

Macroeconomic Revision Note: The China Effect

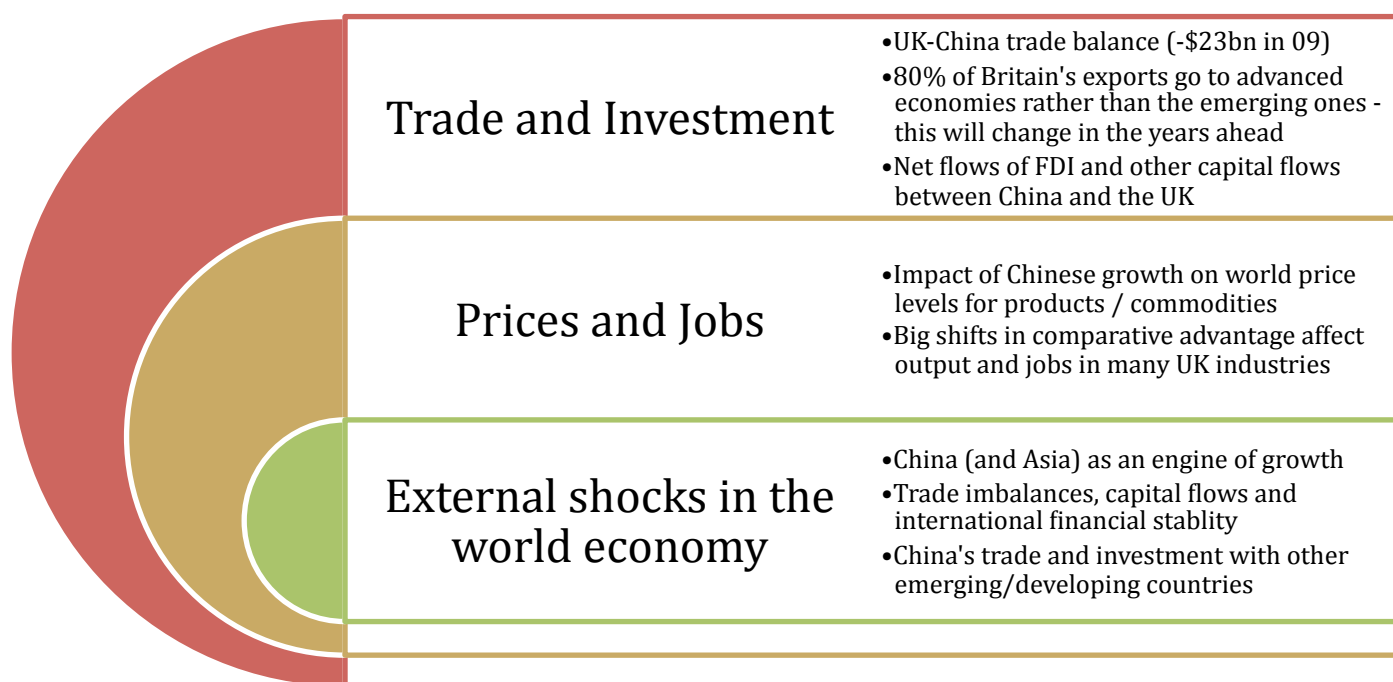
"I don't think of Brazil, Russia, India and China, (BRIC) as emerging markets. It is an insult and inopportune. And in any case, they are different markets. The BRIC economies are increasingly the major story for the world economy; they have lifted the world economy's growth trend from 3.7 percent to 4.5 percent."

Jim O'Neill, Goldman Sachs, March 2011

"China is rife with overinvestment in physical capital, infrastructure and property... Eventually, most likely after 2013, China will suffer a hard landing. All historical episodes of excessive investment – including East Asia in the 1990s – have ended with a financial crisis and/or a long period of slow growth."

Professor Nouriel Roubini, April 2011

What is happening in China and in China's changing economic relationships around the world is and will continue to have a profound impact on the UK and European Economy



Macroeconomic summary for China (2006-2011)

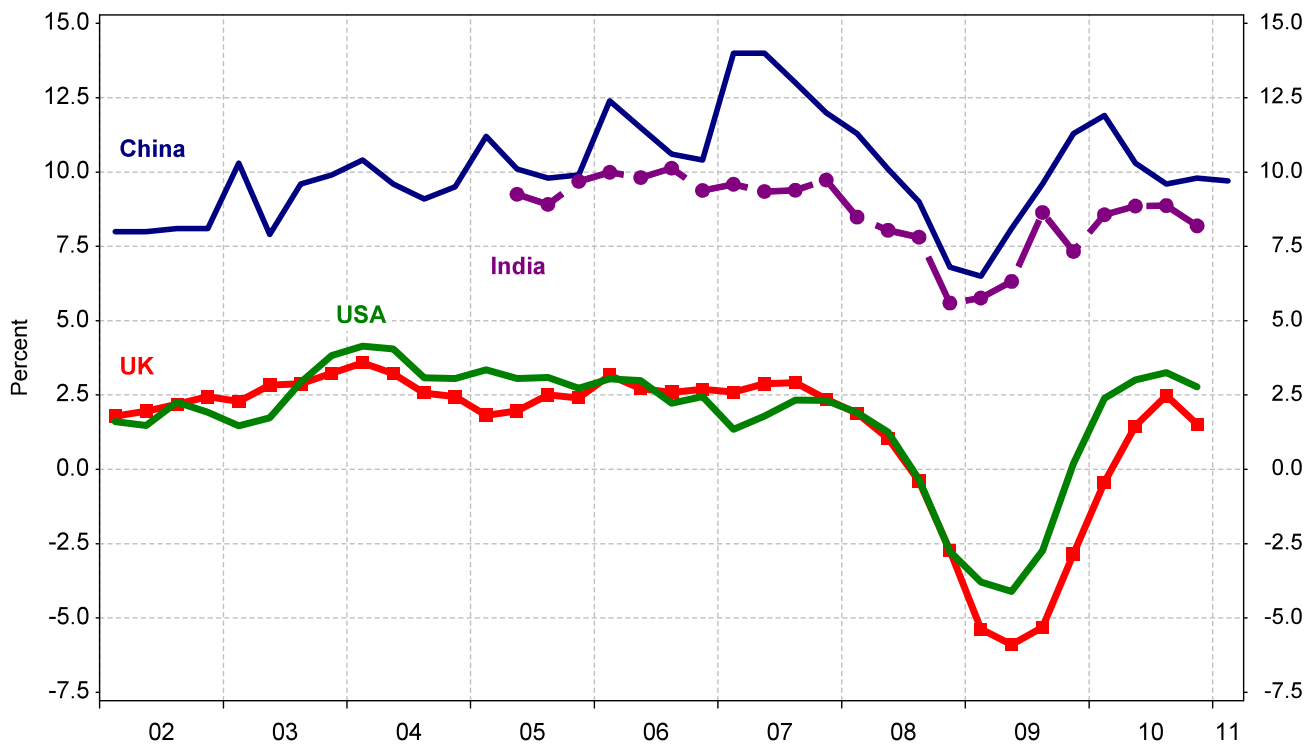
Main indicators	2007	2008	2009	2010	2011*
Gross domestic product (% change in real GDP)	14.2	9.6	9.1	10.5	9.7
Consumer price index (annual % change)	4.8	5.9	-0.7	3.1	3.3
Fiscal balance - as a percentage of GDP	1.9	0.9	-1.2	-1.9	-2.2
BoP Current account balance - as a percentage of GDP	10.6	9.6	6.0	5.8	5.9
Economic Structure (% of GDP)					
<i>Share of GDP by value added from</i>					
Agriculture		10.0	9.5	9.0	8.5
Industry		54.3	54.7	55.5	56.0
Services		35.7	35.7	35.5	35.5
Total population (millions)		1,328		1,431	
GDP, PPP terms (US\$ billions)		7,967		10,084	
GDP per capita, PPP terms (US\$)		5,999		7,517	

- 2011 is a forecast, Sources: OECD World Economic Outlook, May 2011 (forthcoming), World Bank, PWC Analysis
 - 2009 was a year of global recession (world GDP fell 2% and world trade slumped by 12%)

Revision points from the table

Chinese and Indian Growth compared to the USA and UK

Annual percentage change in real national output



Source: Reuters EcoWin

1. Economic growth and economic structure:

- [Strong growth of real GDP continues](#) – some context is that world GDP growth per annum over the last twenty-five years has been 3.7%. In the last decade, the increase in Chinese GDP has been seven times the rise in the GDP of Japan
- China has a new **growth target** of 8% pa for the next five years – a downgrading of growth but still way in excess of normal trend growth for any of the advanced economies.
- **Per capita incomes** are rising though still very low by advanced nation levels. But China is now the biggest car market in the world and there has been a huge rise in the sales of luxury goods to China (strong income elasticity of demand)
- China wants to achieve a **re-balancing of her growth** – towards domestic consumption and away from exports. Another key aim of the plans for the next 5 years is a surge in **market-driven entrepreneurial activity**. Plus a continued shift towards **higher-value, high-knowledge manufactured products**
- Note the low share of Chinese GDP accounted for by **service sector industries** (36%). The new 12th Five Year Plan is centered on developing the services sector, increasing urbanization and improving incomes (opportunities here for UK service multinationals?)

2. Inflation in a booming economy:

- The Chinese government's **inflation target is 4%**
- Inflation is a growing worry for the Chinese government – after some **mild deflation** in 2009 there has been clear acceleration in the consumer price index. **Agricultural prices** have been a key driver of inflation with **food costs** up 12% in the year to March 2011.
- Is China now **exporting inflation** to the rest of the world? Is high inflation a symptom of an over-heating economy with an unsustainable credit boom?
- **Wages are rising fast** in China – many economists believe that China has hit a point in its development at which demand for labour starts to grow faster than supply, creating labour shortages and pushing up salaries. This is known as a **Lewis Turning Point**.

Have we reached a Lewis Turning Point for China?



FoxConn is raising wages for workers at its factories by 70% with effect from the 1st of October 2011. Following the latest rise the basic salary for production-line workers at Foxconn's will have risen from 900 renminbi (£91.30) per month two weeks ago to 2,000 renminbi (£203).

Honda, Japan's second-largest automaker has recently reached an agreement with most of the 1,900 employees at a Chinese parts factory to raise pay by 24 percent after workers walked out on strike.

China, once an abundant provider of low-cost workers, is heading for the so-called Lewis turning point, when surplus labour evaporates, pushing up wages, consumption and inflation. The result may prompt manufacturers to switch to cheaper countries such as India and Vietnam, Bangladesh and Indonesia.

Source: Adapted from news reports, June 2010

3. Fiscal policy:

- China has run a small fiscal deficit as a share of GDP in recent years – the move from surplus to deficit from 2008-09 was in part the result of a fiscal stimulus by the Chinese government in the wake of the global financial crisis.
- The government launched an expensive programme of infrastructure spending on everything from new roads and bridges to modernizing hospitals. China's \$586 billion Stimulus Package (2008) allocated a major portion of government spending to renewable energy projects including smart electricity grids.
- Chinese government debt is low as a share of GDP (21%) but there are huge debts in the Chinese banking system that risk going bad if and when their property sector bubble bursts.

4. Exports, trade and investment:

- For many years China has practiced **export-led growth** with exports accounting for over 40% of GDP. China ran a trade surplus with the rest of the world of around of \$200 billion in 2009 – this looks huge, but is fairly modest as a share of GDP
- The **surplus on the current account** remains high but the surplus has diminished from over 10% of GDP in 2007 to less than 6% in each of 2010 and 2011.
- There has been a change in the **pattern of trade** since the global financial crisis – notably a big rise in imports of goods into China and a [sizeable reduction in their trade surplus](#)
- This is an important development given [trade tensions](#) between China & the USA
- Korea, Japan, Germany and Switzerland run surpluses with China because they are able to export the **high-value manufactured items**, particularly investment goods, China needs

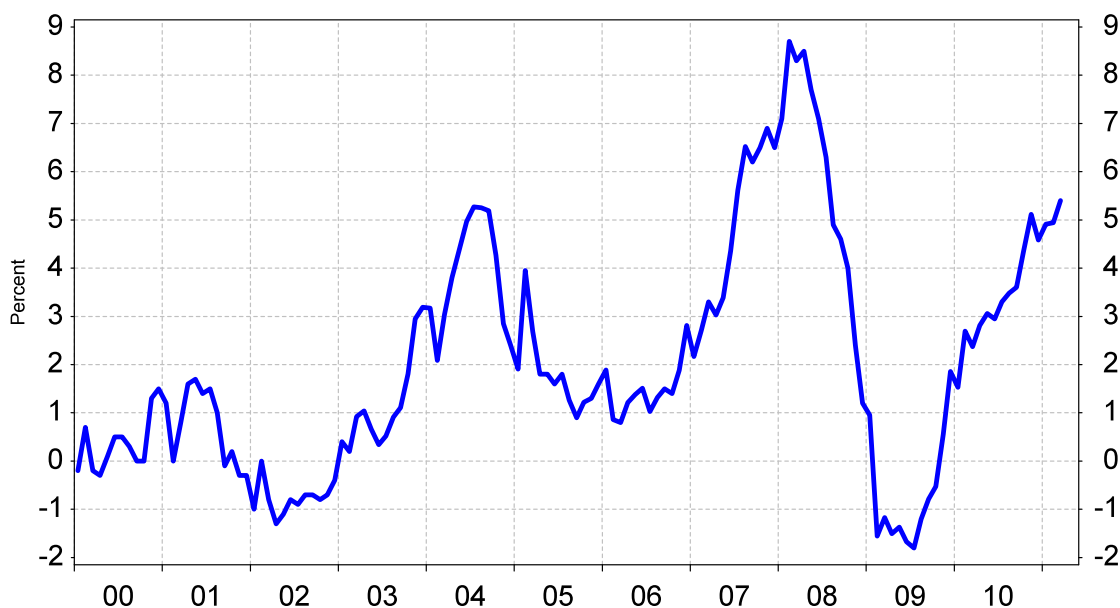
Size and Scale, Power and Influence – China has arrived

- [China has undoubtedly arrived](#) as an **economic superpower**.
 - China has overtaken Japan as the **world's second-biggest economy**. Japan's economy was worth \$5.474 trillion (£3.414 trillion) at the end of 2010. China's economy was closer to \$5.8 trillion in the same period
 - China is now the **world's largest goods exporter** - China is moving toward more trade with other emerging economies including [other BRICs](#) (Russia, India, Brazil)
 - Because of persistent trade surpluses, it has accumulated **foreign-exchange reserves** in excess of \$3 trillion. These surpluses allow for huge levels of **overseas direct investment** – much of the current focus is on China's investments in many African and Latin American countries. China earns **\$1 billion per day interest income** from their FX reserves.
 - In 2000, China's accounted for 7.1% of the world's total GDP (in PPP terms). By 2015 China will have a 19% share of global GDP. This is higher than any of the other BRIC nations.
 - **FDI flows to China** topped \$100 billion in 2009 for the first time.
 - Although now the second largest economy in the world, **China ranks at 119 in terms of average incomes**, according to World Bank data (per capita incomes, PPP adjusted)
- The **economic cycle** does exist in China (!!) but the **drivers of their cycle** are different to what we understand in market-driven economies
 - For years, China's growth model has relied on **exports** and **investment** as its drivers. The emphasis of policy is changing, the government wants **stronger domestic consumption** of goods and services and an economy less reliant on global trends and external shocks (this is known as "**de-coupling**")
 - A quote from Premier Wen Jiabao - 'China's economy needs to be quickly put on the path of **endogenous growth** driven by innovation'.
- This change of emphasis will drive changes in macroeconomic policy
 - Supply-side economic reforms to encourage **entrepreneurship**
 - Changes in the priorities built into their 5 year plans (i.e. favoured and non-favoured industries when it comes to government financial support – big focus on green/cleaner energy industries now – shift towards sustainable growth)
 - Reassessment of the **role of the currency in economic management** – for years the value of the Yuan has been seen as a variable that affects the competitiveness of exporters; the emphasis will move towards using it as an instrument of managing growth and inflation
- Foreign direct investment from China
 - Trade surpluses provide funds for enormous overseas investments
 - Some of which are channeled through state "**sovereign wealth funds**"
 - Big Chinese investments in Africa and hundreds of thousands of Chinese are now living and working in Africa – major source of **remittance income** back to domestic Chinese economy
 - But China is looking west too!
 - Chinese companies are preparing for a wave of investments in Western Europe (EU) and Eastern Europe in engineering and technology as part of an effort to find new markets and gain greater control of global supply chains – a shift away from the protectionist USA?
 - £2bn paid by China National Bluestar of Elkem, a Norway-based supplier of high-purity silicon for the solar power industry
 - Geely (Chinese car maker) purchasing Volvo (Sweden)

The inflation issue for China

Consumer Price Inflation in China

Annual % change in consumer prices



Source: Reuters EcoWin

Originally the "China Effect" described the **deflationary effects** on prices in the UK and other countries from China's export-led growth. The **shift in manufacturing** of shoes, clothing, iPods and household appliances to a lower labour cost country has until recently helped to keep inflation down in the UK. This appears to be coming to an end – rising Chinese prices will affect us all over the medium term.

The **main causes** of rising inflation in China are:

1. **Rapid economic expansion** – i.e. strong growth of real GDP
2. **Higher food prices** – for example the surging price of pork and other meats and corn. In tune with other countries, the greater weight allocated to food and energy prices in inflation indices leaves China more exposed to surges in food and commodity prices (food is 1/3rd of their CPI, 11% in the UK). Food price increases represent a **transfer of wealth** from urban to rural China. For the country's roughly 600 million rural residents, food price inflation is equivalent to a pay increase – useful in addressing rural/urban inequalities but creating many social and political pressures too.
3. **Rising wage costs** – fast growth, increasing living costs and increasing inequality has brought pressure for wages to increase. The 5 Year Plan aims to achieve a doubling of wages from 2011-2015 and many foreign-based businesses in China including Foxconn (makers of the iPad) have agreed to double-digit wage rises. Rising inflation has caused a rise in inflation expectations in China – the minimum wage has been raised – most recently in Beijing by 20%

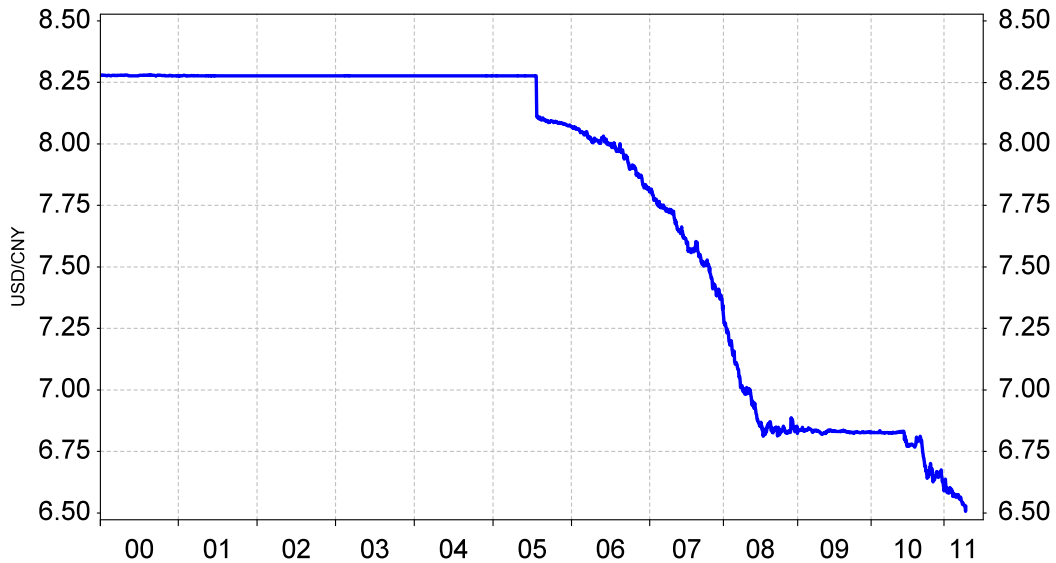
Controlling inflation in China

1. Fears of high inflation and rising property prices have led to a **tightening of monetary policy** (**higher interest rates** (6.3% in April 2011) and an increase in the **ratio of bank cash reserves to loans** (now at 20%) - a bid to control the rapid expansion of credit supply and slow the rate of growth. Note: The Chinese central bank is not independent – it is controlled by the government
2. The Chinese government has also brought in **direct market interventions** to control the prices of necessities, which include grains, cooking oil, sugar, and cotton
3. Another way of limiting inflationary pressures is for China to allow a **gradual Renminbi (Yuan) appreciation** e.g. against the Yen, US dollar and the Euro. Remember that China operates with a strictly controlled exchange rate - the Yuan can only trade within 0.5% of a daily reference rate set by the government. A stronger Yuan would reduce the costs in local currency of crude oil, iron ore, soybeans and other commodities that China imports in big quantities (outward shift of SRAS)
4. Another option is to **reduce tariffs** on imported products (similar impact on import prices)

US-Chinese Trade

China Exchange Rate against the US Dollar

Chinese Yuan to the US Dollar



Source: Reuters EcoWin

Trade imbalances between these two countries are a major cause of **trade friction** between the world's two largest economies. Both countries have pledged to work on correcting "global imbalances," but the U.S. trade deficit with China in 2010 rose to \$273.1 billion, up from about \$226.9 billion in 2009.

Many U.S. lawmakers believe China's currency is significantly undervalued, giving Chinese companies an unfair price advantage in international trade. China loosened the Yuan from a nearly two-year peg to the dollar in June, and since then it has risen about 4 percent in value.

When discussing bi-lateral trade imbalances, remember that official data over-estimates the true size of the deficit/surplus – it depends on how the value of exports and imports is measured.

Measuring the Trade Gap – Smaller than the politicians claim

The US trade gap with China hit a record \$273.1 billion in 2010. But a quick look behind the figures suggests that the US economy is enjoying a surge in exports a major stimulus to their recovery hopes. The raw data is that US goods exported to China totaled \$91.9 billion in 2010 while imports from China rose 24 percent to \$364.9 billion. In fact that represents a rise in the value of US-China exports in 2010 of more than 31%. And the true scale of the trade imbalance with China is likely to be much smaller than the conventionally published data suggests.

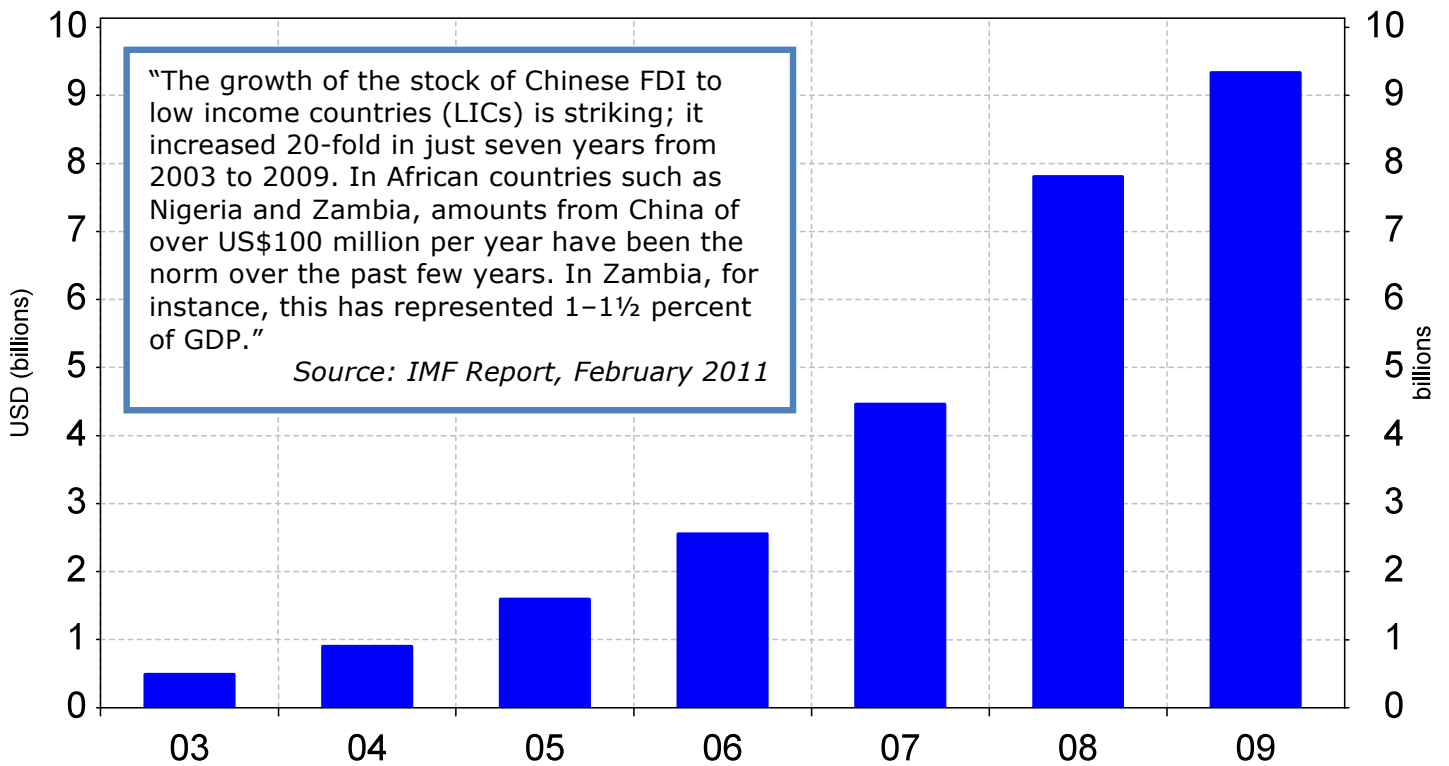
The globalisation of supply chains means that many manufactured consumer products are made up of components sourced from literally dozens of countries, based on designs and research from others, and brought together for final assembly in one before being sold.

An iPhone made by FoxConn and shipped to the United States counts as an import and is usually valued using country of origin methods - on that basis, last year the millions of iPhones arriving in the States contributed \$1.9 billion to the U.S. trade deficit with China. The cost of assembly is about \$6.50 per phone. But the total manufacturing cost of each iPhone — about \$179 for each handset — is counted toward China's export totals and millions of iPhones are imported into the States each year.

If China's iPhone exports to the United States were measured in value added—the value added by China to the components—those exports would come to only \$73.5 million. And according to the head of the World Trade Organisation Pascal Lamy, "if trade statistics were adjusted to reflect the actual value contributed to a product by different countries, the size of the U.S. trade deficit with China—\$226.88 billion, according to U.S. figures—would be cut in half."

China - Outward Investment to Africa

Cumulative value of outward investment, \$bn



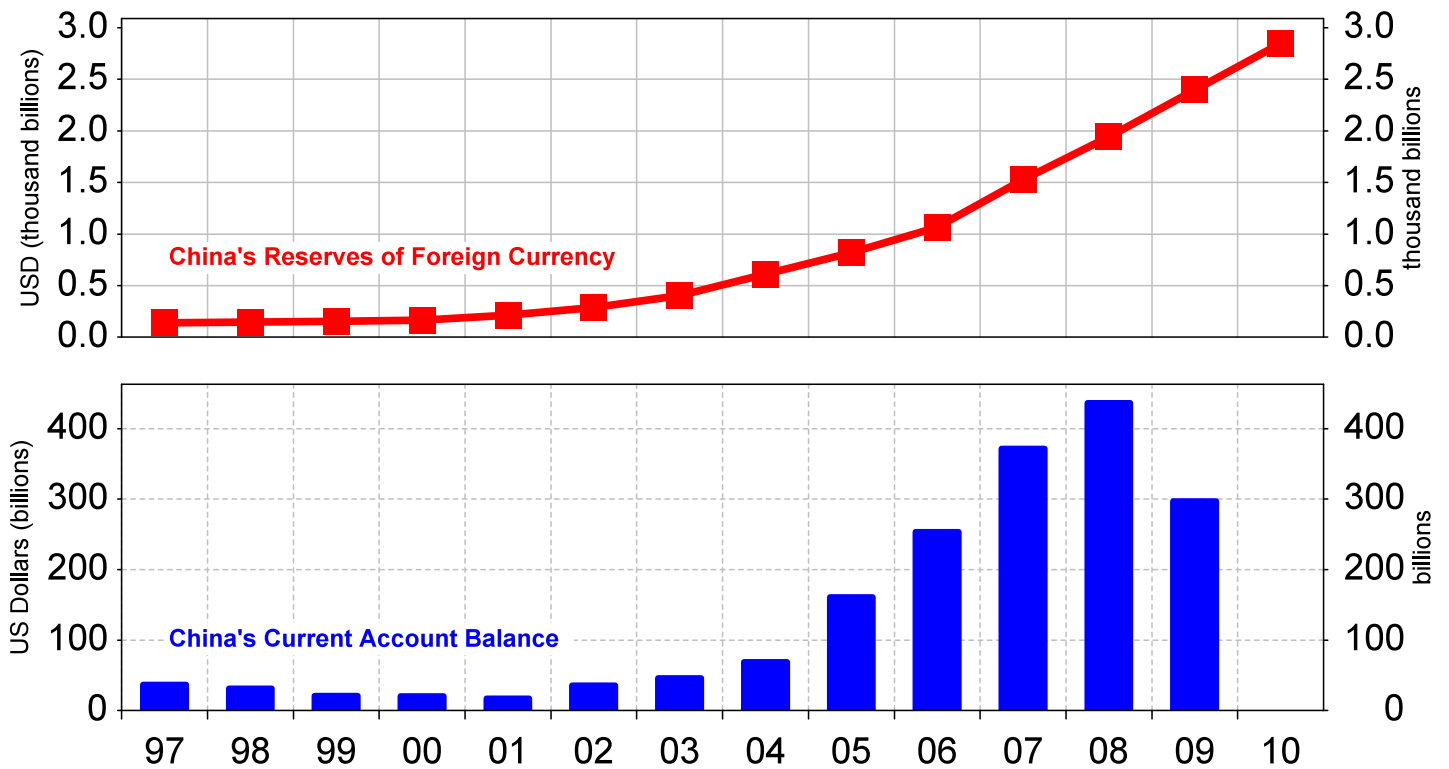
“The growth of the stock of Chinese FDI to low income countries (LICs) is striking; it increased 20-fold in just seven years from 2003 to 2009. In African countries such as Nigeria and Zambia, amounts from China of over US\$100 million per year have been the norm over the past few years. In Zambia, for instance, this has represented 1–1½ percent of GDP.”

Source: IMF Report, February 2011

Source: Reuters EcoWin

China's Trade Surplus and Reserves

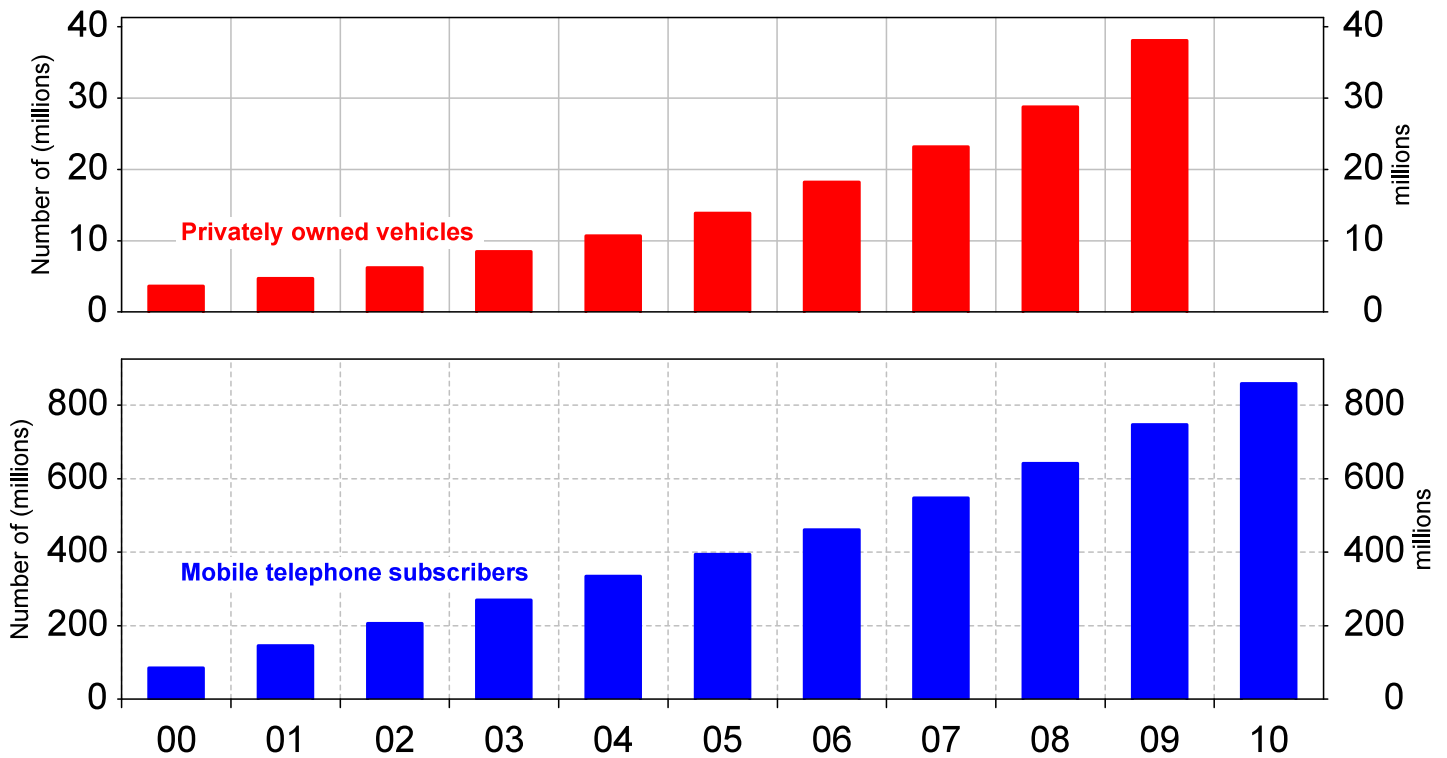
US dollars, billions



Source: International Monetary Fund

Chinese Consumption Takes Off

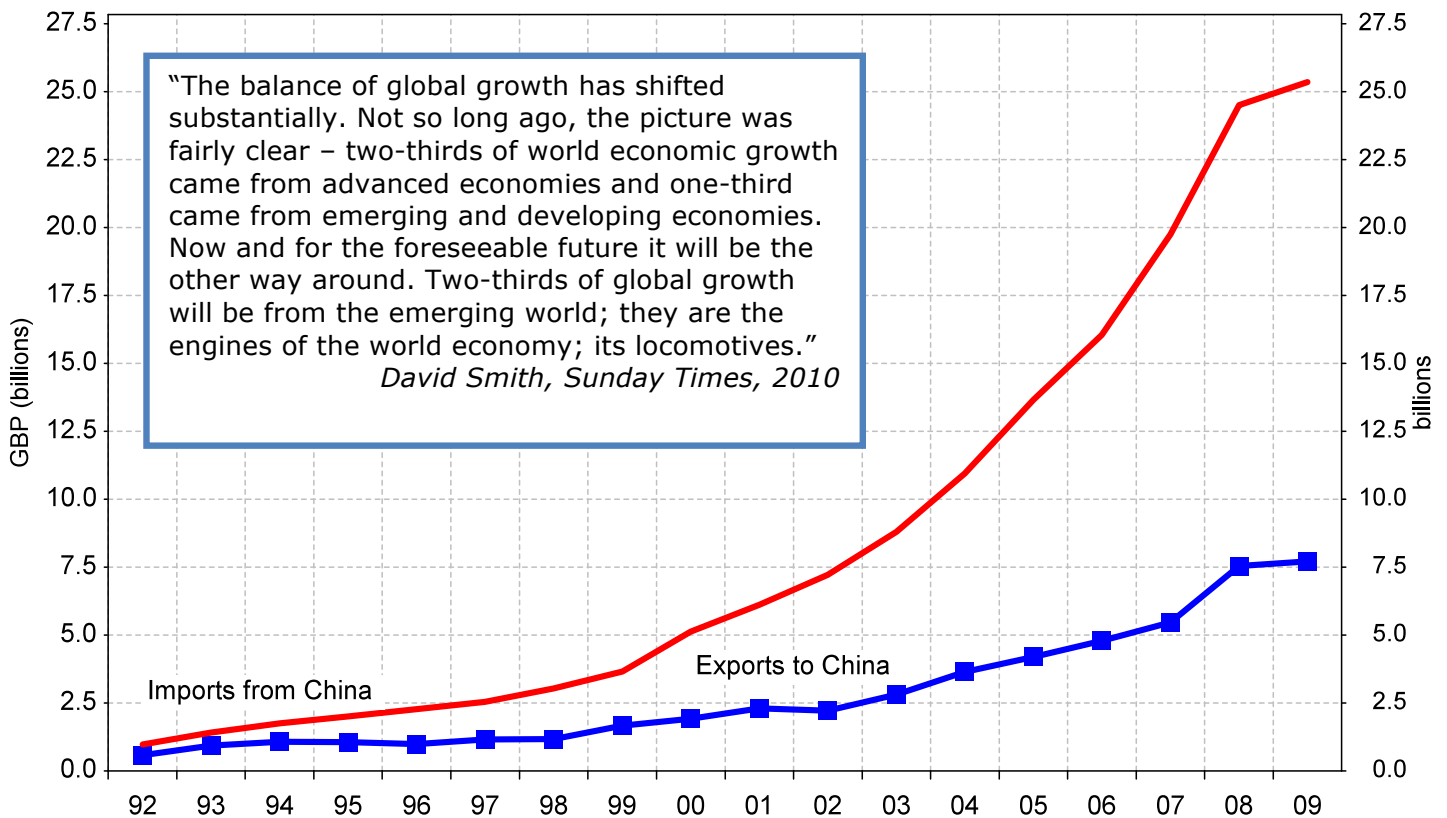
Number, millions



Source: Reuters EcoWin

UK - Exports and Imports to and from China

Annual trade figures, £ billion, Source: UK Balance of Payments Account



Source: Reuters EcoWin