Notes
for the Meeting of the
Task Force on Economic Challenges

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Partial “De-Coupling” of the Chinese Economy

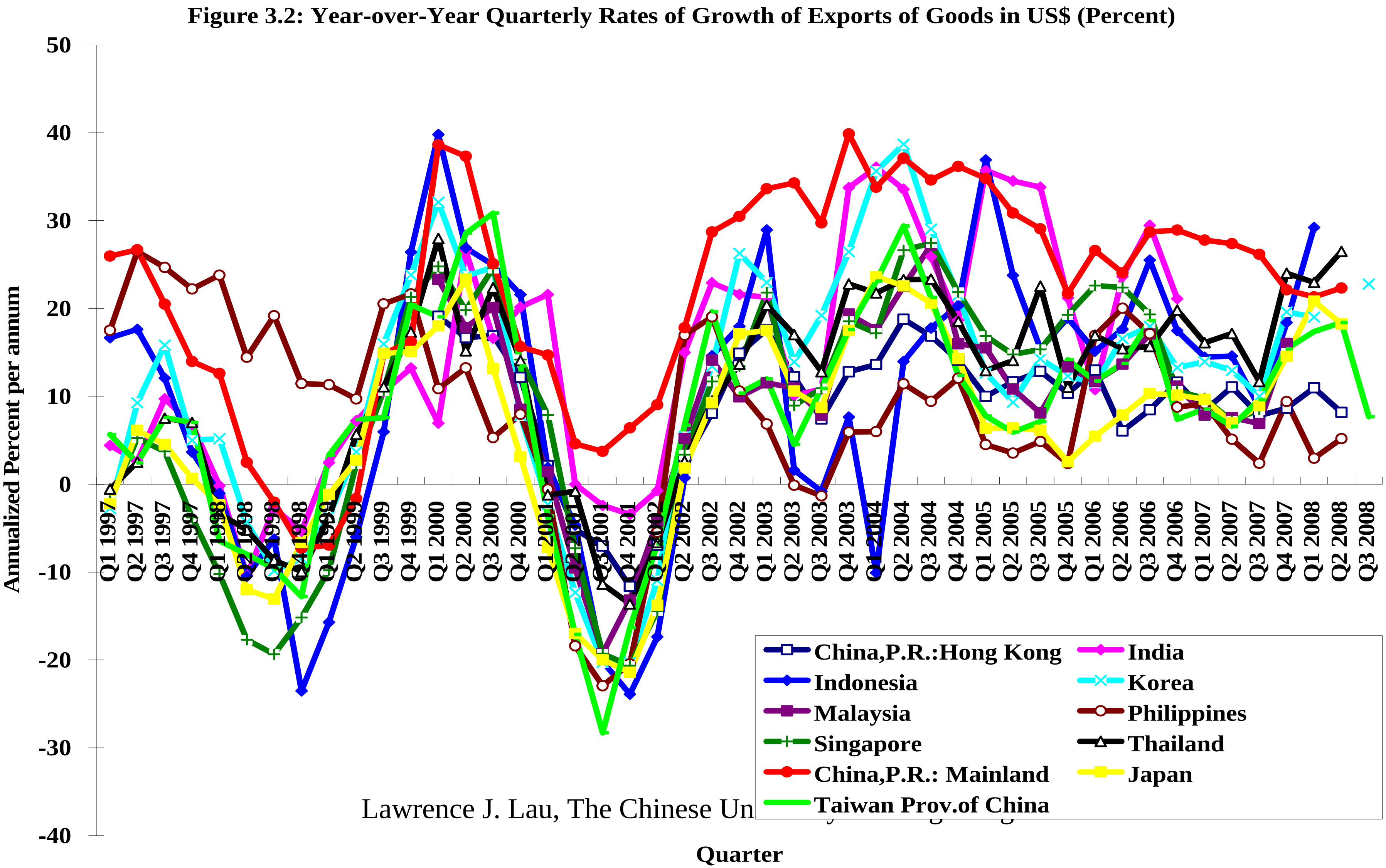
De-Coupling from the U.S. Economy

- In general, the phenomenon of (partial) "decoupling" is expected to be operative. Chinese economic growth will be mostly unaffected by external developments, including an economic recession in the United States. The other so-called BRIC countries—Brazil, Russia and India—are even less dependent on exports, especially exports to the U.S. Brazil has recently discovered huge oil reserves and should be entering a new era of rapid economic development, financed by its new found oil wealth instead of foreign loans. Russia has benefitted from the high world price of oil (which has recently fallen back to more normal levels) and is not a major exporter of manufactured goods and hence will be relatively unaffected by the economic recession in the U.S. and elsewhere. India is also not a major exporter, except in computer software, and its economic growth is mostly internal-demand driven.

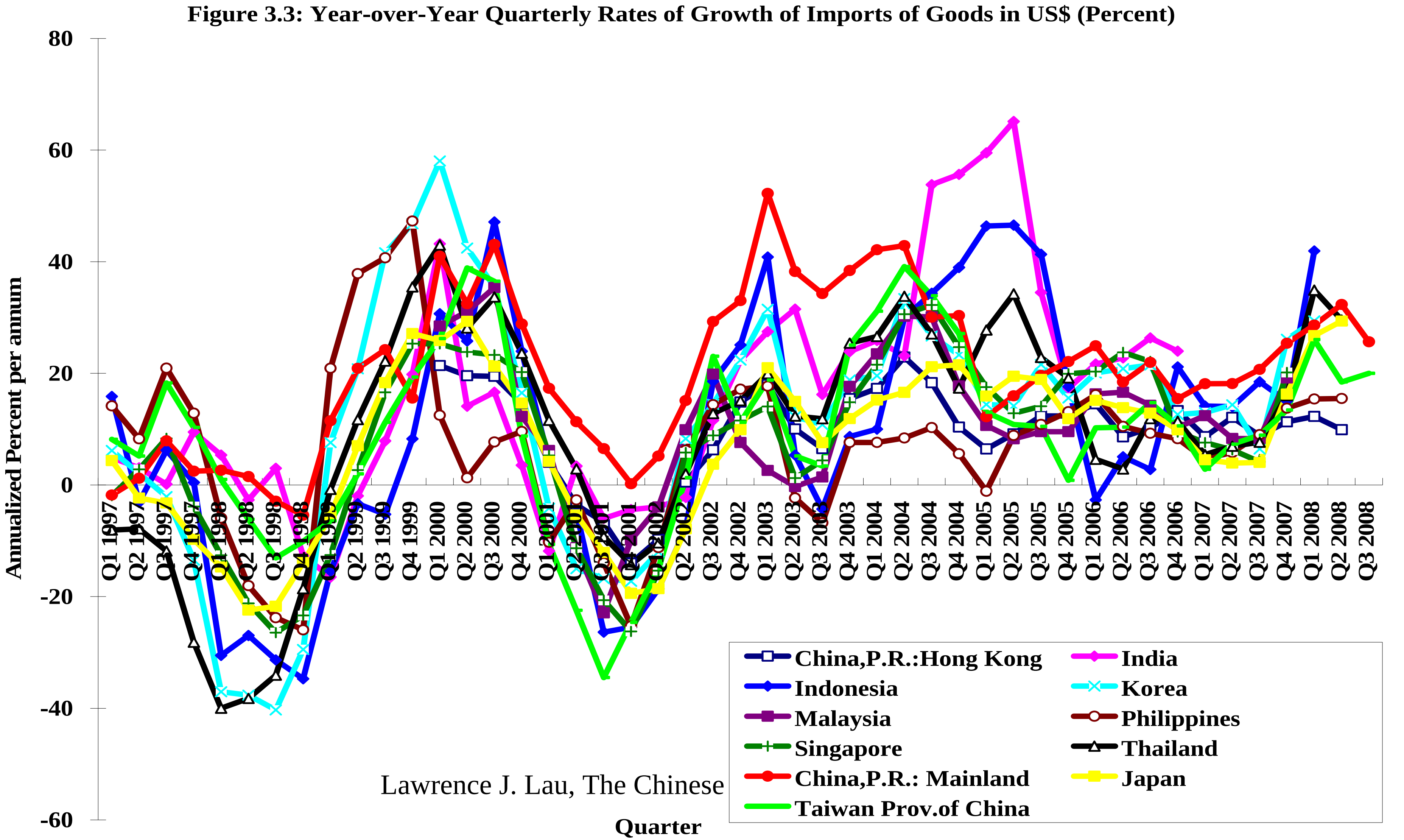
De-Coupling from the U.S. Economy

- The BRIC countries can be expected to continue growing, albeit at somewhat lower rates, and the rest of developing East Asia should be able to manage.
- The high domestic savings rate found in almost all of the East Asian economies is a major advantage of East Asia which makes it independent of capital inflows from developed economies and hence de-coupling much more possible and likely.
- During the East Asian currency crisis of 1997-1998, the mutual impacts of the simultaneous downturns and upturns on the part of East Asian economies on one another were amply demonstrated. So that so long as they continue growing together, by creating demands for one another's exports, their collective growth can be more or less sustained.
- Through it all, the rate of growth of Chinese real GDP remained relatively stable even as the rates of growth of exports and imports fluctuated widely.

Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies



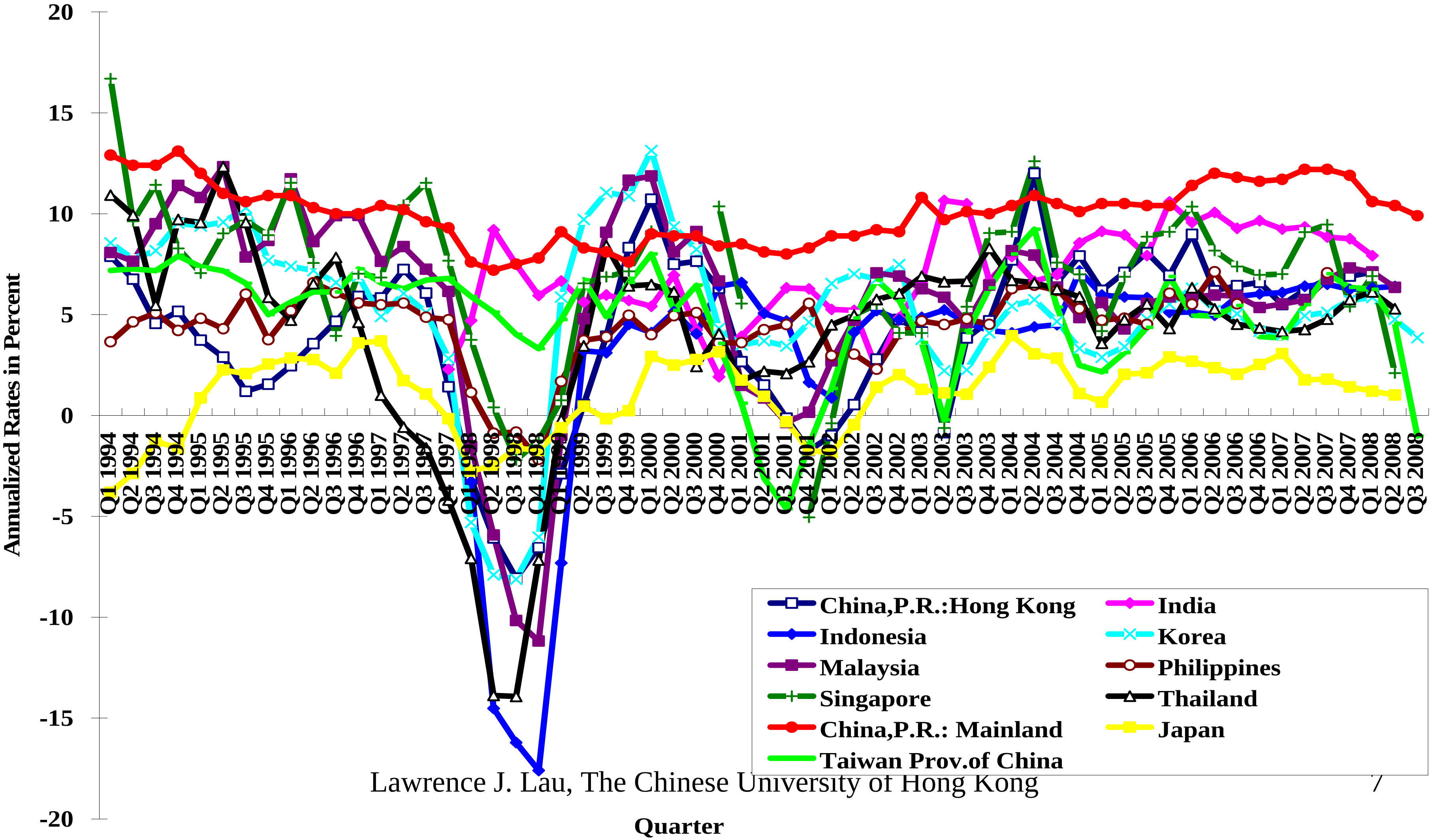
Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies



Lawrence J. Lau, The Chinese

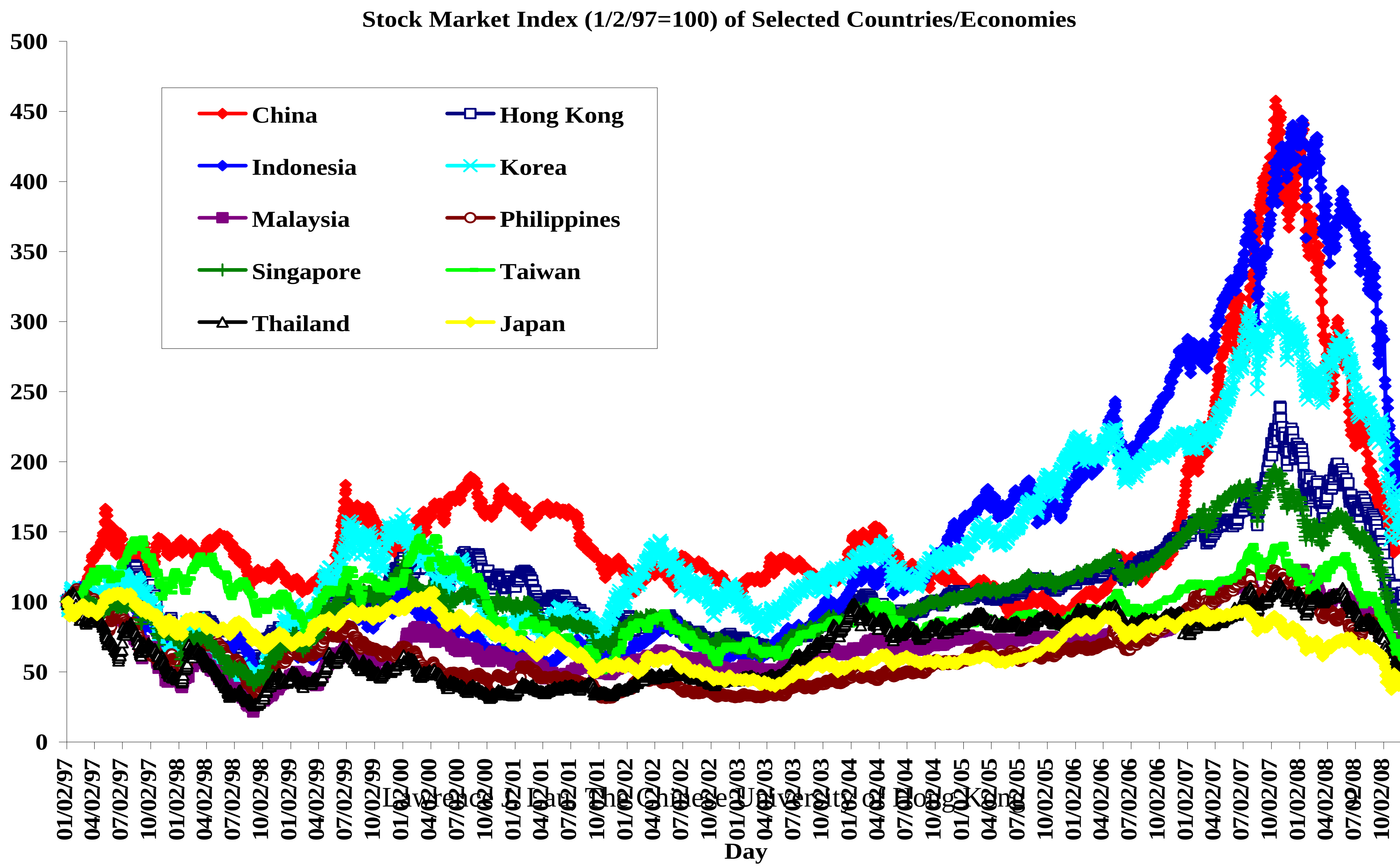
Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies

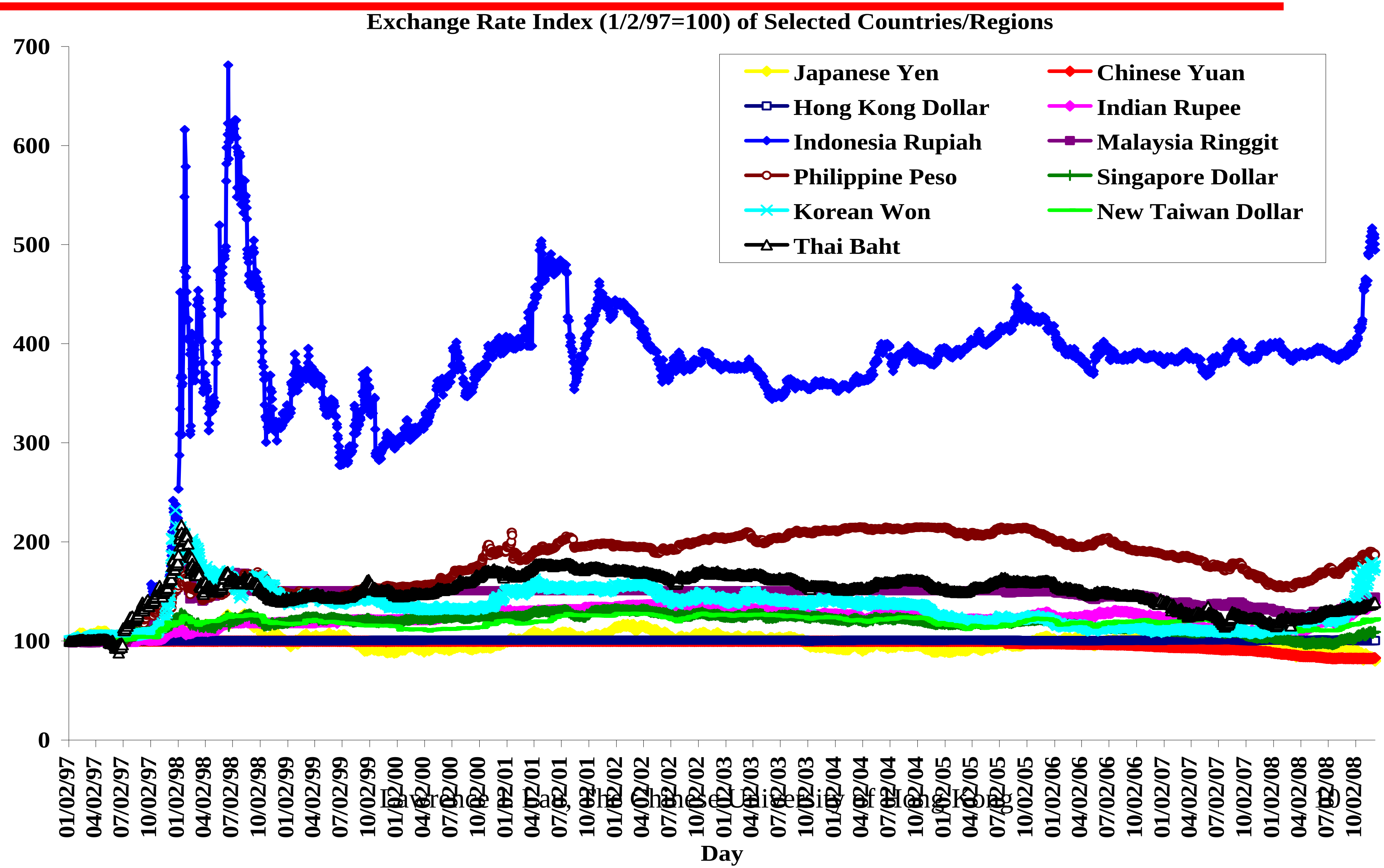


The Recent
Fall in East Asian Stock Markets & Devaluation of East Asian Currencies Due to Repatriation & Fall in Oil Price

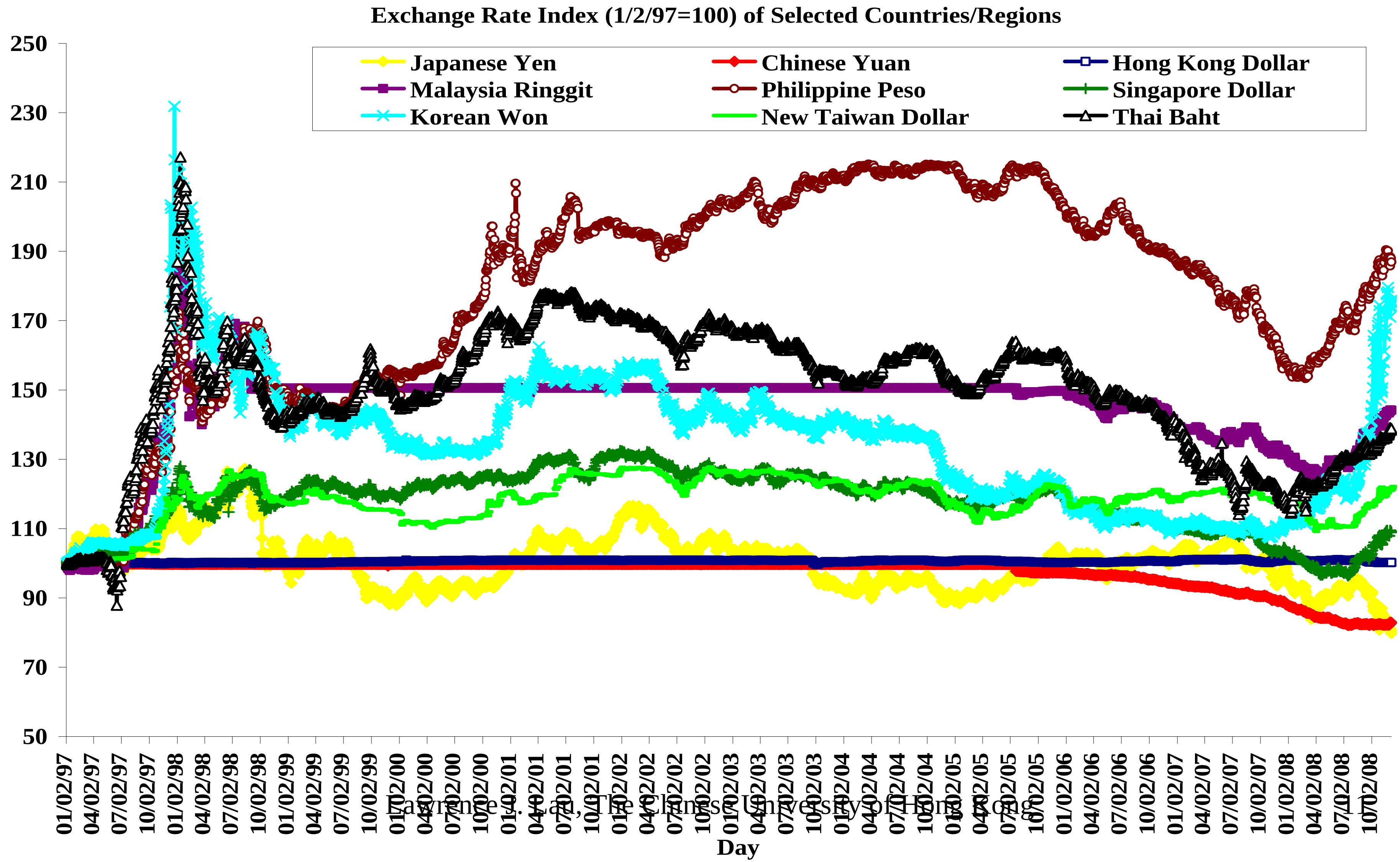
Indexes of East Asian Stock Market Indexes:Local Currency (01/02/1997=100)



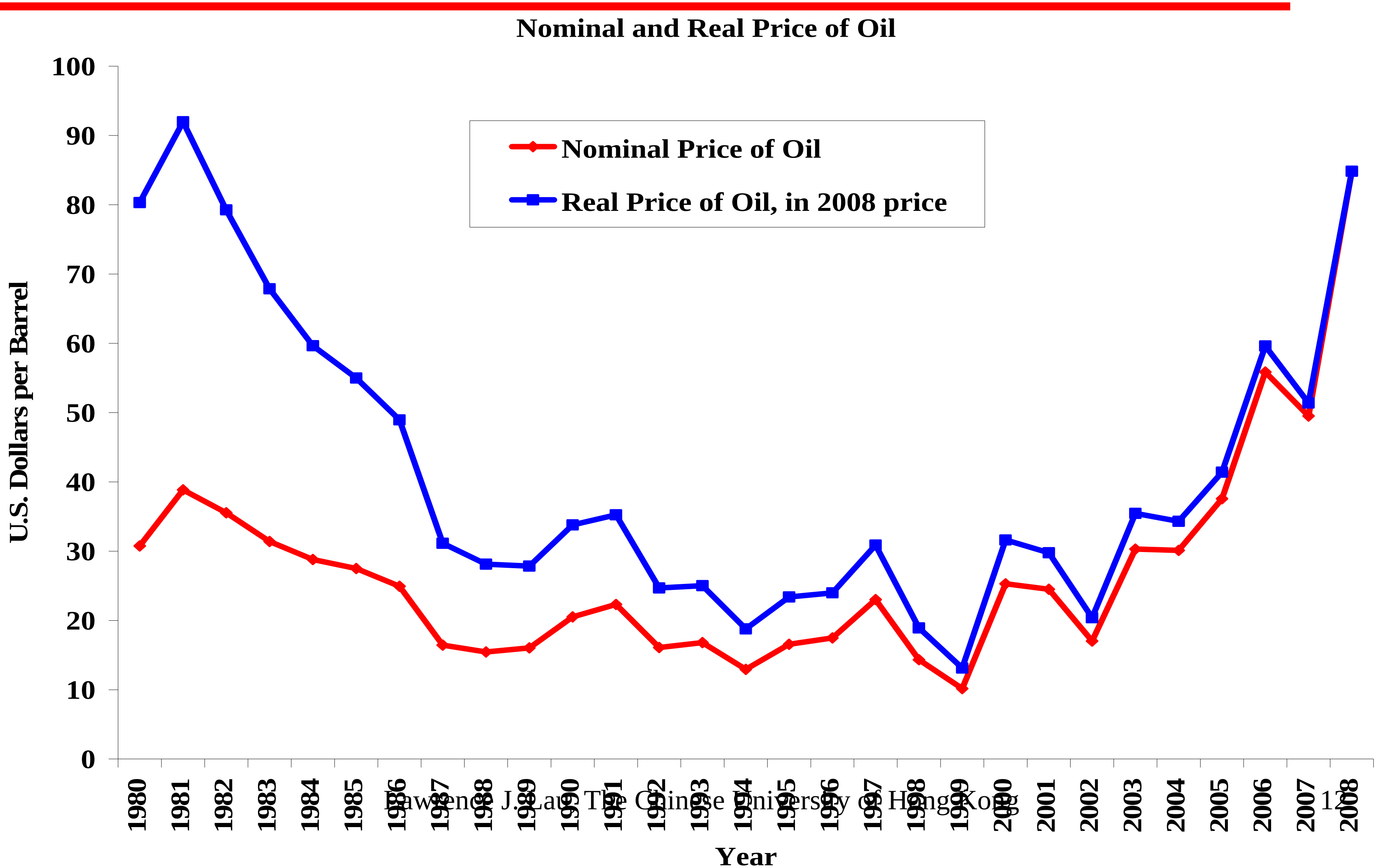
Indexes of East Asian Exchange Rates: Local Currency/US$ (01/02/1997=100)



Indexes of East Asian Exchange Rates: Without Indonesia (January 2, 1997=100)



The Nominal and Real World Prices of Oil (2008 prices)



The Relationship between Chinese Exports and Chinese GDP

The Impact of the Economic Recession in the U.S. on Chinese Exports

- Chinese exports to the U.S. constitute between 8% (Chinese estimate) and 12% (U.S. estimate) of Chinese GDP; however, the direct domestic value added content of Chinese exports to the U.S. is quite low, averaging 17.7%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 2.2% (12% times 18% = 2.16%).
- 2.2% of GDP is reasonably significant and will result in hardships in some localities if completely lost. However, even if Chinese exports to the U.S. falls by 10% in real terms, it will cause Chinese GDP to fall by only 0.22%, which is clearly tolerable, especially if the remaining 97.8% of the Chinese economy continues to grow.
- If the indirect domestic value added of Chinese exports to the U.S. is also taken into account, a 10% real decline in Chinese exports to the U.S. may result in a decline of Chinese GDP of no more than 0.5%.

The Impact of the Economic Recession in the World on Chinese Exports

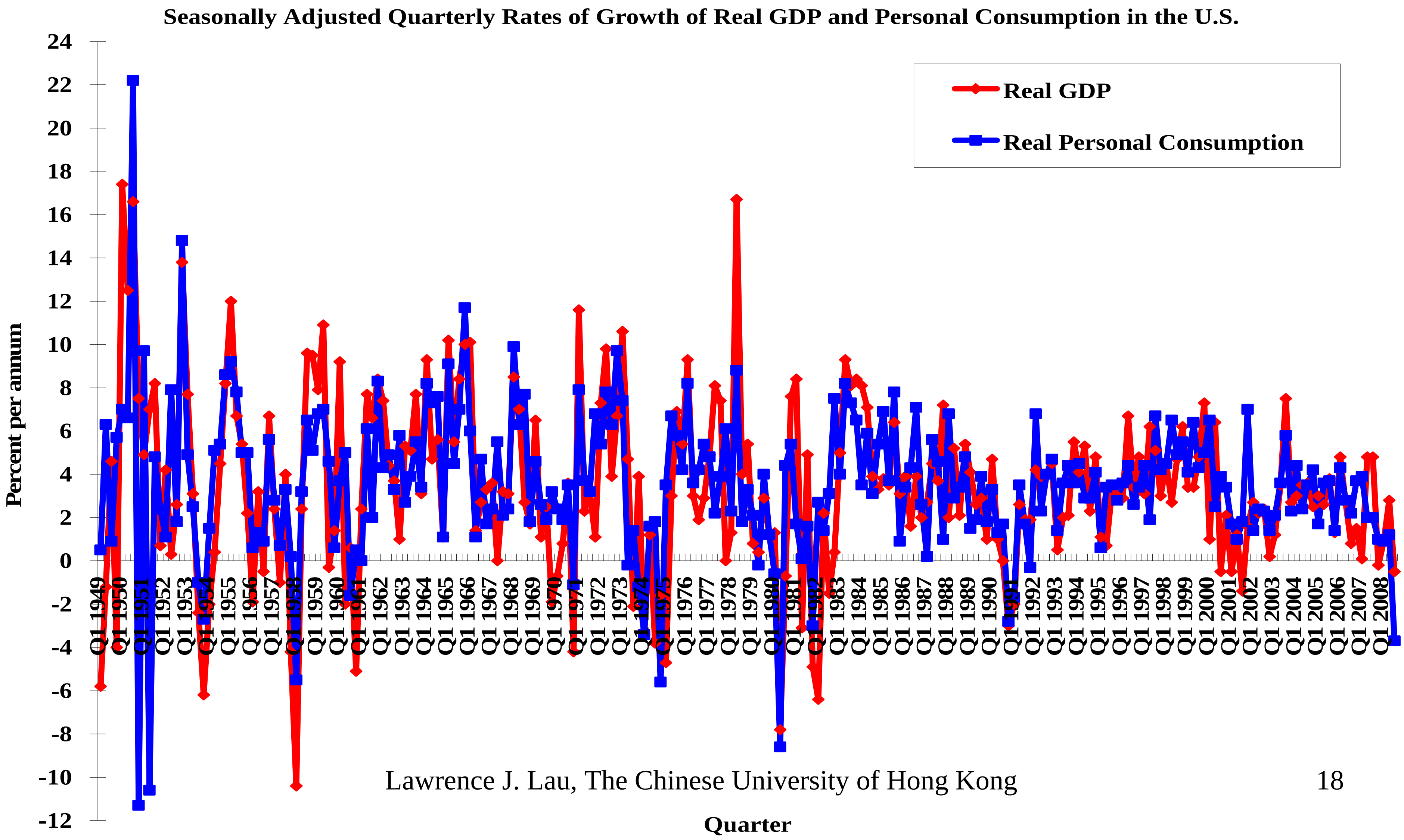
- Chinese exports to the World constitute approximately 35% of Chinese GDP; however, the direct domestic value added content of Chinese exports to the World. is also quite low, averaging 20.0%. Thus, the Chinese GDP originating from Chinese exports to the U.S. is only approximately 7% (35% times 20% = 7.0%).
- 7.0% of GDP is quite significant (almost one whole year's real economic growth) and will result in hardships if completely lost. However, even if Chinese exports to the World. falls by 10% (which is considered unlikely), it will cause Chinese GDP to fall by only 0.7%, which is tolerable, especially if the remaining 93% of the Chinese economy continues to grow. If the indirect domestic value added of Chinese exports to the World is also taken into account, a 10% decline in Chinese exports may result in a decline of Chinese GDP of no more than 1.5%.

Taking Care of Workers Affected by the Fall in Exports

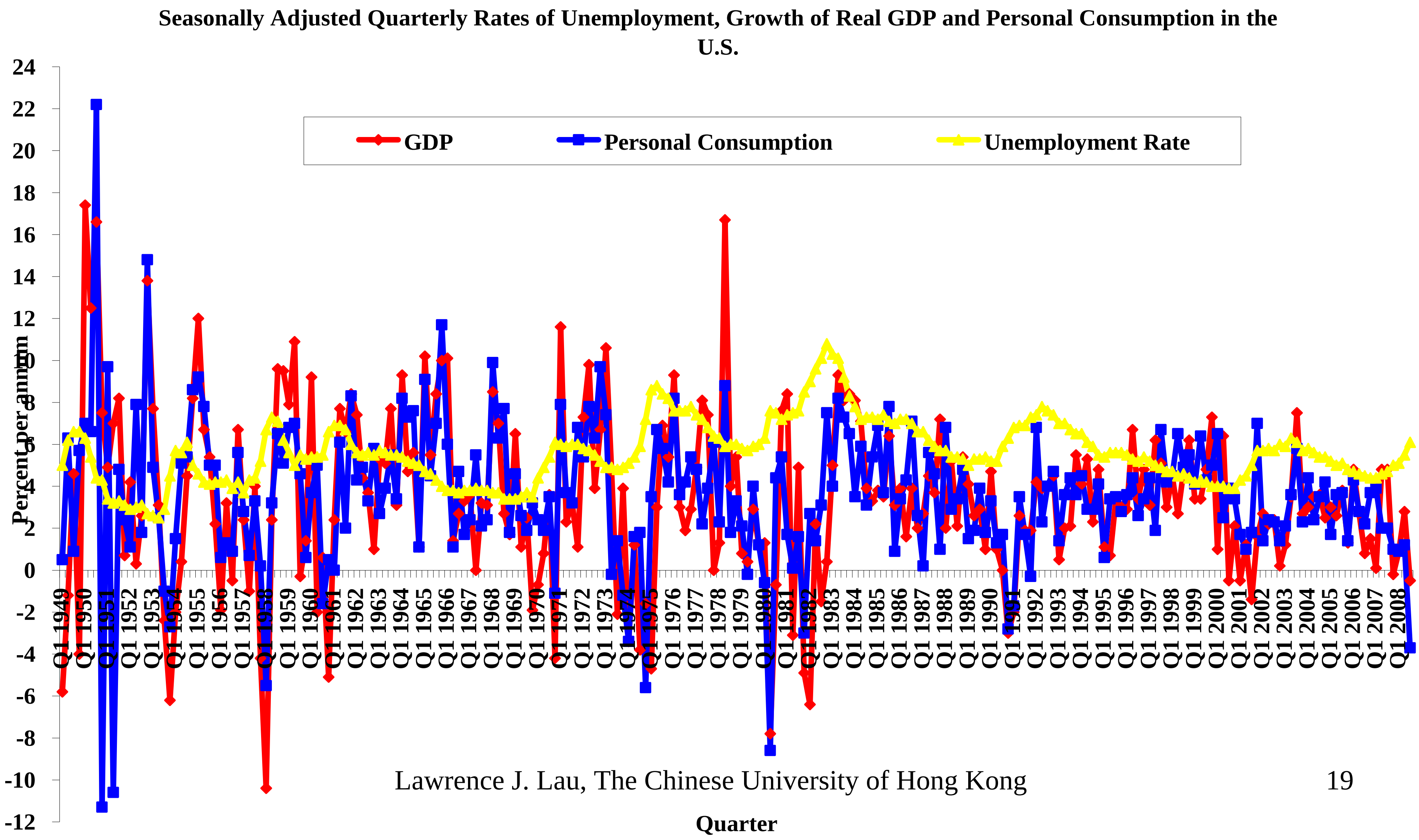
- However, the impact of a decline in Chinese exports, or a decline in the rate of growth of Chinese exports, may be quite severe on certain localities where most of the economy is dependent on exports, e.g., the cities of Dongguan and Shenzhen in the Province of Guangdong, and Suzhou in the Province of Jiangsu, and areas in the Province of Zhejiang. The values of exports in these localities are several times the values of the local GDP.
- Measures must be put in place in these localities to take care of expected lay-offs of workers as a result of the slowdown in export demand and to retrain them for employment in other industries or locations.
- It is not a viable long-term solution for the Chinese Government to try to support the export-oriented enterprises in these localities because the US$ is likely to devalue relative to the Yuan in the longer run and if the enterprises cannot survive now it will certainly not be able to survive in the future. It is far better to simply to provide subsistence support to the laid-off workers.

The Relative Stability of U.S. Real Consumption and Hence Chinese Exports

Seasonally Adjusted Quarterly Real Rates of Growth of U.S. GDP and Consumption



U.S. GDP, Consumption and Unemployment



The Impact of the Economic Recession in the World on Chinese Exports

- The decline in export orders received by Chinese exporters of almost 50% year-over-year since September took almost everyone by surprise. It is true that export orders have been expected to decline and have been declining, but not to this order of magnitude.
- Why was there such a large, precipitous decline? This was principally caused by the importers in the U.S. and elsewhere having their access to bank credit frozen. Importers cannot get their bankers to issue letters of credit to the Chinese exporters, or if they can, these letters of credit may not be accepted by the Chinese commercial banks. For those importers with impeccable reputation whose orders would be accepted by Chinese exporters even without a letter of credit, such as Hewlett-Packard, Nike and Wal-Mart, the problem is with the ability to finance their inventory with bank loans from their U.S. banks. As the availability of such credit dwindles, they also reduce their orders and wait until the inventory is exhausted. The net result is a huge reduction in orders for Chinese exports.

The Impact of the Economic Recession in the World on Chinese Exports

- It is, however, important to realize that this is not the result of a reduction in the expected demand for Chinese exports of this magnitude, but the result of the credit freeze in the U.S. It is also not the result of Chinese exports being too expensive, and thus a devaluation of the Renminbi and/or an increase in the proportion of Value-Added-Tax (VAT) rebate on exports are also not likely to be effective.
- According to the historical experience of the U.S. economy, real personal consumption is a much smoother series than real GDP or real personal income. Since 1949, the worse quarterly decline (at annualized rates) of personal consumption was 12% and since 1952 was less than 10%.
- Imports of consumption goods would therefore be expected to decline with personal consumption, but probably no more than double the rates of decline of real personal consumption. For Chinese exports, which consists of mostly daily consumption goods targeted at the low-price market, the effect should be much smaller, as consumers switch from high-price to low-price items in an economic downturn.

The Impact of the Economic Recession in the World on Chinese Exports

- So the expectation is that the export orders would bounce back in a quarter or two, and that this decline in export orders is only temporary and basically represents a delay or postponement of the demand by a quarter or two for Chinese exports, as opposed to a permanent reduction. Thus, the decline in Chinese exports, when averaged over a whole year, should not exceed 20%. In terms of GDP, the impact should be a reduction on the order of 1.5%, a significant but still tolerable amount.

The Impact of the Economic Recession in the World on Chinese Exports

- The Chinese Government can however shorten the delay or postponement of demand by allowing the Chinese commercial banks to finance the exports of long-term seasoned exporters to their long-term customers so that they can ship their goods on a consignment basis and allow payment terms of 6 months after receiving the goods. This will allow Chinese export enterprises to continue their production with minimal interruption and layoffs of workers. To make this happen, the Chinese Government may need to guarantee these loans in whole or in part, possibly through the Export-Import Bank of China—otherwise the Chinese commercial banks may not be willing to extend such credit to the Chinese exporters.

What Can and Should China Do?

The Impact of the Economic Recession in the World

- With the slowdown and recession in the U.S. and in Western Europe, China must rely on its own resources to stimulate its internal demand. It can also provide support for other East Asian economies by maintaining or expanding its imports from these economies. De-coupling of the Chinese and East Asian economies from the United States economy is real and can be made even more significant through appropriate policies.
- The Chinese Government has just announced a major economic stimulus plan of 4 trillion Yuan (US$586 billion), a little less than 20% of Chinese GDP, to be spread over the next two years.
- China can provide help to the U.S. and speed up its recovery by increasing its imports from the U.S. (including agricultural commodities), by financing U.S. non-financial corporations during its current credit crunch (through direct loans or the purchase of their commercial papers and notes), and by systematic purchases of blue-chip U.S. stocks through its investment and pension funds both to benefit itself as well as to provide support for the U.S. stock market as a means of bolstering the global financial markets.

The Chinese Economy
The Macroeconomic Situation

- The Chinese economy has begun to slow, from over 11% real growth to the 8-9% range. However, there is reason to believe that the more recent real rates of growth have been somewhat over-estimated because of the difficulties in separating the real value added (which is part of GDP) from pure appreciation of land value (which is not part of GDP) in real estate development.
- Exports are likely to continue to slow because of the economic recession in the U.S. and the possible slowdown elsewhere in the World and because of other factors such as the revaluation of the Renminbi, the intensified enforcement of environmental regulations, the unification of the tax rates for domestic and foreign-invested enterprises which raises the taxes on foreign-invested enterprises, and the implementation of the new labor law, which preceded and were independent of the global financial crisis.

What Should China Do?

- Increasing Internal Demand—It is most important and urgent to increase internal demand as quickly as possible, through accelerating the reconstruction of the earthquake-affected areas and new public infrastructural investment projects.
- Smoothing International Trade
- Maintaining Price Stability
- Safeguarding Financial Markets
  - Lessons from the Financial Crisis in the United States
- The Exchange Rate and Convertibility of the Renminbi
  - Towards Convertibility of the Renminbi

Increasing Internal Demand

- Reconstruction of the Earthquake-Damaged Areas
- Promotion of Affordable Owner-Occupied Housing
  - Making owner-occupied residential housing affordable to all Chinese citizens with a steady job through the introduction of long-term (say 35 years) and fixed interest-rate mortgage loans
  - Establishment of Chinese versions of Fannie Mae and Freddie Mac
  - Securitization of long-term, fixed-rate owner-occupied residential mortgage loans to eliminate the risk of maturity mis-match between the assets and liabilities of mortgage lenders.
  - Housing demand creates derivate demands on building materials, large appliances, furniture, curtains and drapes, carpets, etc.
- Investment in Infrastructure
  - Building new cities and mass-transit systems as well as other public infrastructural
- Cleaning up the Environment and Keeping it Clean
- Investment in Education and Health Care
  - Building and re-building schools and hospitals

Smoothing International Trade

- The Chinese Government can encourage the Chinese commercial banks to finance the exports of long-term seasoned Chinese exporters to their long-term customers in the U.S. and elsewhere so that they can ship their goods as usual but on a consignment basis, allowing payment terms of up to 6 months. This will allow Chinese exports to continue more or less uninterrupted.
- Similarly, Chinese commercial banks can also finance Chinese importers so that they can continue to import from the U.S. and elsewhere even though export credit has tried up in the U.S. and other countries.

What Can Hong Kong Do?

What Can Hong Kong Do?

- Maintaining Internal Demand and Employment
  - It is most important and urgent to maintain internal demand and employment, for example, through accelerating the construction of public works projects.
  - The Government can consider providing unemployment benefits sufficient for subsistence to those workers who become newly unemployed.
  - The Government can encourage large employers to consider alternatives to lay-offs such as reduction of work hours coupled with a corresponding reduction of pay during this difficult period. This is a method tried in many U.S. employers to retain the labour force in an economic downturn. Everyone can come out ahead.
  - The Government can also encourage the hiring of new entrants into the labour force on a trial basis, e.g., new graduates from universities and high schools, by sharing the cost of employment for the first full year (with the employers being reimbursed at the end of the first year).

What Can Hong Kong Do?

- Maintaining Internal Demand and Employment
  - The Government can promote longer-term owner-occupied residential mortgage loans to enable the average citizen to purchase their own homes or to reduce their monthly payments through refinancing—by lengthening the maturity of such loans to say 35 years to 15 years, the monthly payments can be reduced by more than 50%, releasing purchasing power for either new homes or current consumption. (Such government-supported long-term mortgages will be subject to various ceiling restrictions as to cost and size—the objective is to help the average household in Hong Kong.)
  - Long-term mortgage loans can also be considered for owner-used premises for small and medium enterprises to enhance their long-term economic viability and sustainability and to insulate them to some extent from the volatility of commercial rents in Hong Kong.

What Can Hong Kong Do?

- Sustaining External Demand
  - Hong Kong should request the extension of the “individual visit scheme” (個人遊) to include Mainland citizens from more provinces and cities to replace the lost travellers from North America and Europe and from the now economically depressed areas in Guangdong, Shanghai, Jiangsu and Zhejiang.
  - The Government can consider the facilitation of visitors from Taiwan by granting them the privilege of “instant visa” (落地簽證) which Hong Kong citizens already enjoy going to Taiwan. This should also be helpful to Cathay Pacific Airways and Dragonair as cross-strait air traffic becomes increasingly direct.

What Can Hong Kong Do?

- Sustaining External Demand
  - The Government can also consider the facilitation of visitors from Shenzhen by granting the residents there with proper household registration (戶口) the privilege of visiting Hong Kong on demand through an identification card system (e.g. "Hong Kong visit card" (訪港證)) similar to the "home return card" (回鄉證). The number of Shenzhen citizens who can qualify is a little over 2 million, our of a total permanent population estimated to be over 8 million and a total population, including floating population, that has been estimated to be as high as 17 million. With a per capita GDP approaching U.S.$10,000 for this group of residents, their visits to Hong Kong should be helpful to the tourism-related and retail and service businesses in Hong Kong.

What Can Hong Kong Do?

- Sustaining External Demand
  - The Government can consider helping long-term exporters to finance their exports to long-term customers in the U.S. and elsewhere who are unable to issue letters of credit or carry their inventories because of the credit freeze in North America and Europe. This can take the form of export loan guarantees so that the Hong Kong exporters can ship their goods in part on consignment to their overseas customers and wait to receive payments in up to six months.

Concluding Remarks

- If the Chinese economy continues to grow in the 8% range in the next couple of years, the Hong Kong economy will 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 survive the financial earthquake relatively unscathed.