ISAS Brief

No. 389 – 9 September 2015
Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

China and South Asia – IV

A Changing Trade Landscape?

The on-going restructuring of the Chinese economy has rung alarm bells across the global financial markets. However, South Asian countries like India, Bangladesh and Pakistan may stand a chance of capitalising on China's emerging trade pattern.

Shahid Javed Burki[1]

What we are about to see are a major restructuring of the Chinese economy and its trade pattern. It will have enormous consequences for Asia and within it for the South Asian sub-continent. In a way this is China's 'pivot to Asia'. The original American version

[1] Mr Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be contacted at sjburki@gmail.com. The author, not the ISAS, is responsible for the facts cited and opinions expressed in this paper. During a professional career spanning over half a century, Mr Burki has held a number of senior positions in Pakistan and at the World Bank. He was the Director of China Operations at the World Bank from 1987 to 1994, and the Vice President of Latin America and the Caribbean Region at the World Bank from 1994 to 1999. On leave of absence from the Bank, he was Pakistan's Finance Minister, 1996-1997.

focused on military preparedness. The Chinese will place emphasis on economic links. The stage for this fundamental change was set in motion by the events in August 2015.

Over a period of less than three weeks, there was unprecedented turmoil in the world's financial markets. China was the reason for most of this. On 11 August, the Chinese central bank devalued its currency by 1.9 per cent against the United States dollar and followed up with smaller adjustments in the next two days. On 24 August, Dow Jones Industrials in the New York stock market fell by more than 1,000 points soon after the opening bell. The reason for this was the sharp adjustment in the Chinese markets. On the same day, the Shanghai market declined by 8.5 per cent. The day quickly earned the title of Black Monday. Trillions of US dollars of value were sliced off the markets in the United States and other major financial centres. This raised the question as to what to expect in the future?

While this drama was unfolding, the International Monetary Fund indicated that China would not be able to meet its "new normal" of 7 per cent GDP growth over the next decade. In 2015, the Chinese economy will increase by only 6.8 per cent, having declined from 7.8 per cent in 2012, to 7.7 per cent in 2013, to 7.4 per cent in 2014. This means that the Chinese demand for raw materials supplied by countries such as Australia, Chile, Brazil, and Peru would decline by significant amounts, negatively impacting the commodity-producing and -exporting countries. On 24 August 2015, the price of oil fell below US$ 40 per barrel. This was the lowest in years. On 28 August, the Brazilian authorities announced that the country's economy had plunged into a deep recession. All this was a reminder of the deep links that had developed among different parts of the world economy. If one major part of the global economy catches cold, all other begin to sneeze.

These and other developments created the impression – endorsed by several financial analysts – that the world was moving towards a very uncertain and volatile economic future. There was a great deal of anxiety all around. Was that justified? My answer is simple: what we are seeing is an overreaction to the changes in the structure of China's economy and in the policies adopted by the government in Beijing to deal with them. Let us first understand the policies being adopted by Beijing and how they are impacting the Chinese economy.

China could not have sustained, into the future, its rate of growth of the last almost forty years, from 1979 to 2013. In 1979, China's paramount leader Deng Xiaoping announced a number of reforms that, when fully implemented, would move China from a socialist to a quasi-capitalist economy – 'quasi', since the state, while giving up the ownership and direct management of a number of assets, would remain actively involved. In 2013, political and economic power passed into the hands of a new leadership group headed by President Xi Jinping. The new president took a number of initiatives in addition to proclaiming the "new normal" of 7 per cent rate of growth. In the period between these two important events, the Chinese economy grew by 9.8 per cent a year. This record of a very high level of growth, stretched over such a long period of time, has had no parallel in economic history. At this time, the Chinese economy has grown 31 times its size as at the beginning of the Deng period. Income per head of the population has increased sixteen fold. The country has virtually eliminated mass poverty; the World Bank estimated that only 10 million people were "absolutely poor" in a population of 1.4 billion.

With changes of such a magnitude, it was clear to the new leadership in Beijing that it could not continue with the old model of economic growth powered by exports of manufactures produced by cheap labour. The first generation of development economists had suggested that mass transfer of workers from low-productivity agriculture to more-productive manufacturing would fuel growth. This would continue for as long as the reservoir of cheap labour was not depleted. It is now exhausted in China.

Ever ready to experiment with new methods for propelling the economy, the Chinese authorities turned to investment in infrastructure as the new engine of growth. Roads and rail-lines were laid in all parts of the country, and new houses were constructed for the tens of millions of workers who moved from the countryside to towns and cities. China now has by far the largest network of fast trains in the world. And one way of promoting domestic consumption was to encourage those with capital not to save it in the banks but to invest it in domestic companies. But the local governments and the investors in the stock markets over-shot the mark. The former became heavily leveraged while the latter became over-bought. The gross values of the main stock exchanges doubled in a year and a correction was expected; it occurred.

That was not the first time that the Chinese stock markets were adjusting; that had occurred ten years earlier as well. The current correction had eroded only a part of the gains made over the last one year. By the end of August, the Shanghai index fell by 43 per cent; even with this fall, it was 50 per cent higher than in early last year. Even after the plunge, the Shenzhen market was trading at the still-lofty 39-times earnings. The Shanghai market traded at 15 times' earnings, almost twice the ratio in Hong Kong. If the adjustment in the markets was not a cause of worry, were there reasons to believe that the Chinese economy was not in a major crisis? The answer is yes because the authorities have instruments in place to deal with the situation.

William Pesek, a keen observer of China, notes in Bloomberg that foreign investors, while encouraging China to move even closer to becoming a market economy, swoon when the country accepts their advice. "For years, the world has called on China to loosen its grip on the yuan, drop its arbitrary growth rates, allow stocks to fall, attack corruption and let reckless borrowers suffer losses. But whenever Beijing has taken any of these steps, global investors have responded with fear and trembling".[2]

With absolute poverty virtually eliminated, the Chinese consumers are looking for a different basket of consumption goods than that demanded by the less-well-to-do. If there is to be a consumption-led pattern of growth provided mostly by industry and the modern service sector, the Chinese will need a policy framework within which that can be done. Some of what the new consumers require will come from outside, particularly from Asia – particularly from the southern parts of the continent. This means a major adjustment in

[2] Willam Pesek, "Panicking investors need a time-out on China," *Bloomberg*, 27 August 2015.

the patterns of growth and trade. What China was producing for the West, it will need from Asia. Its own industry will focus even more on investment goods required to supply for the massive construction projects it has begun in Central Asia and is preparing to launch in Europe.

With these adjustments in mind, the policy makers in Beijing adopted measures to facilitate the contemplated change in the pattern of trade. For this they needed to move towards a convertible currency that the Asian nations could use to increase their trade with China without using the scarce US dollar resources. One step was to realign the renminbi rate of exchange with market fundamentals. This was done by the series of devaluations undertaken, starting on 11 August 2015.

If we see China and the performance of its financial markets and that of its economy from this perspective, the reason for panic seems less justified. Moreover, a significant change is likely to occur in the destination and origin of China's exports and imports, respectively. Currently, South Asia does not figure among China's ten largest trading partners. Total trade with the United States, the largest partner, was estimated at US$ 525 billion, with Japan and South Korea in the third and fourth place. Two South Asian countries – Bangladesh and Pakistan – have significant amounts of imports coming in from China: 21.7 per cent of the total for the former and 19.7 per cent for the latter. India's total trade with China in 2012-13 was US$ 68 billion (well below Russia, the tenth largest partner) with a trade deficit in China's favour of US$ 41 billion. All this is likely to change in favour of South Asia, if the Chinese economy is restructured along the lines I have indicated above.

. . . . .