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# If China Slows

## Implications for the World Economy

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Policy Papers

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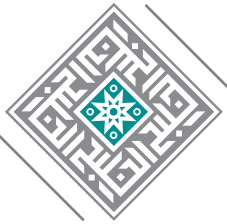

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## Introduction

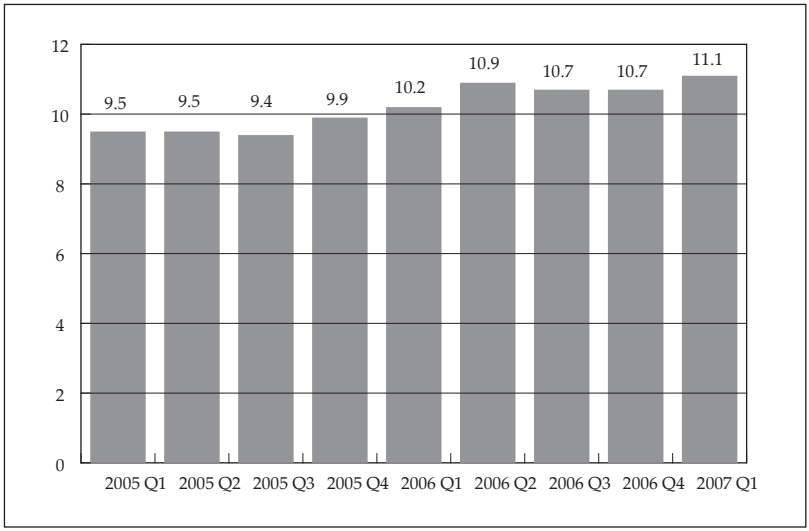
China's economic predicament today is unenviable. Its problem is not that it is experiencing slow growth or is faced with recession, but that it has grown too fast for too long. Its difficulty is not that it is strapped for foreign exchange, but that it has an embarrassing surplus of foreign exchange reserves exceeding a trillion US dollars in value. Its concern is that the export success that had won China the world's admiration is widening its trade surplus too much for comfort.

The paradoxical problem of excessively-high, externally-driven growth was flagged when China's National Bureau of Statistics announced that growth during the first quarter of 2007 had touched 11.1 per cent relative to the corresponding period of the previous year (Chart 1), up by 0.7 percentage points when compared with the last quarter of 2006. The announcement triggered panic-selling in the Shanghai stock market, resulting in a 4.5 per cent drop in the Shanghai Composite Index. Coming in the wake of a 9 per cent decline on February 27, 2007, this "correction" of an index widely held to be overvalued indicates that perceptions are that Chinese growth must slow.

For an economy that has grown consistently at extremely high rates for around a quarter of a century, expectations of a slowdown should not be alarming, unless it refers to a substantial fall in growth rates. Of greater relevance is the answer to two sets of questions: First,

what are the potential drivers of the slowdown, if it occurs, since this would determine how sharp and how prolonged the slowdown can be. Second, what are the implications of a slowdown for the rest of the world, given the fact that the period of high growth in China has also been one in which it has substantially increased its integration with global economy.

*Chart 1: GDP Growth Rates by Quarter Relative to Previous Year (Percent)*




Source: National Bureau of Statistics of China at:
http://www.stats.gov.cn/english/statisticaldata/Quarterlydata/

Being substantially integrated into the world economy through trade and capital flows, a slowdown in China can occur because of one of two sets of reasons (or a combination of both). First, a slowdown can be triggered by "external" factors, such as a recession in the US, which is an important destination for China's large exports. Second, it could occur because of developments "internal" to China that directly or indirectly ensure a deceleration in the rate of growth.

The former set of factors have been speculated on for a long time

now, though expectations of a US recession, or even a "soft-landing" have been belied many times. But recent concerns about the prospect of a slowdown in Chinese growth have been based on the perception that internal developments may precipitate a deceleration in growth.

## Potential Internal Triggers

One obvious internal trigger for a slowdown is inflation that forces the government to curtail its consumption and investment expenditures to cool the "overheating" economy. This is a plausible, but relatively weak, trigger as of now. It is indeed true that an annualized inflation rate (as measured by the Consumer Price Index) of 3.3 per cent in March 2007, driven by a 6.2 per cent increase in food prices, is seen by the Chinese central bank and the Chinese government as a bit too high for comfort. But inflation rates of this magnitude are low by global standards especially when placed in the context of China's consistently high growth.

### *Exchange rate appreciation*

The explanation for the expectation that growth would slow must therefore lie elsewhere. One source from which such expectations derive is the fact that China's exchange rate is under pressure to appreciate. Large foreign exchange reserves combined with a rising trade surplus and large inflows of foreign capital are a surefire recipe for exchange rate appreciation. China had for long been managing its exchange rate, keeping it pegged to the dollar. But after pressure to undo the peg forced the Chinese government to loosen the link between the Renminbi Yuan and the dollar, the Yuan has appreciated by as much as 6.7 per cent (from 8.2765 Yuan to the dollar to 7.7211) between end-June 2005 and April 27, 2007.

Though this is a minor appreciation given the depreciation of the dollar vis-à-vis most world currencies, it has implications for the future for two reasons. First, once the process of appreciation has

begun, preventing further appreciation of the Yuan becomes difficult given the fact that China's rising trade surplus is the focus of the world's attention. China's trade surplus for the first two months of 2007 was about $40 billion which would have taken it to $240 - 250 billion for the whole year. However, there are signs that the appreciation of the Yuan is having some effect. Thus, China's trade surplus tripled in 2005 to $102 billion, but rose by only 74 per cent to $177.5 billion in 2006.(1) Moreover, on April 12, the *People's Daily* reported that China's trade surplus was merely $6.9 billion in March 2007, reflecting a 38 percent fall on a year-on-year basis and a 70 per cent decline from a surplus of $2.4 billion in February. The March figure represented a 13-month low. What is noteworthy is that the decline in the trade surplus was not the result of a rise in imports, which stood at $83.43 billion in March having risen by just 6.9 percent year-on-year. The trade surplus does not rise as fast as before because exports are not growing at the earlier pace, though they are still well above imports.

These signs of a moderation in the rate of widening of the trade surplus as a result of the appreciation of the Yuan vis-à-vis the dollar are worrying because of China's heavy dependence on the US market. According to the IMF's Direction of Trade Statistics, China's exports to the US accounted for more than a fifth of its exports to the world as a whole and two-fifths of its exports to the industrial countries. If the appreciation of the Yuan vis-à-vis the dollar continues, adversely affecting the country's competitiveness in US markets, export growth can decelerate further, slowing China's growth.

## *Speculation fed by excess liquidity*

But, besides the effects of an appreciating exchange rate, the threat to real sector growth in China is financial. China's economic success generates and feeds on a huge expansion in money supply and credit

(1) Data from Ministry of Commerce of People's Republic of China available at http://english.mofcom.gov.cn.

that results from its rapidly increasing reserves of foreign exchange. And that credit is increasingly financing investments that are risky.

Rising foreign exchange reserves are the inevitable corollary of the Chinese government's efforts to moderate appreciation of the Yuan by buying out a large part of the foreign funds flowing into the country. As a leader in the *Financial Times* (January 12, 2007) put it: "The market intervention needed to hold the renminbi down boosts domestic liquidity, fuelling asset price bubbles and greatly complicating the task of economic management." The problem is that the expansion in credit that fuels speculative real estate and stock market investments, is also fuelling real growth by financing productive investment and consumption spending. Efforts to control speculation could, therefore, adversely affect real sector growth as well

There is sufficient reason to believe that credit-financed investment spurs real growth in China. While productivity has increased in China, growth can be largely explained by the high rates of investment in the country. The investment rate in China (investment as a share of GDP) has fluctuated between 35 and 44 per cent over the past 25 years, and has ruled well over 40 per cent in most recent years. However, what is interesting is the manner in which these high rates of capital formation are financed in China.(2) Budgetary appropriations and foreign investment accounted for small shares of between 8.6 and 11.7 per cent of total fixed assets formation during 2001 - 05. The bulk of financing comes from two sources both of which involve a substantial degree of borrowing: Domestic loans (17.3 to 20.6 per cent) and Raised funds and others (70 - 74 per cent). Domestic loans refer to loans of various forms borrowed by investing units from banks and non-bank financial institutions. "Raised" funds refer to extra-budgetary funds for investment in fixed assets received by investing units from central government ministries, local governments, enterprises and institutions. And "other funds" refers to funds for investment in fixed assets received from sources other than

(2) Data from National Bureau of Statistics of China, *China Statistical Yearbook 2006*.

those listed above, including capital raised through issuing bonds by enterprises or financial institutions, funds raised from individuals, and funds transferred from other units. All of these involve some degree of direct or off-budget borrowing.

These borrowed funds flows into real estate "investment" as well. Real estate development accounts for a significant share of total investment, amounting to 17 - 19 per cent in the first five years of this decade. This category includes real estate development by central and local government bodies as well as investment in residential construction. The former includes investment by local government bodies in economic development zones and what have come to be referred to as "image projects" launched by local leaders to beef up their public stature. The latter includes a substantial amount of private residential construction that is underway, especially in urban China, in the wake of relaxation of laws governing residential property ownership. However, real estate development is the most volatile part of fixed assets formation. According to economist Yongding Yu of the Chinese Academy of Social Sciences: "During the early 1990s, the growth rate of investment in real estate varied between 11.7 and -1.2 per cent."

This kind of volatility could partly be the result of speculation. It does appear that excess liquidity created by China's burgeoning foreign exchange reserves is resulting in a credit-financed real estate boom. For example, the annual rates of growth of property prices stood at 15.1 per cent and 19.5 per cent in 2004 and 2005. The evidence suggests that bank lending has played an important role in this increase in property prices. Thus, the credit exposure of commercial banks to the property and property-related sector had increased from 3.6 per cent in 1998 to 14.8 per cent in 2004 and the mortgage loan to total loan ratio had increased from 0.59 per cent in 1998 to 8.88 per cent in 2005 (Luang and Cao 2007).

Faced with this credit-financed speculative boom in the property market, China's Banking Regulatory Commission (CBRC) announced (in August 2006) policies aimed at tightening bank

credit to the real estate sector. Principally, financial institutions were barred from granting loans to property development projects whose developers fail to raise 35 per cent of the investment from their own resources. The policy also tightened lending to developers suspected of hoarding land and property. With respect to personal housing mortgage loans, the new policy required banks to decide on down payments by borrowers based on their credit worthiness, rather than some unified standard. The move was a clear indication that the government was concerned that commercial banks may fall victims to a real estate bubble gone bust. If that were to occur, a liquidity crunch could ensue, slowing growth sharply.

Overall, efforts are on to slow credit growth by raising reserve requirements and hiking interest rates. On April 29, 2007 the People's Bank of China hiked the reserve requirement of commercial banks by 50 basis points, to 11 per cent. This increase in the stipulated reserve ratio was the fourth announced by the central bank in 2007 and the seventh since June 2006. The central bank had also increased interest rates three times in the year preceding April-end 2007.

To the chagrin of the central bank, this is not braking credit growth. Chinese banks are reported to have extended new loans to the tune of 1.5 trillion Yuan ($186.6 billion) in the first quarter of 2007, which was more or less equal to the loans advanced over seven months from June through December 2006.

### *Stock market volatility*

Credit growth of this kind also seems to underlie stock market volatility. During one week in April 2007, Chinese retail investors opened more than 1 million new trading accounts, taking the total for the previous four months to more than 10 million, or more than that seen during the previous four years combined. Not surprisingly, the Shanghai stock index was ruling nearly 40 per cent higher during the first 4 months of 2007, on top of a 130 per cent increase in 2006 (Anderlini and Dyer 2007).

Retail investors began swarming into the stock market in May 2006, after an almost five-year bear run. Part of the reason was a boom in the market that attracted Chinese households and corporations holding $4.5 trillion in bank deposits earning less than 3 per cent per annum (Anderlini 2007). At the current rate of inflation these depositors were earning negative real returns, attracting them to the stock market.

This of course implies that if the stock bubble unwinds, many innocents would burn their fingers. Not surprisingly, China's policy makers are concerned that cheap and easy liquidity is fueling the boom in the domestic stock market. But the fear remains that any drastic correction could unwind investments too fast leading to a crash. The two sharp downturns in the market have only enhanced those fears.

In sum, the danger today is that the liquidity built up by China's external success has not only financed real sector growth, but spawned asset bubbles that could trigger a financial crash. The more the government tries to correct the rise in speculation, the more it could adversely affect real sector growth. Together with the effects of inevitable Yuan appreciation, this could set off China's next growth slowdown.

## Fall-out of the Slowdown

This brings us to the second of our concerns in this paper: the likely impact of a slowdown in Chinese economic growth (if it occurs) for the rest of the world. One obvious and direct way in which the effect would be transmitted stems from the sheer size of the Chinese economy when measured not at the official exchange rate but in terms of purchasing power parity (PPP). According to the Goldstein *et. al.* (2006), in PPP terms China's contribution to world output stands at around 15 per cent and its contribution to global income growth averaged more than 21 per cent over the five year period 2000 - 04 (Table 1). This implies that a slowdown in China would in and of itself result in a slowing of global growth.

But the global effects of a Chinese growth slowdown would also be mediated by the impact the former has on growth in other countries, especially the other locomotive of global growth, the United States. Even though the rate of growth of GDP in the US is not comparable with that in Asian drivers like China and India, the sheer size of its market and the fact that growth in the US has been accompanied by widening US trade and current account deficits, makes it a major source of global demand and an important determinant of global growth trends.

*Table 1: China's Contribution to Global Growth, 2002 – 2004*

| Percentage share of annual growth rate | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| Global growth, per cent p.a. | 6.9 | 4.8 | 4.6 | 5.7 | 7.4 |
| China | 15.8 | 23 | 25.2 | 23.4 | 19.9 |

Source: Goldstein *et al* (2006)

However, the specific way in which a slowdown in Chinese growth would impact on the US would depend on the mechanisms driving China's economic performance. For example, if China decides to deal with its exchange rate and monetary management problems by allowing the Yuan to appreciate, resulting also in a slowdown in monetary, credit and GDP growth in China, the rest of the world would benefit from a loss of competitiveness of Chinese producers. The rising Yuan would make Chinese exports more expensive (in foreign currency terms) and Chinese imports cheaper (in terms of the Yuan), reducing China's share in world exports and partially redressing the imbalance in trade between China and many countries of the world. This should normally benefit the US, which sucks in a large share of China's exports.

The difficulty, however, is that the loss of Chinese competitiveness in trade would not only reduce China's trade surplus but also make it a less attractive destination for foreign capital inflows aimed at using China as the location for world market production. This could reverse

the recent relentless rise in China's reserves, and reduce the flow of Chinese surpluses into dollar denominated assets in the US.

China's stock of foreign exchange reserves, the world's largest, surged to $1.2 trillion at the end of the first quarter of 2007, after adding $136 billion or more than half the total increase of 2006 during those three months. Estimates are that around a third of China's reserves are invested in US Treasury Bills. At the end of 2006, China is estimated to be holding $350 billion worth of Treasury bills. And Fitch reportedly estimates that China holds another $230 billion in bonds from government-backed agencies such as Freddie Mac and Fannie Mae (Chandler 2007). A sharp curtailment of such flows from China to the US is bound to destabilize financial markets. China's decision to create an investment fund on the lines of Singapore's Temasek Holdings, which would invest anywhere between $200 billion to $400 billion of these reserves to earn better returns threatens such a curtailment.

Lower inflows into and larger outflows from US capital markets would result in a fall in financial asset prices that would reduce the wealth position of US households and institutions. This would reduce consumer spending and curtail demand. That problem could be aggravated by a possible liquidity crunch in the system, as banks and financial institutions experiencing a depreciation of their asset values turn cautious. Further, lower financial asset prices imply higher interest rates that could affect investment, housing construction and consumer spending adversely as well. Growth is bound to slow and a recession may ensue.

However, a recession in the US combined with the dollar's constitutes a problem for the rest of the world, especially countries in Europe and in Asia (including China), that are heavily dependent on the US market. Dollar depreciation increases the dollar value of their exports to the US and undermines their competitiveness and recessionary trends in the US would squeeze an important market for their exports.

### *Use of administrative measures*

China could, of course, resolve its "overheating" problems by directly curtailing investment through what are termed "administrative measures" rather than an appreciation of the Yuan. These partly involve setting ceilings on commercial bank lending; increasing excess reserve requirements; and hiking interest rates on central bank refinance to commercial banks, on deposits with commercial banks and on loans provided by commercial banks. But besides these, the Chinese government has used central "commands" and guidelines to hold back runaway rates of investment. As one financial sector executive reportedly put it: "The central bank does not use reserve ratios or open market operations to transmit monetary policy - this is accomplished via direct instructions to China's banks, all of whom are controlled by the Communist Party via the personnel system. "If the leadership wants to slow lending, it simply instructs the banks to slow." (McGregor 2007a).

The difficulty is that once such commands and guidelines are carried down to decision-makers at lower levels in what is still politically a centralized system, they remain in place till the government retracts these guidelines and works to ensure that the message reaches down to where it matters. In the meantime a bout of deflation is a possibility. Thus, "stop-go" around a high trend seems to be an inevitable feature of the current conjuncture.

The use of such measures, instead of exchange rate appreciation, would imply that the Chinese growth slowdown would not be accompanied by any reduction in export growth, though it would adversely affect imports. The net result would be that the growth slowdown would be accompanied by an increase in the trade surplus and larger reserve accumulation. In the circumstances, the fall-out for the global economy would be through the direct effects of a contraction in Chinese demand for global goods. It is to a discussion of that impact that we now turn.

### *Contraction in China's demand*

There are three components of such an impact that need to be considered. The first is the impact that this would have on China's demand for primary commodities that affects a large number of countries, including countries in Africa. The second would be the impact it would have on countries and firms which are major suppliers of manufactured goods and services to China's burgeoning domestic market. And, the third would be on countries and firms that are major suppliers of goods to production facilities in China involved in processing these imports for export to the world market.

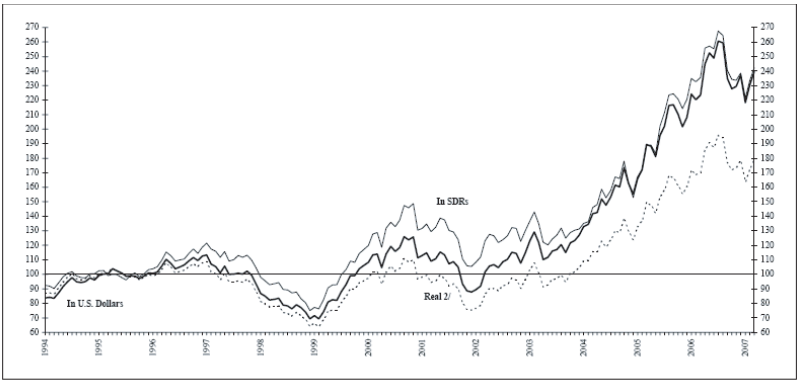
## Impact on Commodity Prices

One major impact of the China boom has been a degree of buoyancy in commodity prices. While it is true that other factors have been important in driving commodity prices, it seems likely that but for China's presence, commodity prices may not have reflected the buoyancy they have. It is widely recognized now that over the last five years there are signs of a reversal (however temporary) of the long term trend in global commodity prices. According to the IMF (2006), by the beginning of this decade commodity prices had fallen relative to consumer prices (as measured by the US Consumer Price Index) for over five decades, with some degree of fluctuation around this trend. But from around 2002, commodity prices have been on the rise (Chart 2). This would have definitely benefited countries, including poorer countries, which are primary product exporters. While exporters of oil have been the principal beneficiaries, the index of non-fuel commodity prices has also been rising (Chart 3), though the gains in real terms here have been much smaller.

Despite recent volatility, the global prices of oil have retained much of the gains that they registered in the last four years. According to IMF figures, the Average petroleum spot price (APSP) rose from around $18 per barrel at the beginning of 2002 to $76 a barrel in

August 2006. Subsequently it declined to around $55–$60 during October–December 2006 and further to just over $50 a barrel in early 2007, before rebounding in late March to almost $65. This trend has indeed been influenced by political developments in the region. The uncertainty in West Asia resulting from the occupation of Iraq, the stand off in Iran over the nuclear issue and the conflict in Lebanon, had created a situation where any destabilizing influence—such as political uncertainty in Nigeria, the battle for control of Yukos in Russia, civil strife in Venezuela or fears of the impact of periodic hurricanes in the Gulf of Mexico—triggered a sharp rise in prices. But equally important was the closing gap between global petroleum demand and supply (Chart 4) at a time when the spare capacity held by Saudi Arabia is more or less fully utilized.

*Chart 2: Indices of Primary Commodity Prices (1995=100) 1/*




1/ Combines indices of non-fuel primary commodity prices and petroleum prices.
2/ Deflated by US CPI.

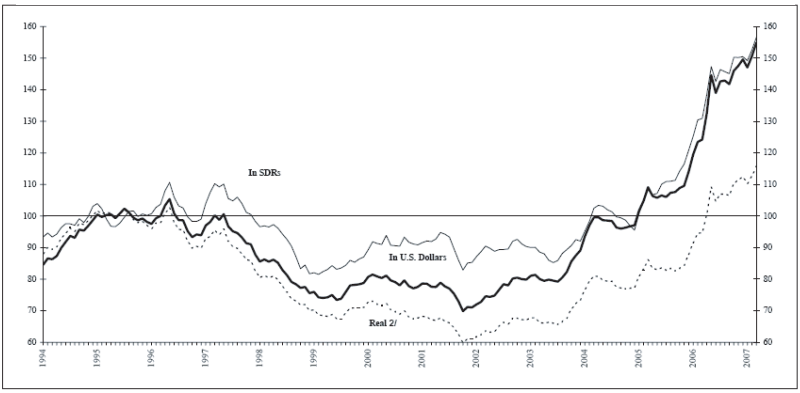
4-Apr-07

Source: IMF at http://www.imf.org/external/np/res/commod/chart1.pdf accessed May 2, 2007.

What is noteworthy about the recent experience with high oil prices is that unlike after the oil shock of 1979 - 80, rising prices have not curtailed demand to an extent to ensure a subsequent fall in prices. An important reason for this is the expansion of demand

driven by growth in China. Thus between the first half of 2005 and the first half of 2006, while oil demand in the US fell by 300,000 barrels per day and in Europe by 50,000 barrels per day, that in China increased by 400,000 barrels per day. This helped increase aggregate world demand by 5000,000 barrels a day.

*Chart 3: Indices of Non-Fuel Primary Commodity Prices (1995=100) 1/*




1/ Indices comprise 60 price series for 44 non-fuel primary commodities. Weights are based on the 199597- average of world export earnings.
2/ Deflated by US CPI.

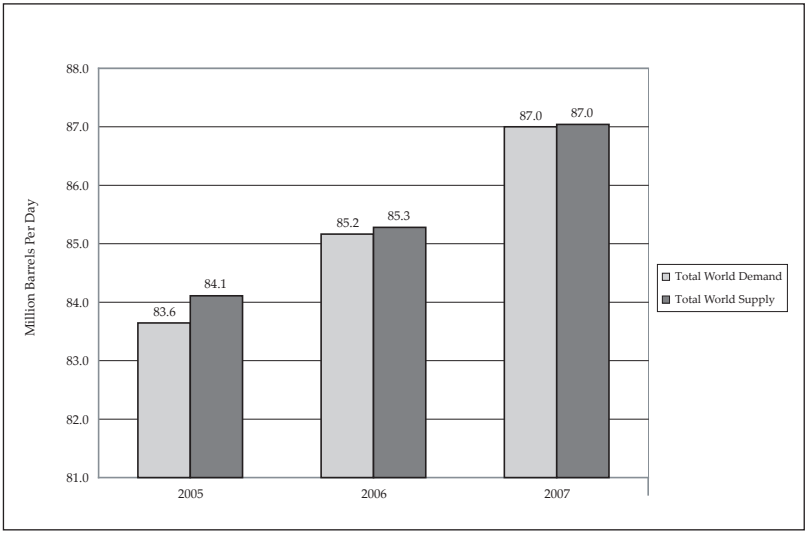
4-Apr-07

Source: IMF at http://www.imf.org/external/np/res/commod/chart2.pdf accessed May 2, 2007.

We must note that in the years since January 1974, the recent peak in the (US CPI-adjusted) real price of oil was exceeded only during a brief period between July 1979 and early 1983.Thus the ability of oil producers to maintain a relatively high price of oil in real terms was clearly related to China's high growth and insatiable appetite for imported oil.

The implication is that if China's growth slows, dragging down with it its demand for oil, oil producers who have not diversified significantly away from dependence on oil for exports and GDP growth would be adversely affected. Moreover, the reduction in the foreign exchange surpluses of oil producers would adversely affect capital flows to the US, with effects on US growth for reasons discussed above.

*Chart 4: Global Petroleum Demand and Supply*




Source: US Energy Information Administration, *Short-Term Energy Outlook – April 2006*.

## *Non-fuel commodity exporters*

More important than the effect on oil exporters of a slowdown in China, is the impact this would have on exporters of non-fuel commodities, which too have benefited from the China boom. To quote the IMF (2006): "Non-fuel commodities have a higher share in world trade (about 14 percent during 2000–04) than fuel commodities (7 percent). As in the case of oil, many developing countries are highly dependent on non-fuel commodities as a source of export earnings – 36 countries have a ratio of non-fuel commodity exports to GDP of over 10 percent, and in 92 countries the ratio is over 5 percent. Indeed, in many low-income countries, a large share of export receipts is generated by just a few commodities."

Globally speaking, therefore, a rise in non-fuel commodity prices would have a much more widespread impact that touches on poor countries, particularly in Africa. What is noteworthy about the

commodity price boom since 2002 is that some non-fuel commodities such as metals have registered price increases that are higher than the increase in oil prices. Thus, for example, between early 2002 and late 2006, the IMF metals index rose by 180 percent in real terms, while oil prices increased by 157 percent. This trend has continued. The IMF non-fuel commodity index rose by 28 percent in 2006, touching a new record high, as a result both of a surge in metals prices as well as a strengthening of agricultural prices. And during the first quarter of 2007, metals prices remained strong despite fluctuations, while agricultural prices continued to rise (IMF 2007).

The role of China is even more important in influencing price movements in metals and cotton, than in oil. China has always been a major source of demand growth for metals, contributing between 12 and 43 per cent of the global growth in consumption of some of the principal metals. However, the contribution of Chinese demand growth to global consumption growth increased sharply during the years of the metal price boom, touching 86 - 87 per cent in the case of tin and nickel and exceeding average global consumption growth in the case of lead and zinc (Table 2). In copper and steel too China's contribution to global demand growth was in excess of 50 per cent.

These trends are a result of the fact that China's high rate of GDP growth has been (unlike in the case of India) driven by increases in industrial production. The rate of growth of industrial production in China rose from a high 10.5 per cent during 1993 - 2000 to 16.2 per cent during 2002 - 05. This has meant that manufacturing accounts for more than 50 per cent of the increment in GDP during these years, when growth elsewhere in the world is based largely on services. This industrial dynamism has meant that China today accounts for 8 per cent of global industrial value added when estimated at current exchange rates and 25 per cent when valued in PPP terms. It has also meant that China is today the largest consumer of several metals, accounting for about a quarter of the total world demand for aluminum, copper and steel (IMF 2006).

*Table 2: Consumption of Industrial Metals and Oil*

| | 1993–2002 | | 2002–05 | |
|---|---|---|---|---|
| | World Consumption Growth | Contribution | World Consumption Growth | Contribution |
| | (Annual % change) | Per cent | (Annual % change) | Per cent |
| Metal | | | | |
| Aluminum | 3.8 | 38 | 7.6 | 48 |
| Copper | 3.5 | 43 | 3.8 | 51 |
| Lead | 3 | 42 | 4.3 | 110 |
| Nickel | 4.4 | 12 | 3.6 | 87 |
| Steel | 3.4 | 38 | 9.2 | 54 |
| Tin | 1.3 | 34 | 8.1 | 86 |
| Zinc | 3.4 | 42 | 3.8 | 113 |
| Oil | 1.5 | 21 | 2.2 | 30 |

Source: IMF (2006)

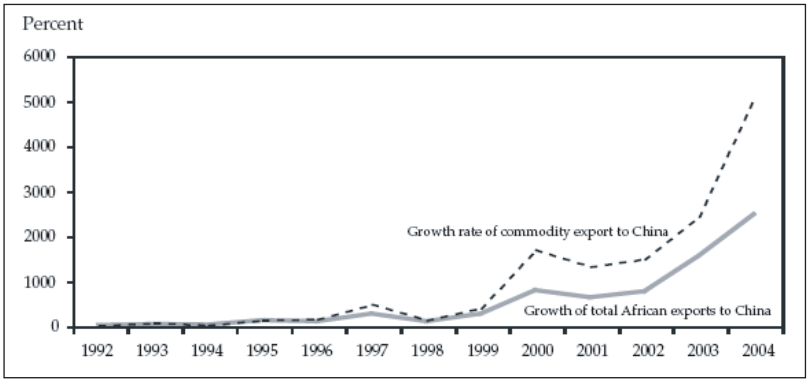
Outside of metals China has also been a major source of demand for beef and cotton, accounting for 103 and 90 per cent respectively of the growth in global consumption. In the case of these and other commodities, had it not been for China's contribution, world demand would have remained almost flat.

The major beneficiary of these trends in commodity demand and prices is Africa, in which China's presence has expanded substantially. African exports to China started accelerating around 2000, and have since risen at an annual growth rate of more than 50 per cent. By 2004, African exports to China touched $11.4 billion, reflecting a more-than-threefold increase since 2000. By 2004 China accounted for 6 per cent of total African exports to the world. Chart 5 shows the importance of commodity exports in Africa's rising exports to China.

One consequence of the rise in the volume and unit value of commodity exports from Africa, is the sign of a reversal (for the

present) of the long-term deterioration of net barter terms of trade faced by developing countries dependent on primary products for their export revenues that go to finance imports of manufactured products. Chart 6 shows the net barter terms of trade and purchasing power of exports (income terms of trade) for developing countries and Africa from 1980 to 2002. With competitions in manufactures export trade (influenced by China) moderating price increases in manufactured goods, and China's demand driving up commodity prices, developing countries as a group and Africa in particular that are still substantially dependent on the exports of primary products, have experienced an improvement in their terms of trade.

*Chart 5: Africa's Commodity and Total Exports to China, 1992 - 2004 (Cumulative Growth Relative to 1992)*

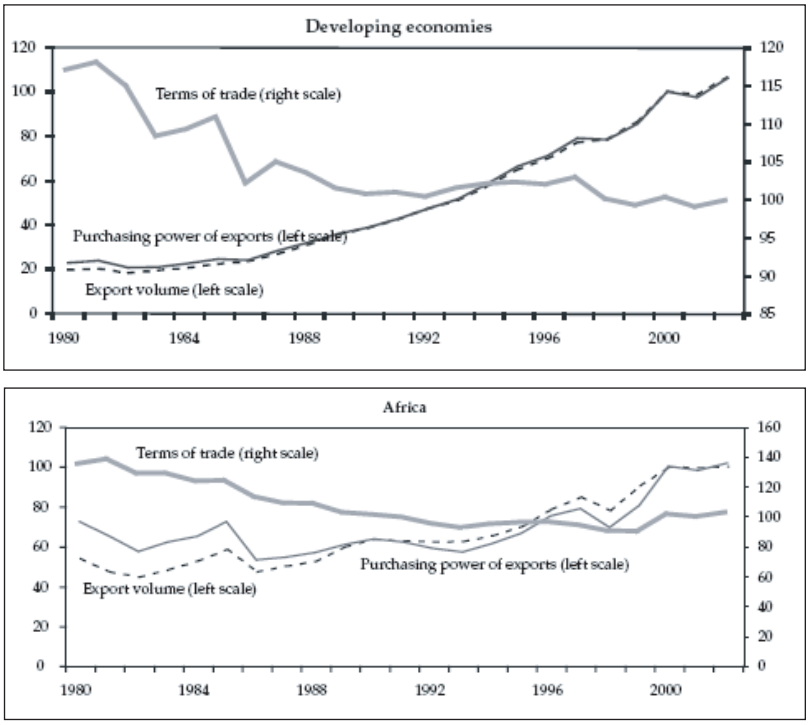



Source: Goldstein *et. al.* (2006)

The net result of all this is that the China boom has helped a continent like Africa, which is integrated with the world system principally as an exporter of primary products and an importer of raw materials, improve its economic position. Real GDP growth in Africa rose to an average annual rate of 4.2 per cent during 2001 - 2004 from 3.3 per cent during 1997 - 2000. Sub-Saharan Africa gained even more with its real GDP growth rate touching 5.4 per cent in 2004, which was an eight-year high. The African Economic Outlook 2005

(AfDB/OECD 2005), among others, attributes this improvement substantially to the rise in commodity prices. What is more, China's interest in the region's natural resources has resulted in huge flows of aid and foreign investment from China to Africa, bolstering the region's infrastructure and putting much needed investment into the natural resources sector. Needless to say, all this will be under threat if China slows. But commodity producers and commodity traders are optimistic, at times linking the recent commodity boom to a long-term, Kondratiev-type 'super cycle', which would keep commodity prices buoyant for years to come.

*Chart 6: Terms of Trade, Export Volumes and Purchasing Power of Exports in Developing Economies, and Africa, 1980 - 2002 (Index numbers, 2000=100)*

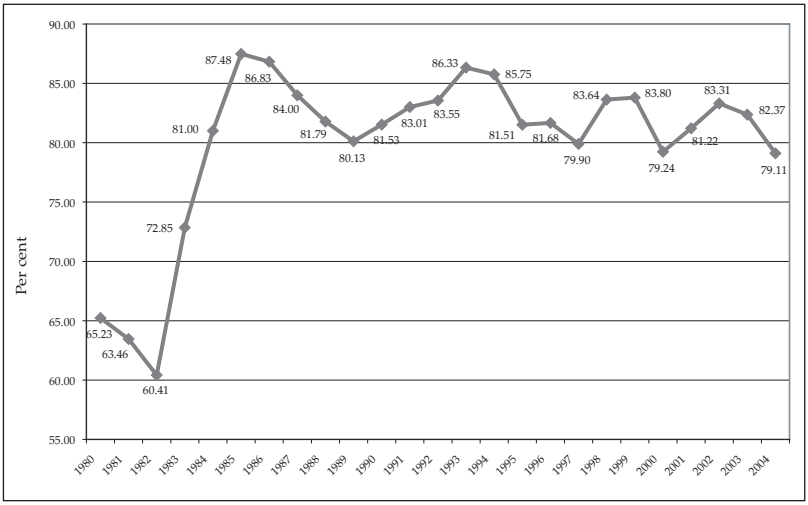



Source: Goldstein *et. al.* (2006)

## China's Demand for Manufactures and Services

China's burgeoning domestic market, driven by its scorching pace of growth, has also created a growing market for world manufactures and services. This process has been facilitated by China's entry into the WTO which has opened its domestic market to foreign producers and its domestic industrial and financial sector to foreign investors. As Chart 7 shows, the share of manufactures in China's imports rose sharply during the early to mid-1980s, from 60 to more than 85 per cent, and has remained close to that level since. Needless to say, a significant share of these imports was from developed countries, especially Japan.

*Chart 7: Share of Manufactured Goods in Chinese Imports*




It is however true that imports from the US and Japan have been falling, and also those from EU, but to a smaller extent. But, figures on sources of imports do not often adequately reflect the true picture, since firms from these countries have chosen to locate in China or in third countries to produce for the Chinese markets. This is especially true of Japanese firms, whose competitiveness was

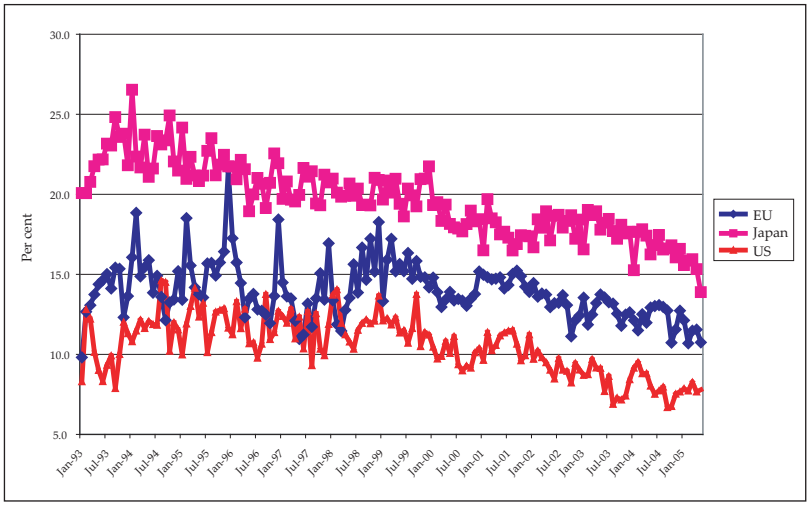
threatened by the appreciation of the yen, but holds for firms from other developed countries as well. In sum, China is and does remain an important market for firms from many countries including the developed countries, and any slowdown in China would affect their profits and therefore the profits repatriated to their parents.

Another area in which China is emerging as an important market for foreign firms is in the services sector. This is illustrated by the experience of the US, which is the world's largest exporter of services and, despite evidence of a decline since the late 1990s, still notches up the world's largest services trade surplus. In 2004, the United States recorded a $1.6-billion services surplus with China, with which it recorded a $161.9-billion bilateral merchandise trade deficit (USITC 2006). China was in that year the eighth-largest market for US services, accounting for approximately $7.2 billion (2 percent) of total US services exports. But this clearly is only the beginning, since rapid per capita income growth and growing liberalization of services trade in China is expected to substantially increase China's imports of services. The potential market was revealed when in December 2005, China's official statistical agency revised its GDP figures to take account of previous underreporting of services incomes. According to the revision, approximately $265 billion, or 93 percent of the 17 percent overall upward adjustment in GDP, was attributed to the services sector. China now estimates that the services sector accounts for 41 percent of its GDP.

The two areas in which the market is expected to expand rapidly is telecommunications and banking. Opportunities in the latter are reflected in the fact that while 480 million Chinese consumers have cell phones only 1 million have credit cards (Callan et al 2007). This has resulted in some differences in perspectives on China among American businessmen. Sections of US industry that are facing stiff competition from Chinese firms at home and abroad are keen that the US administration push for further appreciation of the Yuan. But the financial services industry, looking for a share in the US banking pie and worried about the impact that Yuan revaluation would have

on the profits of Chinese banks, is calling for more focus on greater access to the Chinese market for US banks. In their view, capital market reforms rather than currency appreciation is the best first step the Chinese can make.

*Chart 8: Shares of EU, Japan and the US in China's Imports*




Source: International Monetary Fund, *Direction of Trade Statistics Online*.

These developed country firms operating in or out of China to cater to the domestic market would indeed be concerned with the prospect that overheating could lead to a Chinese slowdown. Any such development would directly affect a market which has become an important contributor to their global profits in recent years.

## Impact on Outsourcing Firms

Differences over the best China policy are visible also among firms that use China with its strong infrastructure, state-provided land and cheap labor as an outsourcing hub for world market production. Resorting to imports into China for reprocessing for export, these firms would find any talk of Yuan appreciation as a solution to

the world's problems anathema. This would render their imports expensive and raise costs of production. It would also reduce the foreign exchange price they obtain for their exports.

It is known that a small share of the final prices of outsourced production is currently due to costs incurred in China. They are largely constituted of trade margins in markets such as the US and profits. The net result, however, is that much of the value-added is due to activity in the US. Consider this: "As an example of outsourcing, consider the Barbie doll. The raw materials for the doll (plastic and hair) are obtained from Taiwan and Japan. Assembly used to be done in these countries, as well as the Philippines, but it has now migrated to lower-cost locations in Indonesia, Malaysia and China. The molds themselves came from the United States, as do the additional paints used in decorating the doll. Other than labor, China supplies only the cotton cloth used for the dresses. Of the $2 export value of the dolls when they leave Hong Kong for the United States, about 35 cents covers Chinese labor, 65 cents covers the costs of raw materials, and the remainder covers the costs of transportation and overhead, including profits earned in Hong Kong. The dolls sell for about $10 in the United States, of which Mattel earns at least $1, and the rest covers transportation, marketing, wholesaling and retailing in the United States. The majority of value-added is therefore from US activity. The dolls sell worldwide at the rate of two dolls every second, and this product alone accounted for $1.4 billion in sales for Mattel in 1995" (Feenstra 1998).

If the Yuan is revalued, firms such as these would find that the cost share attributable to production in China would rise, and the margins available to cover transportation, trade mark-ups and profits would shrink. In the circumstance, while they would not immediately be affected by a Chinese growth slowdown, assuming that their markets are predominantly abroad, any role for Yuan appreciation to deliver that slowdown would be damaging. They too are therefore with the financial services industry when it comes to solutions for China's peculiar growth predicament.

## Conclusion

The import of the above discussion should be clear. Despite the widespread belief that China is stealing the good times from the rest of the world, there is a real, even if still small, danger of a marked growth slowdown in China. If, however, such a slowdown occurs there would, it appears, be more losers than gainers in the global system. Those who would lose fall in a variety of categories: developed countries, developed country firms, oil exporters, oil-importing primary product exporters, besides the emerging market countries looking for a foothold in China's burgeoning markets for manufactures and services. It is time for all to get together and find a way to ensure that it is not just the US but China as well that needs to be assured of a soft-landing—and not just for China's sake.

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