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## The Fraying US-China Co-Dependency

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### Summary

After many years of extraordinary growth, China has clearly been adversely affected by the global economic recession. Its own economy is slowing rapidly, with declines in exports, property prices, and fixed investment. In response, the Chinese government, strongly motivated to maintain stability, is injecting large doses of fiscal stimulus and making other administrative efforts to revive economic activity. These efforts, combined with the country's strong balance sheet, make it likely that China will be among the first to rebound when the global economy finally begins to recover. In the interim, however, China's exports will decelerate. Growth in its current account surpluses and accumulated foreign exchange reserves are likely to slow very sharply. This deceleration in Chinese capital exports may represent the end of the "global savings glut" at precisely the time of highest US dependency on these global savings – that is, as US government dissavings (deficit spending) is forced to rise most substantially. In the meantime, with less foreign capital available to support US economic activity, personal savings in the US will need to rise sharply, probably steepening and/or lengthening the US economic downturn.

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*This paper reflects the views and opinions of the author, not necessarily those of Standish, BNY Mellon, or any of its employees.*

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## PART I: CHINA'S ECONOMIC DILEMMAS

### Near-Term Economic Developments

The global economic slowdown has clearly reached China, and there is broad statistical as well as anecdotal evidence of a sharp deceleration in economic activity. Reported GDP growth has slowed from 11% to 9% (still remarkable); exports, which have contributed about 3 percentage points to GDP growth, are slowing rapidly; real estate prices are falling sharply in some areas (property investment had previously added almost 2 percentage points to GDP growth); fixed investment (perhaps 30% of GDP) will be declining as output slackens; and there are many reports of corporate bankruptcies and of business owners simply walking away from their operations and leaving employees stranded. Finally, the recent 70% decline in Chinese stock prices will have a substantial negative wealth effect.\*

There are some important offsets to this dour picture. Because China is also a large importer of goods which it then processes or assembles, the value added from foreign trade may be as low as 15% of GDP. In other words, China is still largely a domestic economy. Thus, as exports from China to the rest of the world decline, that decrease will backup to suppliers of components or raw materials elsewhere in Asia (e.g. Australia), adversely affecting countries other than China. In addition, as a large oil importer, China will benefit from the drop in oil prices. The Chinese government, always concerned with stability and self-preservation, is reacting vigorously. Monetary policy, previously tight, has been eased. Banks have been directed to lend with easier terms. The prior program of managing gradual RMB appreciation relative to the dollar has evidently been halted. Also, export tax rebates have been increased; the legal ability of Chinese to transfer land (through partial privatization) has been expanded; and the government has announced a large dose of fiscal stimulus.

The reported cost of the stimulus package is RMB 4 trillion (approximately \$600 billion) over two years. This represents about 7% of GDP per year, a materially larger fiscal spur than has been applied in the U.S to date. However, the magnitude of the Chinese program is probably overstated. The central government will issue "megabonds" of about RMB 500 billion each year (about 2% of GDP), and the balance of the stimulus will come through provincial and local investments, as well as from a requirement that banks invest in incremental projects. While these latter initiatives may not be direct, it is fair to assume that provincial governments and state banks are materially more responsive to central government direction in China than is the case in most developed countries. Chinese economists told me that, while the main focus of the program will be to spur investment, especially in infrastructure, the package will also encourage consumer spending, which accounts for about 40% of GDP.

While the government has made considerable efforts to improve the accuracy of economic statistics, China remains a very large country where many transactions are simply difficult to track and tally. There is also evidence that past government reports of GDP growth had been smoothed and perhaps overstated. The official line, also embraced by many private economic forecasters, is that growth will slow to perhaps 8%, with a weak first half of 2009 and a recovery in the second half.

\* The data cited in this paper represent averages and educated approximations of numbers derived from a variety of public and private sources – Datastream, Bloomberg, Chinese economists, private and central bankers, etc. The author employs these approximations here for purposes of illustration only, and for ease of reading, rather than in any attempt at quantitative precision. Please see additional disclosures on the last page.

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This forecast strikes me as materially too optimistic. While China's recent economic growth may provide reassurance, I have heard many reports of sharp declines (not just decelerations) in exports and in property prices, including drops in major cities of 30% to 50%. There are also rumors of substantial problems in collecting receivables, a significant drop in electricity and steel production, a reduction in the availability of credit, and a rise in unemployment. For several years now, I have argued that China's economy is increasingly exposed to the global business cycle, given its dependence on exports and capital investment. My worries had proven premature until recently, but the moment now appears to have arrived when China is caught in broad cyclical decline. We will probably never learn the true extent of deterioration in GDP, but China has clearly hit a huge speed bump amid the global unraveling of economic growth.

When the global economy does finally start to mend, however, China will likely be one of the first countries to recover. A major cause of the world economic turmoil is balance sheet problems resulting from excessive leverage and burst bubbles. In contrast to many developed countries, China's balance sheet remains relatively strong. The government budget is currently in rough balance and, even with its fiscal stimulus program, will still be in deficit by only perhaps 3% of GDP. Foreign exchange reserves are \$1.9 trillion, household and corporate deposits in the banking system are about \$5 trillion, bank mortgage financing has typically been at only 70% loan-to-value ratios, external debt is quite small, and the personal savings rate (admittedly overstated) is still thought to be somewhere around 40%. Furthermore, particularly for domestic assets, Chinese banks will not suffer the same mark-to-market problems that we observe in the US. Accordingly, when the global economy finally rebounds – whenever that is – China and the economically related countries of East Asia will be among the first to recover.

In the meantime, the Chinese current account surplus, foreign exchange accumulation, and capital outflow will slow dramatically. This has not happened yet. In fact, China's trade surplus in November alone was \$40 billion. The current account surplus has been running about \$300 billion per year. However, four adverse developments are now occurring:

- The central government budget will be moving from rough budget balance to a deficit of 3% of GDP, equivalent to about a \$100 billion swing. In effect, China is refocusing on domestic investment (as opposed to buying US bonds!).
- Foreign direct investment of about \$100 billion per year in China will drop off sharply. Given the decline in output, China has significant excess capacity, and less need for capacity-expanding investment.
- China's trade balance will deteriorate as the rest of the world will be unable or unwilling to accept huge imports from China. The risk of trade protectionism by China's trading partners rises as global economies suffer.
- Lastly, China's foreign exchange reserves have been increasing materially faster than the mere combination of current account surpluses and foreign direct investment. The reason is speculative inflows, prompted in part by expectation of RMB appreciation. Now that government policy has evidently halted such currency appreciation and Chinese asset markets (especially stocks and property) are weak, these speculative inflows will stall. There is evidence of this already.

One of the surprises of 2009 will be the dramatic slowing in Chinese foreign exchange reserve accumulation and thus in capital supplies from China to the rest of the world. These balances may remain positive, but will probably be much smaller than most expect. Furthermore, Chinese policy to date has been based on a goal of managed stability rather than on any desire for high investment return. Chinese investments in US Treasuries, federal agency bonds, and other high-quality US bonds have provided decidedly poor investment returns to this point; and with US Treasuries now yielding less than 3%, such investments will likely provide similarly poor investment returns in the future – especially compared to Chinese priorities for internal investment. In short, it seems likely that China will now decide to invest the bulk of its incremental reserves at home.

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Both the public statements of Chinese leaders and the private statements of bankers with whom I met make it clear that China's first economic priority is stabilizing its own domestic economy. In fact, they argue that their greatest contribution to global economic growth would be the restoration of China's own domestic growth, not committing to some global financial rescue effort. In other words, the rest of the world should have low expectations for China's participation in any multilateral plan. As one prominent Chinese banker put it, "China's objective will be to keep its head down."

### Long-Term Economic Prospects

I am a China optimist. I believe that the exceptionally high Chinese economic growth of the last thirty years is one of the most extraordinary success stories in world history. Many of the ingredients of that success remain in place today:

- the transition to an open economy at a time when the world was receptive to lower-cost Chinese goods
- a huge pool of low-cost rural labor that migrated to much more productive urban and industrial jobs
- the mobilization of enormous capital from high domestic savings as well as from foreign cash inflows
- a very entrepreneurial culture
- generally excellent government policy and leadership

However, China also faces enormous challenges beyond the cyclical economic downturn currently in process. These challenges include:

**Demographic Change:** China's population is aging. In the next few years, the growth in working-age Chinese will slow from 10-15 million people per year to approximately 3 million per year. In about ten years, these numbers will actually begin to decline. During the next thirty years, China will face a shortfall in labor inputs as well as a tripling of the population over age 60, which will amount to some 400 million people! The government is increasingly aggressive in establishing a pension system as well as broader access to health care; however, the costs and problems of addressing the needs of a rapidly aging population will be enormous.

**Resource Constraints:** China's domestic resources are relatively small compared to its huge population. On a per capita basis, critical minerals in China are 50% below the world's average, arable land 60% below average, and water 75% below average. The country is heavily dependent on imported oil and will likely become increasingly dependent on imported food. If China's growth proceeds at the pace of its recent past, the strain on both Chinese and world resources will be unsustainable. To cite one well-known example: Urban auto congestion and exhaust pollution are already horrendous, with only roughly three cars per hundred people. What happens if the Chinese aspire to and attain the US standard of almost 100 cars per hundred people?

**Environmental Problems:** China is an environmental catastrophe. The best-known problem is air pollution: each year an estimated 400,000 to 700,000 Chinese die prematurely because of terrible air quality. While the current economic decline will slow electric output and emissions at least temporarily, the government had planned to construct one to two new large coal-burning electricity-generating plants *per week* over the next five years. Water is probably an even greater constraint on growth – due to heavy contamination, rapid depletion of supplies (especially in dry northern China), and shrinking aquifers.

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**Social Dislocation:** Despite China's general prosperity and government efforts at amelioration, there remain huge disparities between the relatively wealthy residents of urbanized eastern China and the relatively poor residents of rural western China. Each year sees large numbers of local protests (as many as 87,000 incidents in 2005), usually against local landowners, over unaddressed pollution sources, or more recently, company owners who have simply walked away from factories slowed by the global economic decline. Cultural changes have been vast, and they will continue to be. Plans call for moving 300 million to 400 million Chinese from rural to urban China over the next few decades. The country is quite literally in a state of flux. Government intends to address the resulting disparities, but these huge internal migrations, massive underemployment, and a developing super-wealthy class in the midst of a generally poor population make these intractable and potentially contentious problems.

**Political Calcification:** Generally, China has exercised excellent governance. I remain impressed by the dedication and technical skills of Chinese government officials whom I meet. However, there exists a rising tension between the relatively elderly centralized bureaucracy and a younger, increasingly entrepreneurial class dispersed over a huge country. There is also tension between the central government in Beijing and provincial and local officials who often march to their own drummers. Unfortunately, the lubricant between heavy bureaucracy and free-wheeling economic activity is often corruption, which is rampant in China. Both internal political tensions and graft may be exacerbated by the weak economy.

**Immature Capital Markets:** In China, the rule of law is weak: it is often hard to enforce contracts, and the concept of pricing risk appropriately is not yet pervasive. The government is working hard to address these matters and has had some modest success. However, the financial markets remain heavily dominated by a relatively small number of banks, some of which have historically had significant problems in managing risk themselves. Access to credit for small and medium-sized businesses is still difficult. China remains in the early stages of the natural transition from managing the economy by administrative actions to allowing the invisible hand of market forces to work its magic. (Interestingly, the requirement that China administer its economy could confer a temporary advantage over many developed countries, where generalized market failure has exacerbated economic decline and may slow recovery.) In any case, China's financial infrastructure is growing gradually stronger but still remains relatively weak.

The preceding list represents a daunting set of challenges. The good news is that the government is fully aware of these problems and striving mightily to address each of them. Also, not all challenges are equal in terms of their severity or the timing of their effects on either Chinese or global growth. The risks presented by immature capital markets, for example, are severe but not immediate, and could even prove advantageous in the near term, as noted above. Likewise, weaker economic activity during the current slowdown will temporarily ease both natural resource constraints and environmental problems, although the latter remain horrendous. Likewise, demographic change is a long-term rather than a near-term phenomenon and can be addressed gradually and in due course. This leaves what I believe to be the two major near-term challenges facing China: social inequalities and political calcification. These will be exacerbated by the reality that the Chinese economy will no longer be growing at over 8% per year. China will not be creating the estimated 20 million new jobs per year necessary to absorb its burgeoning workforce. The country will be unable to prevent an unsettling rise in under- and unemployment, and an entrenched central government will need to deal with any resulting social unrest.

Again, China will recover relatively early from the current world economic malaise; it will then again, for a while at least, sustain very high economic growth rates. However, the challenges facing China are sufficiently daunting that perpetual growth of 10-11% is impossible. No nation can sustain such growth forever. My best guess is that China has a window of perhaps another ten years before growth slows markedly, and probably permanently. At this point, the challenges represented by changing demographics, resource constraints, and environmental problems will prove to be massive, even insurmountable, headwinds – which will only intensify with any further political calcification in Beijing.

## PART II: US AND GLOBAL CAPITAL FLOWS

### The Savings and Investment Imbalance

By economic definition, savings equals investment – at least on a global scale. Individual countries can run an excess of savings or investment, balanced by capital flows to or from other countries. While some short-term statistical discrepancies occur (for example, the world on balance reports a net capital surplus of \$300 billion), the equation of savings and investment must hold true over both shorter and longer periods. By far the most pronounced abnormality of recent years is that the US, a famously low-savings-rate country, has been importing about \$700-800 billion per year from capital-exporting countries – including particularly China, other countries in East Asia, and nations that are large oil producers.

The US trade deficit with China has been averaging about \$200-300 billion per year. China, with foreign exchange reserve accumulation of about \$300 billion per year, is believed to have allocated approximately two-thirds of its FX reserves to dollar-denominated investments, including large amounts of US Treasuries and US federal agency paper. To date, Chinese investments in US equities have been relatively small (e.g. Blackstone, Morgan Stanley, etc.), and the US objection to China's proposed acquisition of Unocal still rankles the Chinese.

As noted earlier, China's huge current account surplus, its accumulation of foreign exchange reserves, and its heavy purchases of foreign financial assets are all likely to diminish very sharply in this and over the next few years. Also, while there currently is no real East Asian economic "bloc," other countries in East Asia trade increasingly with China, are evermore sensitive to Chinese economic policies and foreign exchange rates, and have been accumulating large foreign exchange reserves and US debt right alongside the Chinese. These countries are now also suffering their own economic and financial woes in the midst of the current global slowdown. Japan is now officially in recession, with rapidly declining exports and trade surpluses; South Korea is experiencing serious financial turmoil; even high-growth Vietnam has hit some speed bumps recently. In this environment, the appetite from East Asia for financing economic growth in the rest of the world – especially in the US – is expected to diminish markedly.

Other sources of global capital supply are also undergoing substantial changes, and in the same general direction. In a study entitled "The New Power Brokers: Gaining Clout in Turbulent Markets," the McKinsey Global Institute estimated that, in 2007, capital power was concentrated in the hands of four major asset groups:

- 1) petrodollar foreign assets totaling approximately \$5 trillion,
- 2) Asian central banks and related sovereign wealth funds, also with assets of around \$5 trillion,
- 3) hedge funds with about \$2 trillion, and
- 4) private equity funds with \$1 trillion.

If one grosses up the hedge funds and private equity funds to account for their leverage in the years leading up to the 2007-08 credit crisis, each of these four "power brokers" probably controlled some \$4 to \$5 trillion of assets with which to stimulate US and global growth.

But that was then and this is now. With the price of oil having fallen from \$150 to below \$50 dollars per barrel, petrodollar reflow is declining rapidly. Likewise, hedge funds and private equity funds that had leveraged up earlier in the decade are now scrambling to deleverage in the largest margin call in capital market history. The result is that East Asian countries are now the single largest provider of global cross-border capital and constitute an even larger portion of total global capital flows. But East Asian capital flows will now be shrinking as well.

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Fed Chairman Bernanke and others have attributed the low interest rates and strong growth of the past decade largely to the “global savings glut” engendered by conditions of global trade involving East Asian countries. To the extent that the Chairman’s analysis is correct, things are clearly about to change. The global savings surfeit could easily move toward shortage, and investment capital could become much scarcer. This shift has serious implications – not only longer-term and theoretical ones for US security prices, the dollar, and interest rates, but also near-term and very real implications for US economic growth.

### International Capital Flows to Finance the US Economy

The US has been running a current account deficit of between \$700 and \$800 billion per year, by far the largest portion of which is our international trade deficit. Financing our current account deficit creates liabilities in US dollars, which have reflowed to the US and helped to finance our economic growth. In fact, because our gross domestic investment has exceeded our gross domestic savings, we have required this foreign cash inflow in order to finance recent levels of domestic economic activity.

A sharp drop in the US current account deficit will alter this pattern and reduce foreign cash inflows. A steep US recession and reduced consumer spending has already dampened Americans’ appetite for imports. In addition to non-oil goods like automobiles and electronics, the US currently imports roughly four billion barrels of oil per year. Calculating the economic impact of recent oil price declines is both difficult and important. Given oil price volatility, using recent daily highs and lows would exaggerate the impact of any decline. However, even using a smoothed average of \$120-130 per barrel at the high to \$40-50 for the low leads to the conclusion that oil imports will fall from roughly \$500 billion to around \$200 billion per year. This is a decline of some \$300 billion, even before considering any likely reduction in demand resulting from the US recession. In short, the combination of oil price declines and declines in other imports stands to shrink the US current account deficit by more than half – from roughly \$700-800 billion per year to a much more sustainable \$300-400 billion. This reduction in foreign inflows is a reduction in the external capital available to finance US economic growth.

### Domestic Capital Flows – Government Deficits

In addition to declines in international capital inflows, major changes are occurring within the US as well, particularly in the growth of government budget deficits. Government deficits may require some explanation here. I have chosen to ignore state and local governments, whose deficits, however painful and problematic, remain small in comparison to the federal deficit. The federal budget deficit, thanks in part to tax law revisions and two wars begun a few years back, has ballooned in recent years to a reported \$400 billion annually. It now stands to swell yet again, as virtually all of Washington agrees that a large fiscal stimulus package will be required to rescue the US economy from its current credit-crisis-induced freefall. Conservatives may want to limit the package to around \$150 billion, but the incoming administration has mentioned numbers closer to \$800 billion. An early 2009 package of at least \$600 billion seems highly likely, making it equally likely that the US federal budget deficit will surpass \$1 trillion this year, and perhaps again in 2010.

The financing needs of the federal government can be grouped into three broad categories based on the immediacy of the requirement for cash:

- 1) “Operating cash deficit” is the most near-term, narrowest, and most traditionally accepted definition of the annual budget deficit. As noted, this number stands to rise from the current \$400 billion to roughly \$1 trillion, as a result of both falling tax receipts in recession and stimulus programs designed to shorten and shallow that recession.

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- 2) “Financial activities” describe the temporary ballooning of the Federal Reserve’s balance sheet as a result of its investments in entities like AIG, Fannie Mae, and Freddie Mac. These latter clearly involve federal borrowing, but the cash appears on the balance sheets of the rescued enterprises, not on the Fed’s.
- 3) Finally, “out-year liabilities” represent the government’s longest-term obligations to programs like Social Security, Medicare, and Medicaid; they also include any potential losses incurred through the government’s bailout of troubled enterprises. These liabilities may be very large, but they are also very long-term and require no current cash.

Given these time-based distinctions, it seems appropriate to include only “operating cash deficit” in calculating the adjustments required to restore the fundamental economic balance between savings and investment.

### Implications for the Domestic Private Sector

If foreign cash flows into the US decline by some \$400 billion, and if the US federal budget deficit rises by some \$600 billion, then by definition, the private sector balance must increase by approximately \$1 trillion – if we are to maintain the essential equilibrium between savings and investment. This increase in private sector balance can be achieved in either or both of two ways: by a decrease in private investment or by an increase in private savings.

The private sector includes both businesses and households; and domestic investment consists of both capital spending, mostly by businesses, and residential investment by households. In the past two years, residential investment has fallen by some 60% to 70%; it may decline somewhat further, although the majority of the decline, by definition, is already behind us. Corporate capital spending has also been curtailed, which is unfortunate since such spending is a source of future productivity growth. And corporate profits have also fallen. In short, we are unlikely to see any additional net capital generation from the corporate sector in the near term. Moreover, the corporate sector is already in rough financial balance. It is also proportionally much smaller than either the government or household sectors. Consumer spending, in fact, exceeds business capital spending by a ratio of almost seven to one.

This leaves higher household savings as the primary means of restoring the balance between savings and investment. For most of the past decade, or since Americans began treating their homes as both their primary savings and their principal investment, the personal savings rate in the US has fallen effectively to zero. It will now need to rise sharply, probably into the high single digits, in order to compensate for the twin deficits rising on the other side of the US ledger. In a report issued November 2008, Goldman Sachs predicted that the swing in the US private sector balance, between the second quarter of 2008 and the fourth quarter of 2009, would be equivalent to about 9% of US GDP.

Personal savings are the net of the accumulation of financial assets less the increase in financial liabilities. One way to increase personal savings is to reduce the growth of liabilities. This process has already begun, of course, and is occurring rapidly as a consequence of the current credit crunch. More and more households are classified as uncreditworthy, and even the most creditworthy grow increasingly afraid to borrow from institutions that are themselves growing more risk averse and/or lack the capital to lend.

The transition from a personal savings rate of zero to one near ten percent will require a substantial adjustment by Americans, not only financially but culturally as well. And this transition will need to occur relatively quickly. To be sure, certain factors will help to ease the adjustment for US households. A sharp deceleration in the rate of inflation, including the recent plunge in oil prices, will leave consumers with somewhat more money that they can decide to spend or save. The new federal stimulus package will also help, although any economic recovery program will be frontloaded to foster consumption, and policymakers will be disappointed to the extent that government windfalls

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are saved and not spent. Finally, the Federal Reserve's aggressive effort to cut mortgage rates may well facilitate refinancing, reduce monthly interest expense, and leave households with somewhat more discretionary income. These mitigating factors will no doubt cushion the transition for American households. At the end of the day, however, the fact remains that the private sector balance must increase by a remarkable \$1 trillion – and a rise in the personal savings rate seems almost the only way for this to happen.

The recent US dependence on external capital is an historical aberration; internal financing and US self-sufficiency have been much more the norm and general rule. Furthermore, large government deficits, once created, tend to be sticky and often take years to work off. These factors suggest that current US problems may persist for some time, and that our transition will cause more pain rather than less.

In any case, the spending binge by US consumers is clearly over, and this is a good thing. Besides possessing a certain inevitability, the US transition back toward saving will bestow obvious long-term benefits – stronger balance sheets, greater self-sufficiency, improved ability to fund retirements and deal with adversity, perhaps even greater national security. In the near term, however, the rise in US personal savings required to replace declining foreign capital increases the risk of compounding US problems, prolonging the recession, even threatening the eventual economic recovery. Ending our addiction to foreign cash flows, the bulk of them from China, could now deepen the US downturn and delay our eventual return to economic health.

### CONCLUSION

The US consumer borrowed heavily, facilitated by China and other capital exporters, in order to finance a decade-long spending spree, one that included substantial purchases of Chinese goods. The Chinese reinvested the proceeds in ultra-safe US government bonds, which kept US interest rates low and liquidity high, and thus facilitated further US borrowing and buying of Chinese goods. This self-perpetuating loop – something of an oversimplification, to be sure – describes fairly accurately the relationship that has existed for more than a decade between the US and China. It was a relationship of co-dependency that benefited both countries mutually and that contributed substantially to the economic prosperity enjoyed by each. It was also, unfortunately, a co-dependency whose terms have now changed dramatically, and perhaps permanently, and more to the detriment of the US than to China.

The United States now finds itself an international debtor nation, one addicted to foreign cash flows at precisely the time when these flows are fast declining, and when the US could most use them. Many have thought it strange and illogical that a relatively poor and developing country like China should be financing a rich developed nation like the US. Such a relationship was unprecedented, after all. We also knew that US current account deficits of \$700-800 billion, the bulk of it with China, were both unacceptable and unsustainable over the long run. But we had hoped that this imbalance could somehow be wound down gradually and painlessly over some period of time. We do not appear to have this luxury now.

The US faces the dilemma of a weak balance sheet. History offers examples of debtor nations that have worked through their difficulties to emerge stronger and more self-reliant in the end. However, the process has almost always been painful. The transition from a savings rate of zero to one approaching ten percent will require a wrenching adjustment for most Americans, culturally as well as economically. Breaking our addiction is necessary and will prove salutary in the long run. We would just have preferred more time for withdrawal from the drug.

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### Edward Ladd, CFA

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