Title	*China, US, global imbalances and the 2008 financial crisis*
Description	Dr Yueh presents on China's position in the global economy, the indirect role played by China in the global financial crisis, and the implications of the crisis going forward.
Presenter(s)	Linda Yueh
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Contributor So the very first thing I want to say is China's economic growth has certainly become one of the most important indicators of the world economies growth prospects, which became very apparent in this crisis. And I suppose one easy way of thinking about how China has managed to get here is to take a look at what's happened in the last thirty years.

So in 1979 China started market oriented reforms, moving away from central planning and this shows you real GDP growth in China. And the impressive part to me is what this actually means in terms of incomes in China. So at a growth rate at about 9-10% per year Chinese GDP, the entire output of China doubles about every seven years. That is an impressive, impressive rate of growth.

And this is why China has in the span of just three decades become the world's third largest economy. And I suppose for me one of the most important parts of it is that at the same time it has lifted an estimated 400 million people out of poverty. Yes, 400 million, that's larger than the entire population of the United States. And so it is this record I think that's made China's growth so impressive.

But my focus today is to try and place China within the global context, within the context of the recent crisis. And I think to do that we have to first assess what the impact of China is on the global economy and I've termed this 'The China Effect'.

There are four main avenues as to how it is that China has affected the global economy.

The very first one is international trade. Now within international trade there's going to be multiple elements. Some which have to do with specialisation, so China producing things and making other countries exports less competitive. Other parts of trade have to do with supply chains, globalisation: global production moving across borders.

And amazingly internationally one third of all global trade is actually intra-firm. So these kinds of multi national production and supply chains, are a big component of what we think of as trade. It is no longer just Britain producing bread in exchange for Portuguese wine. Modern trade is much more complex.

The second part is global capital flows. And again this also has a number of dimensions including foreign direct investment, China being a place which competes with other countries for foreign direct investment. But also being a magnet for foreign direct investment in the Asian region; pulling in other investment to help the region develop as an attractive place for manufacturing trade.

And the exchange rate of course plays into both of these elements at the balance of payments: The trade side and the capital side.

The third part is global supply and demand for commodities and raw materials. Now I point this out separately because I suppose the way that I think about it is that even if you as a country do not trade with China, China's demand for energies and commodities will push up supply prices in your country because it affects global prices, and so that is another separate avenue of impact.

And then very finally it's in terms of generating global growth. Now this one has become really important in this recession. Where is growth going to come from?

And so I would say of these four different avenues, up until about the real commodity boom of 2007/2008 the net China effect was to push down global inflation, reducing prices. And then this third avenue in the real commodity boom of the last couple of years began to outweigh that and then China became an inflationary force in the global economy.

So the impact of China is much more complex than just it produces cheap goods that we can buy cheaply. It is a mixture of these different avenues.

This is just to set the scene for what 'The China Effect' is before we move on to how this played into the global imbalances, which themselves was the backdrop to the global financial crisis.

Just a couple of charts very quickly to show you how quickly Chinese trade has grown really since the early 1990s. So, starting in the early 80s, which this chart maps, Chinese exports have increased tenfold… Chinese imports have increased eightfold and most of the increase has come after China joined the World Trade Organisation in 2001.

So what is China's role in the financial crisis? I would say it is an indirect role. It is certainly not responsible for the global financial crisis but it is one component of the macroeconomic picture that had fed into some of the economic decisions which led to really the worst banking crisis we've had in a century. So let me kind of trace out where China fits into the global macroeconomic context of the noughties. And these are the main avenues and I'll show you some data in the next slide.

The very first one is via its impact as a major trader. So China today is the world's largest trader. It has certain affected the macroeconomic context of globalisation after it joined the WTO. And the impact up until, as I say, the last couple of years, has been to push down inflation and contribute to the great moderation, which describes this past decade as a period in which the volatility of the business cycle has been lessened and we have had very strong growth with low inflation, leading I'm afraid to a great deal of complacency, including a famous claim by the British Prime Minister Gordon Brown on 'Newsnight', when he claimed to have ended boom and bust. They replay that clip a lot. (Laughter)

The second part of the role is global imbalances. Let me try to define that a little bit and as I say I will walk you through some data behind it.

This is this idea that America in particular consumes by borrowing. So they consume too much. And China saves too much and consumes too little. So America has low savings and a large trade deficit from all of its consumption, including of imports sold by China and other countries.

And China of course sells these goods and has low levels of consumption. This global imbalance feeds into the next part, which is when a country accumulates trade surplus that means that lots of money, foreign money is coming into their economy, the Chinese economy, building up foreign exchange reserves. Which in China's case is the worlds largest at two trillion US$. Two trillion US$, that's roughly the size of the British economy. We could use some of that, but that's a different topic.

And what this implies is when you have these reserves you end up with an appetite for US debt because the reserves in order to maintain your exchange rate means that you will buy up the dollars that aren't demanded with your foreign exchange earnings in order to keep your exchange rate fixed and rather low. So there is a huge appetite for US debt which I should add, not just from China but also from other developing Asian countries who also run trade surpluses and also Middle Eastern oil exporters. And I'll show you some of the trends.

And then very finally, normally when you have these global imbalances there is an automatic rebalancing. So in other words if there is a huge trade surplus in China then the currency ought to experience a great deal of demand. You demand Chinese Renminbi to buy Chinese goods. So demand for the currency should rise. And as the currency appreciates, it makes the goods less competitive, so therefore it should reduce the trade surplus. And the same thing should happen to the United States. People shouldn't demand the US Dollar because the US is running a large trade deficit. But of course a fixed exchange rate means the currency doesn't appreciate, you don't shrink the trade surplus. And in the case of the United States it is the global reserve currency. You demand the dollar for all sorts of reasons, not just having to do with its trade position. So there was no automatic rebalancing either.

So a bit of data to show you what I'm talking about. Now sometimes when you have these figures they can be difficult to read because they're crunched together. But I don't think there is any doubt which country this is. This is Chinese real GDP growth from 1980 to the present, measured against the richest countries in the world. America, Japan, Germany, France and yes Britain. We are still there, for the moment.

The thing I would like to point out about this chart is up until the beginning of the noughties, this decade, world economic growth was always roughly the growth rate of the rich economies. Since the beginning of the noughties world economic growth has actually been higher than that of the rich economies. It is being pulled up. Not just by China but also by other emerging economies.

This one I think shows you what's happened, probably even more clearly. And this is share of global GDP and as you can see from this the United States still accounts for about 20% of world GDP. It is still by far the richest economy in the world, But again, no surprise perhaps that China has quickly become the second most important economy in the world, when you calculate GDP, adjusted for purchasing power. And this is why China, alongside the US have become known as the twin engines of growth for their importance.

Now if you look down here, these are the other rich economies. And if you look closely, I'm afraid that China surpassed Britain some time in the early 90s. So this has been a dramatic transformation which most of us didn't notice, I should add, until the noughties when China's trade impact became so important.

But this is important to stress, despite the fact that China is such a big economy, per capita levels of income are very low in China. So this is GDP per capita from last year. And what you can see is that the Euro area, the United States, the UK, Australia and New Zealand remain much wealthier on a per capita basis than China and the Middle East, East Asia, the other emerging markets, which are part of the global imbalances and picture as well.

So, lower levels of income imply a number of things, including lower levels of consumption. Even if they're fast growing they are poorer. It's hard to see how they would be able to take the place of say the US consumer, because of the differences in disposable income.

The other implication of is that lower incomes mean it's cheaper to produce in these countries. So what I have mapped here is foreign direct investment to the developing world, which started to rise in the early 1990s. If you cast your mind back, the early 1990s heralded a transformation in the world. Well certainly in the world economy.

China's open door policy took off in 1992. India turned outward in 1991/1992 after a balance of payments crisis. Eastern Europe abandoned communism and the planned economy and adopted capitalism and rejoined the world trading community. This is what Richard Freeman of Harvard calls 'The Great Doubling'. These three countries and regions, these three regions doubled the global labour force at the start of the 1990s. All of their workers doubled the world labour supply from $1\frac{1}{2}$ billion to 3 billion. And so that puts downward pressure clearly on wages in the developed world and it increases the pressure and the attraction of off shoring and locating in these countries. And that's what the 1990s picked up.

This I think shows you the deflationary effect of having all of these new workers pushing down prices in the world economy. So the other extraordinary consequence is that in the last decade this maps inflation around the world, for rich countries, developing countries. And what you can see in the last decade is that there has been a very low rate of inflation despite very strong rates of growth, because of 'The Great Doubling', because of the emergence of these low cost countries.

At the same time what you had was a decline in the US savings rate and a rise in the Asian savings rate. So as this globalisation was taking place there was clearly something else which was going on. Which is the savings behaviour of Asia and was mirroring and to a large extent the savings behaviour of the United States, setting the stage for the global imbalances of low savings and borrowing by the Americans and high savings by the Asians.

Now I put the Euro area on here just to show you what's happened there. Even though of course you can see the Euro area, the savings rate hadn't changed a great deal in the last decade. And this chart shows you the current account part of the consumption in the United States. So the US consumed a great deal, including of imports. So the US current account balance as a share of global GDP is almost exactly mirrored by the current account surpluses of Asia and Middle Eastern oil exporters. And again I've put up the Euro area just to show the Euro area has actually been roughly in balance.

So you might be wondering, just as a brief aside, how is it that Europe ended up in this financial crisis? Well in Europe after about 1999 European banks were permitted to access US wholesale money markets. Tapping into this global imbalance of which the US was a big part. So I'm afraid we put ourselves in it.

Okay, so when you have these surpluses as I say, a consequence is that you accumulate foreign exchange. So what you see from this chart is that starting in 2000 the global imbalances translated into a rapid accumulation of foreign exchange reserves. In particularly China, Asia and the Middle Eastern oil exporters. So this was in a sense the macroeconomic backdrop to this current crisis.

So how does it all add up to a crisis? The very first thing is there was no regime to watch for global imbalances. And so what you had instead was rich economies like the US where the central bank, which is supposed to be on the look out for possible instability in the economy, was focussed on inflation. Because inflation targeting, aiming for a level of inflation price stability was the main aim of the Federal Reserve. And of course in Britain and in the Euro area there were explicit targets of what central banks were to do.

So when there was low inflation as a result of the emergence of emerging markets inflation seemed extremely low while growth was strong. So the central banks didn't see the need to raise interest rates, which is normally what you would expect if there was this huge amount of demand for US assets. So, global savings being funnelled into US debt which was then translated into a lot of liquidity in the US.

And to make matters worse the low interest rates in the US meant that a lot of lenders were looking around for borrowers even if they were sub-prime ones, because lending was so cheap. And it didn't matter if you were a 'NINJA', "No income, job or assets, but here's your mortgage." And so the low interest rate policy certainly contributed to this.

Another way to think about it, which I think I find useful, is I showed you the decline in the US savings rate. Normally if the savings stock falls you actually would expect that savings would become harder to get, so therefore they should be more expensive to get liquidity, to get loans. But that didn't happen and interest rates, which is the price of money, stayed low, despite this liquidity.

The other thing that I should add is that also within western central banks there was this feeling that their goal wasn't to target asset bubbles and in fact one central banker described it as "If you were to do that it would be like being the guy who takes away the punch bowl just as the party gets started." They always thought it would be easier to deal with the aftermath of the asset bubble. Now we know from this crisis there's just some times the aftermath is not easier to deal with.

And let me just finally reiterate why fixed exchange rates also played a role. So I already described why it is you don't get rebalancing. Another part of it is when the US Fed began to raise interest rates in 2004 there was a worry then at the time, they began to see the sub-prime mortgages build up and there was some concern about why it was there was excess liquidity and therefore mis-priced risk.

So the Fed started to raise interest rates between 2004 and 2007 when the US housing market began to decline. And nothing happened when they raised interest rates. And at the time Alan Greenspan described it as a conundrum. And the reason was actually because central banks and emerging economies were buying US Treasuries and therefore when the Fed was raising interest rates they weren't getting the rise in interest rates that they expected on yields. So these emerging central banks were buying Treasuries to fix their exchange rate regardless of the yield. So therefore their demand also pushed down the efforts of the Fed to raise interest rates.

So the 2008 global financial crisis in a nutshell is 1980s financial de-regulation clearly led to a very unregulated in many respects, financial market. The 1990s globalisation set the scene for a very different inflationary environment which was, in retrospect not picked up by central banks, for the reasons I've described.

And now finally, the noughties global imbalances... It was in part because the dot com bubble, which burst in 2001, the Fed avoided a recession in the US at the time by cutting interest rates. So that set the stage for the low interest rates and the cheap lending and therefore driving savings even lower in the US. And that in turn led to sub-prime mortgages through the processes I've just described and then of course I think we're all very familiar with what happened next, which was 'The Credit Crunch'.

And housing of course has much wider coverage than text stocks and this was always going to be a worst bust than the dot com bubble. And of course securitisation meant we got these toxic assets which were spread through the global financial system as a result.

So what was the effect of the global financial crisis on China? And this is the final part of my lecture, which is to try and pick through what the effect is on China and then conclude with what it all means for a global rebalancing as we come out of this crisis.

In China of course this kind of financial crisis works through two different avenues. One is financial effects contagion, what I've described for Europe. The Europeans had of course their own set of problems. But for the most part you got a lot of contagion because of securitisation.

In China there wasn't much contagion, and I'll go through the next slide. But the main affect was on the real economy, the decline of exports, which have pretty much disappeared in China. But because of what I'm going to outline next, there was some de-coupling. So China was able to grow despite the fact that the world was in recession.

So the financial sector effects in terms of contagion. China's under developed capital market in this sense helped it. So we hear sometimes in development this concept of the advantages of backwardness and so in this China does not trade in derivatives or exotic instruments. So the only contagion that it felt was via direct losses, where some of its banks were Lehman creditors. But there was no contagion.

Of course there has been dramatic movement in the Chinese Stock Market. That certainly has happened because China is very much globally integrated in many ways. But I would say it reflects concerns and optimisms primarily about the real economy in China itself. It's not a reflection of devaluation of banks, as you see in the West.

The main effect for China is certainly on the real economy side. Exports have collapsed with an estimated 20 million migrant workers who have lost their jobs. Unemployment is rising but it's not captured by official statistics, which show that unemployment will only rise to about $4\frac{1}{2}$ % this year, which is not accurate because unemployment figures in China don't capture migrant workers; it's only of urban residents.

Now annual growth in China last year was 9%, which is about its average growth rate over the last thirty years. And it was 7.1% in the first half of this year. And there is still even now some concern that the global recession and the decline in exports will drag growth down even further, unless of course it's offset by government spending stimulating the economy.

Now this I think gives an idea about the size of government in China, which is pretty small, relative to what it is even in other developing countries. China's government spending is less than a fifth of GDP. In Britain, as we know, it is half, it is huge. And actually it is growing every day.

But whether or not it can offset the decline in exports certainly depends on whether or not Chinese spending can boost domestic demand in its stead. But the other feature I want to show you on this chart is that China has had a falling consumption rate throughout this decade. This is the other side of the US savings rate that I mentioned earlier.

And as China has grown its consumption rate used to be about half of GDP, which is about what it is for market economies. Between half and two thirds is about what it is for most market economies. The US is 70% which is too high. China today at only about the high 30s maybe 40% is considered to be too low. And so you do have falling consumption and rising savings in China as the other component to stimulate, so that reliance is not just on government spending to get out of this recession.

But a word on fiscal stimulus and the problems that I see here. China has unleashed a very large stimulus programme. Worldwide, governments have pledged, in the very first round of co-ordinated stimulus spending about 2 $\frac{1}{2}$ trillion dollars. Of that $1\frac{1}{2}$ trillion was to be spent by the United States and by China. And the US is a much bigger economy.

The problem I see is that only about a quarter of the stimulus was to be funded by the central government. Most of it was to be financed by state owned banks. And what's happened is that the Chinese stimulus package was 4 trillion Renminbi, which is a large figure. But the credit unleashed to finance it in the first half of this year was 7 trillion Renminbi. And there is now quite a lot of obviously concern that this credit, this money which is being unleashed, is just feeding asset bubbles in the stock market and in real estate.

In terms of what this money is to be spent on, most of it is on infrastructure which is needed, but if the worry is that Chinese consumption has fallen and can't sustain domestic demand then arguably too little is spent on social spending, reducing social insecurities to boost consumption.

Now the Chinese subsequently added 125 billion to spend on health and another 400 million on rural pensions. But irrelative to the size of this stimulus these are still smaller perhaps than what's needed.

So I think what this crisis has shown China is it doesn't need to be an export led economy. It has a large domestic market. By losing exports and being pulled by the global recession I think has pushed them to consider improving domestic demand.

Specifically this is an opportunity to focus on why it is that consumption has fallen as a share of GDP and during a time when growth in real incomes exceeded 10% annually. And the other part of it, which is I think important to also keep in mind, is that Chinese savings is growing but only half of it is savings by households. The other half is by Chinese corporations because the credit system is state dominated so companies save a great deal in order to grow organically. And that also pushes up the savings rate.

So, reforming capital markets to allow for productive investment would also boost domestic demand, the investment component that I showed you.

But in the short term certainly infrastructure – China needs a great deal of roads, can create jobs, especially for the migrant workers who have lost their jobs. And it can provide future benefits with roads and rail being much more efficient.

And I think the other thing which has been a huge issue in China is this crisis has shown a great deal of institutional fragilities in the economy. When people lose their jobs they have no recourse. And I think again this has been highlighted.

So this just shows you a composition of GDP in China to give you data behind what I'm referring to. Chinese industry was half of GDP in 1978 and it remains half of GDP today. What they have to do is re-industrialise. Reform state owned enterprises, reform capital markets, so that this re-industrialisation shifts capital to more productive uses. It's not trying to industrialise, it is a different challenge.

And services is already growing as a share of GDP and investment services in particular can also help to reduce the savings motive and the asset bubbles that you see in China today, where investment has very few places to go.

So, my last few slides. I just want to bring it all back together and say what this is all meaning for global rebalancing.

So this slide just points out some internal reasons I think why it is that it is in China's interests to undertake global rebalancing.

The very first thing is volatility in its own assets points to the problems of being a source of trapped savings and liquidity. So China's worried about asset bubbles and this is indeed one of the reasons why you ought to have a much more balanced global economy, so you don't have these asset bubbles accumulating due to global capital flows.

And this I think is the reason why China has agreed in the G20 to participate in this new forum run by the G20, to have an early warning system about the build up of macro imbalances. That's not to say that they would agree to do anything if say the G20 forum says "Oh no, now you must raise interest rates and float the Renminbi." No I don't think that would work, but I think they've all signed up because they recognise they have to be able to monitor what's happening in terms of global liquidity and these imbalances.

And I think what China's also doing is they're changing their own capital account. They're beginning to allow for capital outflows. By doing that they naturally reduce the balance of payments, reducing the need to buy US Treasuries, shifting Chinese savings into US lending.

Instead by allowing its companies to go global, become multi-nationals, they could just invest the money into assets. And, as far as I know, we in Britain have quite a lot of bank shares we would like to sell. So there are potentially good opportunities there. And the Chinese have now become serious about this policy. They said they are going to use foreign exchange reserves to finance m and a activities by its firms.

So, the implications for global imbalances of China's own desires and actions is, let me first say, there's already some rebalancing of the global imbalances. The US, because of the recession, is already consuming less and the savings rate is already up. The US trade deficit is now only 3% of GDP, it's halved in a span of just the past few months. And China again, its consumption is steady, but as I say, the problems of domestic demand are much more structural. It's government, its households, its firms.

And I suppose I would also argue that gradual rebalancing is preferable, rather than having some system imposed, you must rebalance, for the simple reason that western economies are issuing record amounts of debt. Surely we would want countries to continue to buy these debts while they gradually liberalise their own exchange rates. So they're not so reliant on buying debt to stabilise their currencies.

And the G20 Agreement covers a great deal of this. It has been called 'The New World Order.' At least it's been called that last night on 'Newsnight'. (Laughter)

So in conclusion, China has played a indirect role in this crisis. It's just been part of the transformation of the global economy in the noughties. But there are clearly real consequences for China as it struggles to reach the 8% growth rate that it needs, which generates an upwards of 10 million jobs for its own still developing economy.

Where China goes from here is undoubtedly a challenge. But I think more so than ever it now sees that it has been too easy to sell to western consumers for too long, and perhaps it is time to focus on the Chinese domestic consumer and firms.

And I'll stop there and start the Q and A session.

Thank you very much for your attention.
