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SALON SPEAKER SERIES
Grano Restaurant
Toronto Ontario –

MAY 5, 2011

China in the Post-Crisis World

We're here to talk about something that is near and dear to me and that is the role of China in this post-crisis world. I think it's an important topic. And in talking about China, in talking about the post-crisis world, it's really important to think about this crisis that we have gone through in 2008 and 2009 as one of the seismic events in the modern day global economy.

Two thousand and eight and 2009 were a wakeup call for us in the West, obviously, but they were an equally profound wakeup call for the rest of the world, especially a country like China. I think it has changed China's perception of where it is headed in terms of substance, in terms of timing and I think it has added a great sense of urgency.

The model for China has been an extraordinary model. Think back 30 years. It was not that long ago; post-Cultural Revolution and post-Mao. The economy was really in a shambles, the system was this far away from disintegrating from within. And China had been operating

as the People's Republic of China for about 30 years. They'd put in place a series of Soviet-style five year plans which hadn't worked.

The Cultural Revolution came, Mao died and the new leader, Deng Xiao Ping, made an enormous bet with a strategic vision that changed the course of the world's most populous nation. The so-called reforms and opening up that drove China for 30 years were an outgrowth of that tumultuous period. It's a model that worked brilliantly -- with the benefit of hindsight -- because it turned China into the most powerful production machine that the modern post-World War II world had ever seen.

The production machine has limits, however, if you don't have a sustainable broad-based powerful source of demand. And the production machine worked for as long as the demand in the West -- by that I mean the United States, Canada and Europe -- held up. The crisis of 2008 and 2009 has now drawn that key presumption into serious question. I would say it was our wakeup call but China's wakeup call, as well.

In a short span of seven months, the Chinese model was turned inside out. In July of 2008 -- if my memory is right -- the export sector in China, which had been China's most dynamic sector for 30 years, was still expanding on a yearly basis by 26%. Seven months later, in February of 2009, the number was minus 27%. Boom

to bust in seven months. This was an outgrowth of a collapse in global trade and global demand in the West. Meanwhile, the Chinese GDP growth as we measure quarter to quarter sequentially, slowed to a number very close to zero. Over 20 million migrant workers in export-led Guangdong Province were laid off.

China was in the functional equivalent of a recession. Again, a country that had come so far out of the ashes of the Cultural Revolution was facing a dreaded bout of social instability that sent a chill through all aspects of the senior Chinese leadership. And yes, I spent a lot of time consulting with the Chinese leadership over what was going on then and they were scared.

It was at that point that they made a strategic decision -- that has now been implemented in the form of another one of their five year plans -- to change the model. The producer model would now become a consumer model. And you don't just push a button to do it; there are a lot of moving parts. I'll give you some of the highlights in just a second. But the producer model needs support from consumers. And consumers in the West, especially those in the United States, are not going to provide that support.

I'm not here to talk about my cheery view of the U.S. consumer. It's not a pretty picture. In fact, it's so bleak that the true reason, if you really want to know, that I went to Asia to live and run

Morgan Stanley's Asia businesses about four and a half years ago was that Morgan Stanley got tired of me talking about the sad state of the overextended American consumer. I was deported. And I went to Asia where I was a lot happier and a lot more upbeat.

Well, my worst fears have come to pass. The American consumer is now toast and the growth rate we have seen in U.S. consumption over the past three years has been de minimis. It's likely to be that for several more years to come. I wish I could be more upbeat about the European consumer and the Japanese consumer. You get the drift. The big consumers of the world are close to flat-lining and what's an export-led economy like China to do? They need to grow. They need to absorb surplus labour. So they change the model.

I promised myself when I was walking up here I wouldn't give you too many numbers. But I'll give you a couple more: the U.S. consumer is the most overextended consumer in world history and the consumption share of the U.S. economy is still about 70%. In China the number is about 35%, half that of America. That is pretty extraordinary. This is the People's Republic of China we are talking about and the people are on the outside looking in. The goal for China now is to focus all of their energies on getting this consumption share up.

The twelve five year plan was just enacted by a close vote, as most votes are in the National People's Congress -- "unanimous consent" they say. Anyone who votes against it is taken outside and you don't see him again. I'm joking. But this is a plan that lays out a very powerful program for change.

There are three legs to the stool that I will just briefly describe. One: jobs. Believe it or not, the current model in China doesn't generate enough jobs. It's a manufacturing model where they boost manufacturing productivity by substituting machines for people. It's a capital intensive, not a labour intensive model, so they don't generate enough jobs per unit of GDP growth. They need more units of GDP growth and that's why they have to grow 10% to keep the place together. So in the twelve five year plan there is a huge emphasis on a new mode of economic activity in China: services.

Labour intensive services in China contain about 35% more jobs per unit of output than manufacturing. They consume far less in the way of natural resources and this is what China wants. Sorry for you resource guys in Canada but they can't afford open-ended demand for natural resources from coal to oil to base metals. So the service industry is building block number one.

Building block number two is that they don't just need jobs. They need to boost the wages of average Chinese workers. You start

from the fact that about 147 million Chinese are still living at very impoverished levels in the rural countryside, and yet that number has come way, way down in the last 20 years. In the twelve five year plan there is a focus on boosting the urban population by moving over 310 million people from the rural countryside over the next 20 years. And when you move people from the countryside to the cities it's an enormous boost for the average per capita income. People in urban areas in China earn about three and a half times as much as those in rural areas.

The third leg of the stool is saving. Chinese people are scared. They save because they have no retirement income security. When they changed the ownership model in the 1990s, they broke what is called the iron rice bowl, the cradle-to-grave income support you got for working for the state. It's gone. Just to give you an example, if you add up all the assets under management from the social security funds, central and local, add in private pensions, divide it by the number of workers, you get 470 dollars of lifetime retirement benefits for the average Chinese worker. Now money goes a long way in China, but I want to tell you, 470 bucks doesn't do it. Not even 470 Canadian dollars would do it.

So they've got to build up the safety net and in the twelve five year plan there are a number of initiatives aimed at doing just that.

You put those three pieces in place -- jobs, wages and the safety net -- and they'll boost labour income and shift the incentive in allocating that labour income from fear driven precautionary saving to discretionary consumption. The Chinese consumer will come alive. I think it's going to happen. I actually do.

When you study economic development, when you study economic growth, at the end of the day there are three things that really matter as to whether or not economies can deliver on their growth objectives. One is to have a strategy -- to look beyond the short term, the next election. If you think I'm taking a shot at my own country, I am. Number two is to have a commitment to implementing that strategy. And China, seared by the chaos of the Cultural Revolution, believe me, they have a commitment. And number three is to have the wherewithal to deliver on that commitment.

And I believe they've got it: by their reforms, by their rural urban migration, and by the needs of the Chinese people to now play a more active part in driving a more balanced growth model. I think the consumption share of the Chinese economy is going to go up a lot over the next five years. When things happen in China they happen much faster than in any other developing economies that any of us have studied or lived in, in our lifetime.

I think the services share of the Chinese economy will go up a

lot. It's the smallest services sector of any major economy in the world today. There's a lot of low hanging fruit that could be picked in building new transactions, in building new intensive industries with enormous scale in the wholesale and the retail trade and distribution areas. There is also domestic transportation, supply chain logistics, hospitality and leisure. This is where the newly migrated workers from the countryside will find work. You can staff industries like this with a minimum of training. It doesn't require a massive investment in human capital and educational reforms.

If China does this it's a huge win for China's trading partners, especially those in East Asia who because of their scale and demographic issues are all export-dependent economies. From Japan to Korea to Taiwan to the smaller economies in Southern Asia, they're all export-led. And today their largest export market is no longer the United States. It's no longer the European Union. It's China. They are well positioned to benefit from the emergence of the Chinese consumer. It's a huge plus for Europe.

Germany's largest non-European export market is China. I go to Germany a lot. The Germans don't want to talk about the European Union. They want to talk about China. Germany was the first country in Europe to actually publish a foreign language edition of my book. It's a huge plus for the United States; with its consumers on ice for a

number of years America needs new sources of growth. Our export shares are too low. And our third largest and most rapidly growing export market is China.

So I think the coming transformation of the Chinese consumer will probably be the greatest consumption story the world has ever seen. And for a guy who is congenitally pessimistic, that's probably the most optimistic thing I've said about macroeconomics in my career. I've learned however that when you have a strong view on any theme in the macro area, you've got to always ask yourself the question of where you could go wrong.

When I was bearish on the U.S., I would always think, where could I go wrong? I would think, well, I could go wrong if the American consumer keeps spending but you know here are twelve reasons why I don't think that will be the case. And it didn't happen. I mean, American consumers are done. But still, you have to ask yourself those questions.

So where could I be wrong on China? I'll give you three candidates and then I'll stop and we can engage in a little conversation. Risk number one is protectionism, made in Washington. Washington has a hard time accepting responsibility for America's problems, in case you haven't noticed. We practice what is known as the blame game. We want to blame others for our problems. We have

a president who wants to blame Wall Street for everything and we have a congress that wants to blame China for everything.

I'm not here to defend Wall Street, but I am here to defend China. We do have a big trade deficit with China. It's our largest bilateral trade deficit and congressmen say that it isn't fair, China's not playing by the rules and they manipulate their currency. If we get China to move the currency up higher this will be better for American workers. This worked big time in the midterm elections last November. Last September, in fact, the U.S. House of Representatives by a 4-1 majority, bipartisan support, passed a bill that would impose huge trade sanctions on China if they didn't revalue their currency. Fortunately the bill never made it to the Senate.

The analysis is deeply flawed because America doesn't just have a bilateral trade deficit with China. It, in fact, has trade deficits with 90 countries. We have a multilateral problem because we don't save. We're not addressing our savings problem. If you try to address a multilateral problem with a bilateral fix the Chinese deficit just goes somewhere else. This is not complex and yet this is an argument that is completely missed in the U.S. Congress and completely missed by some very prominent academics, which really disturbs me.

I won't mention any names, but there's a guy with a beard who writes a column in the New York Times on Mondays and Fridays who

supports the view that China is America's problem. With a high unemployment rate, there is a serious risk of trade protectionism. I hope it doesn't happen.

A second risk is China's inflation. It's on the rise, and the government is trying to address it but they're being too slow. They're addressing it the way they handle most problems, with a combination of central planning adjustments aimed specifically at the agricultural area, by a modest move upward in the currency, by raising reserve requirements for banks to limit loans and also by some interest rate hikes.

They haven't done enough on interest rates. They've raised short-term rates four times in the last five and a half months, but if you adjust the current level of their so-called policy benchmark lending rate it's only about one percentage point above the inflation rate. That doesn't cut it. They need much tighter money and they can't let inflation get out of control. It's very destabilizing for them.

The third risk -- and this is the China nightmare scenario -- is what I'll call the Jasmine factor, for lack of a better name. The Chinese are paranoid right now about what's going on in North Africa and the Middle East. And you wonder what it is that makes the Chinese leadership so paranoid, so insecure. What's eating at them? What's the problem? The country has gotten so much wealthier over the last 30

years, so what's the deal?

I think the deal is, in large part, the story that I just laid out for you -- the emergence of the consumer society. They know they need to do it but think about the value propositions of a consumer society: free and open communication, upward mobility. It's an aspirational value proposition. How does that work with a fairly repressive one-party political regime devoid of free elections?

There is a potential, and I hope the Chinese address it sooner rather than later, of an outbreak of tensions between their political system -- the lack of political reform, I should say -- and the consumer society. And should those tensions break out, remember that the Chinese have the largest internet community in the world and it's increasing far more dramatically than we've seen in any other society. So should those tensions break out, IT-enabled China will communicate those tensions broadly very quickly and it's a Jasmine-like story.

Those are the three risks that concern me. In light of what I know about China, in light of what I see happening to the structure of their economy and the context of this new five year plan, I think those are low probability risks but I wouldn't dismiss them. I wouldn't ignore. They're risks that all must be addressed by the Chinese leadership in the years ahead.

What about us? We've got to wake up. I think we've got to get our act together. The world doesn't stand still. There's a lot of fear in the West, we have squandered an awful lot of the benefits that have come to us through years and decades of hard work and prosperity. I think we mismanaged our system. My dinner companion sitting to the right of me says she is very optimistic about the U.S. I'm optimistic about the U.S. but I'm afraid we're at a point right now where there is no gain without the pain.

We seem to be unwilling to face up to the hard work that is required to get the job done. The mistake we made, in my opinion, was in turning the other shoulder to a lot of these powerful global forces: the emergence of China, the emergence of India, other global forces that began to have powerful impacts in squeezing the way in which we could receive income from work. Job growth has slowed, real wages have stagnated, our educational system has started to erode and we haven't faced up to it.

Instead, what we did was we turned to a new model of economic growth. We augmented our shortfall of income generation the old-fashioned, by extracting purchasing power from a bubble. We used a combination of a credit bubble and a property bubble to keep the American miracle alive. I was very critical of that throughout this great

period of excess and I'm still extremely critical of a power structure in Washington -- especially the Federal Reserve and its QE1, QE2, QE12 -- trying to recreate the same miracle. I think that is an unworkable recipe, it's a recipe for a false prosperity. You cannot sustain a mature, strong economy by extracting purchasing power from bubbles.

So China's moving and what are we doing? That is a fair question. I'm hopeful that as the crisis of 2008 and 2009 was our wakeup call in the West and clearly China's wakeup call to change its model, at the end of the day we all learn important lessons from each other. The risk right now is that we've still got those blinders on in the West.