A Wake-Up Call for the US and China: Stress Testing a Symbiotic Relationship

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Since the turn of the century, no two nations have been more important in driving the global economy than the United States and China The American consumer has been the dominant force on the demand side of the global economy, whereas the Chinese producer has been the most powerful force on the supply side. Few argued with the payback. Over the four and half years ending in mid-2007, world GDP growth averaged nearly 5% – the strongest and most sustained boom in the global economy since the early 1970s.

But now both engines are sputtering, with ominous consequences for a world in its worst crisis since the 1930s. This poses great challenges for each nation, as well as to the bilateral relationship between them. There is hope but it comes with a big "if" – if China and the United States pull together in forging common solutions. However, if these two nations end up at odds with one another, they will both suffer – with dire consequences for the rest of a crisis-torn global economy. The stakes are enormous. There is no margin for error.

A World in Crisis

No nation has been spared the impacts of this wrenching financial crisis and recession. While America's so-called subprime crisis may have been the spark that ignited the inferno, every region in this globalized world is now faltering in lock-step fashion. That includes China – long the most resilient economy in an otherwise weakened world. And it includes the rest of an increasingly China-centric Asia, where all economies either have tumbled into outright recession or are slowing sharply. Ten years after the Asian financial crisis wreaked havoc in the region, a new crisis is at hand. Far from having decoupled from the rest of the world, Asia's problems – and China's in particular – are tightly linked to the crisis and recession that started in America and have since spread like wildfire throughout the developed world.

These problems have arisen, in large part, because of the unbalanced state of both economies. America's excess consumption model is in serious trouble because the asset bubbles that have long supported it – property and credit – have both burst. China's export-led growth model is in trouble because it is being adversely impacted by a massive external demand shock that is very much an outgrowth of America's post-bubble compression of consumer demand. The rest of Asia – export-dependent economies, which have become tightly integrated into a China-centric supply chain – has nowhere to hide. Ten years after the wrenching upheaval of 1997-98, Asia is facing another crisis.

Significantly, these imbalances did not occur in isolation from each other. America's consumption bubble was, in effect, sourced by an equally destabilizing Asian export bubble. And now both sets of bubbles have burst – on the demand side as well as on the supply side of the global economy. It had to happen at some point: Long simmering global imbalances have finally come to a head in a post-bubble world (see Figure 1)

China: Unbalanced and Unstable

During the boom, China's imbalances actually worked in its favor. Over the 2001 to 2007 period, the export share of Chinese GDP nearly doubled from 20% to 36% while the global export share of world GDP went from 24% to 31% (see Figures 2 and 3). In other words, China's timing was perfect. It upped the ante on its export dependence at precisely the moment when global trade enjoyed its most spectacular growth. That effectively turbo-charged China's benefits from the strongest global boom since the early 1970s, powering GDP growth at a 10.4% average rate in the seven years ending in 2007.

That was then. Reflecting the impacts of a rare synchronous recession in the US, Europe, and Japan, the world trade boom has now gone bust. And Chinese exports, which had been surging at a 25% year-over-year rate as recently as mid-2008, reversed course with a vengeance – ending the year in a mode of outright contraction, falling by 2.8% in December.

With exports such a large and rapidly expanding slice of the Chinese economy, little wonder measures of aggregate activity slowed in an equally dramatic fashion. Industrial output increased only 5 7% in December – one-third the average 16 5% growth pace of the preceding five years. And real GDP growth ended the year at just 6.8% – in sharp contrast to the nearly 12% pace of the preceding three years

China's growth compression as reported on a year-over-year basis masks the severity of its recent downshift. A translation of these figures into sequential quarterly changes, such as those reported by the United States, suggests that Chinese GDP and industrial output growth were in the flat to slightly negative territory as 2008 came to an end. As seen from this real-time perspective, the Chinese economy hit a wall late last year. Such an abrupt downshift implies it will be extremely difficult for China to achieve the government's 8% GDP growth target for 2009. An outcome closer to 6%, or even lower, is a distinct possibility. China is hardly an oasis of prosperity in a crisis-torn world.

For a nation long focused on social stability, this growth shortfall is a worrisome development. It has already taken a serious toll on Chinese employment. The government has now acknowledged job losses in coastal export manufacturing businesses of over 15% – or 20 million workers – of the nation's pool of some 120 million migrant workers. If the export and GDP shortfall persists, more slack would open up in the Chinese labor market – raising long dreaded risks of worker unrest. I remain convinced that the Chinese leadership will do everything in its power to avoid such an outcome. But in this global recession, the challenge is daunting, to say the least.

Asia: China-Centric and in Peril

It has become conventional wisdom to proclaim that the 21st century would be the Asian Century. China's miraculous development story is central to this vision – a transformation that many believe would inevitably push the pendulum of global power from West to East. It's hardly an exaggeration to claim that such a tectonic shift would turn the world inside out. The Asia Dream is an exciting and powerful story – a magnet to financial and human capital from all over the world.

I suspect it may be premature to crack out the champagne The Asian century is hardly as preordained as most seem to believe. The main reason, in my view, is that the region continues to rely far too much on exports and external demand. Developing Asia's export share hit a record high of 47% last year – up ten full percentage points from levels prevailing in the late 1990s (see Figure 4). That hardly speaks of a true economic power that has become capable of standing on its own.

At the same time, there can be no mistaking the increasingly China-centric character of the Asian economy – another dimension of the region's search for growth. As China boomed, the rest of Asia was more than happy to go along for the ride. A China-centric supply chain led to increasingly tighter pan-regional integration, with assembly lines in China drawing freely on inputs and components from Japan, Korea, Taiwan, Malaysia, Singapore, Indonesia, and elsewhere in the region. Yet that dependence cuts both ways – a two-way causality that is now complicating the here and now of the Asian century. As noted above, the China boom was itself very much tied to the record surge in global trade. But now with global trade contracting for the first time since 1982, China's export-led impetus has been quick to follow.

This has hit China-centric Asia extremely hard. The December 2008 export comparisons were nothing short of disastrous for the other major economies in the region: For example, Taiwan's exports were down an astonishing 42% y-o-y, with the Chinese piece off 56%; Japan's exports plunged 35%, with the Chinese piece off 35%; and Korean exports fell 17%, with the Chinese piece also off 35%. In all three of these cases, China had become each country's largest trading partners in recent years – accounting for 28% of total Taiwanese exports, 23% of Korean exports, and 16% of Japanese exports. But now that the Chinese export machine has screeched to a standstill, the rest of the region has weakened even more. This puts an Asian spin on an old adage. When China sneezes, the rest of Asia catches a bad cold.

I am convinced that the Asian century is coming. But the risk is that it may take a lot longer than widely presumed. All this underscores the biggest test to the Asian century – the ability of the region to stand more on its own in the event of an external shock. In the late 1990s, it was an external funding shock. Today, it is an external demand shock. These developments should put the region on notice that its leadership agenda is far from complete. Until export-led growth gives way to increased support from private consumption, the dream of the Asian century is likely to remain just that.

America: Bubble-Prone and Externally Dependent

There can be little doubt that this global crisis started in America. The ever-deepening recession in the US economy is very much an outgrowth of a massive post-bubble shakeout. It began with housing but has now spread to the biggest sector of all – the American consumer. At is peak in early 2007, US consumption accounted for fully 72% of real GDP – a record for the United States, and for that matter, a record for any major economy in the modern history of the world (see Figure 5).

The problem with this consumption binge is that it was not supported by the US economy's underlying income generating capacity. In the now-ended expansion, private sector labor compensation expanded at an unusually sluggish pace – falling over $800 billion (in real terms) below the trajectory of the previous four business cycles (see Figure 6). The confluence of subpar job growth and relative stagnation of real wages left consumers well short of the labor income that would typically support booming consumption. But that didn't stop the American consumer. Drawing freely on asset appreciation – first equities and then housing – consumers uncovered new sources of purchasing power The credit bubble was icing on the cake – enabling homeowners to extract equity at little cost from ever-rising home values and then use the proceeds to fund current consumption and build saving for the future. Net equity extraction soared from 3% of disposable personal income in 2000 to nearly 9% in 2006 (see Figure 7).

There are important consequences of such a bubble-dependent consumption and saving strategy. Significantly, by shifting the mix of consumer support from income to assets, the United Sates drew down its domestic saving rate to rock bottom levels. The net national saving rate – the sum of household, business and government saving after adjustment for depreciation – plunged to a record low of 1.8% of national income over the 2002-07 period, and then actually tumbled into negative territory in 2008 (see Figure 8). The global consequences of this development are profound: Lacking in domestic saving, the United States was forced to import surplus saving from abroad in order to grow – and run a massive current account deficit in order to attract the capital.

The saving shortfall of a bubble-prone US economy is a major source of vulnerability. During good times, it made America increasingly dependent on foreign lenders, such as China, to fund economic growth. During bad times – especially in the aftermath of the bursting of the property and credit bubbles – it triggered a massive consolidation of asset-dependent US consumption. Real consumption expenditures fell at a 3.6% average annual rate in the final two quarters of 2008 – the first time in the post-World War II era when consumer demand fell by more than 3% for two consecutive quarters.

Despite the unprecedented contraction of consumption in late 2008, there is good reason to believe the capitulation of the American consumer has only just begun. The consumption share of US GDP has fallen only about one percentage point from its 72% peak – still leaving this gauge four full percentage points above the pre-bubble norm of 67% that prevailed from 1975 to 2000. On this basis, only about 20% of the consumer's mean reversion has been completed. Notwithstanding the extraordinary monetary and fiscal stimulus measures that have recently been put in place by US authorities, the post-bubble deleveraging of the American consumer is likely to be an enduring feature of America's macro landscape over the next 3-5 years.

Therein lies the essence of a massive and sustained global demand shock. The American consumer is the biggest consumer in the world (see Figure 9). And US consumption growth has long outstripped far more sluggish gains elsewhere in the developed world. Little wonder the post-bubble capitulation of the American consumer proved so decisive in undermining the external demand underpinnings for China and for the rest of export-dependent Asia. Nor is it likely to be over quickly. This multi-year headwind imparted by a sustained weakening in the growth of US consumption could well be the most powerful force shaping the demand side of the global economy for years to come.

Mounting Bi-Lateral Tensions

The current global crisis poses new challenges to the relationship between the United States and China – quite conceivably the world's most important bilateral relationship of the 21st century. Those challenges were underscored in the recent Senate confirmation hearings of America's new Treasury Secretary, Timothy Geithner, when he accused the Chinese of currency manipulation. Moreover, with the US in recession and unemployment high and rising, there is good reason to fear that Geithner's comments were just a warning shot of more China bashing on the horizon.

This is an unfortunate outgrowth of the blame-game mentality that has long been prevalent in Washington. During tough times, US politicians apparently need scapegoats to deflect attention away from the role they have played in creating serious problems. Wall Street is being singled out for causing the financial crisis – despite regulatory and central bank complicity – and China, with its large bi-lateral trade deficit with the United States, is being blamed for the pressures bearing down on American workers.

Washington's "logic" for turning tough on China trade policy is based largely on three factors – an outsize bilateral trade deficit between the two nations that hit a record $256 billion in 2007, long-standing claims of RMB currency manipulation, and a seemingly chronic stagnation of real wages for American middle class workers. Fix the China problem, goes the argument, and unfair pressures on US workers will be relieved.

This argument is deeply flawed. The main reason is that the US-China trade deficit did not arise in a vacuum. As noted above, a bubble-prone, saving-short US economy needs to import surplus saving from abroad in order to keep growing. That also means it must run massive current account and trade deficits to attract that capital. The US-China trade deficit, along with deficits with 100 of America's other trading partners is, in fact, an important outgrowth of that problem. America has a multi-lateral trade imbalance – not a bilateral problem driven by unfair Chinese competition. China has the largest bilateral piece of America's multilateral deficit – not because of the value of its currency but mainly because of conscious outsourcing decisions of US multinationals.

Nor is the evidence on the so-called undervaluation of the Chinese renminbi nearly as conclusive as many US experts seem to believe. For starters, the RMB is up nearly 21% against the US dollar (in real terms) since China abandoned its currency peg over three years ago. Moreover, recent academic research puts the RMB's multilateral undervaluation on the order of only 10% – hardly a major advantage for China (see Yin-Wong Cheung, Menzie D. Chinn, and Eiji Fujii, "China's Current Account and Exchange Rate," a January 2009 working paper of the US National Bureau of Economic Research). Significantly, these same researchers go on to demonstrate that China's bilateral and multilateral trade flows are not nearly as sensitive to movements in its currency as the RMB bashers would want to believe.

Nevertheless, if US-China trade is diminished or closed down through forced RMB revaluation, tariffs, or other means, a saving-short US economy will still need to run a large multi-lateral trade deficit. That means it will simply end up shifting the Chinese piece of its external imbalance to another trading partner. To the extent that shift is directed toward a higher-cost producer – most likely the case – the outcome will be the functional equivalent of a tax hike on the already beleaguered American middle class But it won't stop there. Undoubtedly, Chinese currency managers would retaliate by reducing their purchases of dollar-denominated assets. And that would push the world's two great powers all the closer to the slippery slope of trade protectionism.

Avoiding such an outcome – strikingly reminiscent of the trade wars of the 1930s triggered by America's infamous Smoot-Hawley tariffs – poses a major challenge to the body politic of both nations. That's particularly true for America's new president. Campaigning on a platform of support for beleaguered middle-class American workers, Barack Obama underscored his concerns about real wage stagnation in an era of unfettered globalization. The real wage issue is a serious issue. However, the challenge for Washington is to determine the linkage between this issue and trade policy It may well be that real wage stagnation is related more to America's under-investment in human capital – especially, lagging educational reforms and re-skilling programs in an era of rapid IT-enabled globalization – than it is to cross-border trade pressures. It may also be that trade deficits are far more a function of flawed policies that discourage saving – a problem that s now going from bad to worse in an era of trillion dollar budget deficits. Resolving this dilemma, without derailing globalization, will be an early and important leadership test for President Obama.

Don't Count on Symbiosis

In economic terms, there can be no mistaking the natural symbiosis that has long existed between America, the consumer and low saver, and China, the producer and high saver. But this complementarity cannot be taken for granted as a co-dependence that will forever cement the bi-lateral ties between these countries. In fact, it may well be that US-

Chinese symbiosis is nothing more than passing phase – reflecting a coincidence of mutual interests that will exist for only a relatively brief period of time. Yes, as long as a saving-short US economy continues to run massive current-account deficits to support the excesses of personal consumption, it needs a lender like China to provide foreign capital. And as long as an excess saving Chinese economy needs export-led employment growth to maintain social stability, it needs the world's largest consumer to absorb its output.

But what happens if those conditions change? If America starts to save more – a distinct possibility for its over-extended post-bubble consumers – the need to borrow surplus saving from China will diminish. Conversely, if China starts to spend more – an equally likely possibility in light of its excessive reliance on exports and investment – it will have less surplus saving to lend to the United States. If both of these adjustments are perfectly timed to occur at precisely the same moment, it is possible to envision an uninterrupted symbiosis. The odds of such an exquisitely synchronized rebalancing of both economies are extremely low, in my view. That suggests the growing likelihood that symbiosis is likely to give way to disequilibrium – adding a new source of tension to the US-China relationship.

Unfortunately, that's not the only source of economic tension between the United States and China. Over the 2005-07 period, fully 45 pieces of anti-China trade legislation were introduced in the US Congress. While none of these bills passed, that may change. As the US unemployment rate now mounts in an ever-deepening recession, the politics of trade frictions may well gather greater support. Treasury Secretary Geithner's warning on Chinese currency manipulation is especially worrisome in that regard. The same can be said of the "Buy America" provisions that have slipped into America's recently enacted stimulus package.

At the same time, China must also be sensitive to the impacts of its export-led growth model on its trading partners. Any subsidies – either to its own domestic wages or to its currency – take on heightened importance as China's stature in world trade grows. As now the second largest exporter in the world, China can hardly afford to take that responsibility lightly. Moreover, if China competes unfairly by ignoring environmental degradation and pollution, the world pays a much greater price for the cross-border labor arbitrage than a simple comparison of wages would suggest. To the extent that cost-effective outsourcing ignores environmental considerations, the real wage squeeze in relatively "greener" economies may be all the more acute.

Resolving the complexities of the US-China economic relationship is an urgent challenge for an unbalanced global economy. As a crisis-torn world now moves into a severe recession, the stakes can only grow larger. As both the US and Chinese economies evolve and change, a fleeting state of symbiosis could well give way to heightened tensions. The time to diffuse those tensions is now – before it's too late.

China's Policy Imperatives

Ironically, China saw many of these problems coming. Two years ago, Premier Wen Jiabao warned that the Chinese economy was "unstable, unbalanced, uncoordinated, and unsustainable." Similar vulnerabilities were anticipated in the 11th Five-Year Plan enacted in 2006, which stressed China's need to embark on a major structural transformation from export- to consumer-led growth.

But the government's execution of this aspect of its plan was lacking. In particular, it failed to build out an institutionalized safety net – the support system necessary to temper the fear-driven precautionary saving that inhibits the development of a more dynamic consumer culture. As a result, the consumption share of Chinese GDP fell to a record low of 36% in 2007 – underscoring the dark side of China's macro imbalances that is now so problematic in this global crisis (see Figure 10). A severe external demand shock found an unbalanced Chinese economy without a back-up plan.

A pro-consumption rebalancing is the only sustainable answer for China. Pro-active fiscal stimulus measures, such as the recently announced RMB4 trillion infrastructure-led investment initiative, can help temporarily. Such efforts borrow a page from China's counter-cyclical script deployed in the Asian financial crisis in the late 1990s and again in the mild global recession of 2000-01. But these actions are not enough to compensate for the structural vulnerabilities that China's externally-dependent growth model now face as American consumers begin a multi-year retrenchment.

China needs to be bold and aggressive in framing pro-consumption policies. It should start by announcing major initiatives on the safety net front Specifically, China should sharply expand the funding of its national social security fund, which currently has only a little over US$70 billion in assets under management – not even enough to provide $100 of per capita lifetime retirement income for an aging Chinese population. China also needs to move quickly in establishing a comprehensive private pensions scheme, as well as broaden its support to nationwide health and unemployment insurance. Recent passage of an RMB850 billion three-year medical reform plan is an encouraging , but small, step in that direction.

The bottom line for China: Its unbalanced economy must be rebalanced. The export-led growth formula, which served the nation well for three decades, must now give way to the internal impetus of consumer-led growth. For China, the imperatives of such a rebalancing have never been greater. For the rest of Asia – to say nothing of an unbalanced global economy – China's post-crisis economic leadership role hinges importantly on this critical rebalancing

Policy Risks

Needless to say, a weakened economy usually doesn't take kindly to suggestions that it ought to increase the value of its currency. That's especially the case for an export-led Chinese economy, where sequential growth slowed to a virtual standstill in late 2008. With overall economic growth remaining weak in early 2009 and currently running well below the 6-8% zone that China requires to absorb surplus labor and maintain social stability, the pro-cyclical implications of a tighter currency policy would only add to mounting downside risks.

Little wonder that US Treasury Secretary Geithner's recent remarks on currency manipulation were met with an incredulous response in Beijing. While such strident rhetoric hardly implies action, it is worth considering the consequences if the war of words leads to outright trade sanctions. The impacts would be felt immediately in financial markets. Given America's reliance on China's funding of its external deficit – a reliance that can only grow in an era of open-ended trillion dollar budget deficits – the US is in no position to risk reduced Chinese buying of dollar-denominated assets. Yet that is exactly what might occur if a proud but wounded China retaliates to currency-induced trade sanctions imposed by Washington.

Such retaliation could take the form of a China that simply doesn't show up at an upcoming US Treasury auction. That's hardly a trivial consideration for a United States that needs about $3 billion of capital inflows each business day to fund its current account deficit. If China fails to provide its share of America's external funding, the dollar could plunge and real long term interest rates could rise. A dollar crisis is the very last thing a US in recession needs. But it could happen if the US turns rhetoric into action in the form of imposing sanctions on Chinese trade. In short, Washington is treading on increasingly thin ice in blaming the Chinese currency for America's woes. A post-bubble US economy is suffering from a major shortfall in domestic demand that is unlikely to be remedied by China bashing. Saber-rattling in this climate is both ill-advised and dangerous.

At the same time, it is equally important to underscore what China should not do. First and foremost, Chinese policymakers must not be overly-optimistic in counting on the old external demand model to start working again. A multi-year weakening of the US consumer is tantamount to a global consumption shock that will impart a protracted drag on any export-led economy. As such, the imperatives of Chinese rebalancing have never been greater. It is increasingly urgent that China shift its growth model from one that has been overly reliant on exports to one that draws increased support from private consumption.

Nor should China be tempted to use the currency lever or other subsidies to boost its export sector In an era of rising unemployment and mounting concerns in the developed world over the benefits of globalization, such efforts could be a recipe for anti-China trade sanctions. As previously noted, those actions might then prompt China to reconsider its role as one of America's most important overseas lenders. And then, as was the case in the 1930s, the race to the bottom could be on.

Wake-Up Call

There has long been a dispute over the English language translation of the Chinese word for crisis. One popular view is that "*wēijī*" roughly translates into the compound phenomenon of both danger *and* opportunity. Unfortunately, that meaning – correct or not – has been lost on a world in crisis Today, more than ever, a world in crisis and recession needs to pull together – not push itself apart Globalization and its cross-border connectivity through trade and capital flows leave us with no other choice

The blame game is completely counter-productive in this environment. Those blaming surplus-saving economies such as China for America's unsustainable spending binge ought to be embarrassed. This is a US problem and one that must be addressed at home with a new and disciplined approach to monetary policy, tough regulatory oversight, and more responsible behavior on the part of consumers and businesses, alike. A bubble-dependent economy that lived beyond its means for a dozen years must now accept the reality of having to live within its means – and not holding others accountable for this painful yet necessary adjustment.

Similarly, China needs to accept that the export-led growth formula always had its limits. An unprecedented external demand shock driven by unheard of synchronous recessions throughout the developed world drives this point home with painful clarity. Economic development is not just about producing for others – especially if those "others" are living beyond their means. In the end, export-led growth must eventually give way to the internal demand of a nation's private consumers. China is ready for this transition and must begin the process as soon as possible.

In short, it is high time for an unbalanced world to begin the heavy lifting of global rebalancing. By framing such an adjustment in the context of the United States and China, the verdict is clear: America needs to save more and consume less, while China needs to save less and consume more.

Easier said than done. But a world in crisis can no longer afford to perpetuate an unstable *status quo* Global rebalancing is not a quick fix – and therefore, is not all that appealing to myopic politicians. But in the end, it is the only way to put the world back on a sustainable growth track. If there is a silver lining to this crisis, it must be in the wake-up call that it sends to politicians and policy makers throughout this unbalanced world.

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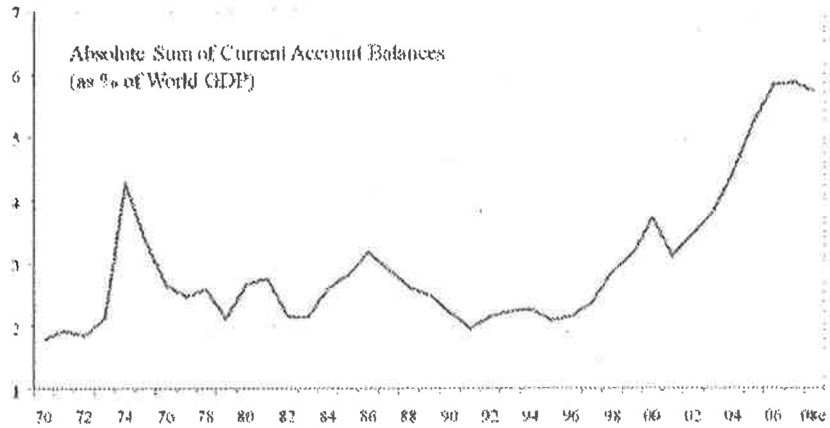
Figure 1: Global Imbalances



Source: IMF and Morgan Stanley Research

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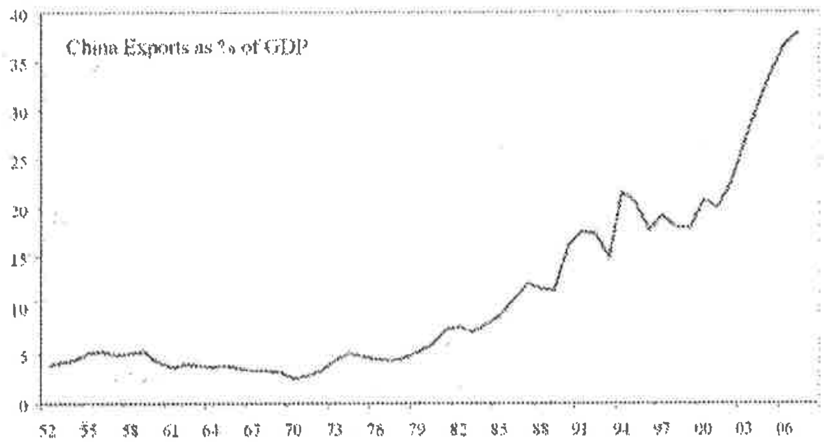
Figure 2: Chinese Export Surge



Source: China National Bureau of Statistics and Morgan Stanley Research

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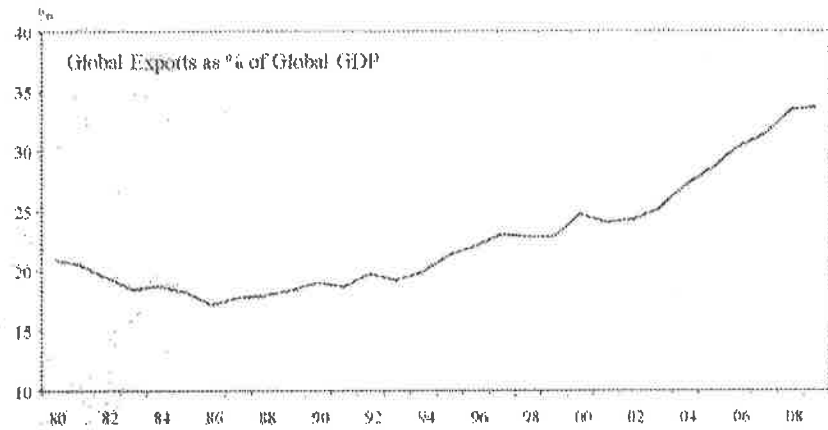
Figure 3: The Great Boom in Global Trade



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Source: IMF, Morgan Stanley Research

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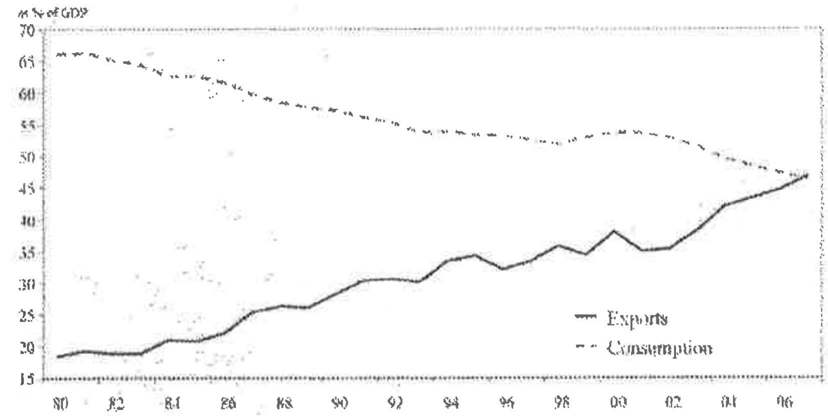
Figure 4: Export-Led Developing Asia



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Source: IMF, Morgan Stanley Research

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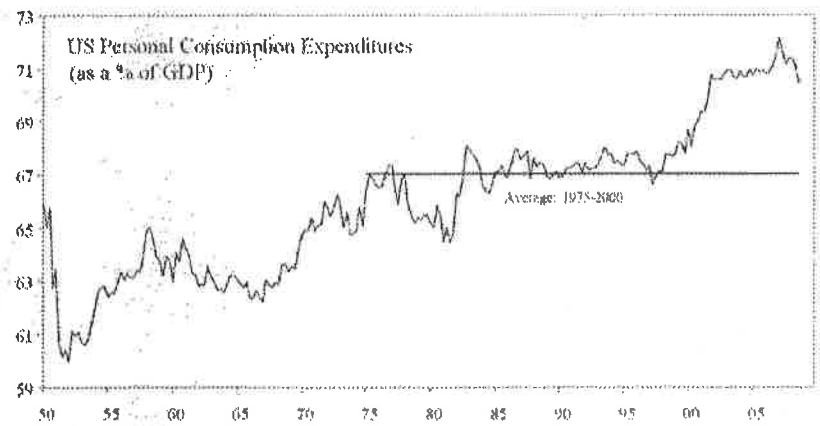
Figure 5: US Consumption Binge



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Source: Haver Analytics, Morgan Stanley Research

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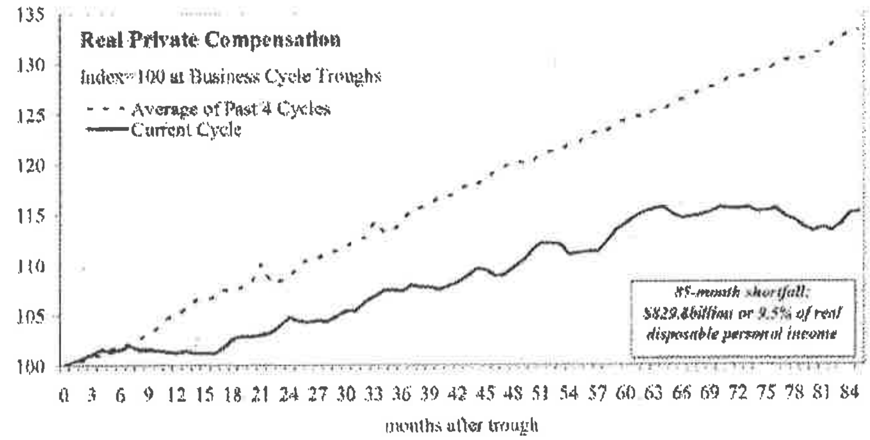
Figure 6: US Labor Income Shortfall



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Source: Bureau of Economic Analysis, Morgan Stanley Research

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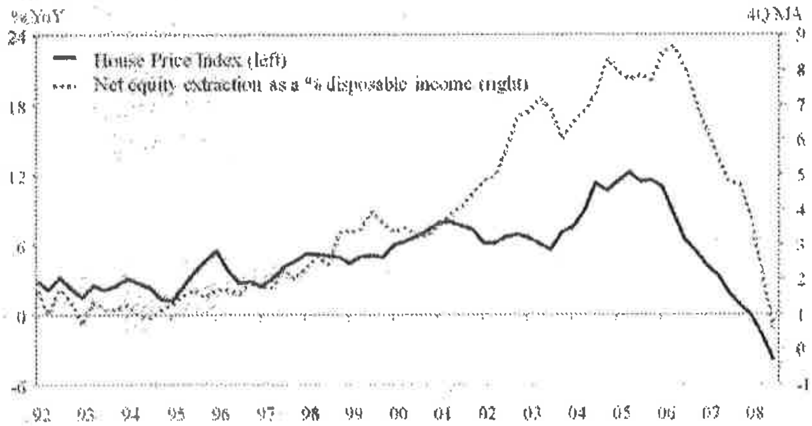
Figure 7: US Wealth Shock



Source: OFHEO, Federal Reserve, Morgan Stanley Research

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Figure 8: America's Saving Shortfall

Source: US Bureau of Economic Analysis, Morgan Stanley Research

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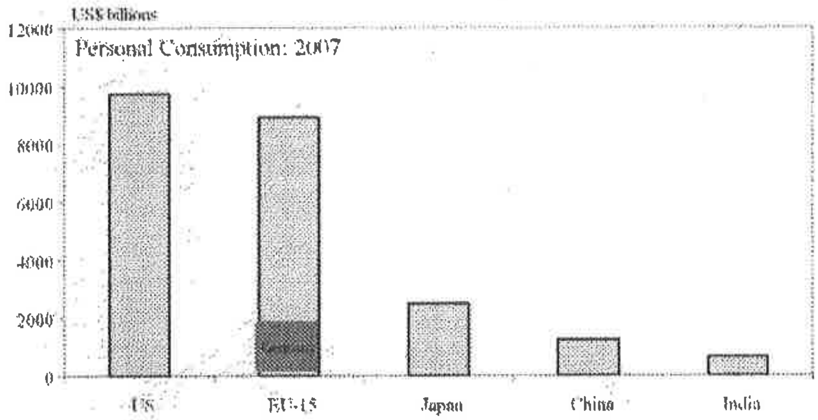
Figure 9: The Global Consumer



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Source: National Sources, UN, Morgan Stanley Research

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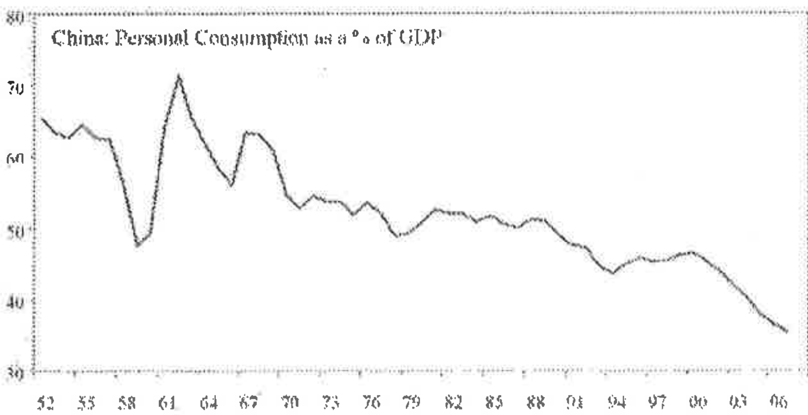
Figure 10: Chinese Consumption Shortfall



Source: China National Bureau of Statistics and Morgan Stanley Research

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