The great American Downgrade : What would China do and what are its long-term implications?

The unprecedented US credit rating downgrade comes in the midst of a political paralysis on Capitol Hill to revive an anaemic economy and a struggling job market. In the light of the simmering sovereign debt crisis on the other side of the Atlantic, three related questions spring to mind on China and the rest of the emerging economies.

First, as China is the largest foreign creditor to the United States while the European Union is now China's largest trading partner, what would China do to safeguard her best national interest? Second, could the emerging markets especially China now consolidate their lead in the world's economic growth? Third, would this be a defining moment marking the inevitable shift of global economic gravitas from the West to the East?

Turning to the first question, ***what would China do***, hours after the US downgrade, China's official Xinhua news agency issued a sharply phrased warning (1) that the US has only itself to blame and must cure its 'debt addiction', a reflection of growing concern amongst the Chinese people that China's $1.1 trillion holding of US debt is increasingly being devalued if not put at immediate risk.

The downgrade is likely to strengthen China's resolve to ease herself out, over time, of what Paul Krugman, a New York Times columnist and a Nobel laureate, calls the *Dollar Trap*. In future, we are therefore likely to see, on the quiet, more diversification of China's reserve into other currencies; more vigorous internationalization of the RMB for international trade settlements; and more outward flow of China's accumulated capital to acquire overseas assets, resources, markets and expertise.

But with a still immature financial system, China is unlikely to readily give up the protection of the RMB's capital account non-convertibility, which served her well during recent global financial crises. So the RMB is likely to remain non-convertible and is therefore incapable of replacing the greenback as a leading reserve currency any time soon.

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(1) See article in the *New York Times*
http://www.nytimes.com/2011/08/07/business/global/china-a-big-creditor-says-us-has-only-itself-to-blame.html (accessed on 7 August, 2011)

Additionally, the US is still by far the largest economy for now and there is no real substitute in sight which is relatively large and safe enough to replace US Treasuries. So Uncle Sam remains able to continue enjoying the seigniorage of printing fiat money which is still valued around in the world. That's why Alan Greenspan recently told MSNBC *Meet the Press* - "Credit rating is not the issue. We can always print money'" (2). So, is the greenback "*Our Currency Your Problem*" after all, as Niall Ferguson outlined earlier in an article (30 April, 2005) at the Hoover Institution (3)?

Well, with talks about another bout of 'quantitative easing'(QE3), the printing press seems to be a panacea for now, if only as a last resort. But as creditor countries are wising up to their unfavourable situation and as the greenback is fast losing its attraction as a storage of value, soon or later, faith may begin to crack and a tipping point may turn into a stampede.

Turning to the second question on ***emerging markets' contribution to global growth***, Paul Mortimer-Lee of BNP Paribas, has surmised that emerging markets will account for three quarters of global growth over the next few years. As growth in emerging markets continue to outperform Western markets in the wake of the global financial crisis, and as Western economies are showing no real sign of an economic breakthrough, there is increasing evidence that the emerging markets is accounting for most of global growth, the more so following the continuing European sovereign debt crisis and the American downgrade. In the 6 August, 2011 issue of *The Economist*, two articles marshalled concrete data to show that 'the emerging world begins to seize the lion's share of global markets' and 'now have greater heft on many measures than developed ones' (4).

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(2) View Alan Greenspan's interview on MSNBC
http://www.msnbc.msn.com/id/21134540/vp/44036029#44050320

(3) *Our Currency Your Problem*, Niall Ferguson, Hoover Digest, Hoover Institution, Harvard University, 30 April, 2005 http://www.hoover.org/publications/hoover-digest/article/6386 (accessed on 8 August, 2011)

(4) *Emerging vs developing economies - Power Shift -The emerging world begins to seize the lion's share of global markets* and *Economic Focus - Why the tail wags the dog - Emerging economies now have greater heft on many measures than developed ones*, The Economist, 6 August, 2011

Specifically, while the traditional consumer markets in the US, EU and Japan are still important, over the next few decades, the number of people considered to be in the 'global middle class' is projected to more than double, from 430 million in 2000 to 1.2 billion in 2030 (or from 7.6% of the world's population to over 16%) according to the World Bank. Most of the new entrants are expected to come from China and India - where private consumption has been surging ahead in recent years. By 2030, 93% of the global middle class will be from developing countries, up from 56% in 2000, although the per capita consumption in Western economies would still be much higher. Nevertheless, the World Bank warns that this bulging new middle-class remains vulnerable to aggregate economic contractions as one in six people in the developing world still live between $2 and $3 per day (5)

On the other hand, trade has been rapidly growing amongst emerging markets themselves. At the heart of the global production chain, China has now become the largest trading partner of more and more countries including India and Brazil. Nevertheless, as China's growth slows to a more balanced and sustainable model as highlighted in the latest Five Year Plan (2011-15), and as China steps on the brakes to fight inflation or somehow ends up in a 'hard landing', many other economies, including the rest of the emerging markets, are likely to feel the chill.

Now the final question, ***whether the American downgrade marks the beginning of the end of Western economic leadership.***

Jim O'Neill of Goldman Sachs has projected that China's economy will be bigger than the US by 2027. Amongst the BRIC countries, China's economy is already much larger than the other three (Brazil, Russia and India) combined. By 2015, it is expected to be 47% larger. The BRICs collectively would be bigger than G7 by around 2032. During the trajectory, both China specifically and BRIC collectively would be growing much faster than the US and the G7, according to the projection.

While the above prognoses are not clockwork, the general direction so far appears to be on track. If anything, the milestones could be reached even earlier. For example, China is now slated to overtake the US by 2020, according to recent forecasts of *The Economist*, PriceWaterhouseCoopers, and Standard Chartered Bank plc. Goldman Sachs also updated their forecast in 2007 to say that India will be overtaking the US by 2043 (instead of 2050).

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(5) *The Developing World's Bulging (but Vulnerable) 'Middle Class'*- Policy Research Working Paper WPS4816, The World Bank, January 2009

However, the reality is much more complex as these numbers don’t tell the full story.

The first doubt may be cast on whether China’s growth masks a declining level of productivity as capital allocation is becoming very inefficient, favouring much less efficient state-owned entities. Surprisingly, according to a study in June 2010 by the Federal Reserve Bank of Minneapolis (6), starting from a low base and thanks to a rapidly rising share of a vibrant private sector, total factor productivity growth in China has remained fairly high in the past decade and the actual rate of return in both the state-owned and the private sectors has been increasing substantially.

Second, China’s growth has so far been driven largely by a great deal of imported proprietary foreign technology. She is still way behind the world's top league in science and innovation except in a limited range of fields such as life sciences. There is, for example, yet no home-grown Chinese Nobel laureate scientist. There is also a dearth of international Chinese brands. Moreover, China has yet to overcome huge challenges in resource and ecological constraints, social inequalities and the rising aspirations of a growing middle-class before the demographic burden of an aging population kicks in.

As for India, while the slow-growth era of the ‘*Licence Raj’* is now a thing of the past, she still has to streamline bureaucracy a lot more and vastly expand a woefully inadequate infrastructure if she is to grow a manufacturing base large enough to provide sufficient jobs for the teeming masses. Otherwise, as her population is to exceed China’s by 2030, that would be a heavy albatross weighing down her future growth rates.

Third, compounded by Climate Change, food and energy scarcity including water are likely to throw many a spanner in the works for these fast-growing emerging economies with massive populations.

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(6) *Awash in Cash - Why do China's banks hold low-yield U.S. Treasuries? A theory of economic transition*, in *The Region*, Douglas Clement, Editor, The Federal Reserve Bank of Minneapolis, 1 June, 2010
http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4462 (accessed on 8 August, 2011)

The above are largely reflected in a sobering note (7) on why the West (especially the US) may still rule, at least for now, by Peter Nolan, director of the China Big Business Program at Cambridge University. It shows how much China's export prowess is dependent on imported and embedded Western technologies and how far ahead and entrenched is the West in the commanding heights of global strategic businesses including commercial aircraft industries, finance, and the world's top brands.

However, the political and economic paralysis on both sides of the Atlantic does not seem to bode well for Western economic leadership. If the future by 2050 should look like as Goldman Sachs predicts, the top ten economies in the world would be, in descending order, China ($70 trillion), US (about $38 trillion), India (about the same as the US), Brazil (barely over $10 trillion), Mexico (just under $10 trillion), Russia, Indonesia, Japan, United Kingdom, and, lastly, Germany (about $5 trillion). Only four of the G7 would thus remain on this list. Except the US, the other three G7 countries, Japan, UK, and Germany, would have fallen to the bottom of the list. The combined economic weight of the six so-called Emerging and Growth-leading Economies (EAGLE), what may be called the E6, would be over two and half times more than the remaining G4. By 2050, therefore, the E6 would have soared well above the G7 to rule the world's economy. It is, of course, a bold prediction and many a black swan may appear.

Shakespeare refers to a tide in the affairs of men. Could the Great American Downgrade mark a clear turning? In the fullness of time, how would the tide change again?

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(7) *Who Are We? Who Are They? The Real Facts of a Globalized Chimerica'*, article excerpted from a paper prepared for the US-China Business Council, summer 2011. http://www.digitalnpq.org/archive/2011_summer/17_nolan.html (accessed on 8 August, 2011).

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Positions

Chairman and CEO, Andrew Leung International Consultants Limited (Founded in London)
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International Expert, Reuters Insight Community of Experts, Thompson Reuters
Brain Trust Member, The Evian Group (global think-tank), Lausanne, Switzerland
China Futures Fellow, Berkshire Publishing Group, Massachusettes, USA
Distinguished Contributor, Asymmetric Threats Contingency Alliance (ATCA) (global think-tank)
Elected Member, Royal Society for Asian Affairs
Senior Consultant, MEC International
Global Commercial Agent, Changsha City, China
Visiting Professor, London Metropolitan University Business School
Visiting Professor, Sun Yat-sen University Business School, China (2005-10)
(The following until 19 May 2010, on permanent relocation back to Hong Kong)
Founding Chairman, China Group, Institute of Directors City Branch, London, UK
Vice Chairman, 48 Group Club, UK
China Group Leader, Elected Fellow on Executive Committee of Royal Society for the Encouragement of Arts, Manufactures and Commerce (RSA), London Region
Governing Council Member, King's College London, UK
Advisory Board Member, China Policy Institute, Nottingham University, UK

Included in UK's Who's Who since 2002
Awarded the Silver Bauhinia Star (SBS) in the July 2005 Hong Kong Honours List