Global Crisis:
Can China's Growth Compensate for Sluggish Recovery in the US and Europe?

Dr Dan Steinbock, *Research Director of International Business at the India, China and America Institute (ICA), US, and Fellow, Shanghai Institute for International Studies, China, returned to ISIS a year after his first talk on the `Global Financial Crisis and China's Role,' to speak on the same topic, at an International Affairs Forum on February 25, 2010. He touched on the impact of the global crisis, recovery prospects in the US and Europe, growth in China, trade, as well as possible future scenarios. The talk was moderated by Dato Dr Mahani Zainal Abidin and Mr Steven Wong.* ***Zarina Zainuddin****, Analyst at ISIS, reports.*

Global Crisis Revisited

During his first visit, Dr Steinbock said, the economic scenario was grim. The crisis was global, integrated and synchronised, except in the emerging economies of Asia. Although the downward pattern was similar for Asia, due to continued demand, there was no recession. Hence we saw a more pronounced economic recovery for Asia's emerging economies.

While the financial system has stabilised, problems remain, because the root cause of the crisis was structural. It was brought about by rampant financial deregulation from the 1980s to 2009.

One of results of the deregulation was a skewed rewards system: average wages in the financial sector were four times those of manufacturing - a situation that was simply unsustainable, said Steinbock. Deregulation went too far in the US. It became an ideology: deregulation along with privatisation were thought of as the 'be all and cure all' for economic problems!

In the US, serious problems exist despite the current state of stabilisation; foreclosure issues have yet to be fully resolved, lack of credit persists, the financial crisis has not been entirely tackled, and the existing assets bubble will take five to 15 years to clear. These structural issues are significant, said Steinbock, as they limit the economy and its recovery.

Dan Steinbock

Recovery Prospects in the US and Europe

In the US, the financial crisis moved quickly to affect the economy and employment. The problem of falling domestic demand in the US is serious and as a result, the unemployment rate has doubled to 10 per cent. While the figure has now stabilised, it is still high, he said. The US

(From left) Dan Steinbock , Mahani Zainal Abidin and Steven Wong

needs to create 100,000 to 127,000 jobs per month for the recovery to be sustainable.

When President Obama took office, his approval rate was close to 70 per cent; Steinbock thinks the figure was inflated. Obama's approval rating has since fallen to a figure that is about equal between approval and disapproval. He thinks the primary cause of that is healthcare proposals by the Obama administration. Not only has the administration lost its momentum, it would be more difficult for Obama to push through his plans for economic reform.

Steinbock mentioned an interesting study by a former Goldman Sachs employee on the stimulus package. Basically he asked a simple question: *`where does the money come from and where does it go ?'* The findings were astounding: the bulk of the money comes from the government (tax payers) -- federal reserves and the treasury department -- and 91 per cent of it goes to Wall Street. Only nine per cent goes to the 'real citizen'!

The study was controversial but the outraged reactions were understandable as they represented real fears among the people about America's future. There are real concerns about whether it is right to use the stimulus package to rescue the banks, instead of using it to support the people who were hurt by the banks' actions.

The problems faced by the incumbent president are tough. As Steinbock put it, the administration has to deal with `deficits which tend to boost public debts, which is boosted by health care costs, half of which is paid for by foreigners

the bulk of the money comes from government (tax payers)—federal reserves and the treasury department—and 91 per cent of it goes to Wall Street

holding US treasury bills.' The common denominator for this is the banks that are too big to fail. It is difficult to correct the situation, he concluded.

Steinbock also took a closer look at the US deficit. The US budget deficit now stands at US$1.3 trillion -- a huge figure. Although Obama plans to reduce the deficit to four per cent of the GDP in the next two to three years, the amount would still be high. Steinbock also thinks that, given the current political climate, President Obama may not be able to cut the deficit as much as he would like to.

Steinbock said that the rise of US public debt has a lot to do with the demographic of an aging nation and its associated costs. The situation would not be so serious if the US had an effective health care system. Health care constitutes about 17 per cent of US GDP, which is more than twice the average OECD level of 5-7 per cent. Steinbock said he was surprised at federal deficit figures because he thought social security would have the lion's share of it. But social security expenditure was contained; the real problem was rising costs of Medicare and Mediaid.

While earlier on, some European officials had dismissed the financial crisis as an 'American problem,' they quickly discovered to their dismay that their economies were not immune either. Steinbock thinks that the repercussions in Europe could be as severe if not more than in the US, due to the nature of social conditions in Europe. He estimates it would take six to eight months for the full impact of the crisis to be realised in Europe, mainly because firing processes take longer in Europe than in the US. Social welfare stability in Europe is being questioned.

Currently, said Steinbock, Western Europe is having a serious `PIIGS' problem. Portugal, Italy, Ireland, Greece and Spain (countries whose initials produce the unfortunate acronym) are all dealing with economic downturns and huge budget deficits which translate to very low growth prospects. It is a situation not unlike that experienced by the East Asian countries during the financial-turned-economic crisis of the late 1990s.

In Eastern Europe, Steinbock thinks the problems might be bigger given that the majority of the banks are owned by western counterparts. Most of these banks are in trouble. As a result, he said, Eastern European professionals are unable to purchase properties in their own cities. The situation presents a potential long-term problem for both Eastern and Western Europeans.

A section of the audience

Dan Steinbock and Steven Wong

What About Growth Prospects in China?

When China began experiencing an economic slowdown, many thought the problem lay with exports. The premise was that as its exports collapsed, China began to encounter economic difficulties. Steinbock reiterated, as he did last year, that this was not the case. While exports do play a part, China is still predominantly an assembly centre, with substantial production parts coming from other countries. China's real growth driver is its investment in fixed assets.

China's urbanisation rate is about 45 per cent; the US was at that level in 1910. As China strives to redistribute its wealth, it creates new cities and expands older ones. This leads to massive investments in infrastructure -- housing, roads, etc -- which in turn creates tremendous employment opportunities. As incomes increase, demand for consumption goods follows. This represents a dynamic that holds, said Steinbock. The massive and sustained internal demand created would limit the damage from a global slowdown, particularly if the slowdown only hits China's export sector.

Steinbock predicts that given the size of China's population, these dynamics would fuel growth for a long time to come, helped by China's internal demand as well as its stimulus package and active lending. East Asian countries benefit as well; China has continued to import goods from its neighbours, helping cushion the fall in export demands from the US and European markets.

Trade

Steinbock said the current crisis has had a more detrimental effect on world trade (volume) than the last crisis of the 1930s, so anything that hinders the fragile recovery of trade, such as trade protectionism or trade isolationism is likely to have a negative impact in the future.

China's urbanisation rate is about 45 per cent; the US was at that level in 1910

Global trade recovered strongly in the second quarter of 2009 although it is still far behind pre-crisis levels. In the US, China is often singled out as a source of trade deficit, when in reality petroleum imports and trade with 'other countries' are equally large. Moreover, China is the US's fastest growing export market; the US also has a surplus in the services trade with China. These are facts that are often neglected in US-China trade discussions!

The foreign direct investment (FDI) picture is more problematic, said Steinbock. The US invested far more in China than China has in the US. While China is looking to invest in new technology, which the US has, the US needs more capital, which China in turn has abundantly. However, as is the case with Japan, politics often hinders this perfect match-up. Steinbock noted that the EU has no such issues. The EU is neither China's biggest partner nor its biggest source of imports.

There is also a growing sense of pessimism in the US on the benefits of free trade, compared to China, India, Germany, etc. There is a feeling that the US is starting to restrict imports from China by imposing tariffs on some of its goods. The logic is that China's market is more protected, a claim that Steinbock disputes, particularly if 'openness' is measured in terms of exports and imports as a percentage of GDP. China's 'openness' measured at over 70 per cent, compared to that of the US and Japan which is at 20+ per cent.

What Caused the Crisis? What Next?

There are several competing views on how the crisis erupted. One is that a crisis occurs every hundred years and no one really knows why. Another is that it is systemic – a result of unchecked deregulations which have a destabilising impact on the financial system, and which in turn could spread world-wide. Steinbock believes the latter. It is not that he does not believe in the market economy: he does -- but with the added presence of strong institutions.

While the wars in Iraq and Afghanistan did cost more than was originally estimated, it was the Bush era tax cuts that played a big part in government financial deficits. Interestingly, the bailouts initiated by Obama involved the smallest government expenditure.

The Goldman Sachs study suggests that China and India will overtake the old economic powers of the US, Japan and EU. In terms of aggregate incomes, that appears to be the case. China recently overtook Japan as the second biggest economy and is expected to catch up with the US by 2027. But Steinbock pointed out that the picture is different if one looks at per capita GDP. While some small parts of China have come close to matching US GDP levels, on the average, China still lags behind the US.

Steinbock is a self-confessed optimist. He thinks that the current reform plan falls short of what is required. He thinks that there is a lot more to be done, and a long way to go. But he still has faith in the recovery prospects of the US economy in the long run.

While the wars in Iraq and Afghanistan did cost more than was originally estimated, it was the Bush era tax cuts that played a big part in government financial deficits