

Asia Economics Flash

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China: Decoupling—Why do we believe this time would be different?

- In a previous article, we estimated China's potential to decouple from a US slowdown using data since 1997. In this article, we take a different approach and re-examine the case for decoupling from a bigger picture perspective.
- We argue that the macro divergences between the US and emerging Asia—some serious home-grown challenges facing the US in the coming year(s) vs. the endogenous growth strength enjoyed by Asia, resemble more the divergences between these two regions in the 1980s as opposed to the 1990s.
- In this context, we believe the strong and improved fundamentals in China as well as in the rest of emerging Asia stand a good chance of decoupling from a further weakening of the US economy or its continued sub-potential performance.
- Because of rising uncertainties in the US economy and policy risks in China, some cautiousness for the near-term macro outlook are understandable. However, we remain comfortable with our bullish assessment of the region over the next few years.

The sub-prime crisis coupled with signs of weakness in the US labor market has significantly raised the downside risks to global growth in the coming year(s). Many analysts, including us,¹ have used historical data to estimate the likely impact of a further sharp weakening of the US economy on China's growth. While these exercises are valuable, it still leaves many concerns unaddressed; in particular, will the estimated elasticity change if US growth falls below a certain threshold? Or will the rapid structural changes of the Chinese economy make these historical-data-based estimates less reliable?

These questions and doubts are understandable, given that the US remains the largest economy in the world. But if we take a step back and look at the big picture of how the global economy has been evolving in the past few years, and is likely to continue to evolve over the medium term, we



¹ See *Assessing the impact of a potential US slowdown on China*, Hong Liang and Helen (Hong) Qiao, Asia Economics Flash, August 22, 2007.

still feel very comfortable with our view that China, together with emerging Asia, stands a very good chance of outperforming and decoupling from the US economy in the coming few years.

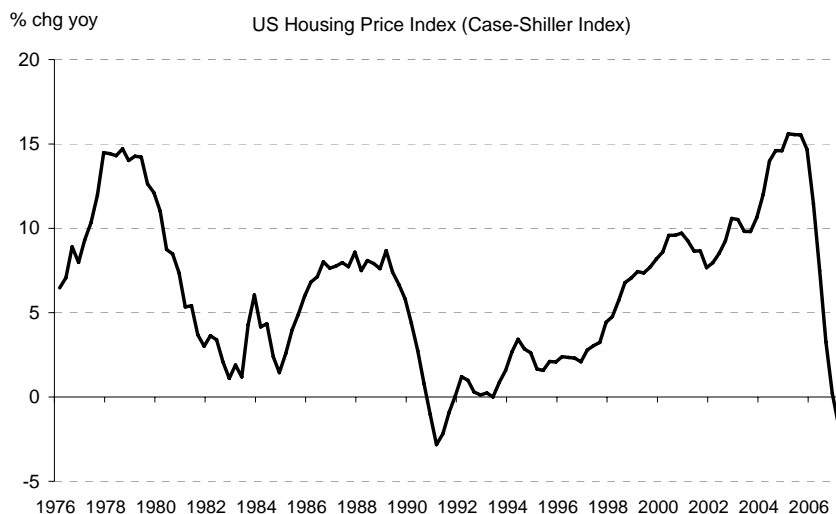
In our view, the home-grown problems facing the US economy vs. the endogenous growth strength enjoyed by Asia resemble more the macro divergences between the two regions in the 1980s as opposed to the 1990s. In this context, China, together with emerging Asia, have the potential to become a more independent engine of growth as the global economy rebalances with a weaker growth engine in the US. Indeed, the BRICs consumers, with China and India leading the charge, may have already contributed more to global demand than US consumers in 2007.²

Housing woes, large current account deficits, and leftover wounds from a protracted war on foreign soil—how did the world do when the US was last facing all these troubles?

Indeed, when one lists the challenges facing the US economy today, many of them were once brought up back in the 1980s:

The last time the US housing market went through a prolonged adjustment in prices and investment, it was in the 1980s until the early 1990s. Residential investment began to slump and prices to dis-inflation in 1980-1982, triggered by the Fed's contractionary monetary policy to control inflation. The housing market had another boom in the second half of the 1980s before it slumped again in 1989-1992 (see Exhibit 1). The savings and loans crisis, a direct result of the over-investment in the housing sector, was resolved eventually at the beginning of 1990s with a fiscal bailout amounting to US\$166 billion.³ **In fact, during 1980-1992, residential investment in the US recorded negative growth rates in 7 out of 12 years.**

Exhibit 1: Long cycles in US housing prices



Note: home price is Case Shiller, spliced with OFHEO before 1987.

Source: CEIC, Goldman Sachs Economics Research.

Rising military-related expenditure and tax cuts had also resulted in ballooning fiscal deficits and current account deficits in the US in the 1980s (see Exhibit 2). The recovery of the US economy was supported by the Fed lowering the Fed Fund rates substantially after the weak domestic economy led to reduced inflation risks (see Exhibit 3), and the rebalancing of the global economy back then involved a substantial weakening of the USD (see Exhibit 4).

² See *The Changing World*, Jim O'Neill, Global Economics Weekly, September 5, 2007.

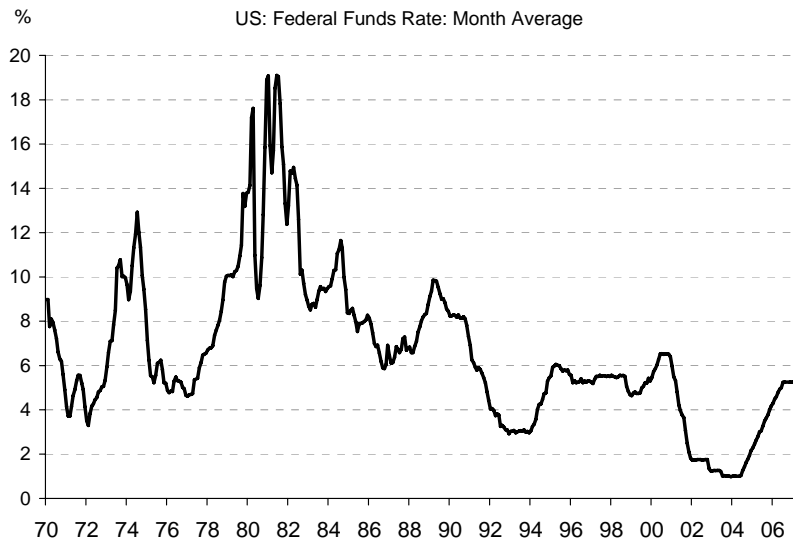
³ See <http://www.millercenter.virginia.edu/academic/americanpresident/keyevents/bush>

Exhibit 2: Evolution of US growth performance and its twin deficits

	GDP	Residential Investment	Fiscal Balance	Current Account
Decade average	% chg yoy	% chg yoy	% of GDP	% of GDP
1980-1989	3.1	2.1	-3.9	-2.1
1990-1999	3.1	3.4	-1.8	-1.7
2000-2006	2.6	3.7	-1.5	-5.1

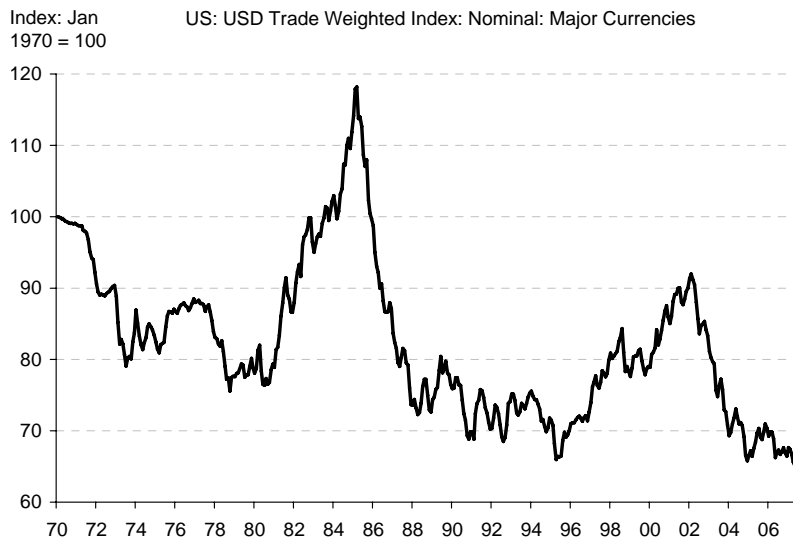
Source: CEIC, Goldman Sachs Economics Research.

Exhibit 3: The recovery of the US economy was supported by lower Fed Funds rate...



Source: CEIC, Goldman Sachs Economics Research.

Exhibit 4: ...and the rebalancing of the global economy involved a substantial weakening of the USD



Source: CEIC, Goldman Sachs Economics Research.

On the other hand, the 1980s were boom years for Asia by most accounts. The rising economies at the time, including Japan and Korea as well as other newly industrialized economies (NIEs, such as Indonesia, Taiwan, Singapore, Hong Kong) enjoyed strong secular growth in the 1980s, with many of them experiencing rapid industrialization and urbanization domestically. Strong domestic demand and confident consumers from Asia were hallmarks of the 1980s. Exhibit 5 shows both overall growth and domestic demand strength were robust in the 1980s, in particular in the major economies of the region at the time.

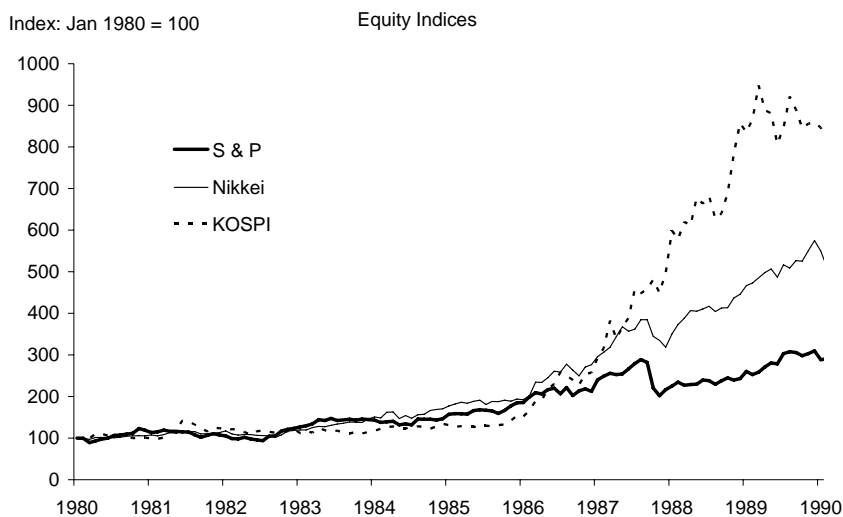
Exhibit 5: Asian growth held up well in the 1980s

average % chg yoy	Asia ex China	GDP		Domestic demand	
		Japan	Korea	Japan	Korea
1980-1989	4.7	3.7	7.6	3.6	7.3
1990-1999	3.6	1.5	6.2	1.4	5.2
2000-2006	3.1	1.6	5.2	1.3	3.8

Source: CEIC, Goldman Sachs Economics Research.

Not surprisingly, booming equity/property markets and rising domestic currency values in Asia were also part of the well-known stories of the time. **In other words, the decoupling also took place in the asset markets** (see Exhibit 6). Some may argue that Asia had over-stimulated its domestic demand in the late 1980s with accommodative monetary conditions, which led to later woes of excessive asset inflation.

Exhibit 6: Decoupling also took place in the asset markets in the 1980s



Source: CEIC, Goldman Sachs Economics Research.

Re-coupling and the disappointing 1990s

The relative fortune between Asia and the US reversed in the 1990s. Rather than being Asia's decade, the 1990s witnessed rather disappointing performance of the Asian economies, and the period of 1997-1999 was marked by a severe financial crisis and economic recession. Excessive asset inflation, weak financial institutions, and mis-management of cyclical policies, particularly a rigid exchange rate system, were among the factors that contributed to Asia's underperformance. As a result of these domestic weaknesses, Asia's growth became increasingly dependent on the demand from the US, who fortunately in the 1990s enjoyed a powerful productivity boom led by the IT revolution.

The excess during the IT boom led to a sharp cyclical slowdown in 2000-2001 globally, including in Asia where the budding signs of cyclical recovery in 2000 was undermined and the economies were pushed back into recession. But since 2H2002, China, Asia's new economic pole, has embarked on a powerful cyclical recovery buttressed by significant structural improvements. India, another emerging economic powerhouse in the region, has also seen a substantial lift in its potential growth rates.

The pendulum is swinging back to Asia

The point that emerging Asia is on a much stronger footing than right before the 2001 US slowdown is best illustrated in Exhibits 7A and 7B. The size of many Asia emerging economies has more than doubled in current USD terms over the past 6–7 years. **Emerging Asia now amounts to a US\$7 trillion economic block, growing at close to double-digit rates!** More encouragingly, we believe the economic perspectives of the two largest growth engines of the region, China and India, continue to look solid over the medium term.

- Productivity growth continues to be robust, driven by supply-side policy reforms to open up and deregulate, and by rapid advancements in industrialization and urbanization of the economies.
- Corporate earnings remain strong, and corporate balance sheets are in their best shape ever.
- Consumers' balance sheets are also very strong, with very limited leverage.
- The government is in a solid fiscal position in China, with ample room to maneuver if needed.
- There is also little risk of any external margin call for China, given its large external surplus and hefty foreign exchange reserves.

Exhibit 7A: Emerging Asia is on a much stronger footing than right before the 2001 US slowdown...

Real GDP growth % yoy	2000	2Q2007
Japan	2.4	1.6
China	8.4	11.9
India	5.3	9.3
Korea	8.5	5.0
Indonesia	5.4	6.3
Taiwan	5.8	5.1
Thailand	4.8	4.4
Hong Kong	10	6.9
Malaysia	8.9	5.7
Singapore	10.1	8.6
Philippines	6	7.5
Vietnam	6.8	8.0
Macau	5.75	37.9
Asia including Japan	6.1	7.8
Asia ex Japan (AEJ)	7.4	9.9
AEJ ex China	6.1	7.5

Source: CEIC, Goldman Sachs Economics Research.

Exhibit 7B: ...which now amounts to a US\$7 trillion economic block

Nominal GDP levels (US\$ bn)	2000	Latest-annualised
Japan	4750	4656
China	1198	3057
India	461	1171
Korea	512	954
Indonesia	166	441
Taiwan	321	376
Thailand	123	245
Hong Kong	169	198
Malaysia	90	181
Singapore	93	156
Philippines	76	141
Vietnam	31	70
Macau	6	14
Asia including Japan	7996	11661
Asia ex Japan (AEJ)	3246	7004
AEJ ex China	2048	3947

Source: CEIC, Goldman Sachs Economics Research.

Concluding thoughts

Undoubtedly the downside risk to US growth has risen significantly since the outbreak of the sub-prime crisis. In the meantime, the higher-than-expected inflation data in August has also increased policy tightening risks in China. However, if we look through these short-term uncertainties, the big picture of Asia's renaissance remains unchanged. While the US economy may likely face some multiyear growth challenges, growth in China and the rest of emerging Asia will likely continue to be driven by their own strong and improved fundamentals.

As a result of these divergences in fundamentals, we believe the strategic case for Asian assets, including its equities and currencies, remains intact.⁴ In this decade, in emerging Asian countries including China, we will likely witness a substantial rise in peoples' living standards and wealth accumulation, supported by strong local asset price performance and appreciation in their currency values. We continue to like the position of owning a basket of Asian currencies, and our Global Economics Team has recommended going short USD/CNY via 2-year NDF as #9 of their Top 10 Trades.

⁴ See our Asian Strategy Team's recent report, *Consuming concerns: Asian earnings and US consumption*, Asia Pacific Portfolio Strategy, August 31, 2007, for their thoughts on equity markets across the region.

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