The Sky is not Falling, III

Lawrence J. Lau[1]

1. Introduction

In 1997, at the height of the East Asian currency crisis, I wrote an article, "The Sky is not Falling (天塌不下来)," basically saying that the Chinese economy would be able to emerge from the crisis more or less unscathed. China at the time decided not to devalue the Renminbi even though every other East Asian economy, except Hong Kong, had done so. The policy of holding the exchange rate of the Renminbi steady at the time was opposed by many people in China, especially by exporters, but ultimately it proved helpful not only to China itself, but also enabled the relatively fast recovery of the other East Asian economies from the crisis, and earned their gratitude and respect.

In September, 2008, the external environment facing the Chinese economy was similarly negative, though in a totally different way. There was a major financial crisis, caused by the failure of Lehman Brothers, in the United States, the magnitude of which had not been seen since the Great Depression of 1929. And the crisis of confidence was spreading to Europe and the rest of the world. Overnight, credit and liquidity dried up in the U.S. and Europe completely. There was panic almost everywhere. The Chinese and East Asian economies faced abruptly reduced demands for their exports as the United States and Europe fell into recession.

At that time, I wrote another article, "The Sky is not Falling II (天塌不下来(二))," arguing once again that the Chinese economy would be able to not only survive but also continue to grow through the global financial crisis, based on the possibility of the partial de-coupling of the Chinese and East Asian economies from the U.S. and European economies. And, sure enough, despite the financial turmoil and economic slowdown and recession in the U.S. and in some of the Western European countries, the Chinese economy was also able to manage to continue to grow, based mostly on its domestic demand alone, and achieved real rates of growth of GDP of 9.1% in 2009 and 10.3% in 2010. Any doubts concerning the validity of the partial de-coupling hypothesis should have been dispelled by the actual performance of the Chinese and East Asian economies (except Japan) during this period.

Today, I write yet another article, "The Sky is not Falling III (天塌不下来(三))," explaining why the Chinese economy should be able to achieve a "soft landing" and continue to grow at around 8% per annum amidst the European sovereign debt crisis, based on its own domestic demand.

2. The External Environment

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The current external environment, while not favourable, could have been much worse. The U.S. economy, despite the political bickering inside and outside the U.S. Government, has been recovering very slowly but surely. In November 2011, the unemployment rate dropped 0.4% to 8.6%, after being at or above 9% for many months. The housing sector has shown some early signs of stirring. The real rate of growth of GDP is expected to rise to approximately 3.5% in the last quarter of 2011. The long-term interest rate has remained low and the U.S. Dollar has maintained its strength, in part because of the problems of the Euro Zone. Thus, even though full economic recovery is still not imminent, there are few signs of a double-dipped recession. In this presidential election year, the U.S. economy can be expected to muddle through, with a positive real rate of growth in the neighbourhood of 2%. Household consumption, and hence imports, can be expected to grow at a similar rate.

The European economies, especially the economies in the Euro Zone, are currently troubled by the sovereign debt crises affecting some of them. However, as I have argued elsewhere[2], it is in the best self-interests of Germany and France, the leading economies of the Euro Zone, to defend and sustain the Euro; and as long as they are able to do so, which they are, they will. It may, however, take a complex and tortuous process, to achieve the desired end result, because of the divisive politics. But just as the U. S. Congress ultimately had to raise the U. S. public debt ceiling, the European Union (except for the United Kingdom) will ultimately come through with a credible and feasible plan to shore up the Euro and Euro Zone economies. It is thus only a matter of time that the Euro and the Euro Zone economies will be stabilised.

The key is for the Euro Zone governments to take decisive action to stem the "irrational panic" that seems to be sweeping through the European financial markets, aided and abetted by the hedge funds and other speculators. It is this "irrational panic" (as well as indiscriminate sales of credit default swaps on European sovereign debts) that has driven yields of European sovereign debts to new highs. So long as the investors expect the market to continue to go down, they will sell, and by selling they will indeed cause the market to go down. These expectations are "self-fulfilling". In order to stem this panic-selling, it is necessary for a collective change in expectations on the part of most, if not all, investors and potential investors. Such a collective change in expectations requires "coordination" among investors, which may be possible only with credible government action. The governments, themselves or through other established institutions, must take decisive action, sending a clear signal to the market that the panic is indeed irrational. Restoration of confidence and reversal of the negative expectations are essential and here government intervention in some form is absolutely indispensable.[3]

The purpose of this long digression is to explain that while the European sovereign debt crisis may last a while longer, perhaps another couple of months, it will be successfully resolved and that the Euro will survive long-term as a currency. And while Europe as a whole is not likely to grow rapidly, the Euro Zone economies

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[2] Hong Kong Economic Journal, 17th October 2011, p. A20.

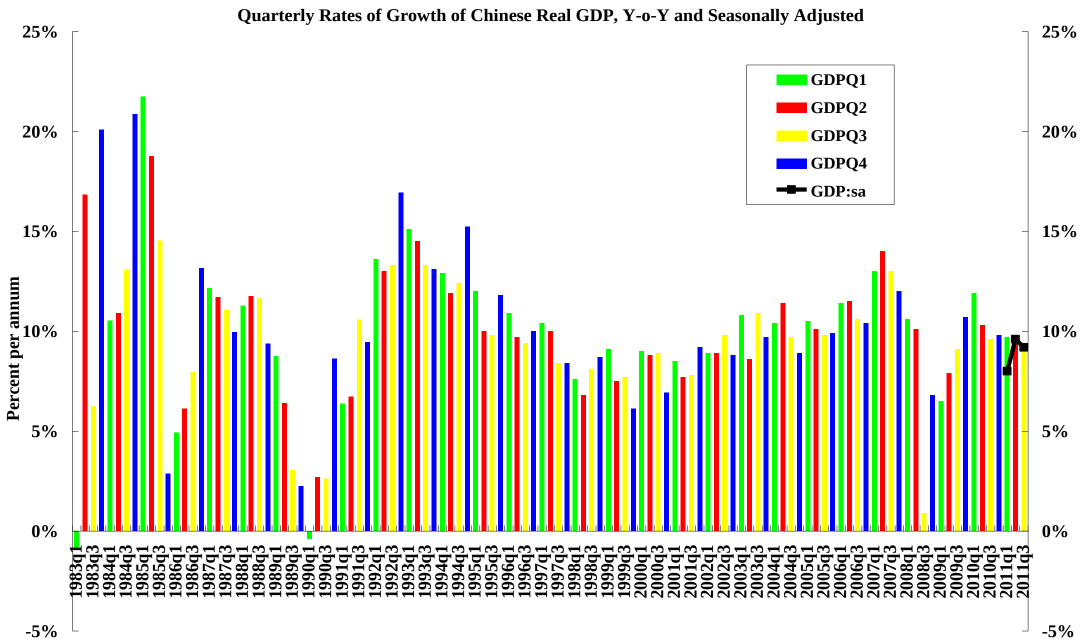
[3] Examples of successful government intervention that stabilised the market include the 1983 pegging of the exchange rate of the Hong Kong Dollar (at the time freely floating) to 7.8 HK$ per US$ and the 1993 support of the "market rate" of the Renminbi in Shanghai at 8.7 Yuan per US$.

will not descend into chaos. European demand for imports from China and East Asia is not likely to grow and may even decline slightly but will not disappear altogether.

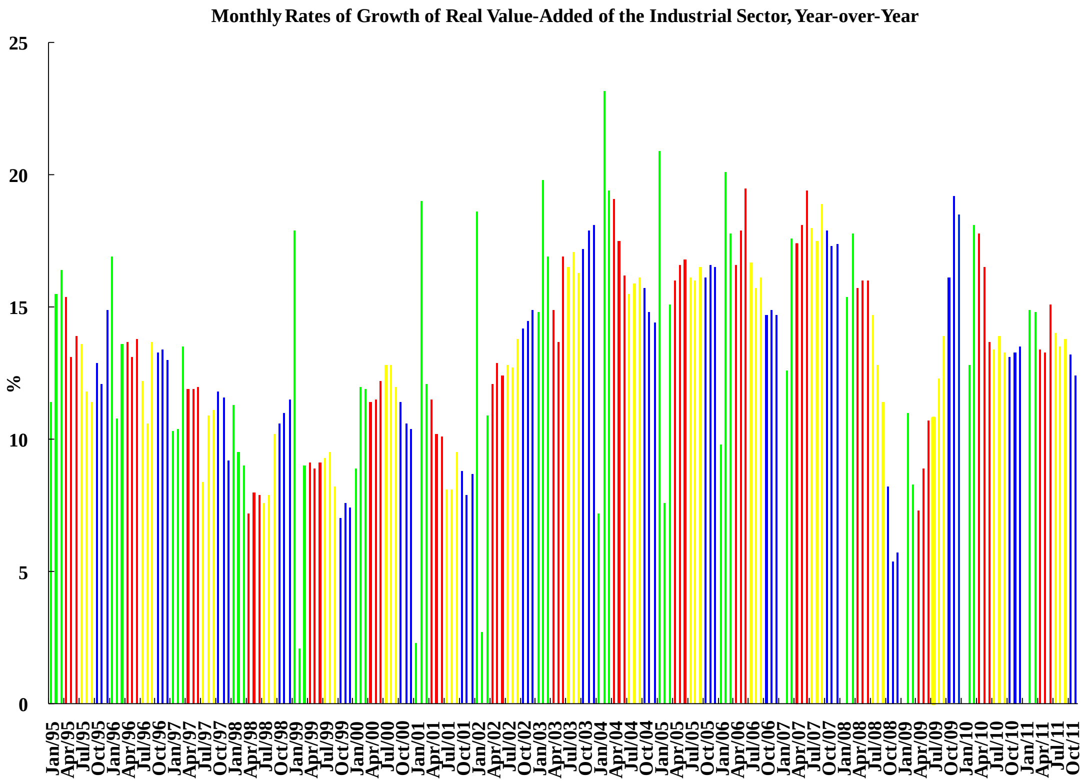
Summing up, the relatively unfavourable short-term developments in the United States and European economies, while not positive for China, are not likely to have a significant negative impact on its economic prospects as it continues its transformation into an essentially domestic-demand driven economy.

3. The Short-Term Macroeconomic Situation

As mentioned above, the Chinese economy grew 9.1% in 2009 and 10.3% in 2010 even as the U.S. and European economies remained in recession. For the first three quarters of 2011, the seasonally adjusted annual rates of growth were respectively 8%, 9.6%, and 9.2%, confirming that an economic slowdown had already begun (see the following chart). Cumulatively, for the first three quarters of 2011, the Chinese economy grew 9.4%, year-over-year. For 2011 as a whole, the rate of growth of GDP is likely to be a little over 9%. The outlook is that there will be a gradual slowdown in the real rate of growth in 2012, to perhaps somewhere above 8%, which is actually a positive development for the Chinese economy, achieving a "soft landing." (Bear in mind that in the Twelfth Five-Year (2011-2015) Plan, the target rate of growth over the five years is only 7% per annum.) In fact, for the Chinese economy, a long-term average rate of growth in the 7-8% range should be considered an excellent performance.



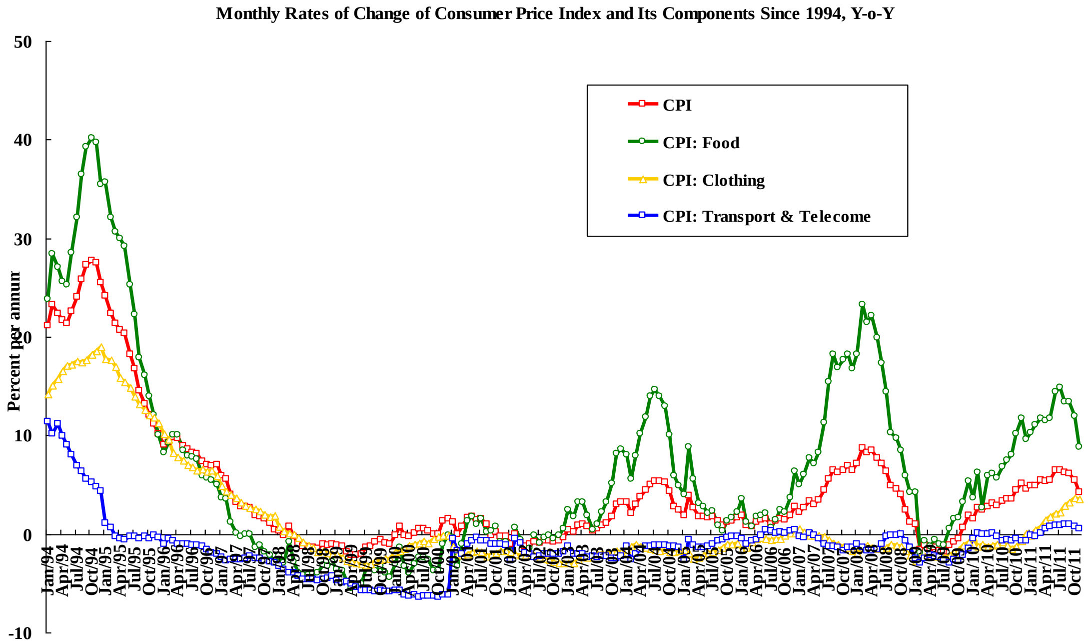
The rate of growth of the real value-add in the industrial sector closely mirrors that of GDP. It has also recently moderated, falling to 12.4% in November, but still significantly higher than the rate of growth of real GDP (see the following chart). If domestic aggregate demand keeps up, the rate of growth of the industrial sector is unlikely to fall below 10% and the rate of growth of GDP is unlikely to fall below 8%.



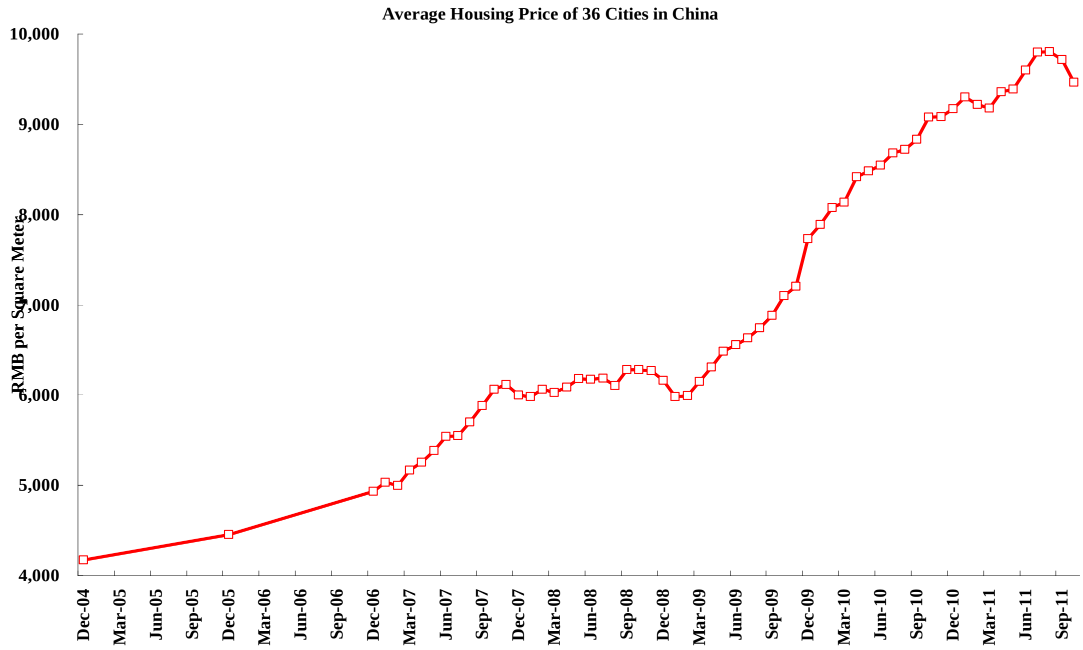
The growth of exports in 2012 is likely to continue to slow because of the economic recession in the major trading partner countries such as the U.S. and the members of the European Union, and because of the continuing effects of other factors such as the revaluation of the Renminbi, the intensified enforcement of environmental regulations, and the implementation of the new labor law and minimum wage rates in China. However, the reduction of the overall Chinese trade surplus vis-a-vis the world is positive for the Chinese economy because it helps to reduce the inflow of foreign exchange (hot money). If Chinese international trade is balanced, then there will be little net 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. With hot money inflow reduced or stopped altogether, China will be able to better control its money supply and conduct its monetary policy. However, even as the growth of exports slows, for the Chinese economy as a whole, the phenomenon of "partial decoupling" is expected to be operative. Chinese economic growth will be largely unaffected by external developments, including economic recessions in the United States and Europe.

4. Declining Inflation

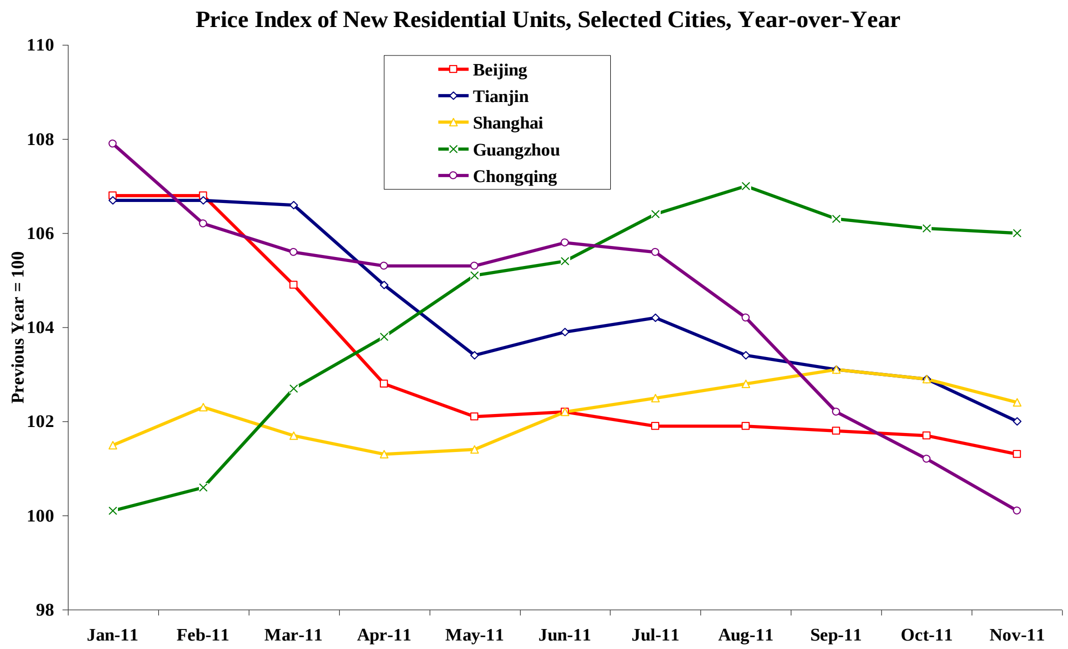
The rate of inflation, as measured by the consumer price index (CPI), has begun to decline. After reaching a peak of 6.5%, year-over-year, in July of 2011, the rate of increase of CPI has declined steadily to 4.2% in November, and is expected to continue to fall. As a year-over-year indicator is a lagging indicator, the CPI, on a seasonally adjusted basis, has actually been falling. This is also most apparent from the decline in the rate of increase of the consumer price index for food, from 14.8%, year-over-year, in July to 8.8% in November. (See the following chart.) The increase in the consumer price index for food accounts for approximately two-thirds of the increase in the CPI. But the price of food is affected by weather and other supply and demand factors peculiar to the agricultural sector (for example, the "hog cycle") and its ups and downs are beyond the control of monetary policy. As the price of food stabilises, or even declines, the CPI will follow suit, as in previous episodes of inflation (so food price inflation is unlikely to be persistent). Of somewhat greater concern is the significant rise in the rate of increase of the price index for clothing for the very first time in years since the beginning of 2011. The question is whether this is caused by more structural factors such as the rise in wage and rental rates, distribution margins and prices of services.



We thus turn to look at the price index of residential housing, which can be regarded as a proxy for the average space rental rate, to see whether it can become a source of persistent inflation in China (see the following chart). For China as a whole, the average price of residential housing began to decline in September 2011, after many months of a tight credit policy. The price of residential housing is expected to decline further in the coming months, relieving the inflationary pressure on the economy, and allowing more room for fiscal and monetary expansion if necessary.



The same trend of declining residential housing prices can be seen in the price indices of new residential units in the major cities (see the following chart). The housing price bubble is beginning to be contained.

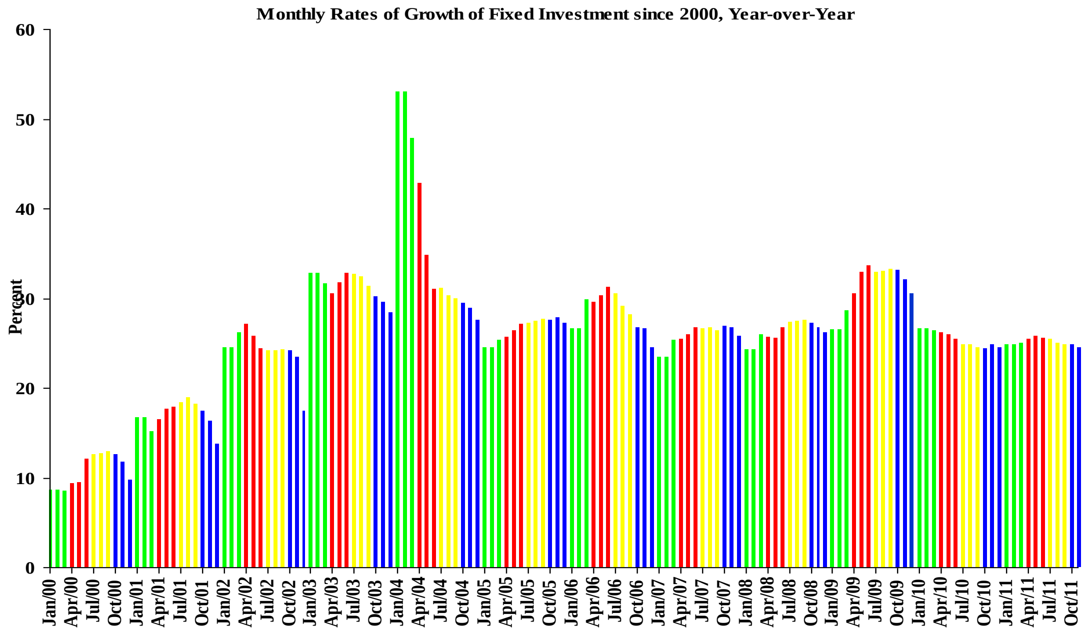


For 2011 as a whole, the rate of inflation as measured by the CPI is likely to be just over 4%, and is expected to moderate further in 2012 as the prices of food and residential housing decline further. It is also unlikely that the prices of oil and other natural resources will rise significantly, given the overall softness of the world economy, unless a major armed conflict breaks out in the Middle East. I am therefore cautiously optimistic that a rate of inflation below 3% is achievable for China in 2012.

5. Maintaining Domestic Aggregate Demand

There is unlikely to be any significant increase in exports in 2012, given the external environment. In fact, even a slight decline in exports is possible. Thus, the increase or maintenance of domestic aggregate demand at or near its current level in a timely manner is a task of the highest priority.

The rate of growth of fixed investment in China has remained at a relatively high level (24.5% in November 2011), lower, but not appreciably lower, than the average rate of growth in the preceding 24 months, and comparable to the average rate during the period between July 2004 and March 2009 (see the following chart). We may assume that such a rate of growth of domestic fixed investment is likely to be continued, with much of it in public infrastructure (e.g., urban mass-transit systems). And although the rate of growth of real retail sales has been falling (to 10.35% in November, year-over-year), largely because of the decline in the sales of automobiles, it is still higher than the rate of growth of real GDP and is expected to continue to do so.



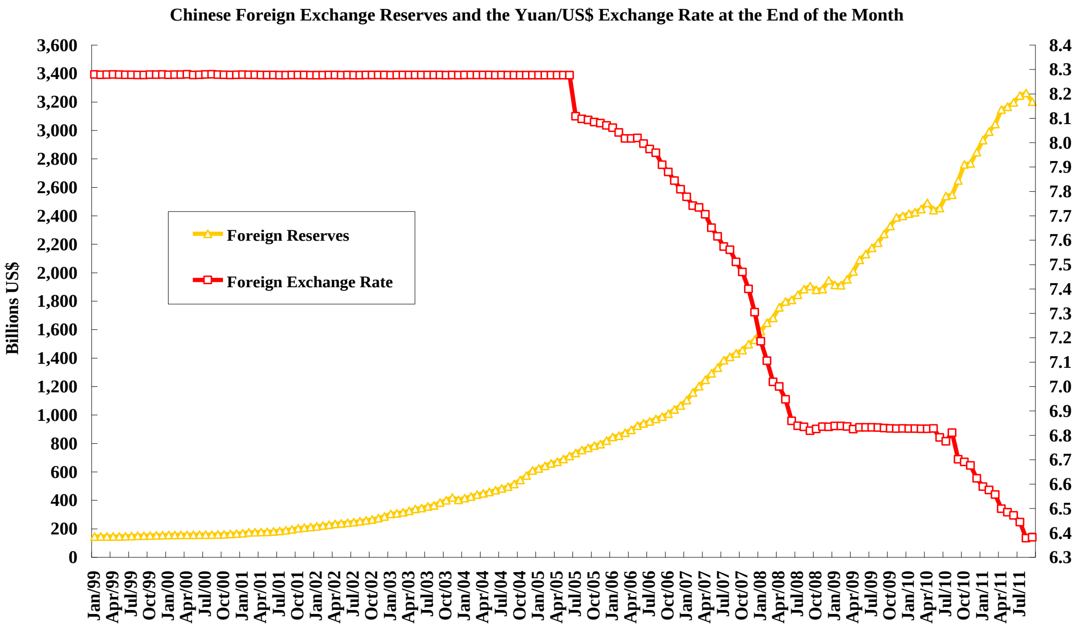
As the housing price bubble is gradually deflated, the development of new housing units will slow down substantially, and the domestic demand associated with private housing development will be significantly reduced—from steel, cement, glass to appliances and furniture and other goods and services. The real challenge for the coming year is how such lost domestic demand can be replaced.

The replacement demand will almost certainly come from housing too, albeit of a different kind. Under the Twelfth Five-Year Plan, 36 million affordable housing units are to be built, between 2011 and 2015. The development of these housing units is unlikely to be of interest to the profit-seeking private developers. Thus, it is imperative that the governments, central, provincial and local, work actively together to ensure that these housing units are planned and built in a timely manner. If this can be achieved successfully, it will replace the slack in domestic aggregate demand caused by the slowdown in the private housing development. And if the domestic aggregate demand can be maintained at a relatively high level, the Chinese economy, which has excess production capacity in many industries and sectors, should do reasonably well.

Other areas of domestic aggregate demand growth can come from the provision of public goods such as environmental preservation and restoration, education and health care, including the building of educational and medical facilities, by the governments. Demands for such public goods are high and far from satiated.

6. A Stable Renminbi

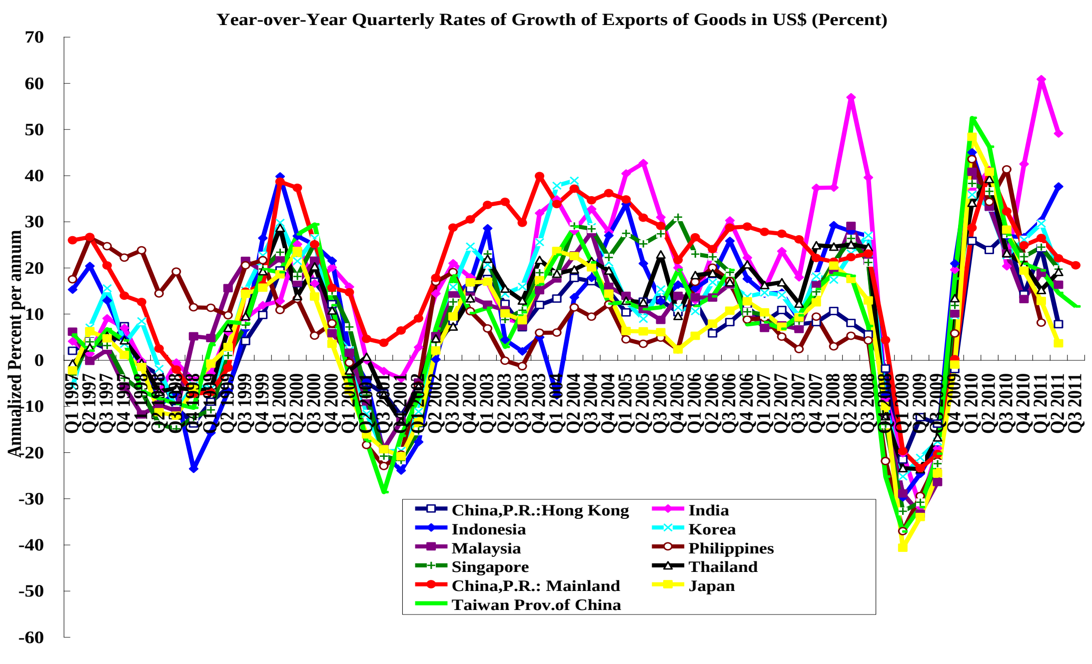
The Renminbi has once again been appreciating steadily relative to the U.S. Dollar since the middle of 2010, at the rate of approximately 4% per year. The Chinese trade surplus vis-a-vis the world has been declining quite rapidly and is likely to end the year 2011 at 2% of its GDP. As the trade surplus disappears, further appreciation of the Renminbi will become less necessary. More recently, currency speculators are beginning to bet on a Renminbi devaluation. However, I believe the Renminbi is likely to remain relatively stable in 2012, even appreciating slightly. The Chinese Government is promoting the wider use of the Renminbi in cross-border transactions as a settlement currency, on a strictly voluntary basis. Relative stability of the Renminbi exchange rate is essential to the use of the Renminbi as a medium of exchange across borders. Thus, it is in the interests of the Chinese Government to maintain the stability of the Renminbi and to resist pressure by currency speculators for a substantial appreciation or devaluation. China has sufficient foreign exchange reserves (US$ 3.2 trillion) at the present time to allow all foreign investors to repatriate their investment in China at the current exchange rate indefinitely (see the following chart).

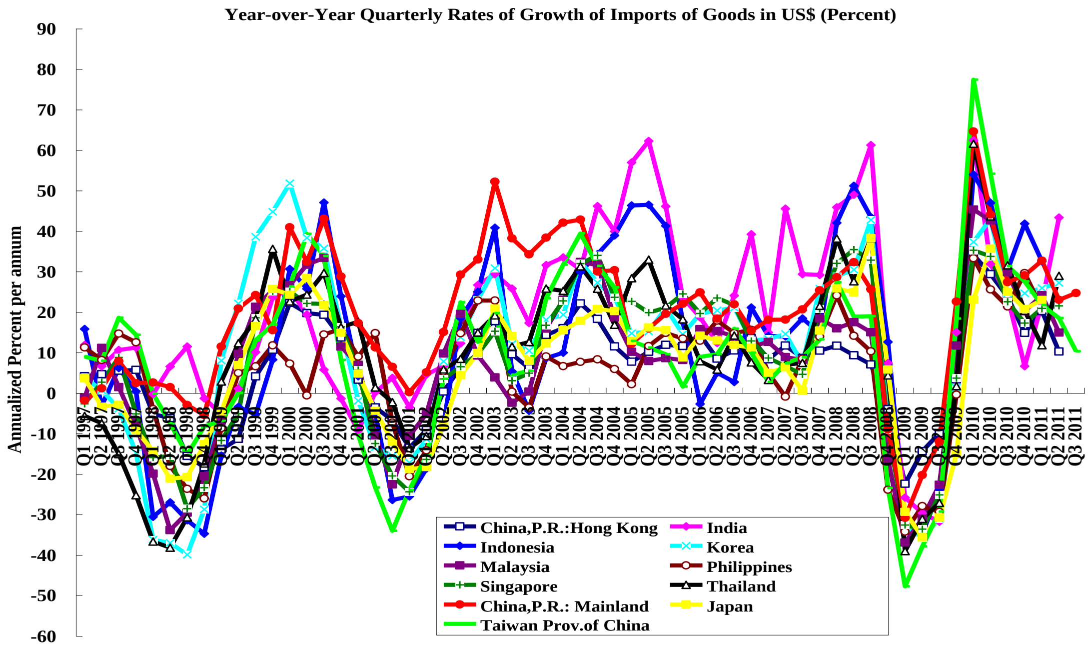


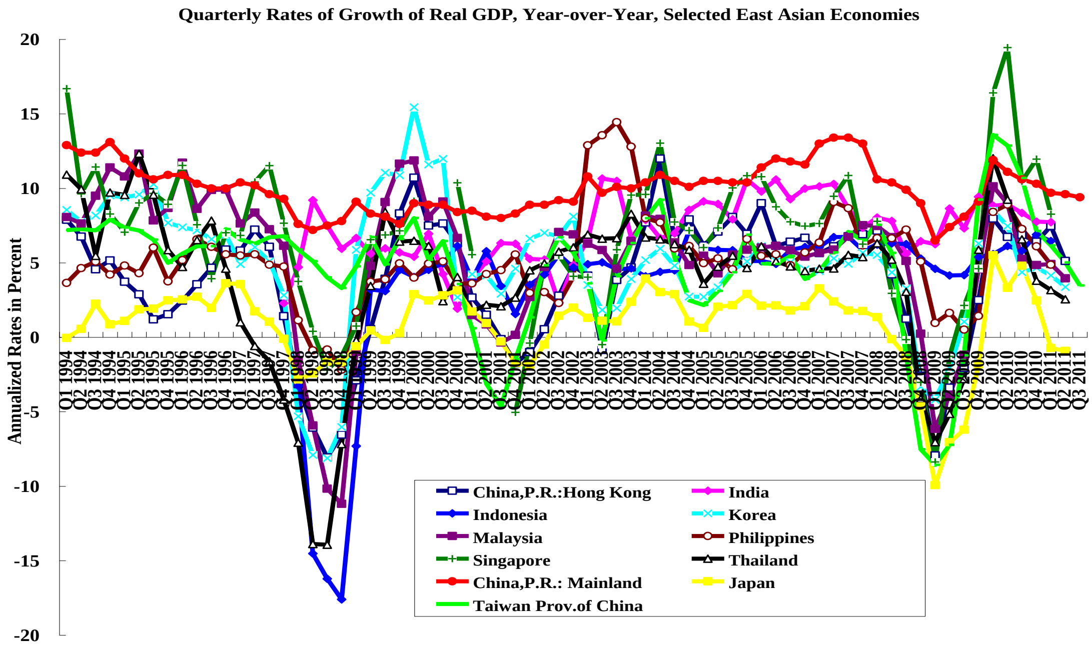
7. Concluding Remarks

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 (for example, with foreign exchange reserves of only approximately US$100 billion). But the Chinese economy managed to do all right then. In 2008, the Chinese Government had far more resources and instruments at its disposal to cope with the negative external environment and was able to launch a 4-trillion Yuan economic stimulus programme that enabled the Chinese economy to continue growing through the global financial crisis. Today, China has an even higher level of official foreign exchange reserves, in excess of US$3.2 trillion, large and rising fiscal surpluses, and a much more effective social safety net. Moreover, domestic demand has become the main driver of the Chinese economy.

The relatively low external dependence of the Chinese economy is not well appreciated. As a large, continental economy like the United States, China is relatively self-sufficient and is therefore relatively insulated from disturbances in the rest of the world. The next three pictures are worth a thousand words. Even though the rates of growth of Chinese exports and imports fluctuate as widely as the exports and imports of other East Asian economies, the rate of growth of the Chinese real GDP is relatively stable, unlike those of other East Asian economies. (See the following charts on the rates of growth of exports, imports and real GDP of East Asian economies).




Year-over-Year Quarterly Rates of Growth of Imports of Goods in US$ (Percent)
Annualized Percent per annum
China,P.R.:Hong Kong
India
Indonesia
Korea
Malaysia
Philippines
Singapore
Thailand
China,P.R.: Mainland
Japan
Taiwan Prov.of China



The fact that the Chinese economy has continued to grow at an average rate of approximately 10% per annum since the beginning of the global financial crisis in 2007 is further evidence that the Chinese economy has been at least partially de-coupled from the rest of the world economy, and in particular, from the United States and Europe, both of which have been mired in economic recession and recovering very slowly.

And if the Chinese economy continues to grow in the 7-8% range in the next couple of years, the Hong Kong economy should be able to do reasonably well. I am confident that China will be able to grow at approximately 8% and that Hong Kong will be able to continue growing in the 4% range in the years ahead, despite the European sovereign debt crisis and the relative stagnation in the U. S. The sky is not falling!