Macro Outlook for the World Economy and Currencies

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Global Financial Crisis

The first thing for me to ask is what is the nature of this global financial crisis and how long is it going to last? In the beginning, I was rather optimistic. I thought this was the usual global crisis and it would recover soon and so on. Then I found that that was not true. This time, the crisis is different because the nature of this global financial crisis is very different from that of previous crises. That is, the fundamental cause of this global financial crisis is a debt crisis, because the wealthy countries spent too much and borrowed too much.

When the subprime crisis broke out, US total debt to GDP was 359%, which is a huge number, double the ratio in the 1980s. Before 2007, among economists, we were debating what would cause a global economic crisis and we paid attention to the 17% of external debt. In other words, the US accumulated large foreign debt. Foreign debt as a percentage of GDP was 17% and we worried that there would be a sudden stop, the dollar interest rate would rise and then an economic crisis would occur. However, this did not happen and we made that mistake because we failed to see the broader picture, which was 359%, among which household debt to GDP was roughly 100%. We just took notice of the 17% and forgot the 100%. Equally importantly, we forgot that the 17% consisted mostly of US government securities, which were supposed to be very safe, and that, in contrast, the 100% consisted mostly of mortgage loans and derivatives, which were much more risky. I think this was where we made a big mistake. The subprime crisis translated to a public debt crisis and I do not know how Obama can hang on to this cliff now that the US public debt to GDP ratio is something like 115%, which is the highest since the Second World War.

Economic Recovery

(a) Historical Methods

This is the basic situation we are facing and now the question is how the United States and many other countries will be able to solve this problem. Without lowering the debt to GDP ratio to a sustainable level, there will be no real economic recovery. I think we have to accept this fact. Throughout history, debt to GDP ratio has been reduced by economic growth, fiscal austerity, default and inflation.

I do not think there is any other choice but to adopt one of these methods to reduce the debt to GDP ratio, then we can talk about economic recovery. In fact, the US owes a huge amount of foreign debt, so dollar devaluation will also be a very important option for the Federal Reserve.

(b) Quantitative Easing

Now we have so-called 'quantitative easing' (QE), which I think has the following objectives:

- To drive investors away from Treasury bills, because this is a very safe asset, and then the investor has to buy other financial assets, so you drive up share prices, gold prices and many other prices. Hence, the wealth effect will have some positive impact on economic growth. This is supposed to be the rationale in the mind of Ben Bernanke.

- To create inflation. Before taking over the Presidency of the Fed, Bernanke was very open in talking about the possibility of using inflation to solve the debt problem. He gained the very apt nickname ‘Helicopter Ben’, and I think he will rule out this option, but of course he will not say so openly.
- To push down the value of the dollar is another very important objective of QE, even though Bernanke refused to admit that this is the policy, but I think Greenspan is more honest, because he is no longer the governor. He said that one of the most important purposes of QE is to drive down the value of US dollars. I think this is a very important way for the United States not only to reduce its debt burden but also to promote exports and hence growth and employment.

Essentially, the policy of QE is to shift the debt burden away from borrowers at the expense of creditors and I think this is basically the situation that China is facing.

China

(c) External Environment

China is facing quite a difficult external situation; firstly, because of the global recession and global moderation, China’s external demand has weakened. For many years, China’s economy has depended on its exports. Even though it is an exaggeration to say China’s growth is entirely dependent on external demand, I have to admit that export is one of the most important growth engines for the Chinese economy. To achieve a decent rate of growth without worsening the debt problem, I think, the only option for the United States is to increase exports and to run a trade surplus. Therefore, the pressure on China for RMB appreciation will still be high, even though China’s current account surplus to GDP ratio is not that high – it is more or less balanced.

(d) Losses

In fact, China has suffered great losses. Over the past two or three decades, China has accumulated something like $5 trillion in foreign assets. It has also accumulated something like $3 trillion in foreign liabilities. China is credited with something like $2 trillion, but for most of the past 10 years, China has had to pay investment income to other countries. Last year, China’s investment income was negative $27 billion. I am a lender, so I lend money to you. Instead of collecting a return from you, I pay interest to you. That is quite ridiculous, but that is the reality that China is now facing. This situation is not difficult to understand. First, China’s investment in the US is mostly in US government bonds. US Treasuries’ 10-year yield is less than 2%, while in American firms’ average investment return in China was as high as 33% in 2008, according to the Conference Board. The corresponding figure for multinationals in China was 22%, according to a World Bank team working in China. To make things worse, US inflation is more than 2%, so the real return for Chinese investment in US Treasuries is negative. Second, China’s claims on the US are denominated in the US dollars and America’s claims on China are mostly denominated in the RMB. The devaluation of the US dollar automatically leads to the worsening of China’s net international investment position (NIIP). In addition, the US will try its best to inflate away its debt burden, so China will suffer even more in the future.

(e) Challenges

China is facing lots of challenges, but a very big one is that, on the one hand, China has to maintain a decent growth rate, because without a decent growth rate, there will be employment problems, social instability and so on and so forth. On the other hand, we cannot rely on exports to promote growth. We cannot rely on running a current account surplus to promote economic growth, because of the global financial crisis, so how China can defend its interests and reduce capital losses is a very big challenge. My personal view is that in order to get rid of a devaluing US dollar and US assets, China should reduce its current account surplus as much as possible. China should not fear running a current account deficit against the US. Only by doing so can China can get its money back. Insisting on running a current account surplus against the US is equivalent to refusing allowing the US to repay its debt to China, which is simply stupid.

(f) Short-Run Growth Prospect

Earlier this year, most Chinese economists predicted that by the end of this year, we would see a growth rate of at least 8%, but until very recently, Chinese economic performance was not that satisfactory. I think there are three reasons why this happened.

Firstly, starting last year, the Chinese Government adopted a tight monetary and fiscal policy, trying to slow down the growth of real estate development. The investment in real estate development is very important for China's economic goals and we underestimated the impact of the slowdown of investment in real estate on China's economic goals.

We also did not expect that the situation in Europe would be so bad. We thought the European countries would be able to overcome their difficulties and have a better economic performance, but we were wrong.

Thirdly, and I think this is very important, until quite recently, the Chinese Government did not rush to use expansionary monetary and fiscal policies to stimulate the economy. In 2008 and 2009, there was a slowdown and the Chinese Government panicked a little and rushed to introduce a few stimulus packages. This year, I think the Chinese Government is more cautious and more relaxed, which I think is a good thing. It has not panicked and so has not, until recently, introduced a more expansionary fiscal and monetary policy. I think this is a very important reason why, so far, the growth performance of the Chinese economy is not as good as we expected earlier this year, but it does not matter. We need a slower but more sustainable rate of growth.

(g) The Talk of the Town

Late last year and early this year, people talked about a hard landing. I think there are three reasons why foreign pundits are talking about a hard landing:

- China's over-investment.
- The low loan quality of China's banking system.
- The property bubble and the possible crash of the housing market.

I think all these arguments are reasonable, but more or less they exaggerate the extent of the seriousness of these problems. Yes, we have these problems, but they are not that serious yet. In fact, we have faced these problems many times in the 1980s, 1990s and 2000s. Indeed, in the 1980s and 1990s, I predicted the fall of the Chinese economy many times due to all these problems and each time I was wrong. Since then, I have become cleverer, I have tried my best to be optimistic and I have been right. I have shifted my position, so I hope you can follow suit. Do not follow the pessimistic forecasting of the Chinese economy, because China is a big country and the situation is complicated.

(h) Loan Quality of the Banking System

People talk about loan quality. In fact, there are a lot of problems, including the local government financial platform and big project finance. For instance, we have built a very good, high-speed railway, but the borrowing by the Ministry of Railways is huge, accounting for something like 4.3% of GDP. How this Ministry can repay the money we do not know, but China will be able to muddle through.

The key thing for me is that China's fiscal position is very good and you should focus on the fiscal position when you are analysing a country's situation. If a country's fiscal position is bad then the situation is hopeless, but in China, the budget deficit to GDP ratio is less than 2%. The public debt to GDP ratio is less than 20%. This is good enough and means that we still have room to manoeuvre. Even though there is a crash of this and that, we can foot the bill and survive. Of course, we cannot make too many mistakes. You can crash once, twice, three times, but perhaps three times is the limit. If the public debt to GDP ratio shoots up to more than 100% or 200%, the Chinese economy will be finished, but we are far away from that perspective, so there is no need for you to worry, at least for the short or medium run.

(i) Housing Market

I gave a presentation earlier this year at the New York Stock Exchange where I said that the real demand for houses will still be strong after the withdrawal of speculative demand and a floor for housing prices will be set. The quality of mortgages is quite good in China and the banks are in a position to absorb a large impact even if there is a crash. The real issue for China's housing market is not a bubble. China is a very big country and maybe in Shanghai there is a bubble, but you cannot say that the whole Chinese economy is suffering from a housing bubble. That is totally wrong. The issue for China is resource allocation, which I will talk about a little bit later.

(j) Growth Rate Slowdown

For me, a bit of a slowdown is a good thing and we should not really worry about it. Rather, we should be happy with it, because the priority for the Chinese Government should be to transform China's growth pattern from being investment-driven, export-driven to a more sustainable and sustained growth pattern. Therefore, China should focus on shifting the growth paradigm. Growth is important, but we should not pursue a very high growth rate and so for me 9% is too high. In order to reallocate resources and make better use of them, you should allow the growth rate to be slower. China's real estate investment to GDP ratio is 10%. In history, no country has had such a high percentage of investment in real estate development. If you take Japan or Korea, once upon a time, they were at 8% for a few years, but no country such as China has had such a high percentage. You cannot base your growth on cement and steel.

Another example is affordable housing in Beijing. The standard for an affordable house is 90 square metres. In Hong Kong, for a medium sized house, it is 47-49 square metres. China is still a developing country with an per capita income of something like $5,000 a year, so building affordable housing of 90 square metres in Beijing is ridiculous.

Do you know how many steel mills there are in China? My guess is more than 1,000. We produce more than 48% of the world's steel products. Japan ranks second with 8%. China has no comparative advantage in producing steel. This is very good for Australians. My view is that China should cut the number of steel mills and reduce steel production. I am sorry or our Australian friends, but we have to do so and hence the slowdown is inevitable.

(k) Staying the Course

Faced with the slowdown, China should stay the course and stay calm, while not barring fine-tuning. According to Premier Wen Jiabao, China's growth pattern was not sustainable, not co-ordinated, not balanced, so we have to shift our growth pattern and in order to do so, we should allow the growth rate to be slower. It is affordable: for many years, we talked about 9% because we thought otherwise there would be huge unemployment, but this time, the labour market stress is not that serious. In fact, labour shortage has become a problem in many sectors and cities, which shows that there is room for the Chinese Government to slow the breakneck rate of growth and pay more attention to improving the quality of growth. This is desirable, because under a tighter economic situation, you force enterprises to have more competition and more incentive for upgrading their industrial structure and cultivating innovation, creation and so on.

(l) Progress in Structural Adjustment

China has made some progress in structural adjustment. They include

- **Slowdown in Investment**: The growth rate of investment in real-estate development plummeted by 16.3 percentage points year on year in the first half of 2012
- **Growth in household incomes**: plentiful anecdotal evidences indicate that growth of household disposable incomes has accelerated
- **Improvement in social security system**: The number of people covered by basic old-age insurance, unemployment insurance, workers' compensation, and maternity insurance has raised substantially. Moreover, universal medical insurance is emerging, and a comprehensive system for providing aid to students from poor families has been established.
- **Decrease in external imbalances:** since 2005, the RMB has appreciated roughly by 30% in real terms, which must have had a serious impact on exporters, reflected in the bankruptcy – as well as the upgrading – of many enterprises in coastal areas.
- **More balanced development across regions:** while growth in coastal areas has slow downed, provinces in Middle and West of China have maintained double-digit growth. Labor-intensive industries in coastal areas are moving inland. The regional disparity in economic development is narrowing.

Growth this Year

Earlier this year, when I talked about China's growth, I said it would be okay and there would be no hard landing. In fact, to make this prediction was not that difficult. Now everybody agrees that the Chinese economy will be okay this year. The Chinese economy has already bottomed out. My bet is that the growth rate will be 7.8% and I do not think I will be too wrong. The Chinese Government has significant room to manoeuvre. If it wants to maintain a growth rate of 8% or even higher, it can do that even with just one quarter left. China's problem is not short-run growth. It is the sustainability of growth.

(m) Rebalancing

China's current account surplus to GDP ratio has been falling quite rapidly. By the end of last year, it was 2.8% – much better than that of Germany – so if the United States wants to attack somebody, it should attack Germany, not China. Thank God, Romney was not elected, not because I fear Romney, I have great sympathy with him and I have sympathy with some Republican ideas. I thank God he was not elected because he does not now need to try to figure out how to label China as a currency manipulator. China is not, so he would have had very hard work to do back up his accusation and now he can just relax.

The factors contributing to the rebalancing are very simple:

- Worsening of the external environment.
- Worsening terms of trade.
- Domestic stimulus package – we use this a little bit and whenever we do, China's current account surplus is reduced.
- 30% real RMB appreciation, which is not immaterial.

A big issue is whether this rebalancing is cyclical or structural. The World Bank said that China's rebalancing was not real rebalancing, but cyclical. I disagree, even though usually I am sympathetic with many of the Bank's opinions. I think this is a fundamental change and not just cyclical. Of course, there are elements that are cyclical, so the safest statement about this is that it is both cyclical and structural, but perhaps more structural than cyclical. I do not think China's current account surplus will rebound strongly in the next few years.

This rebalancing is bad news for you guys, because China's importation of precious metal and mineral products has reduced. The figure for August shows a double-digit fall in prices relating to energy, precious metal and mineral products, so in future I think China will reduce these kinds of imports because it needs to readjust its economic structure. The Chinese economy will be less heavy, which is not very good news for Australia and maybe not very good news for Brazil and other countries, but I think perhaps you should be prepared.

(n) RMB Trends

I think there is still room for the RMB to appreciate, but that room is not very big. You should not expect the RMB to shoot up in a big way. I think that the PBOC may further reduce intervention in the foreign exchange market, but I may be wrong and Mr. Xie Duo can correct me. An important development in China since 2009 is the further opening of the capital account in the name of RMB internationalisation. Certainly, the PBOC will deny that there is RMB internationalisation. It claims that there is just RMB settlement for imports and exports. Whatever it calls the process, the essence is the same. Because of the policy of encouraging RMB settlement for imports and exports, to a very large extent, China has opened the short-run, cross-border capital flows. This is perhaps good news for you, but not good news for me, because I think China's financial system is still fragile and we must be cautious. I am for further opening, but I am against opening up without doing more about interest rates and exchange rates, especially under the current turbulent international financial situation. Now all major industrialised countries are operating press prints at full speed. Cross-border capital flows will become even more turbulent. Why should China jump into the fray and expose itself to all sorts of shocks, without knowing what specific benefits it can gain?

Conclusion

Let me conclude very quickly by saying that the fundamental cause of the global financial crisis is the over-indebtedness of developed countries. Global deleveraging is the only solution for the global financial crisis. The deleveraging will take a long time and so will the recovery of global growth. For the United States, export growth holds the key to recovery; this is very important. To achieve export growth, the US dollar has to be further devalued, which in turn depends on the Federal Reserve's monetary policy. Therefore, there will be more QE, there will be more devaluation of the US dollar and there will be more trade frictions. But rebalancing is perhaps the most important area where the interests of China and the US coincide. Only by running a current account surplus can the US repay its foreign debt. On the other hand, only by running a current account deficit can China get its money back. Why should the two countries fight against each other for the interests of the other side?

2012 was a difficult year for China, but there will be no hard landing. The Government will and can prevent a hard landing from happening. The true danger lies in the medium term, in my view. In the short run, three years, five years, no problem, but in the longer run, it depends. The Chinese Government has to strike a balance between rebalancing the economy and maintaining a slower but still decent growth rate of 7%. This target was set in the five-year plan, but unfortunately we never pay attention to those kinds of plans. A big danger is that the fear of slowdown leads to rolling back the measures aimed at readjustment. The longer the delay in restructuring and rebalancing, the higher the cost will be, as we can imagine. If we had started RMB appreciation in 2003 or we had appreciated in a more determined way in 2005, China's accumulation of foreign exchange reserves would be much less and China would not have fallen into the dollar trap so deeply

In my view, China has entered a new period of adjustment and a paradigm shift, which may last for a few years, maybe five years or longer. During this period, the Chinese economy will grow about 7%. Thereafter, the growth rate will pick up again and eventually lift China up to the plateau of a high-income country.

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