Troika Dialog

Chief Economist's View

Future Risks: Keep an Eye on China

Last weekend's summit of G20 finance ministers in South Korea delivered little of note. Unsurprisingly, the ministers were unable to agree on major issues, as countries face such differing conditions that the chances of finding universal, mutually acceptable solutions to the prevailing economic and financial problems are low. We have previously described the idea of introducing a universal tax on banking assets (aimed at raising 2-3 % of GDP in each country to tackle the ongoing fiscal problems, as proposed by the IMF and others) as unfair and unacceptable for developing and emerging economies, whose banking sectors are relatively small. Advanced economies' banking assets exceed GDP by several times, while in the emerging and developing countries the banking assets to GDP ratio is often below 100%, which implies that if the aim is indeed to raise 2-3% of GDP by taxing banks' assets, then banks in the advanced economies would be less affected than those in underbanked economies with low monetary penetration. If the aim is to introduce a universal tax on banking assets across countries, then collecting 0.2% or 0.5% of GDP in lowly monetized economies would have a marginal impact on revenues. Even Canada – whose budget deficit remains modest and whose banks exercised greater caution and opted not join the crowd playing the financial casino – have also opposed this idea.

No consensus was reached on whether to keep stimulating domestic demand or orchestrate a faster exit strategy. US Treasury Secretary Timothy Geithner insisted that US consumers will no longer be able to pull the global economy out of recession on their own, and he urged other major economies, such as Japan and Germany, to stimulate domestic consumption. The idea that major exporters should be encouraged to spend more domestically and export less to help eliminate the global economic imbalances has been debated for a while and was reiterated in the IMF's Global Economic Outlook in April. This is perhaps more of a theoretical exercise, as it would be hard to implement. Indeed, a stronger currency is what is usually needed to encourage domestic spending and imports. The Japanese yen has remained historically strong for quite a long time and is fluctuating below JPY100/$1, these days, staying closer to JPY90/$1, but little has changed in Japan: it keeps doing what it has got used to doing, namely exporting and saving. Japanese cultural traditions are based on unconditional respect for seniority. Younger people are therefore paid less, meaning that the average Japanese enjoys the peak of his annual income close to the age of 50 or even later. At this age, people tend to become more conservative and consumption habits become less extravagant: they are less inclined to buy big black oversized SUVs or sport cars, as younger people might do. They are also less willing to buy a new mobile phone with a greater number of features every year, and to benefit from the growing range of opportunities that producers can offer. Importantly, Japan lacks sufficient space for people to park and drive oversized Chevy Avalanches or Toyota Tundras, which are more popular in California and in the Midwest, where there are no tundra or snowy mountains but where fuel is much cheaper than in Japan.

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To change consumption habits in Japan right now would mean changing historical traditions overnight – hardly an achievable task. Counting on an expansion of lending looks equally ridiculous, as interest rates have stayed close to zero for more than a decade, the country's debt to GDP ratio is high, and people have on average more than satisfied their basic needs. Japan is a rapidly aging nation, and it is hard to convince Japanese pensioners that they should increase borrowing and start consuming more to help foster global growth, buying more American cars, for example (in addition Japan has one of the most efficient public transportation systems in the world).

Japan will most likely keep doing what it has become accustomed to, at least in the near term, while rescuing the global economy is an issue for the present. For this same reason, Germans will also keep doing what they do best – work efficiently, export high-quality machinery and save money – should there be anything left after Germany's huge current account has been redistributed through various channels across the nearly socialist Eurozone to countries such as Greece. Moreover, it would be hard to encourage more domestic spending in Germany and count on an increase in imports with the euro as weak as it is now. Meanwhile, the fact that the Eurozone's current account is almost balanced means that the Eurozone as a whole is not as much to blame for global economic imbalances as the US or China. The idea that the German government needs to continue stimulating domestic demand via the budget runs counter to the fundamental principle of the Maastricht Treaty, which sets out limits on budget deficits for member countries and is thus aimed at undermining the euro, or at least weakening it more, which would not serve to increase imports to either Germany or any other Eurozone country. The equivalent advice for the US would we, for example, to raise fuel tax, collect more revenues and reduce the deficit while bringing domestic fuel prices closer to those in Europe and Japan.

That said, Americans will also keep doing what they always do – keep buying cheap fuel, driving oversized cars and on average living far beyond their means (also at least in the near term). The fact that the US is likely to achieve 3-4% economic growth this year with a budget deficit of nearly 11% is a clear illustration of where the global imbalances originated from. Other countries are simply responding to signals they are getting from the US that demand is there and the country welcomes imports.

Overall, the global economic situation and recovery look quite unsustainable, and sooner or later even the US administration will be forced to reduce its efforts to artificially stimulate domestic demand; it is not just the financial bubble that needed to be deflated, but the consumption bubble as well. Once that happens, the structure of consumption and consumer habits will start to gradually change over time (although we are unlikely to see the other extreme of Americans driving Nissan Micras). Stimulating demand at this stage means preserving existing consumer habits and excessive production of goods that are not particularly useful. Needless to say, it becomes virtually impossible to do more to stimulate domestic demand when rates are nearly at zero and budget deficits are so big.

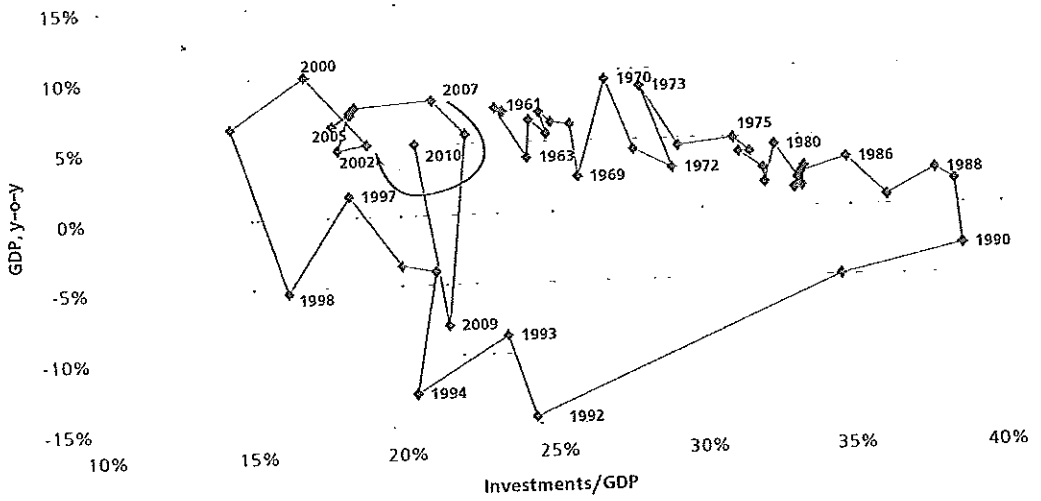
Should domestic demand in the advanced economies stagnate or grow at a much slower rate than before the 2008 crisis, then China will most likely be strongly affected. We cannot rule out negative surprises from the Chinese economy sooner rather than later. We have mentioned this issue in the past, and this note offers more color.

Last year and this year, the Chinese government has increased fiscal stimulus measures to compensate for shrinking global demand. Indeed, growth remained strong last year and will remain equally strong this year, but at a much higher cost – investment in China rose too much last year and will most likely disproportionally rise this year again, implying that the return on such investment is falling.

The chart below illustrates how the Russian economy operated over several decades (we also repeatedly broached this issue in the past). The investment to GDP ratio steadily rising amid growth that is not accelerating always points to long-term inefficiencies and imbalances (such as a lack of consumption). At some point, once it becomes clear that the country is investing too much and too inefficiently, an adjustment becomes inevitable – we can call this a full scale economic crisis, an example of which occurred in Russia in the 1990s. Inefficient and wrong investments collapse and

the system reemerges on a different institutional basis. From a macroeconomic viewpoint, the system tries to find a better balance between domestic consumption, investment and exports. These days, Russia is indeed in a search of a more equilibrium investment to GDP ratio.

Russia is searching for a more balanced economic development model

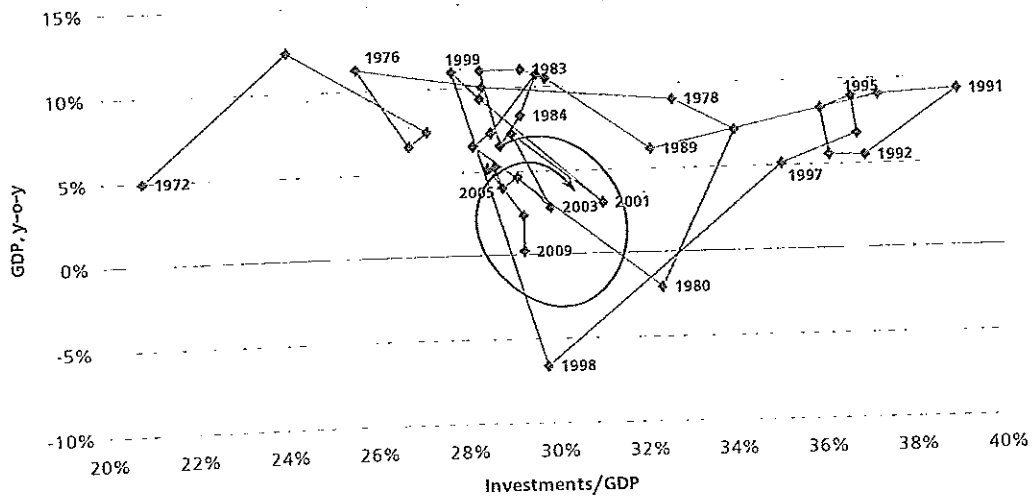


Source: State Statistics Service, Troika estimates

Russia is not alone. Many other countries, such as those in Southeast Asia, have experienced similar problems: unbalanced growth over decades accompanied by a rising investment to GDP ratio. At some point, it becomes clear that investing 40% or 50% of GDP every year is useless and unfeasible. Excessive, inefficient investments collapse, often accompanied by financial crises, as the investments may have been financed via borrowing (no matter whether this is external or domestic).

In South Korea after the 1998 crisis, the economy bounced back quickly in 1999 and delivered strong growth, but since 2000 growth has been more moderate but better balanced on the back of a much lower investment to GDP ratio. The system has seemingly found a temporary equilibrium with respect to growth and investment rates. Needless to say, some institutional adjustment also occurred in the aftermath of the 1998 crisis.

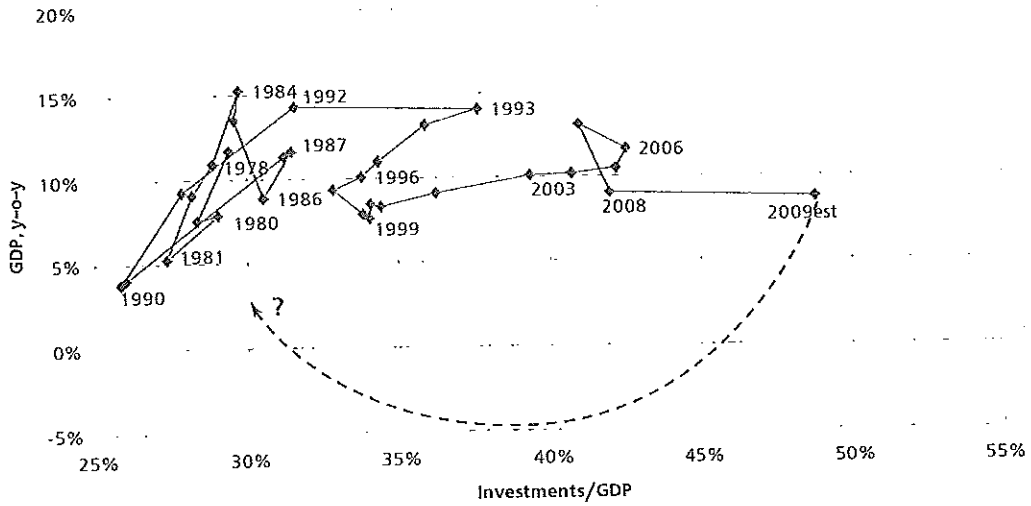
New equilibrium: since 1999, South Korea's growth has moderated following decades of unbalanced investment-led growth



Source: IMF, OECD

With regard to China, the Chinese government orchestrated massive spending in 2009, investments expanding around 30%. There are no official national accounts available for 2009 at this stage, but the most conservative estimate for the country's investment to GDP ratio for 2009 is around 50% (and it could be even higher). This year, it could easily reach or even pass 60%, but at some point it should start coming down. It is hard to imagine that domestic private consumption will be able to smooth this adjustment.

China: yet to find a balance



Source: NBS of China, Troika estimates

We can only guess what will accompany this adjustment should global demand for Chinese gooc remain subdued. Although Chinese growth may not turn negative, it could decelerate sharply.