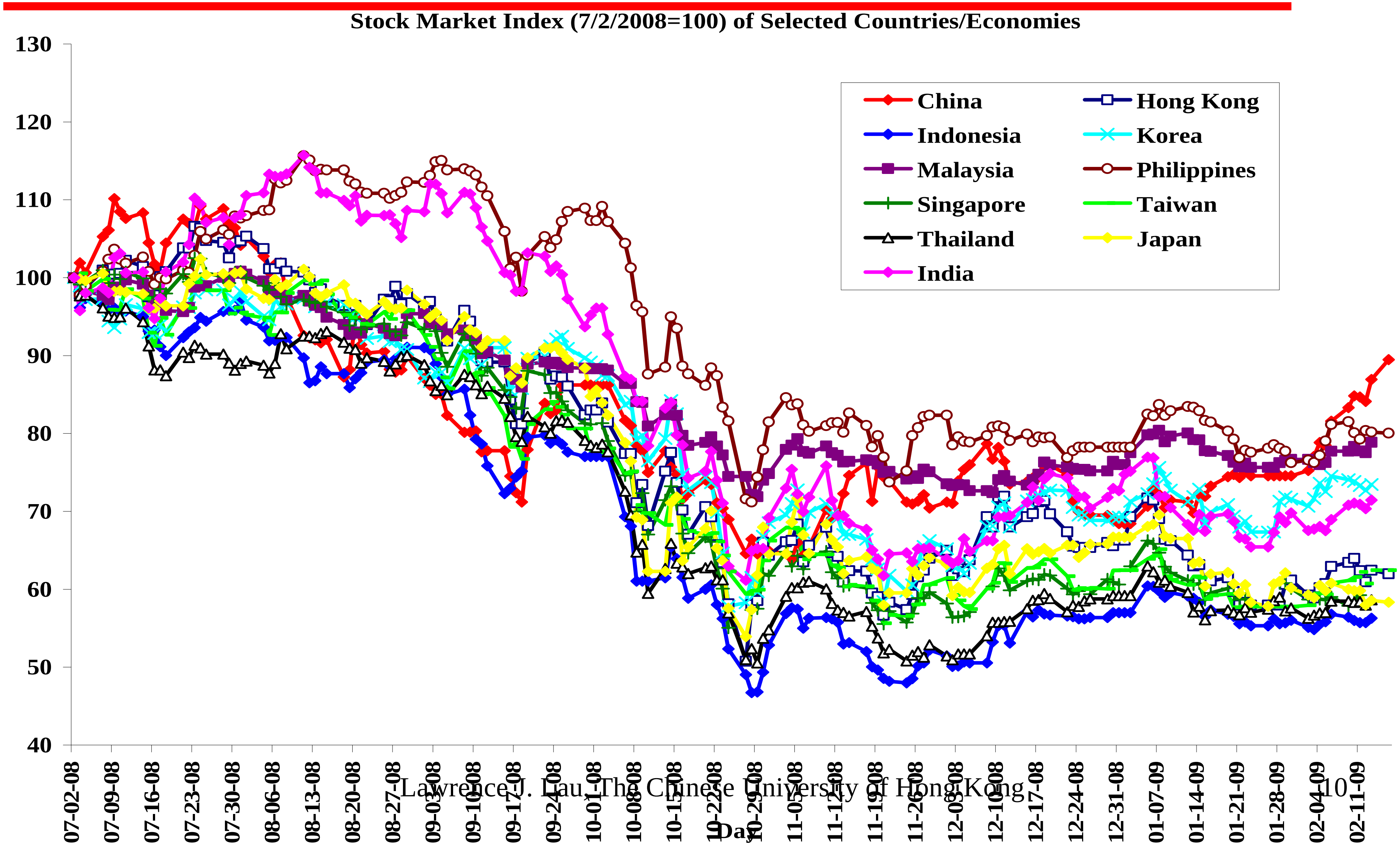
Exchange Rates of Selected East Asian Economies (7/2/2008=100)



Stock Market Indexes of Selected East Asian Economies (1/2/2007=100)



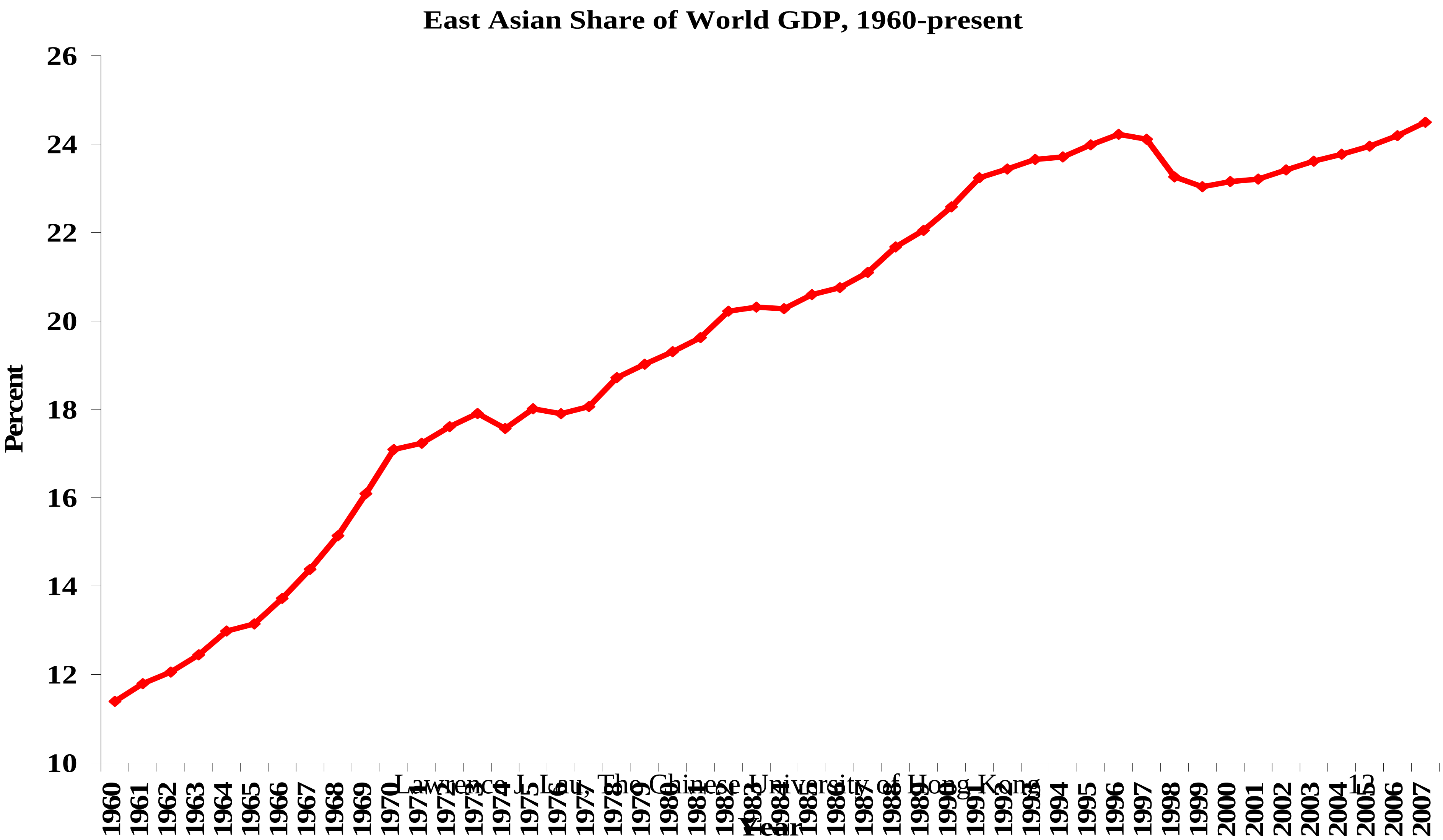
Stock Market Indexes of Selected East Asian Economies (7/2/2008=100)



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, comparable to the size of the U.S. economy and that of the Euro Zone.

East Asian Share of World GDP, 1960-present



The Partial De-Coupling Hypothesis: The Shifting Economic Center of Gravity

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- 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.

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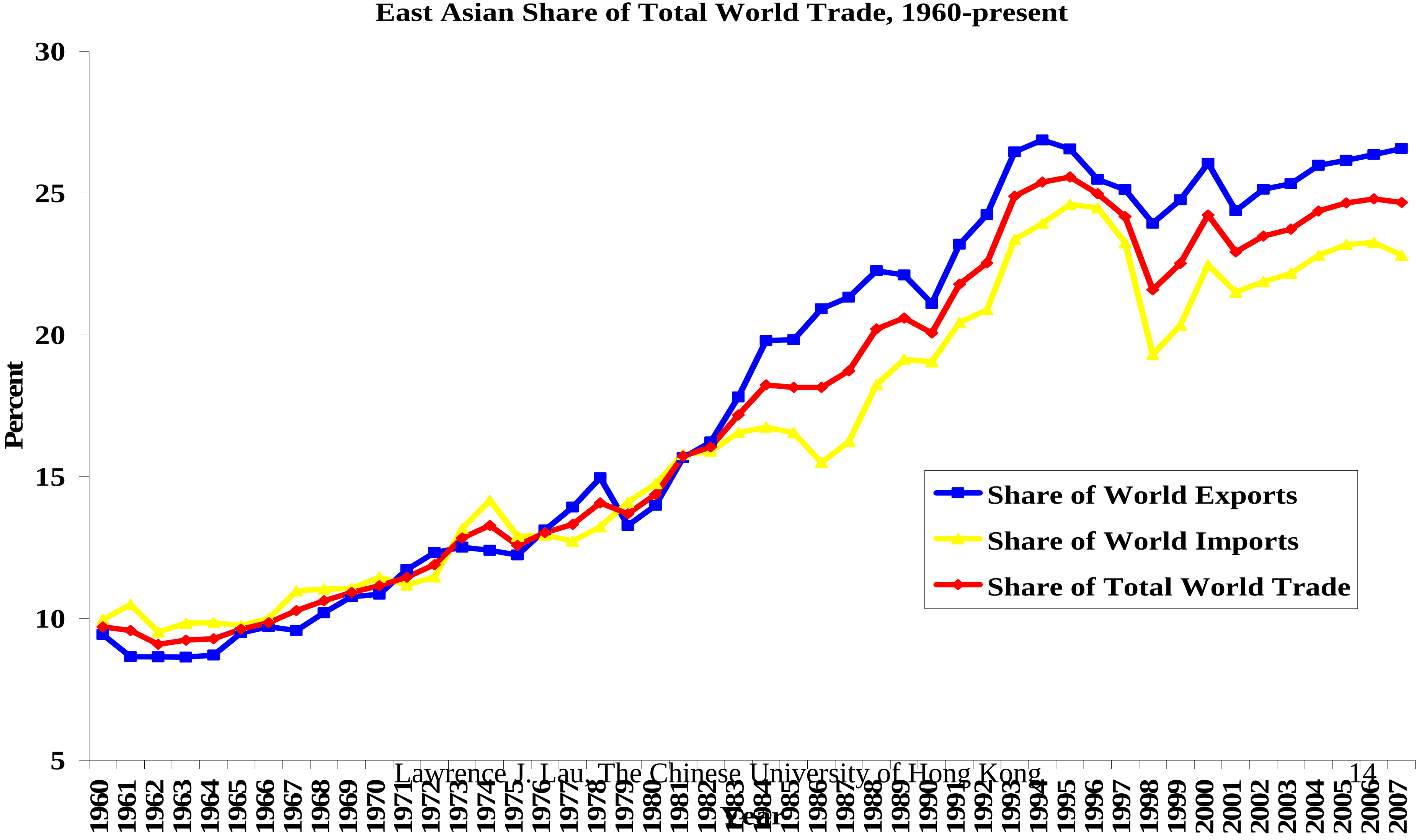
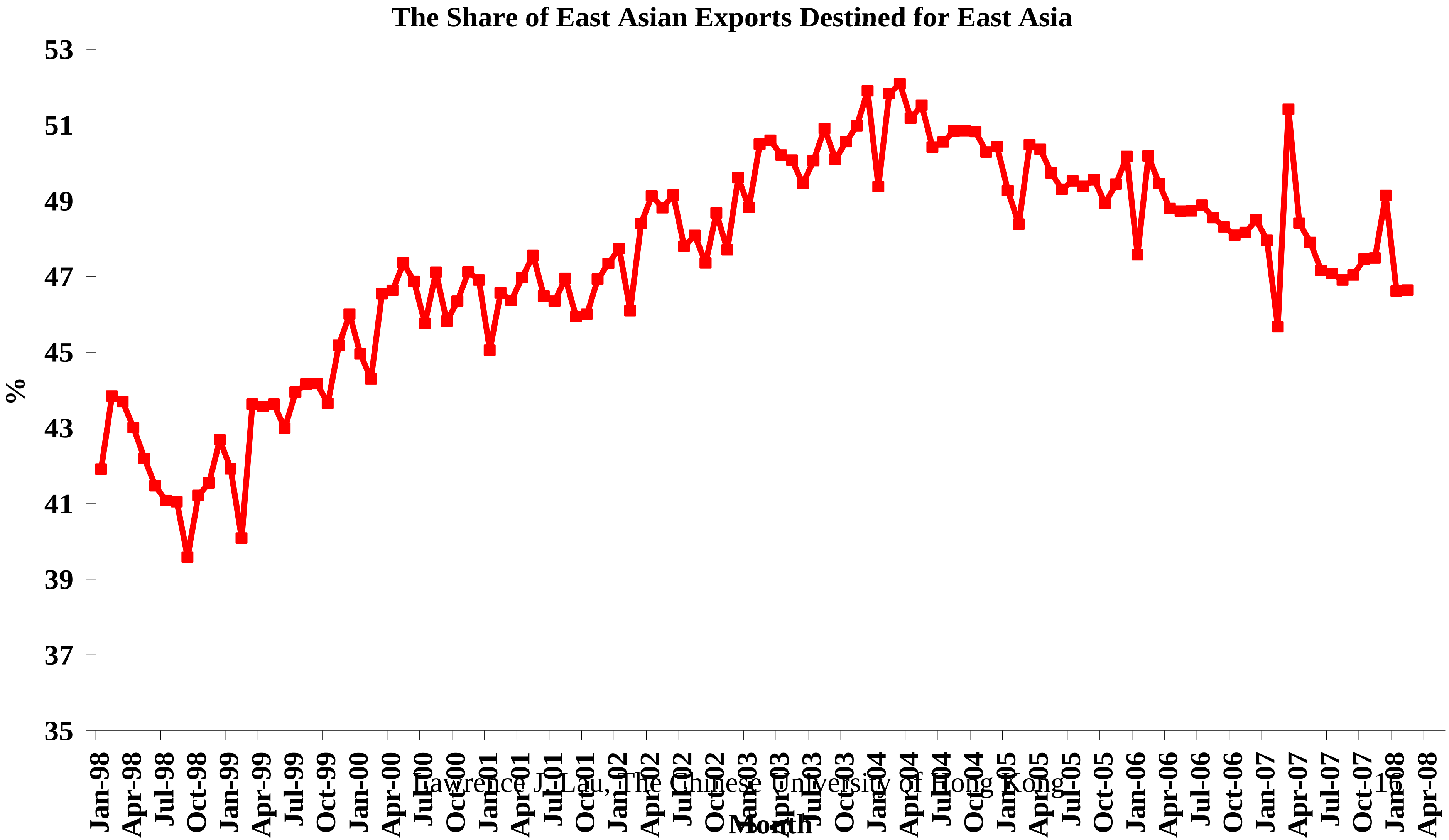
The Rising Ratio of East Asian Trade in Total World Trade, 1960-present



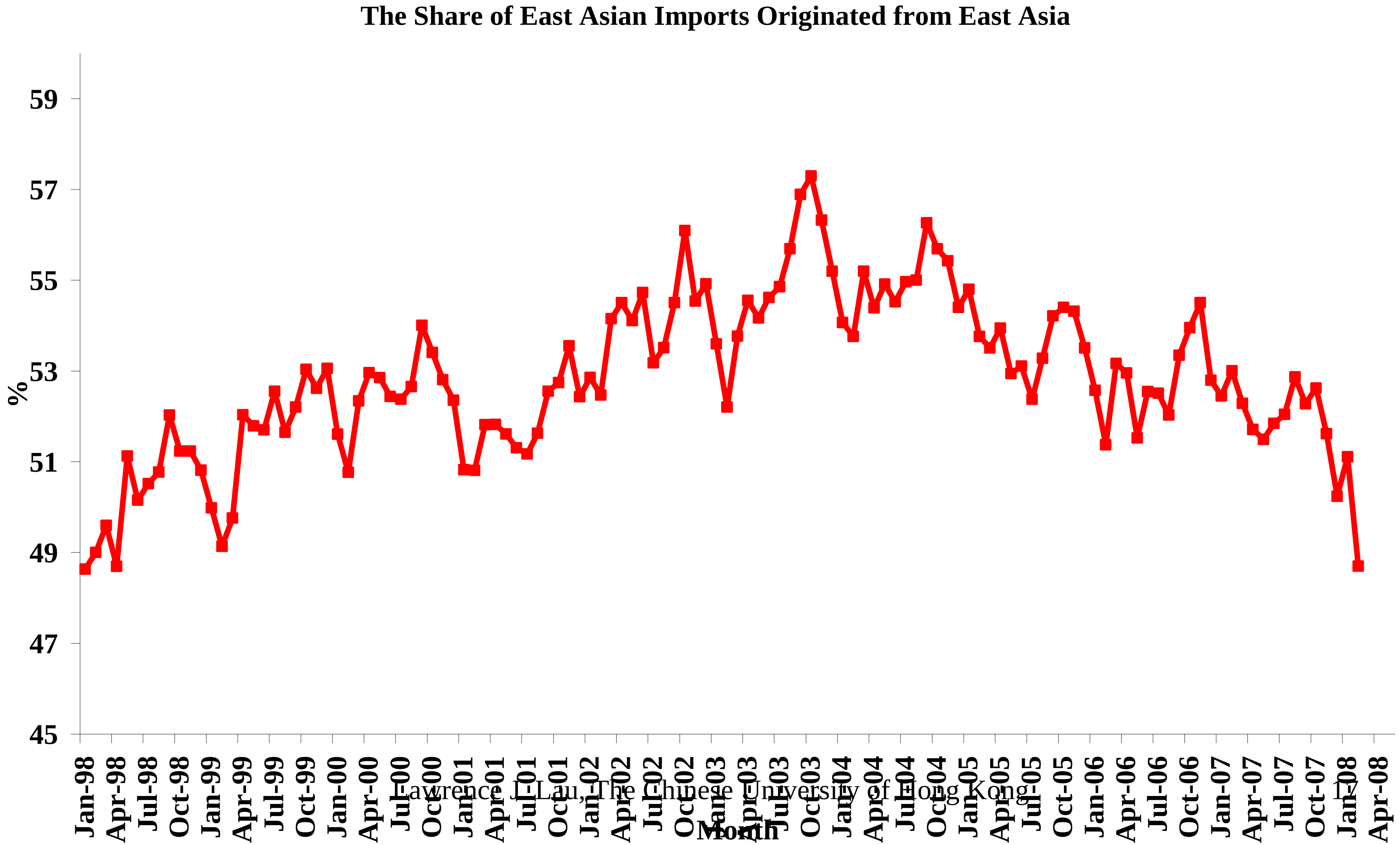
The Partial De-Coupling Hypothesis: The Changing Pattern of World Trade

- 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



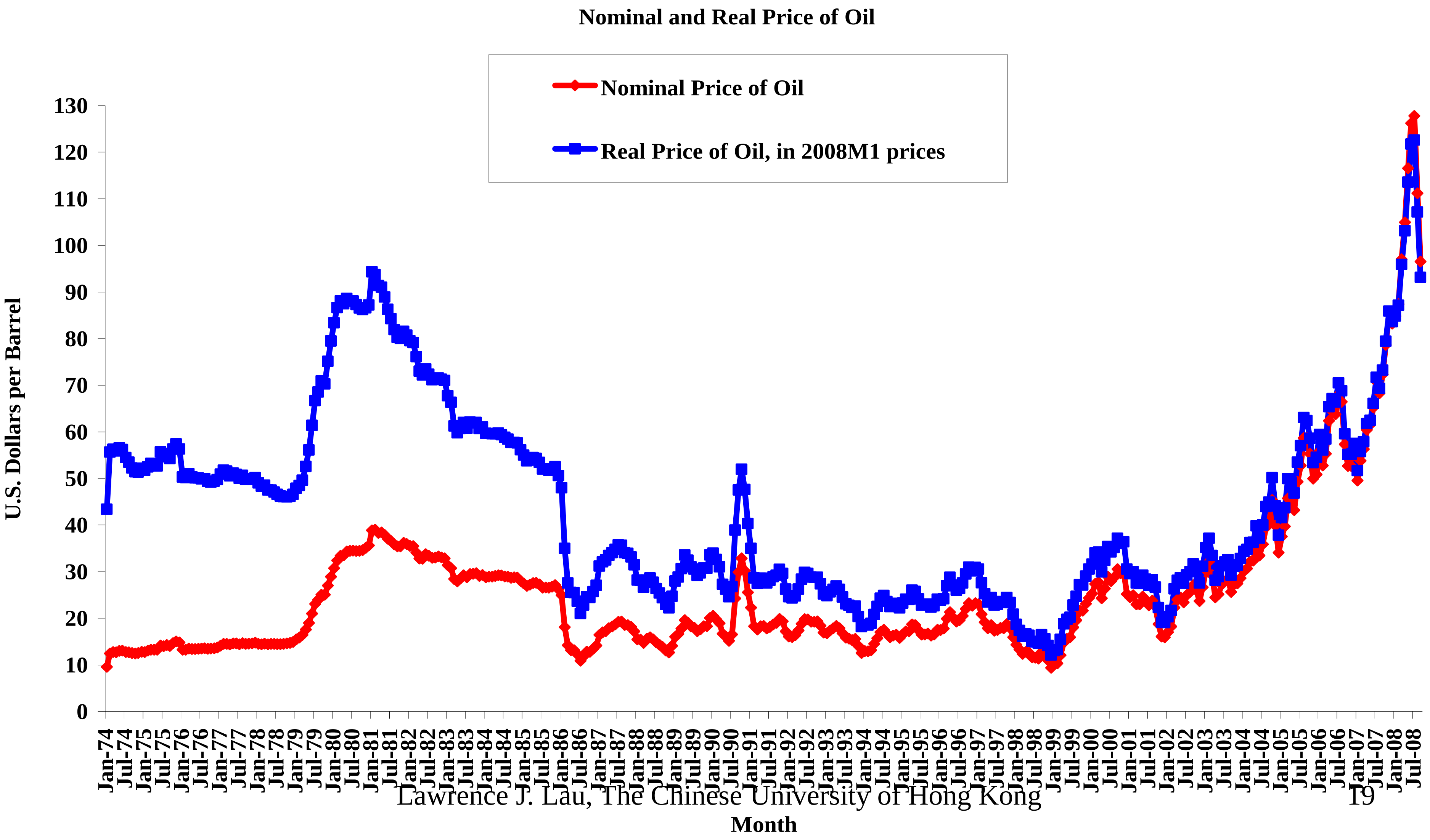
The Share of East Asian Imports Originated from East Asia



The World Price of Oil

- The world price of oil has begun to return to more normal levels. The world price of oil, in real terms, is not significantly different from the price of oil prevailing in the early 1980s. It has the room to fall further to about US$40 a barrel in 2008 prices which was the upper range of the price of oil between 1987 and 2004.

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



The Partial De-Coupling of East Asia from the World Economy

- In general, the phenomenon of "partial decoupling" is expected to be operative. Chinese economic growth will be largely unaffected by external developments, including an economic recession in the United States. India is not a major exporter of manufactured goods (it exports mostly computer software), and its economic growth is mostly internal-demand driven.
- The other so-called BRIC countries—Brazil and Russia—are also not that dependent on exports, especially exports to the U.S. Russia has benefitted from the high world price of oil (which has recently fallen back to more normal levels) but is not a major exporter of manufactured goods and hence will be relatively unaffected by the economic recession in the U.S. and elsewhere per se except through the lowered price of oil.

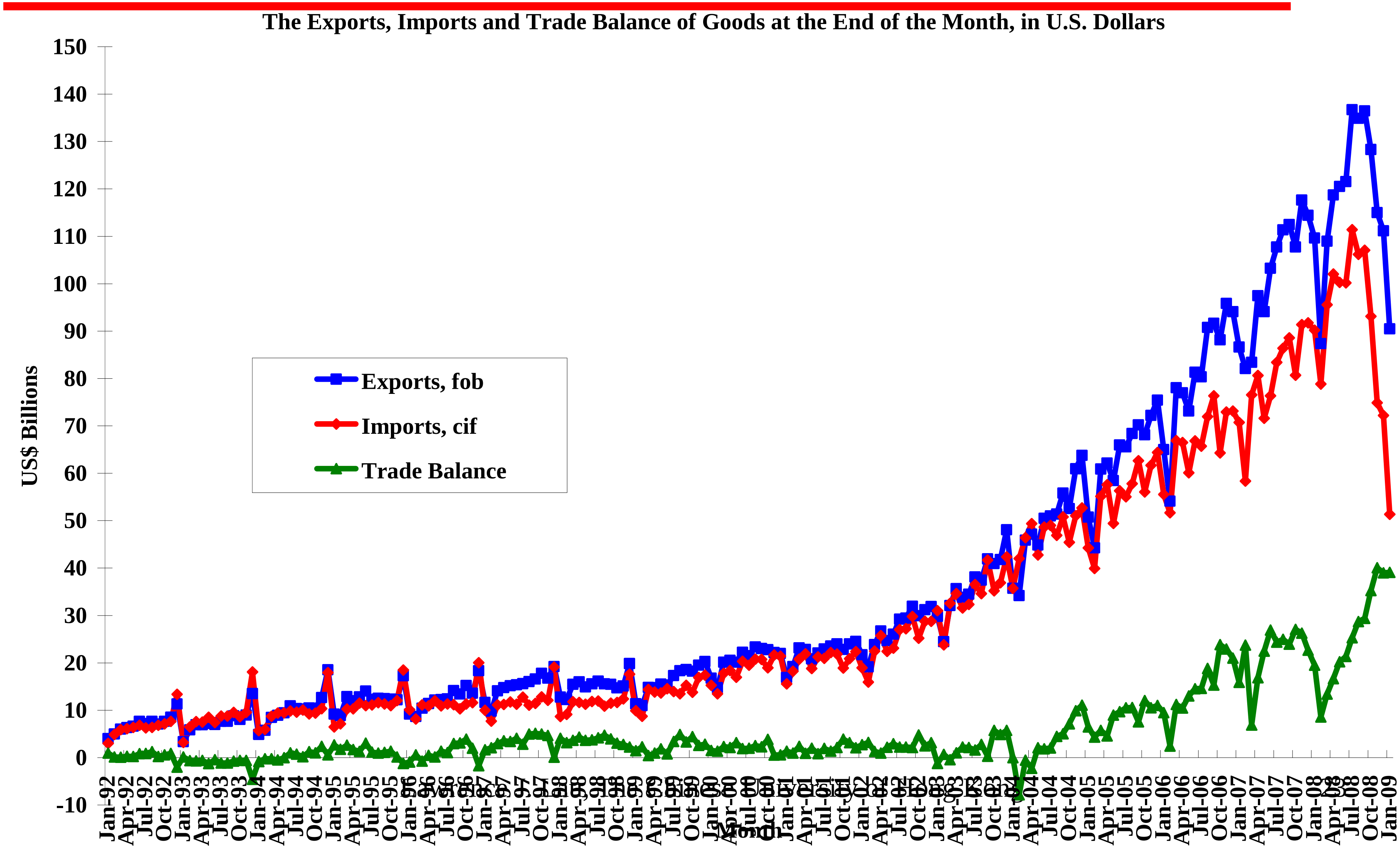
The Partial De-Coupling of East Asia from the World Economy

- China (and India) can be expected to continue growing, albeit at somewhat lower rates, and the rest of developing East Asia should be able to manage.
- The high domestic savings rate found in almost all of the East Asian economies is a major advantage of East Asia, making it independent of capital inflows from developed economies and hence de-coupling much more possible and likely.
- During the East Asian currency crisis of 1997-1998, the mutual impacts of the simultaneous downturns and upturns on the part of East Asian economies on one another were amply demonstrated. So long as they continue growing together, by creating demands for one another's exports, their collective growth can be more or less sustained.
- Through it all, the rate of growth of Chinese real GDP remained relatively stable even as its rates of growth of exports and imports fluctuated widely.

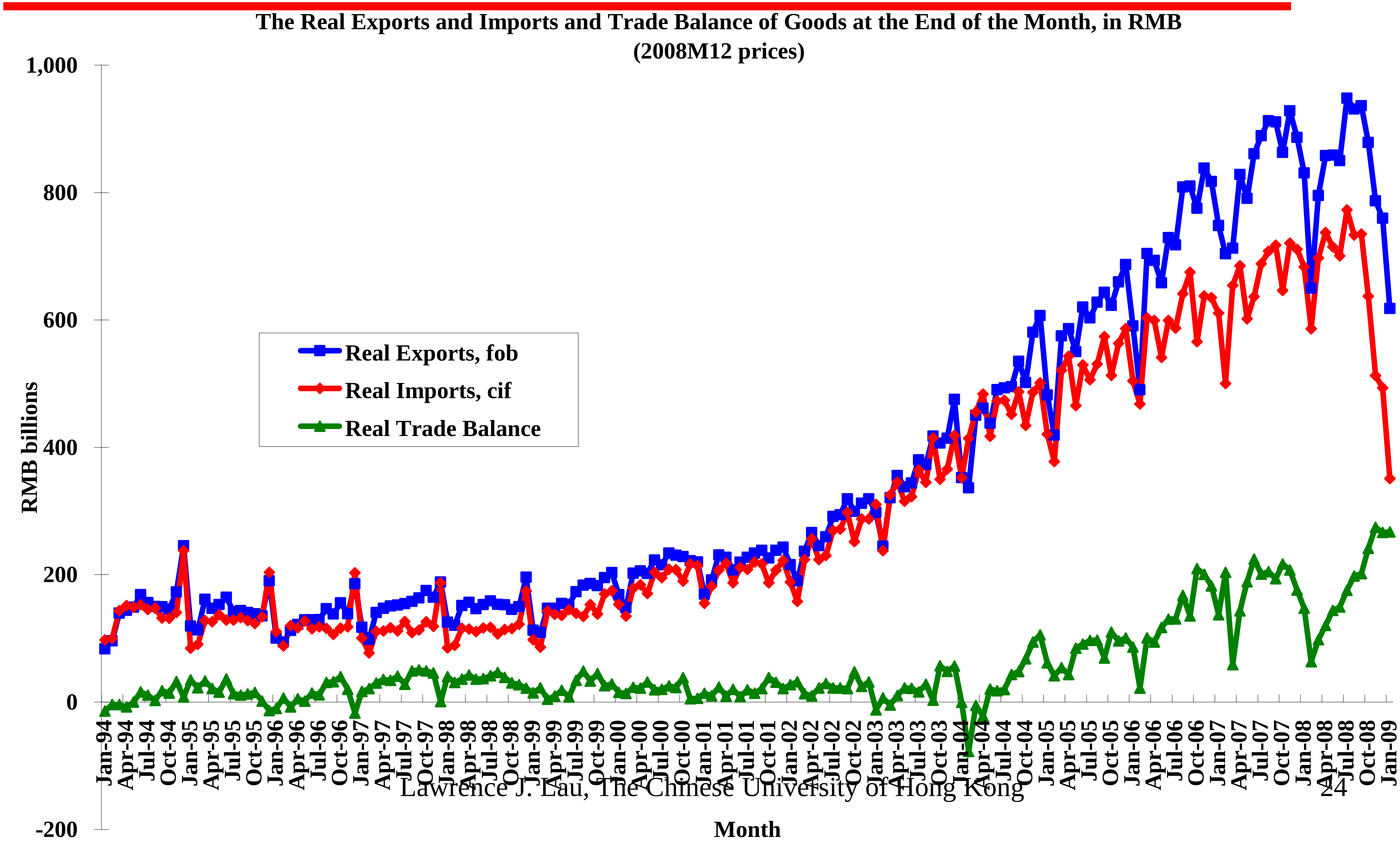
Can Mainland China Grow at 8%?

- 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%.
- Contrary to public opinion, Chinese economic growth has not been dependent on its trade surplus—China did not have any significant trade surplus until 2005, when the Yuan began to be expected to and actually appreciate significantly relative to the US$.

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



Chinese Exports, Imports and Trade Balance, 2008 Yuan, Monthly Data



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%.

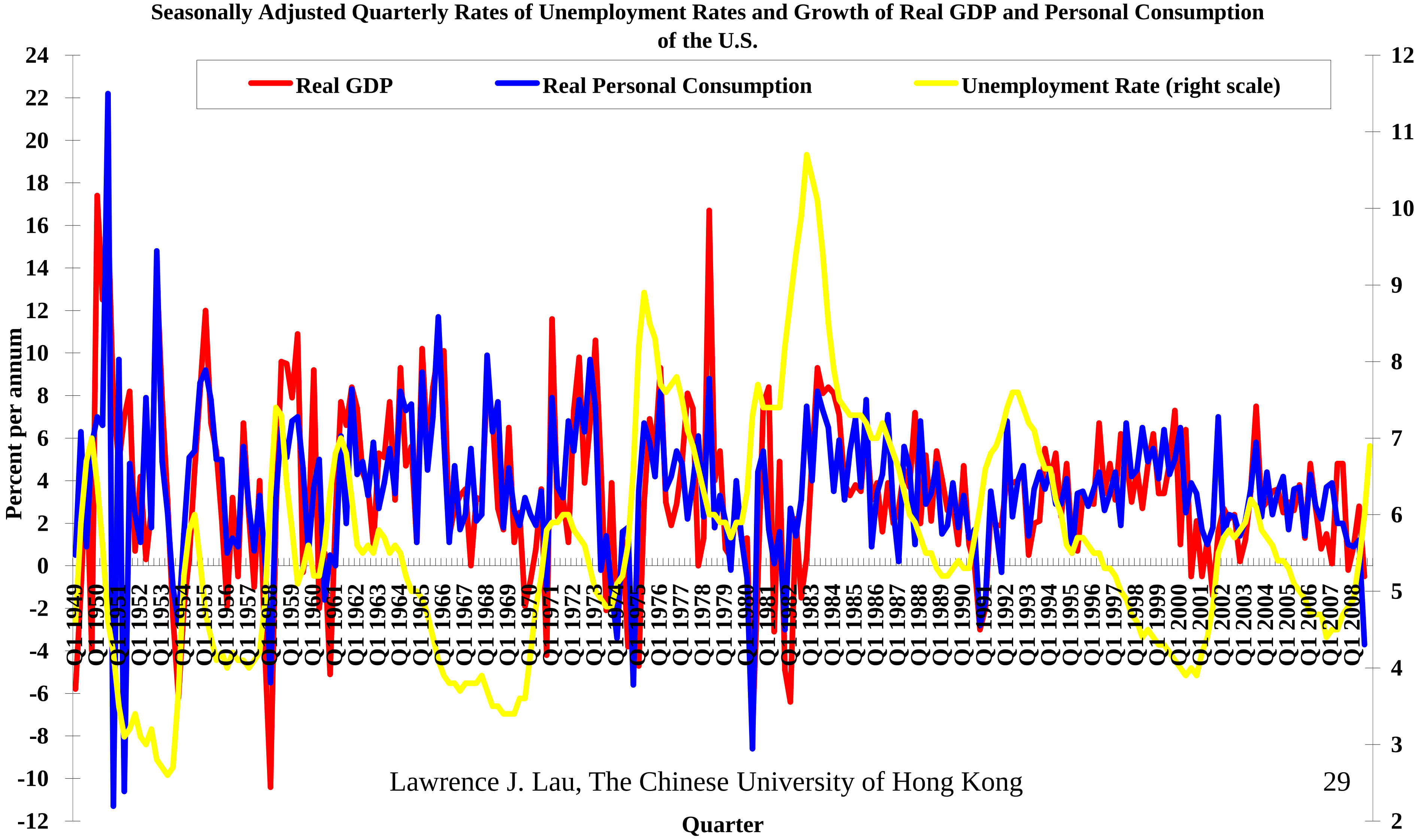
The Impact of the Economic Recession in the World on Chinese Exports

- 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 their inability to obtain bank loans from their U.S. banks to finance their inventory. As the availability of such credit dwindles, they also reduce or withhold their orders and wait until their inventory is exhausted. The net result is a huge reduction in orders for Chinese (and East Asian) 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. and elsewhere. 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 have a significant effect.
- According to the historical experience of the U.S. economy, real personal consumption is a much smoother time series than real GDP or real personal income. Since 1949, the worst quarterly decline (at annualized rates) of personal consumption was 12% and since 1952 was less than 10%. Currently available forecasts are between 1 and 3% decline in U.S. personal consumption in 2009.

U.S. Unemployment Rate and Rates of Growth of Real GDP and Consumption



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

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

- So the expectation is that the export orders should bounce back in a couple of quarters, that this decline in export orders is only temporary and basically represents a delay or postponement of the demand by a quarter or two, 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 Chinese GDP, the impact should be a reduction on the order of 1.5-3.0%, a significant but still tolerable amount. But some categories of exports, such as furniture, large-ticket items such as large-screen flat-panel television sets, refrigerators, washing and drying machines, notebook computers, will take much longer to revive. It is more promising to reorient these products to the domestic Chinese market.

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

- However, as Chinese export activities are not distributed uniformly over the entire country, but are concentrated in only a few provinces and municipalities, such as Guangdong, Shanghai and Zhejiang, the declines in GDP and the rises in unemployment will be severe in the affected provinces and municipalities. The rates of growth of Guangdong and Shanghai in 2009 will decline from double-digit levels to 8.5% and 9% respectively. Measures must be adopted to take care of the needs of the workers laid off because of the export slump.

The Decline in Chinese Exports and Export Orders

- Chinese exports have been expected to slow down not only because of the economic recession in the U.S. and elsewhere in the World but also because of many other factors such as the revaluation of the Renminbi by 20% since July 2005, the intensified enforcement of environmental regulations, the unification of the tax rates for domestic and foreign-invested enterprises which raises the taxes on foreign-invested enterprises, and the implementation of the new labor law, all of which preceded and were independent of the global financial crisis.
- The rate of growth of Chinese exports has actually begun to decline in late 2007, accompanied by the beginning of a wave of closures of export enterprises, mostly owned by foreign investors.
- However, the decline in export orders received by Chinese exporters of almost 50% year-over-year since September took almost everyone by surprise. While it is true that export orders have been expected to decline and have been declining, but not to this order of magnitude.

The Decline in Chinese Exports and Export Orders

- Imports of consumption goods would therefore be expected to decline with personal consumption, but probably at no more than double the rate 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. (Furniture and large appliances, such as television sets, that relate to housing, are exceptions.)
- So the expectation is that much of the lost export orders would bounce back in a quarter or two, and that much of 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 manageable amount.

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

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

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

- The boom in the Chinese economy since 2003 has been largely due to domestic demand, fueled by real estate development in the localities strongly supported by the local governments and not to exports. (There was little trade surplus vis-a-vis the world until 2005).
- 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.

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Macroeconomic Outlook for the Chinese Economy

- The rate of growth of real GDP has slowed from over 11% (revised to 13% in January 2009) in 2007 to 9% in 2008. In 2008Q4, the rate of growth of real GDP, year-over-year, is 6.8%. The Chinese economy may be expected to grow between 7 and 8% in 2009.
- The Chinese Government has launched a economic stimulus plan of almost US$600 billion or 20% of Chinese GDP spread over two years. The effects are expected to kick in some time in the second quarter of 2009.
- Unemployment has become very serious in the export-oriented regions of Guangdong, Shanghai and Zhejiang. However, most of the unemployed are rural migrants, most of whom have returned to their home villages, where they have support. It is inevitable that social disturbances are likely to rise in localities where the unemployment is concentrated but it is believed to be manageable with the provision of subsistence welfare of those who migrant workers that do not choose to return home.

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Macroeconomic Outlook for the Chinese Economy

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- The rate of inflation as measured by the consumer price index has remained tame, making it possible to undertake fiscal expansion without fear of rekindling inflation.
- The stock markets have been stabilized, providing some support for business and consumer confidence.
- Retail sales have also remained relatively stable as a proportion of GDP.
- The decumulation of inventory has apparently reversed course in some sectors because of the anticipation of the effects of the economic stimulus package.

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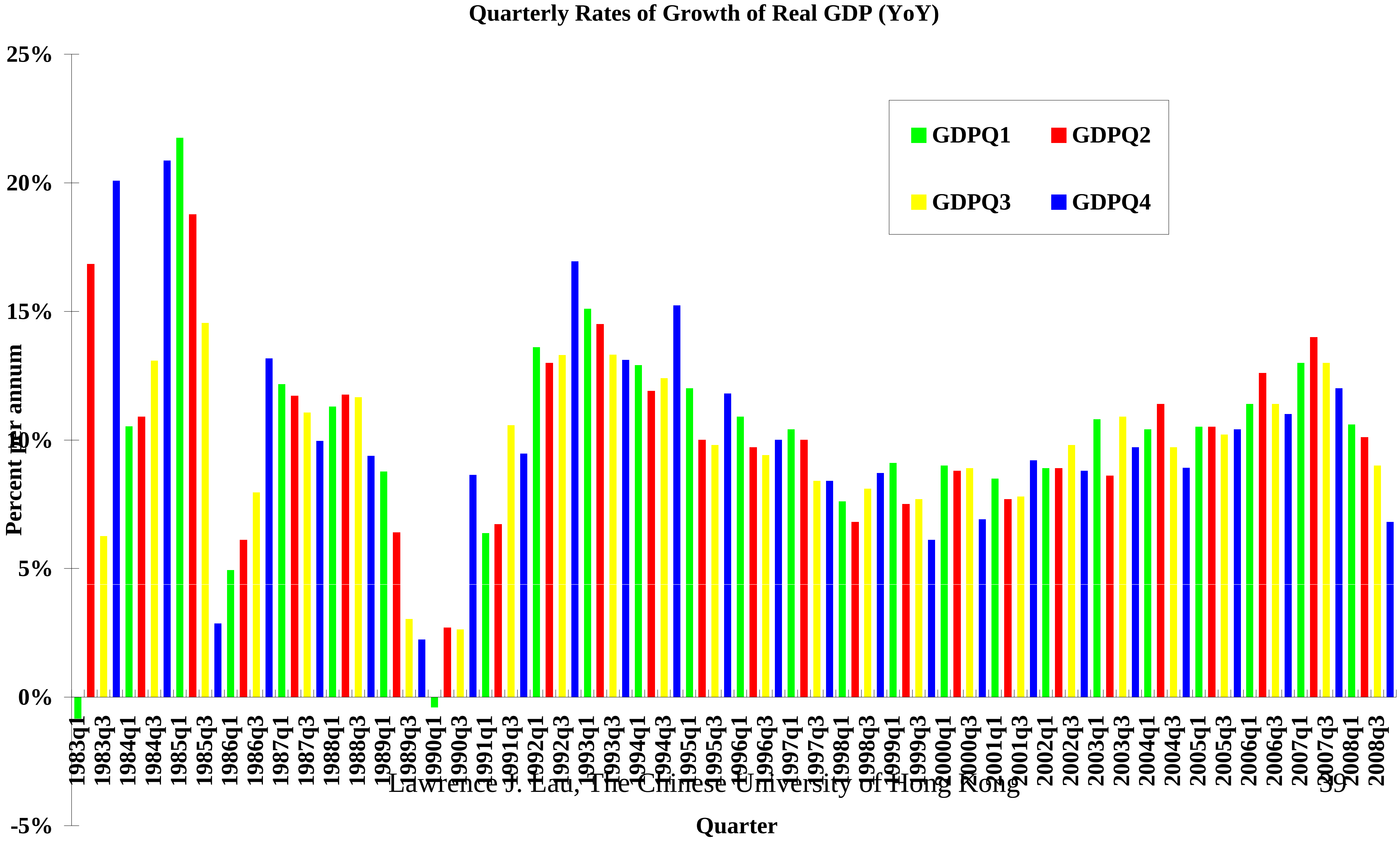
Quarterly Rates of Growth of Chinese Real GDP, Y-o-Y



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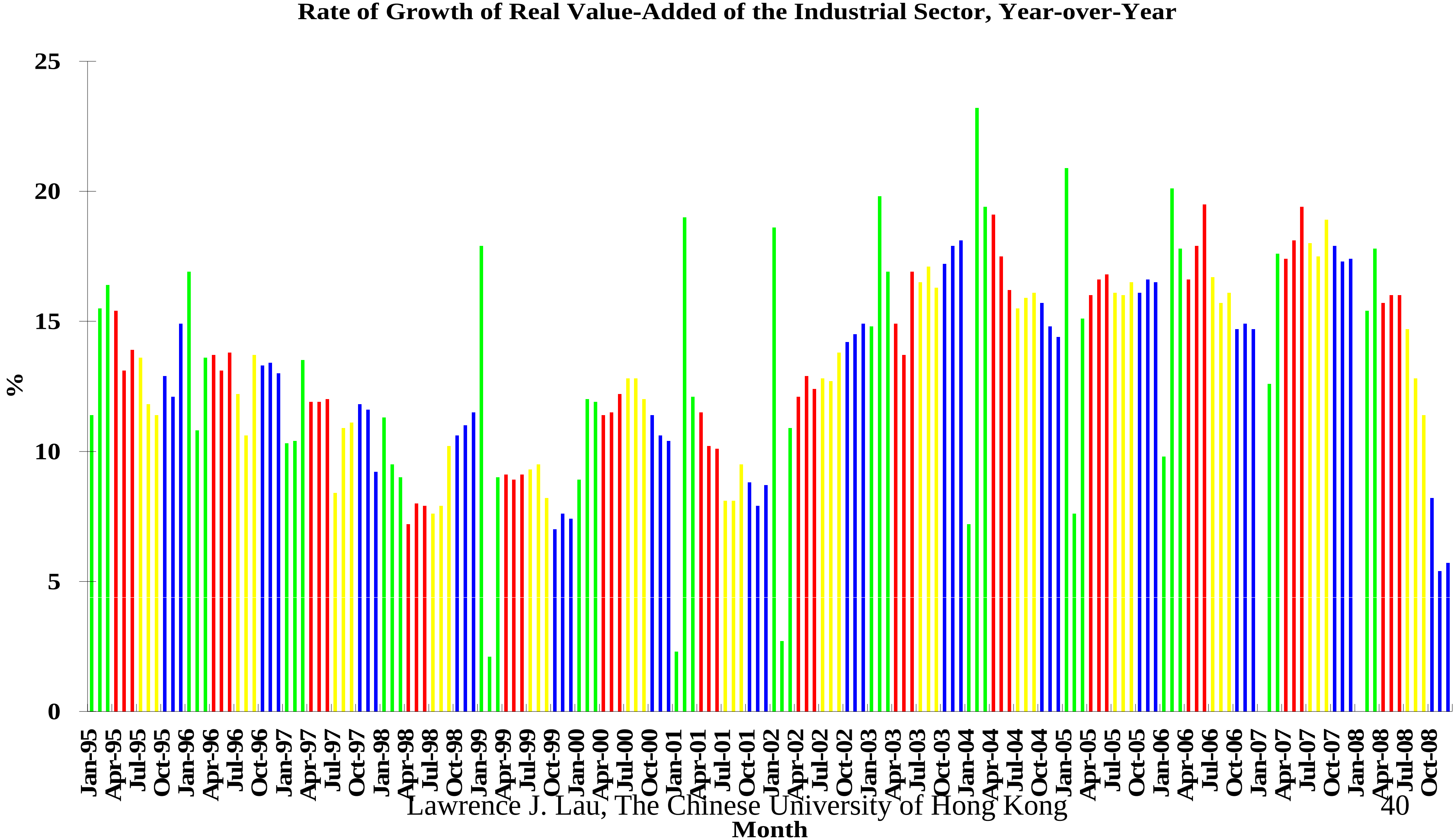
Monthly Rates of Growth of Real Value-added of the Industrial Sector, Y-o-Y



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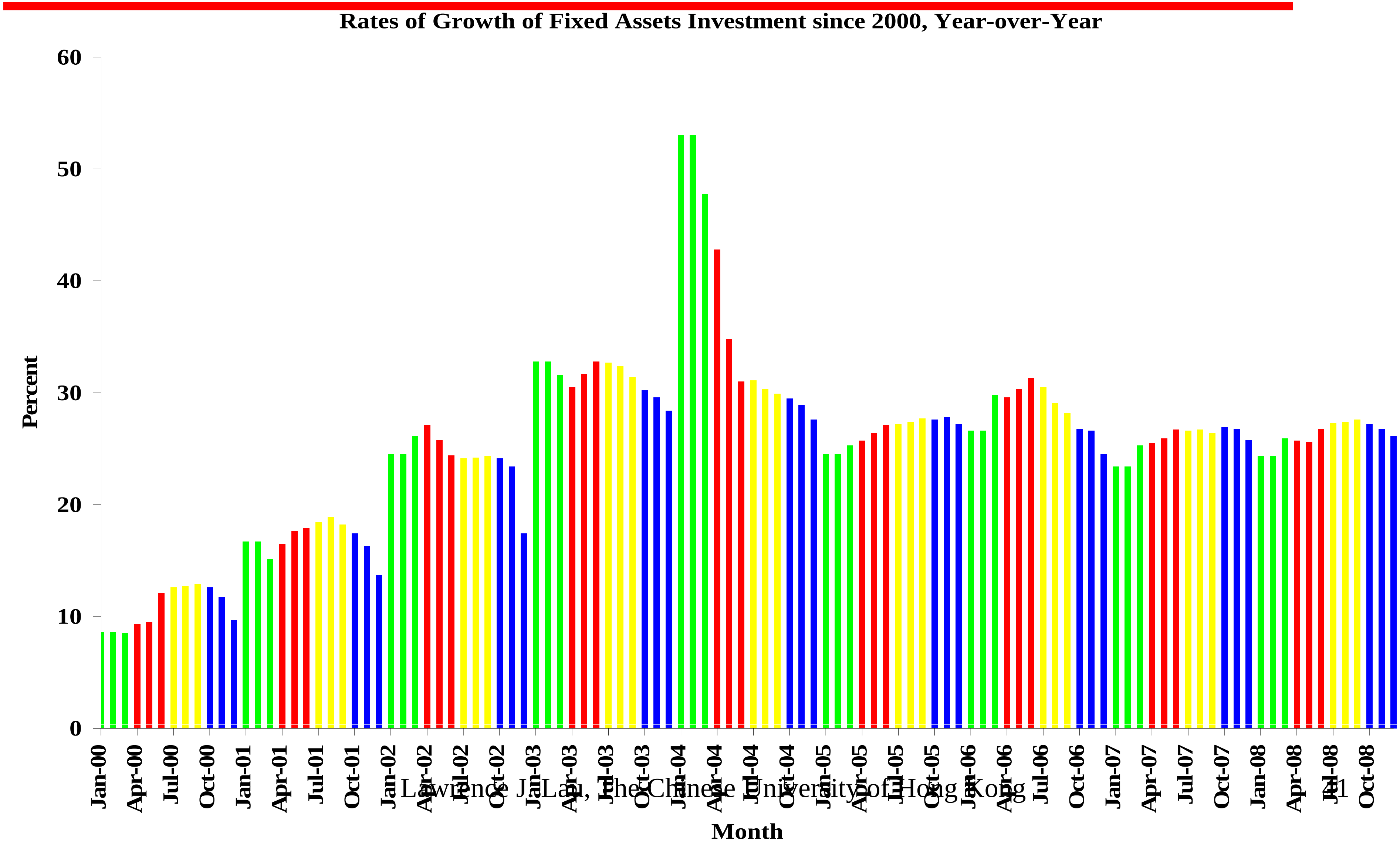
Monthly Rates of Growth of Fixed Assets Investment, Y-o-Y



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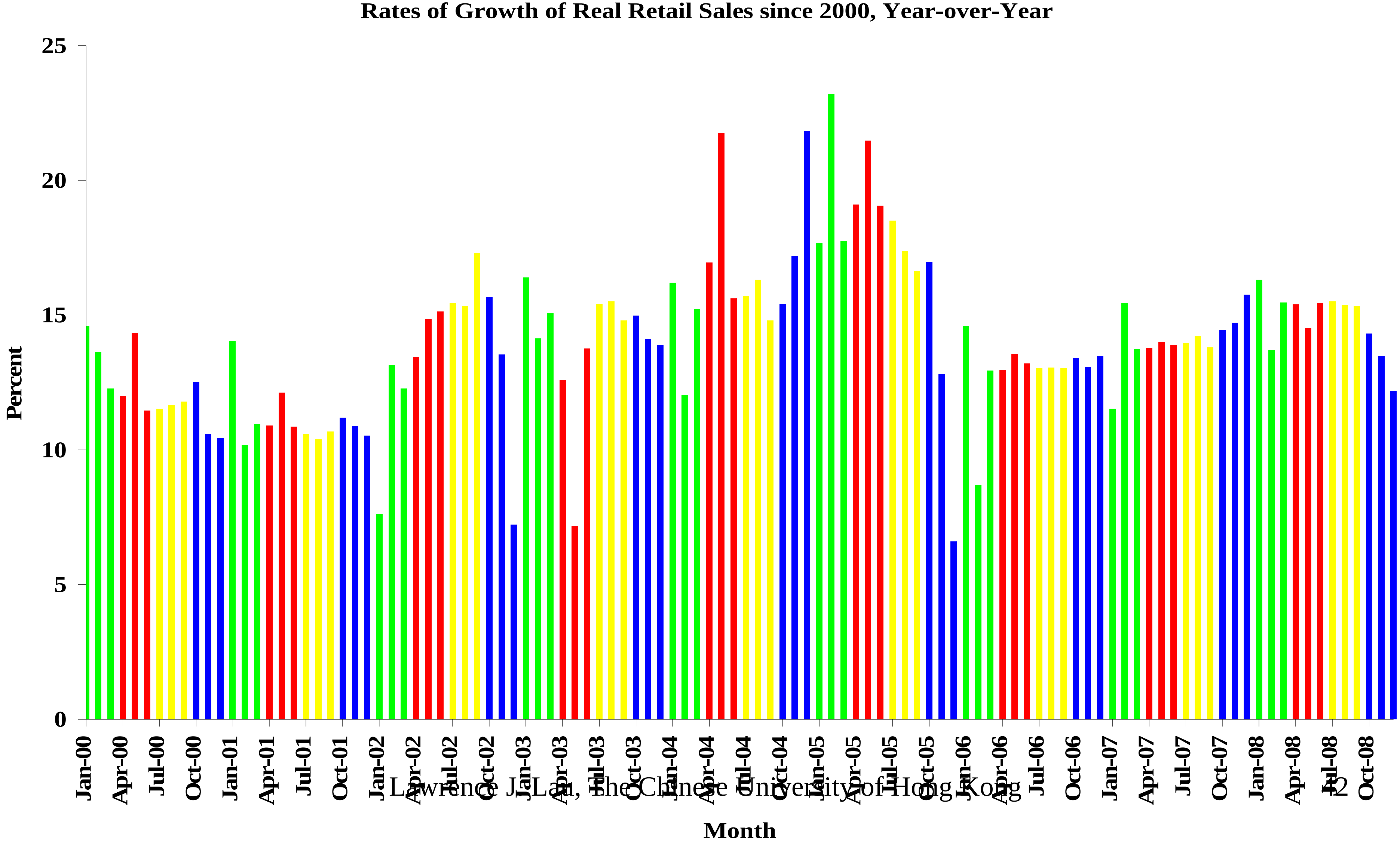
Monthly Rates of Growth of Real Retail Sales, Y-o-Y



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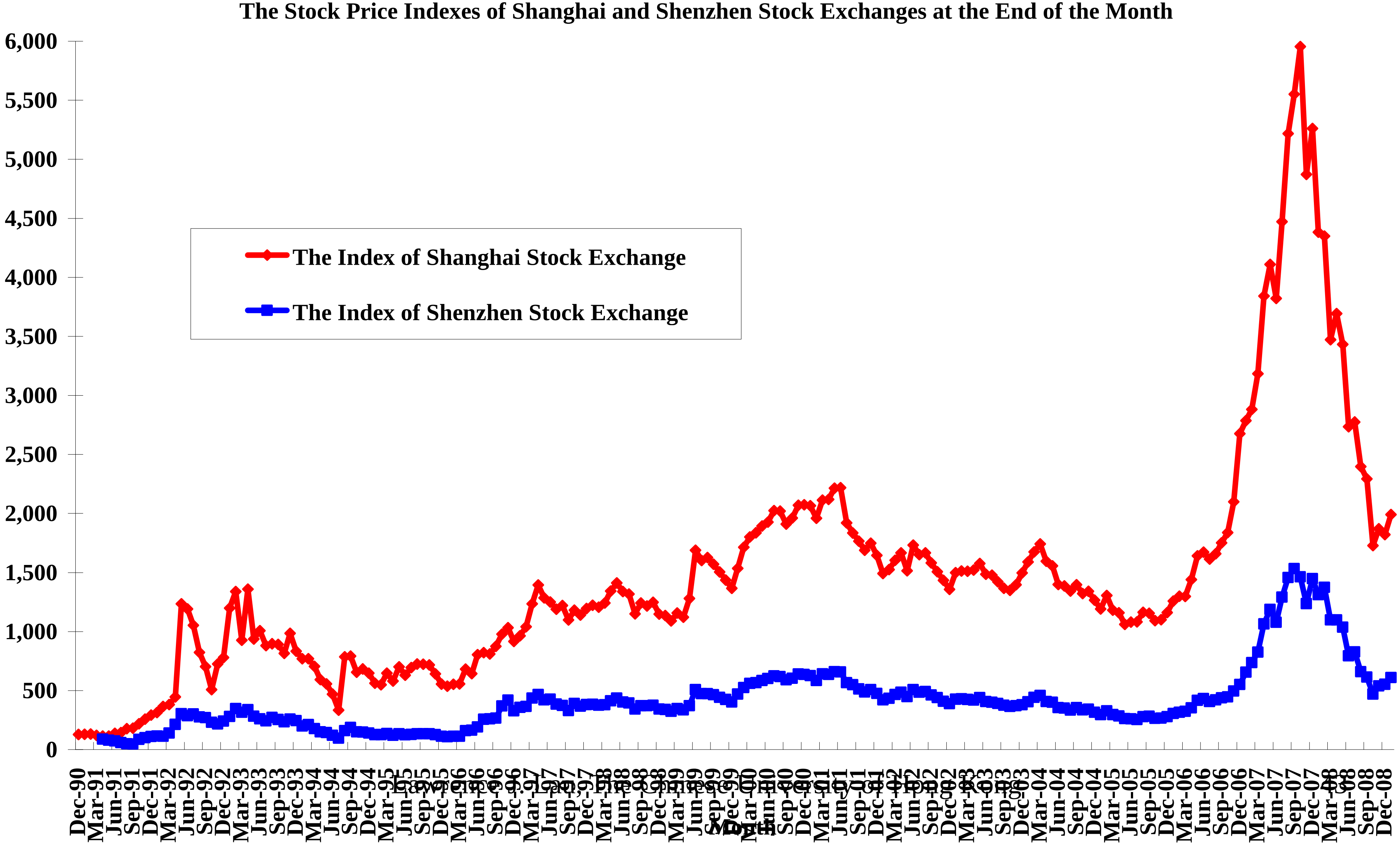
The Stock Price Indexes of Chinese Stock Exchanges Since 1990



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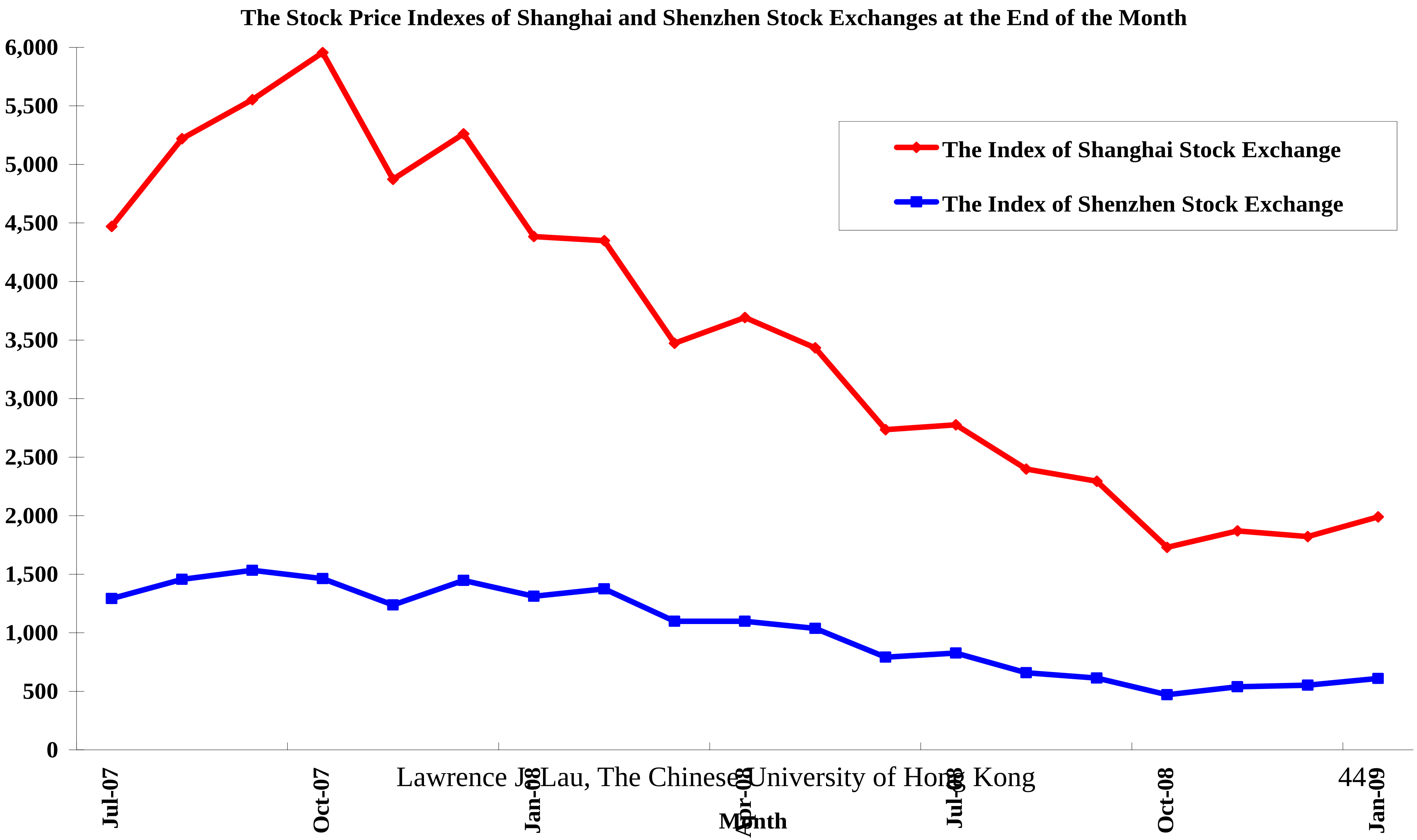
The Stock Price Indexes of Chinese Stock Exchanges Since July, 2007



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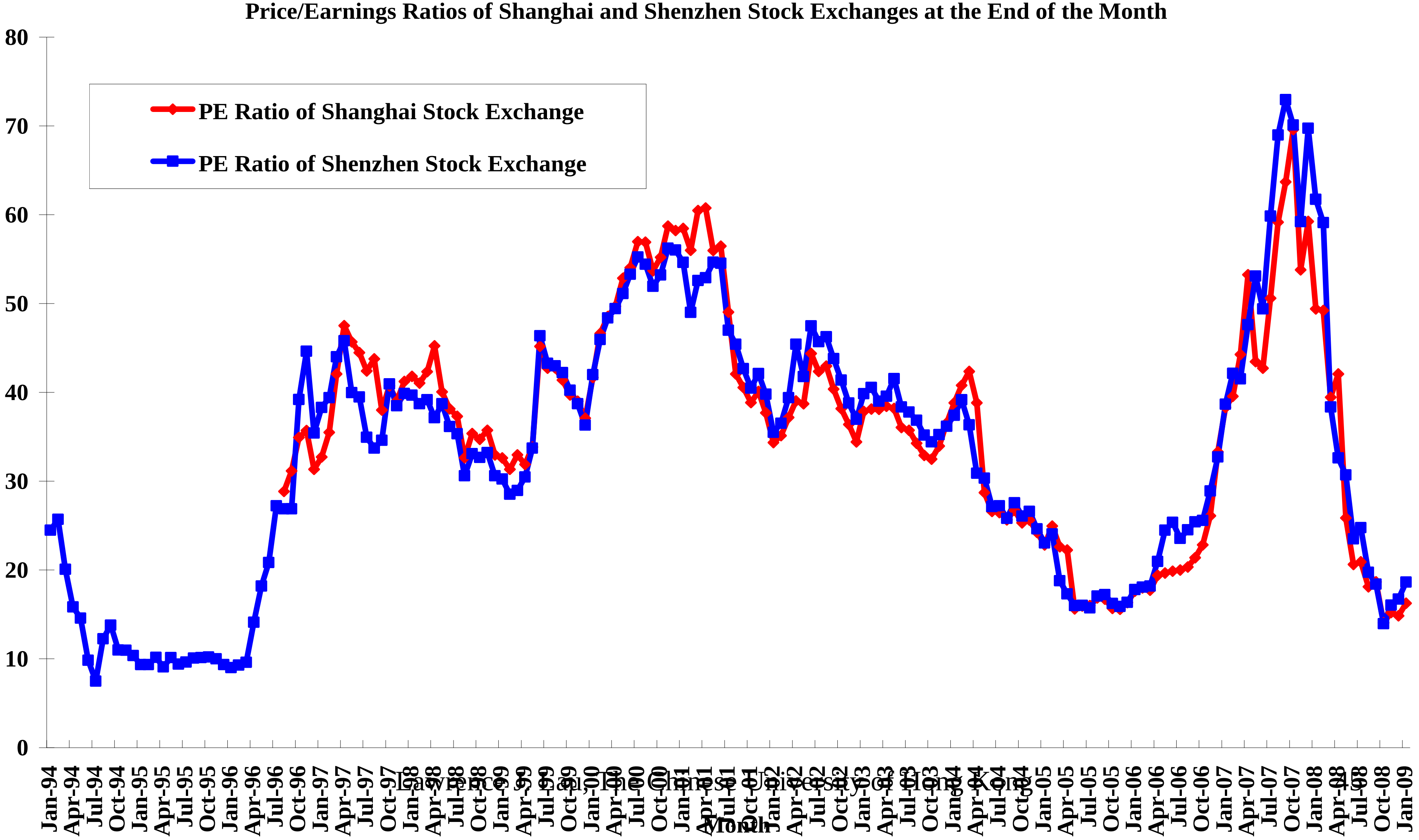
Price/Earnings Ratios of Chinese Stock Exchanges



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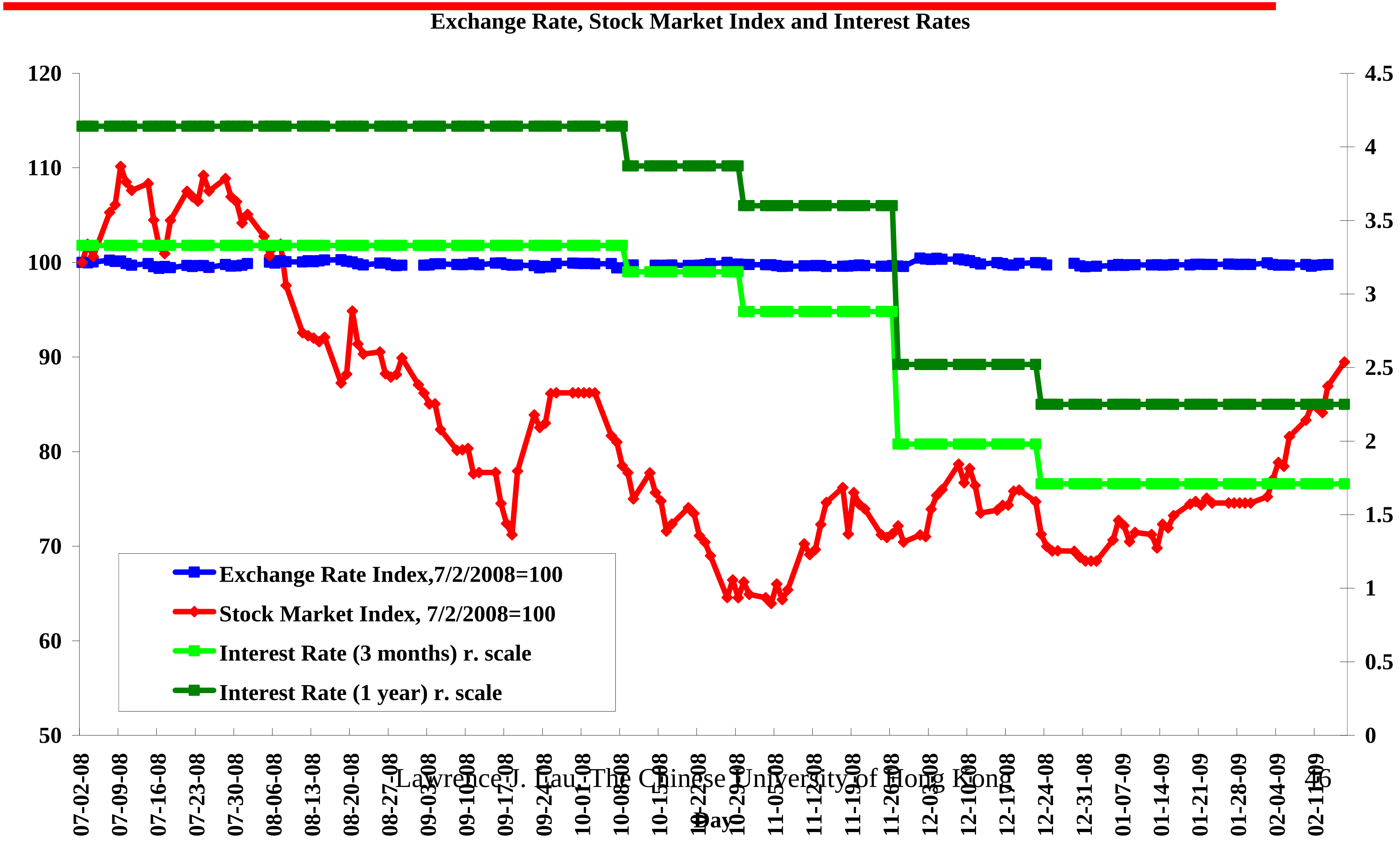
Chinese Exchange Rate, Stock Market Index and Interest Rates



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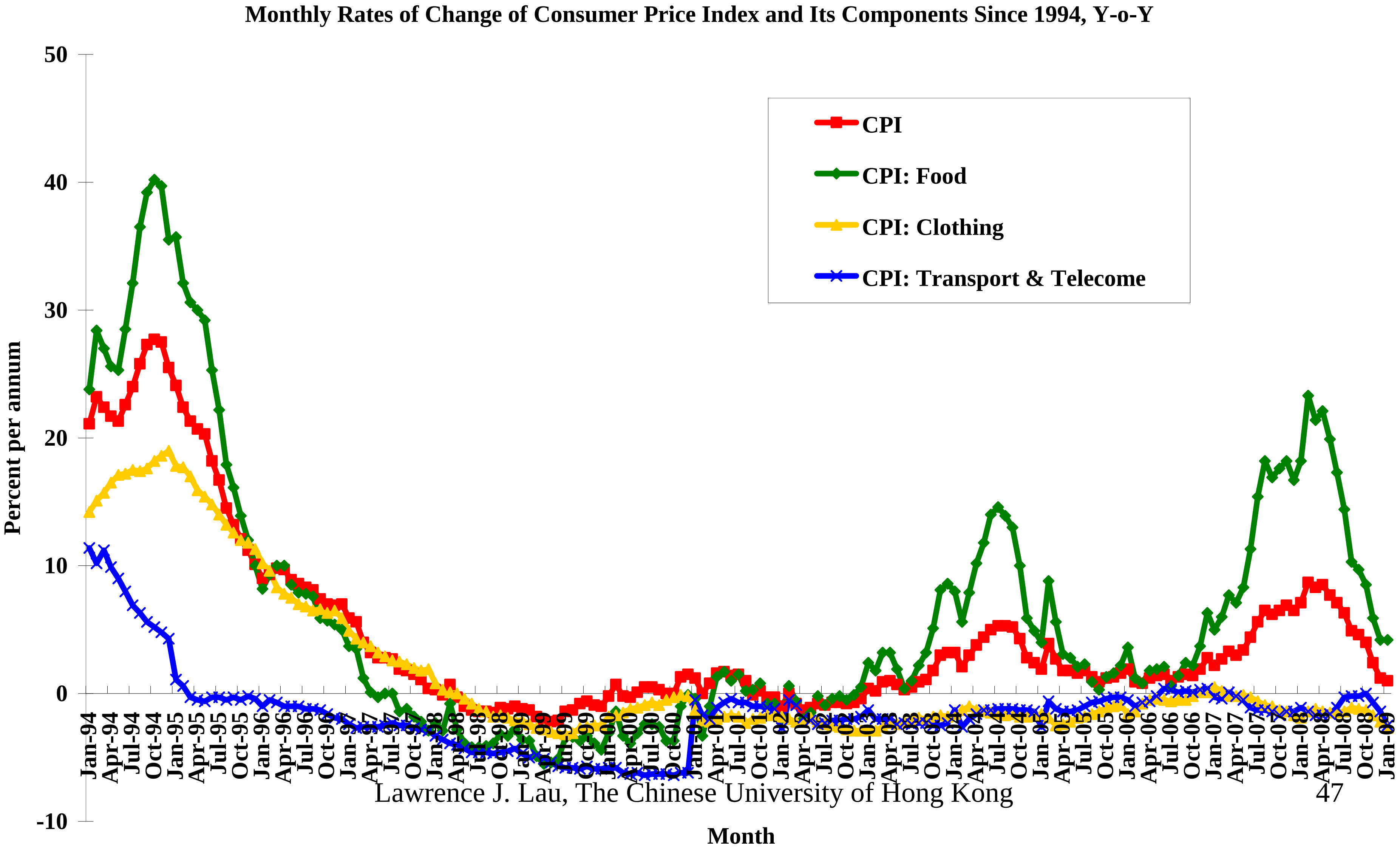
Monthly Rates of Change of the Consumer Price Index (CPI), Y-o-Y



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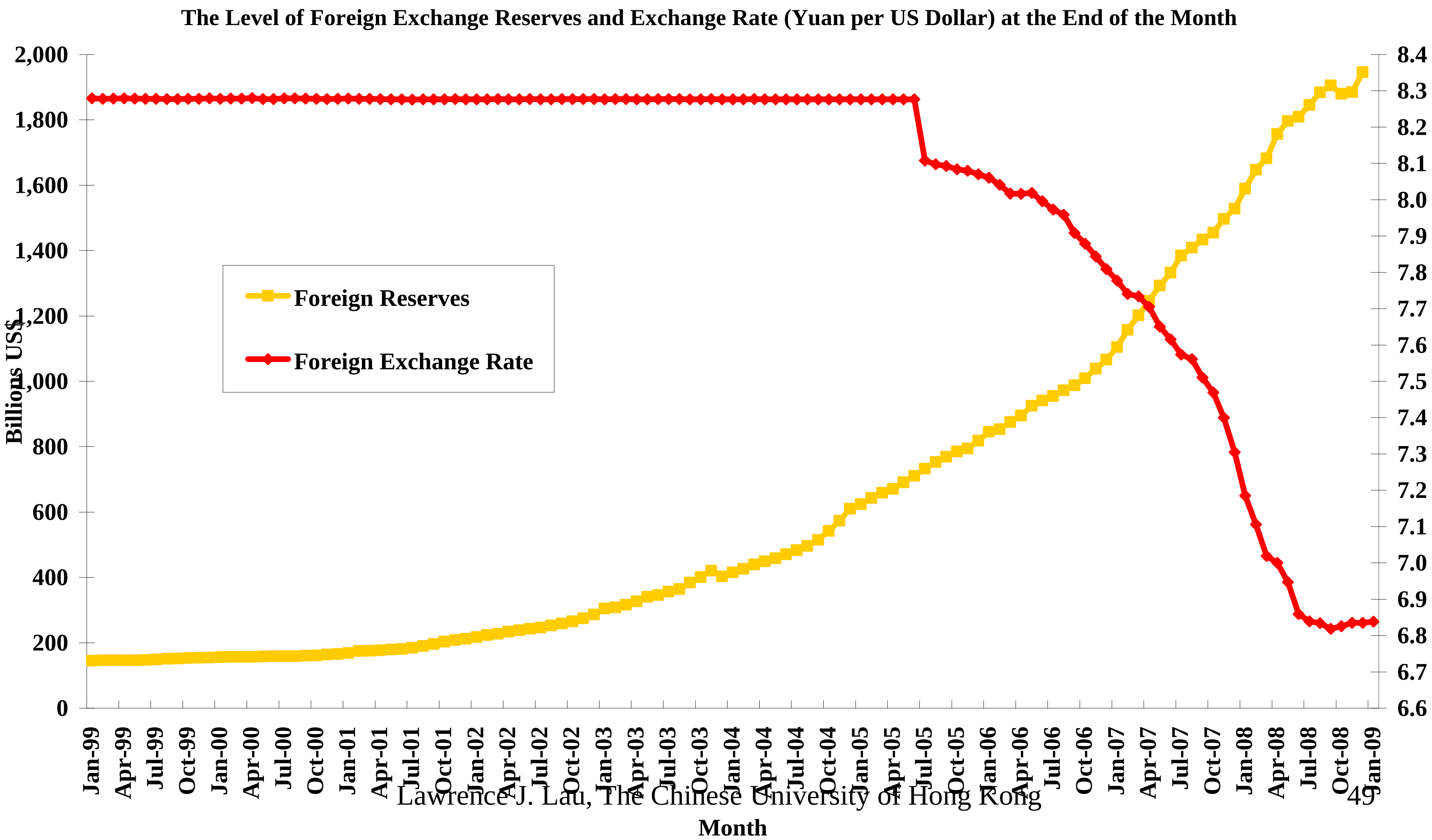
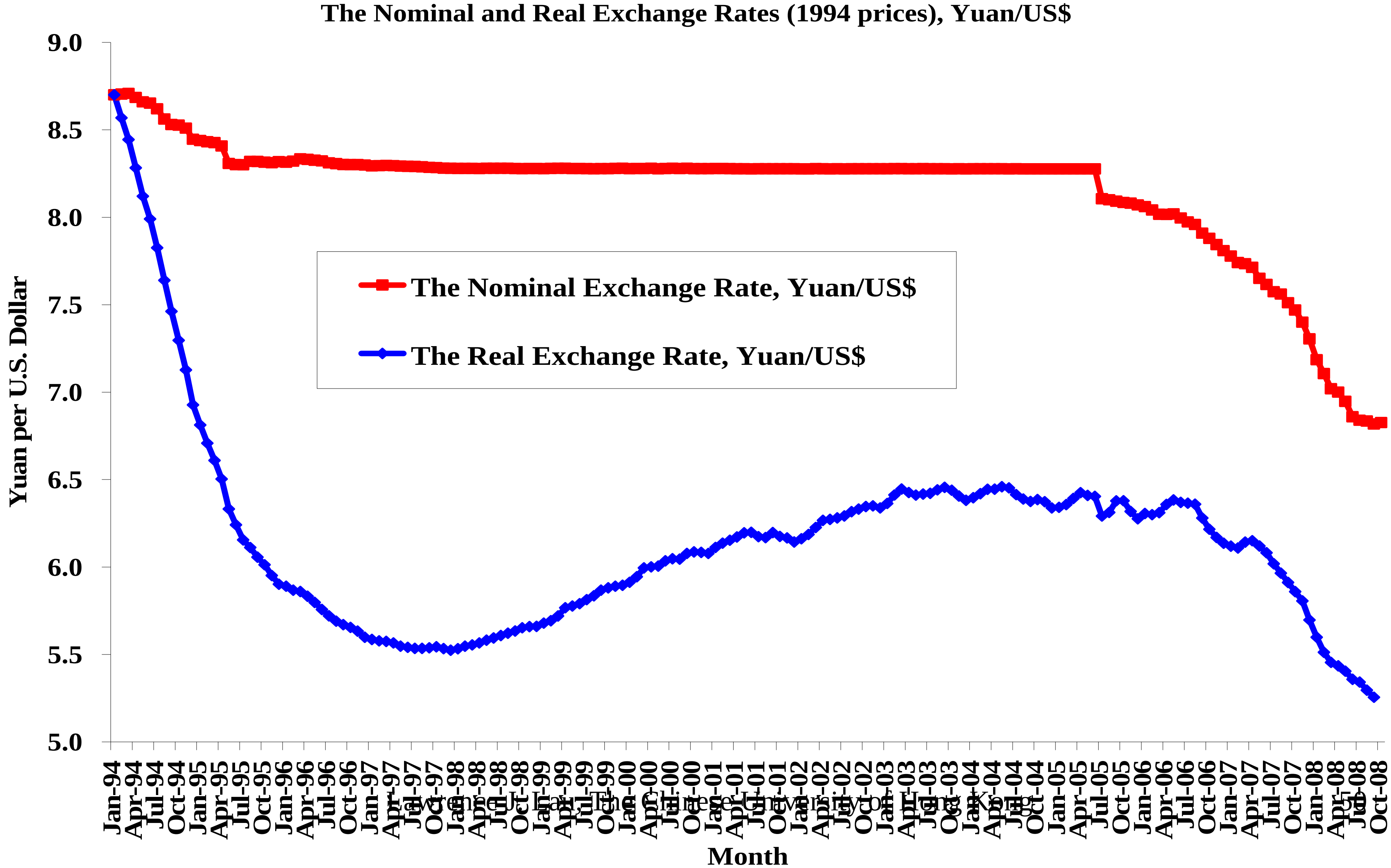
The Renminbi-U.S.$ Exchange Rate

- 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 widely acceptable, especially in East Asian economies, it may gradually supplant the U.S. Dollar as the currency of denomination in international trade in East Asia.

Foreign Exchange Reserves and the Yuan/US$ Exchange Rate

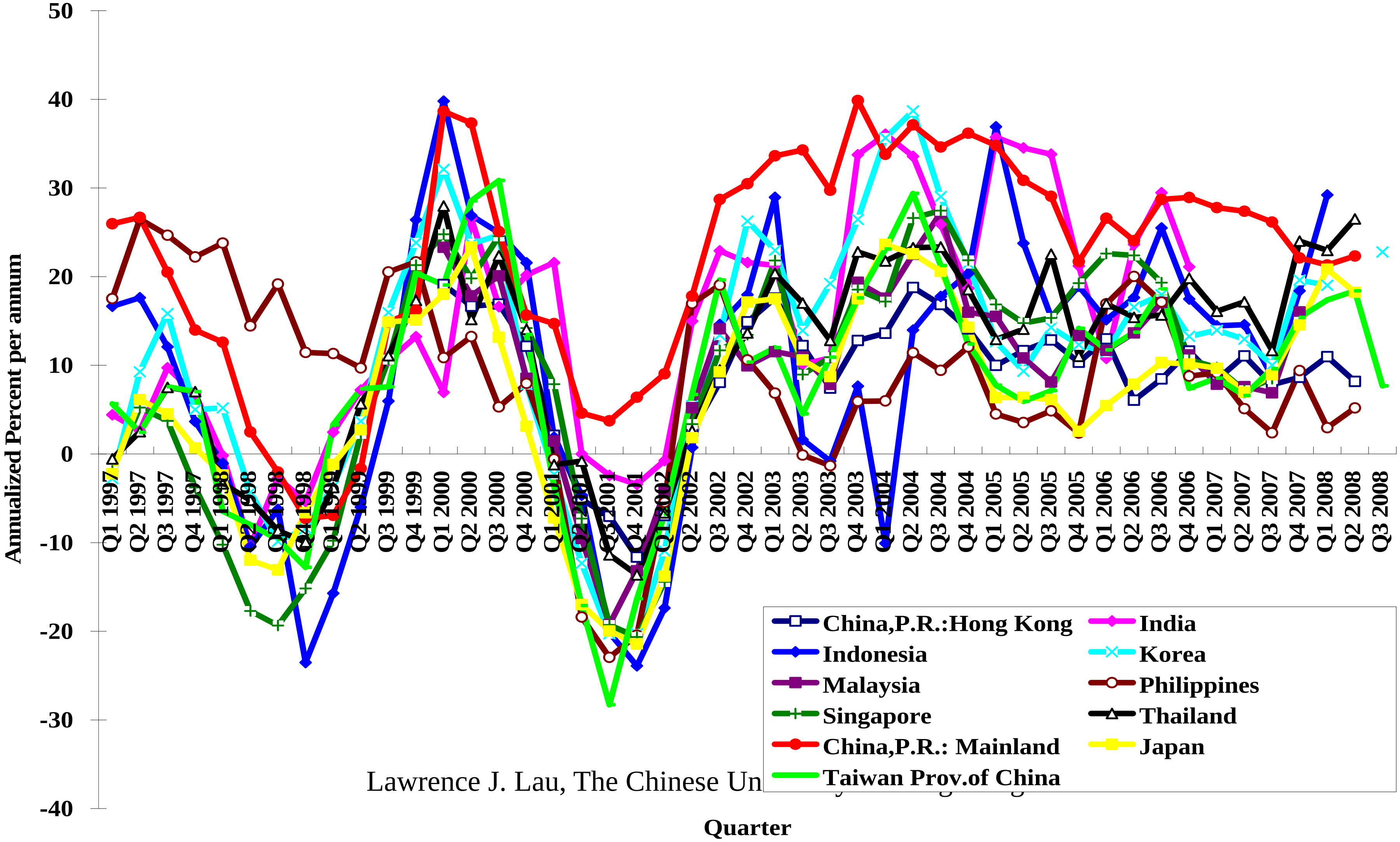


The Nominal and Real Yuan/US$ Exchange Rates

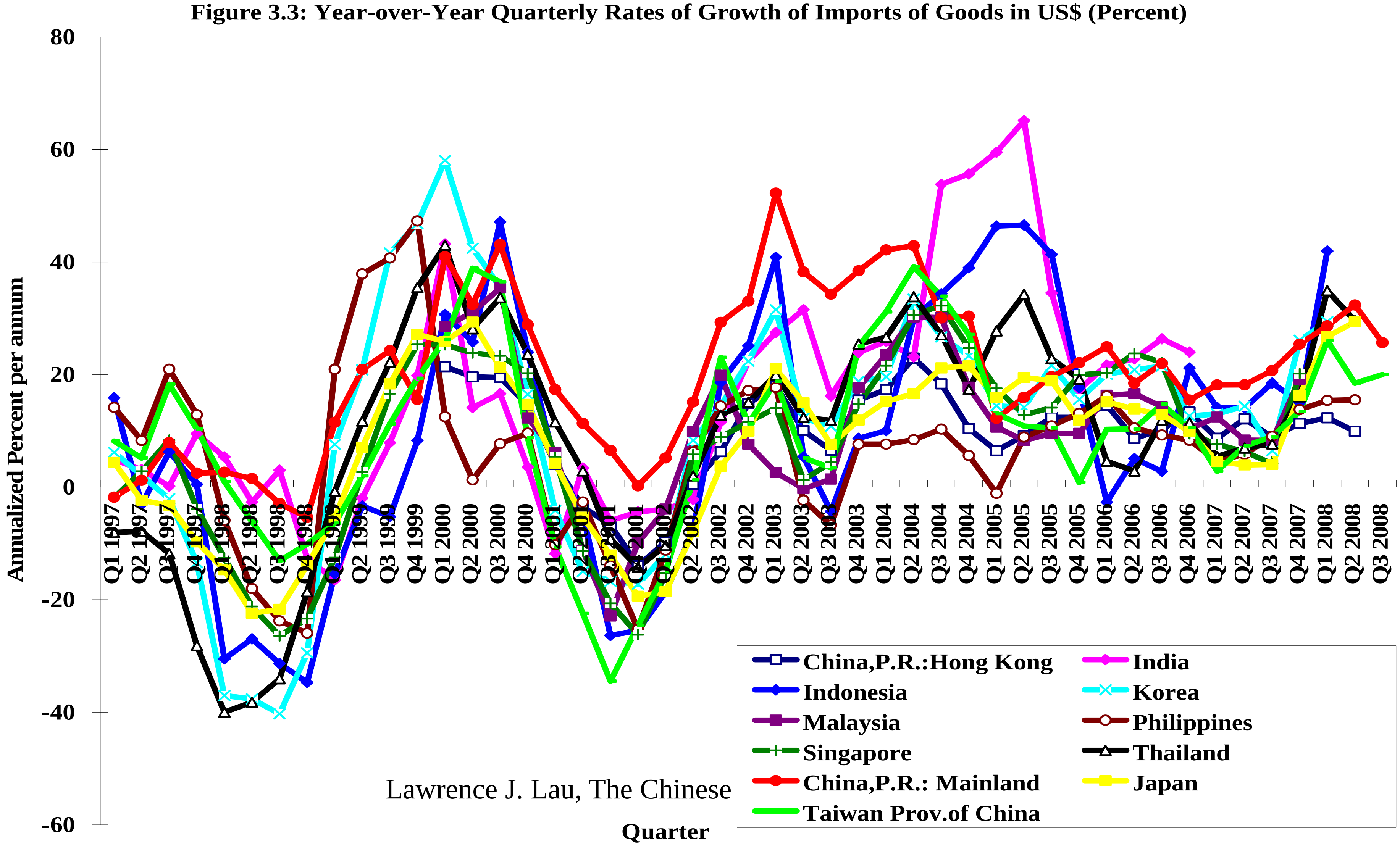


Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

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



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



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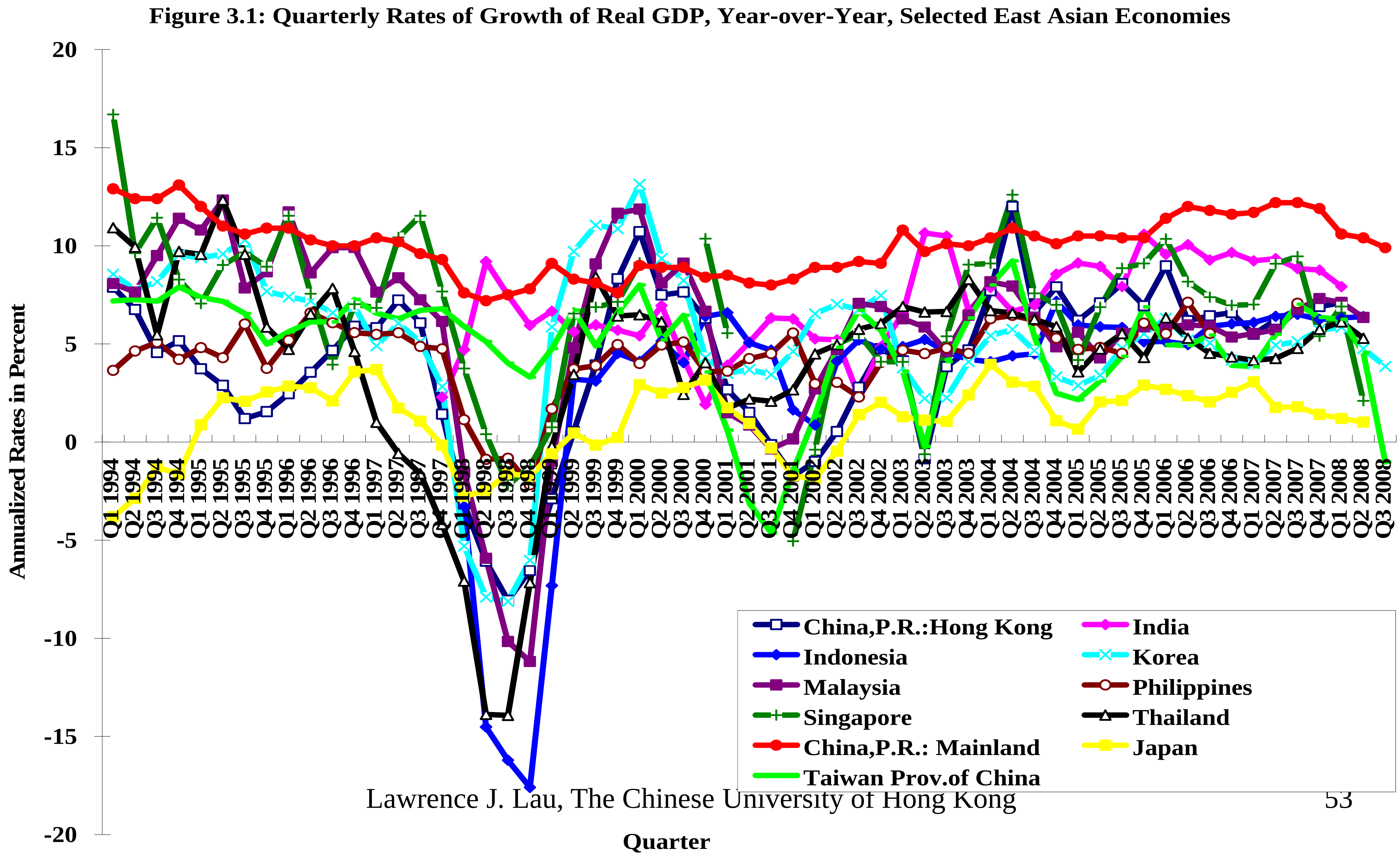
Quarterly Rates of Growth of Real GDP: Selected East Asian Economies



Simultaneous Coordinated Economic Stimulus Packages

- The experience of the East Asian Currency Crisis in 1997 shows that the downturns were especially 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.
- The previous charts also 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.

Simultaneous Coordinated Economic Stimulus Packages

- If the East Asian economies can all adopt significant economic stimulus packages and launch them simultaneously, the economic recovery of all East Asian economies can be accelerated. In launching the economic stimulus packages, protectionism should be avoided. The surest path to a global economic depression similar to that of 1929 is competitive protectionism. Now is the time to promote and expand intra-East Asian trade rather than to discourage and curtail it.

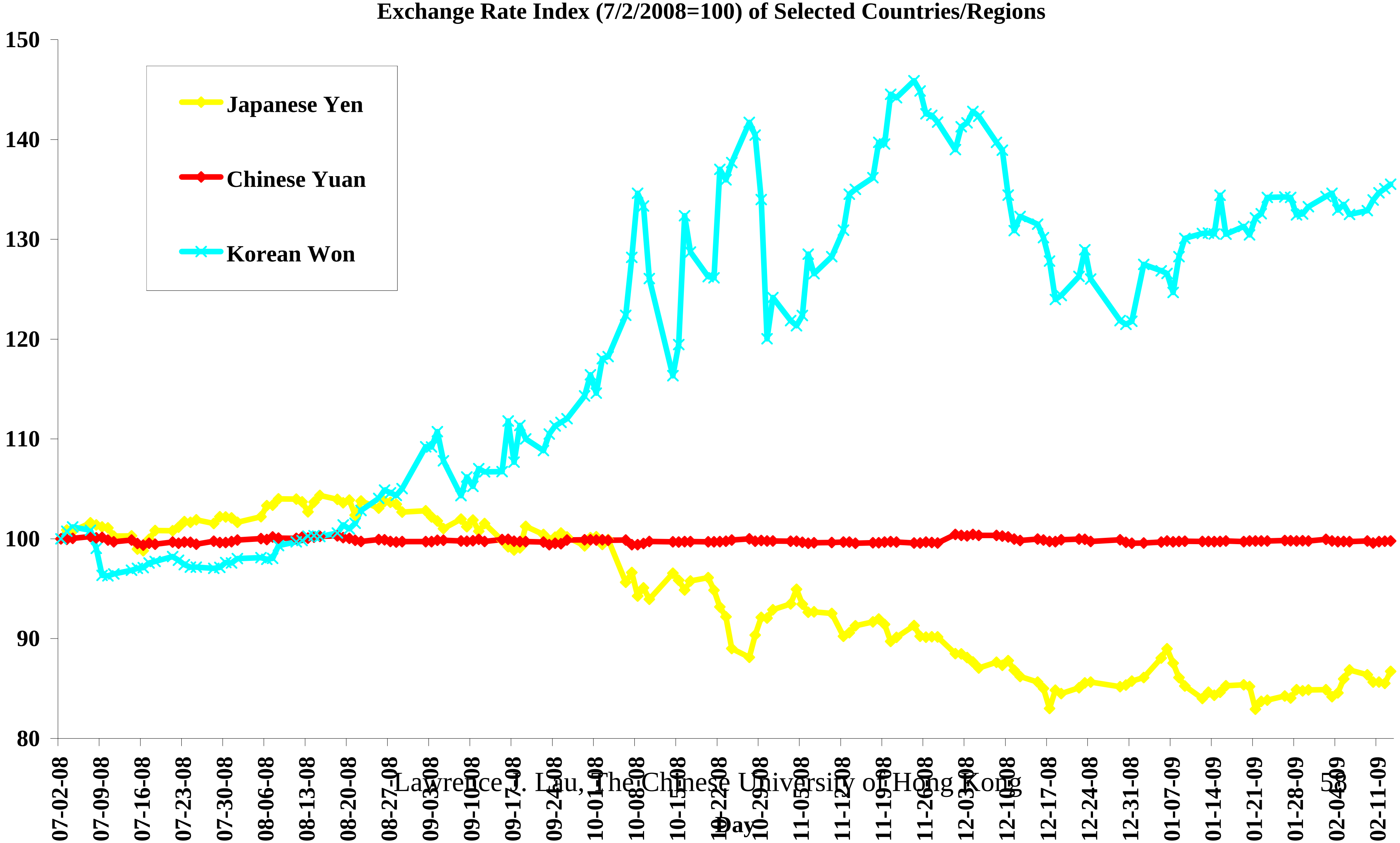
Exchange Rate Coordination

- Thus far, the central banks of East Asian economies have been holding on to their US$ denominated assets, mostly in the form of U.S. Treasury and Agency securities. It is in the interests of the U.S. as well as in their own self-interests to do so. A flight from US$ denominated assets by the East Asian central banks would have a disastrous impact on world financial markets. It is important that no one breaks rank, or others may follow.
- The East Asian economies collectively hold so much foreign exchange reserves (on the order of US$4 trillion) that they are perfectly capable of stabilizing the relative East Asian exchange rates at reasonable, mutually beneficial and long-term sustainable levels as long as there is a common understanding and consensus.

Exchange Rate Coordination

- There is also room for East Asian economies to coordinate their relative exchange rates for long-term mutual benefits. The basic principle is to maintain relative real parities, i.e., to maintain relative exchange rate levels after adjusting for the changes in the relative rates of inflation, so that in real terms, the relative competitiveness remains unchanged.
- One-time adjustments in relative exchange rates that are out of equilibrium due to special unique circumstances should be permitted. For example, the Japanese Yen is abnormally over-valued because of the unwinding of the carry trade and should be allowed to be adjusted downwards. The Korean Won is abnormally under-valued because of the withdrawal of foreign loans from Korea and should be allowed to be adjusted upwards.

Exchange Rates of China, Japan and South Korea (7/2/2008=100)



Concluding Remarks

- The partial de-coupling of global economic growth is a new phenomenon. But with the continued economic growth of not only China but also India, supported by their respective internal demands, East Asia 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.