COUNCIL on FOREIGN RELATIONS

Paging Edward Hugh: Demographics do not explain the recent rise in Chinese savings

Posted on Monday, June 19, 2006

by **Brad Setser**

Louis Kuijs' latest analysis seems to suggest – based on my reading — that three common perceptions of China are more myth than reality.

Myth one: foreign direct investment has been a big driver of China's growth.

The reality: most investment in China has been financed domestically. FDI accounts for no more than 10% of total investment. That is consistent with the analysis in Goldstein and Lardy's critique of Bretton Woods 2 as well. Obviously, that FDI is concentrated in China's export sector, so foreign firms account for a much larger share of exports than of total investment.

Analysis based on the total amount of FDI may understates its impact, as innovations that start with foreign firms diffuse through the economy.

But there is little doubt that most investment in China is financed domestically. FDI this year will probably by something like $70b or so. That is small relatively to the $1300b in total investment that Stephen (a bit more bearish once again?) Roach expects in China this year.

Myth two: China's state banks do little more than finance investment by China's unprofitable state-owned enterprises.

The reality: There is some truth to the argument that state banks finance money losing state owned enterprises. But it also may be a somewhat dated argument that ignores some recent reforms. Jon Anderson of UBS consistently argues that there reforms have increased the profitability of (many) Chinese state firms. And Kuijs' data suggests China's increasingly profitable state-owned enterprises finance lots of investment out of their own retained earnings, without having to turn to the banking system. A surge in business savings, according to Kuijs, is why overall national savings have risen so strongly in the past few years. Some of that surge comes from a surge in private profits. But a decent chunk of it comes from a surge in the profits of state-owned companies. And rather than paying out dividends, state-owned enterprises plow their current profits into new investments.

Incidentally, some of the big state commercial banks seem to have been rather active in the mortgage market recently.

Myth three: China's current account surplus comes from its demographics, not from its policies.

The reality: According to Kuijs, policies – not demographics – explain the recent surge in Chinese savings.

Kuijs highlights two sets of policies, both in his paper and in the earlier powerpoint. First, those profitable state enterprises need to start paying out dividends, not just empire building. Second, China shouldn't finance large capital investments at the local level with revenues transferred from the center. This pushes up government savings. Far better for the government to finance a bit of health care – and start to provide some of the social services that now–profitable state-owned firms don't want to provide.

I am probably stating Dr. Kuijs' arguments a bit more starkly than he would, but that is one of the advantages of a blog – I can opt for a more provocative framing.

Kuijs isn't the only one with interesting things to say about China recently – check out Yu Yongding's latest paper.

You don't have to read too far between the lines to figure out that Yu believes that China has put too high a priority on maintain a (de facto) exchange rate peg (and keeping domestic interest rates low to reduce incentives for money to flow into China) and too low a priority

on other objectives. He thinks China needs tighter monetary policy and looser fiscal policy (seems right to me) – and realizes such a policy mix is inconsistent with targeting a weak RMB. He isn't quite that blunt: he just notes "the multi-objectives of China's monetary policy have deprived the ability to the PBOC to implement a relatively tight monetary policy" … and calls for "reform" to "China's macroeconomic management regime."

Kuijs doesn't really discuss monetary policy. But there is one point of disagreement between Yu and Kuijs. Kuijs emphasizes the growth in Chinese corporate profitability over time – and the failure of Chinese firms to distribute retained earnings. Yu thinks corporate profitability is now falling, as big increases in input costs have not been passed on. But a host of factors – liquid banks, ambitious local governors and the like – have led investment growth to accelerate even as corporate profitability falls (see p. 17 of his paper).

They may be looking at the data over different time frames. Or they may be looking at different sets of data. No one seems to have a great grip on how profitable Chinese state firms really are. Or what exactly should count as a state-owned firm. Stephen Roach:

China, however, is far from a normal economy. Despite over a quarter century of impressive reforms, it remains very much a "blended" economy — a mixture between state- and privately-owned enterprises. While the ownership balance continues to shift dramatically away from the state, the latest statistics put state-owned enterprises at about 35% of Chinese GDP. Moreover, that share undoubtedly understates the degree of state control in the newly privatized — or "corporatized" in Chinese parlance — segment of the economy. Even after public offerings, the state still maintains sizable majority ownership stakes in most of its so-called publicly-listed, privately-owned companies.

I know enough to have an informed view about capital flows into China, and Chinese reserve growth. But not enough to have an informed view on current levels of Chinese corporate profitability.

Do read Kuijs, Yu and Roach. I'll probably have more to say about Yu's paper later.

This entry was posted on Monday, June 19th, 2006 at 6:24 pm and is filed under China. You can follow any responses to this entry through the RSS 2.0 feed. Both comments and pings are currently closed.

81 Responses to "Paging Edward Hugh: Demographics do not explain the recent rise in Chinese savings"

June 19, 2006 at 9:31 pm

1. ***DOR*** *responds:*

   FDI has been a big driver of growth in China.

   The mistake is counting the dollars flowing in while ignoring the technology, management know-how, financial savvy, logistics expertise, quality-control systems, customer relations management and wholesaling and retailing distribution chain. Oh, and marketing, merchandising, advertising and branding.

   * * *

   US$1.3 trillion gross fixed capital investment? At an average 8:1, that would be Rmb10.4 trillion. Add 14% to last year's GDP (just to ensure we're not understating anything) and that works out to CAP/GDP = 50%. That's about 10 points high, unless Mr Roach is using a much stronger exchange rate.

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June 19, 2006 at 9:57 pm

2. ***Dave Chiang*** *responds:*

   Why do you think the People's Bank of China (PBOC) is having to tighten monetary policy now? Because the U.S. dollar is dragging China into higher inflation – inflation in the original sense of the word, excess money creation. By pegging its currency to the U.S. dollar now, China is tying up to a dragging anchor. If the PBOC is serious about slowing Chinese money supply growth, it will have to be more reluctant to support the U.S. dollar vis a vis the yuan. The support entails the purchase of dollars with freshly-printed yuan. But the PBOC is trying to slow the growth in yuan, not increase it. Things could get very interesting in the second half of the year as the dollar starts to sink because of very soft real GDP growth and a Fed on hold.

   Paul L. Kasriel
   The Northern Trust Company
   http://www.safehaven.com/article-5406.htm

June 19, 2006 at 10:28 pm

3. ***Stormy*** *responds:*

 I am having a problem with Kuijs' paper.

 "Ma said that the foreign-funded companies in China have accounted for 57.3 percent of China's overall export in 2005 and they took a share of 87.89 percent of the total high-tech products export.

 "Accounting for only 3 percent of China's overall companies, the foreign-funded companies have taken up 28.5 percent of the country's total industrial added value and 20.5 percent of the tax revenue, Ma said.:

 http://english.people.com.cn/200606/09/eng20060609_272420.html

 But before addressing the problem, I find that Ma's figures leads me to conclude what is not a myth:

 The U.S.-China trade deficit is driven primarily through FDI.

 In terms of its actual size (3% of the companies), FDI has provided more muscle per company than Chinese firms.

 Now to Kuijs: I have a hard time squaring Kuijs' assertions with Ma's facts, especially when you read something like:

 "Its regime for trade and FDI is open, and external trade and FDI are quantitatively important in the economy, amounting to 64 and almost 3 percent of GDP in 2005, respectively. "

 If trade accounts for 64% of GDP and if 57% of that is a result of FDI (foreign companies in China), then at least 36% of GDP is a result of FDI. That meager 3% certainly produced a lot of GDP.

 In short it is misleading to measure FDI simply as an investmentâ€"a meager 3% of GDPâ€"when that investment results in 36% of GDP.

 Am I missing something here?

June 19, 2006 at 10:37 pm

4. ***Gcs*** *responds:*

 brad a lot of this rings well in my ear

 but i'd steer clear of return on investment calcs
 thats mad science at this point

 there is a ponzi feel to such an onslaught eh ??
 but maybe this uniquely "blended"
 is like the booze us grant was drinking
 its maybe naughty and crude
 but they seem to be winning battles with it

June 20, 2006 at 1:09 am

5. ***HZ*** *responds:*

 The big listed state firms pay sizable dividends, at least those listed on the overseas stock exchanges. I think because of the structures of these companies — the majority holders (parent companies) are invariably "group" companies that are wholly state owned, reflecting their former lives as state companies. Now the parent companies are not required to pay dividends (i.e. hand the dividends they receive to the MOF). They are also unlisted with no private equity holders. They use the dividends they receive for investments to buy or develop businesses. If they are successful they will often then sell the businesses to the listed operating companies. This way the private equity holders of the listed companies do not have to take the risk; but by the same token they also put no restraint on the parent companies from investing along lines that are not profit-maximizing.

June 20, 2006 at 2:41 am

6. ***Anonymous*** *responds:*

 I find myself in agreement with Stormy, and will add a Beijing Review article: 'Are these profits or losses?'

 (Excerpt):

 China's state-owned enterprises (SOEs) present a strange dilemma–they are making profits but also draining state assets. This has prompted the National Audit Office to set the examination of SOEs' financial accounts as a key task for this year.
 […]
 At the National Auditing Work Conference held at the end of 2005, Auditor General of the National Audit Office Li Jinhua said that a preliminary overhaul of 11 key SOEs such as the China National Petroleum Corp. and the State Grid Corp. of China revealed that gains and

losses were not reported accurately and many SOEs made false reports of profits. Owing to weak internal control, especially the lack of effective checks and balances on the power of top executives, state assets were embezzled.
http://en.ce.cn/Business/Macro-economic/200604/28/t20060428_6850897.shtml

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June 20, 2006 at 3:09 am

7. ***Guest*** *responds:*

First, those profitable state enterprises need to start paying out dividends, not just empire building.

Rising business saving has another name : too low wages, wages not following productivity growth.

That means only one thing, China needs foreign consumers because it does not pay enough its domestic workers.

US and Chinese workers unite, you are underpaid relative to your productivity by those capitalist monopsonies on the labor market, they offer to lend you money, they try to tell you that housing is a perfect investment opportunity and to convince you to cash in on your illusory wealth.
Don't get fooled.
Or you'll pay the price.

A country where the central bank is happy when wages do not rise in par with productivity is a sick country.

June 20, 2006 at 4:00 am

8. ***Edward Hugh*** *responds:*

Hi Brad,

Thanks for the coverage. Basically I am not responding at the moment since I am stripped down to the waist and thoroughly entertained in the theory boiler room. I am still trying to understand the underlying dynamics of things at the conceptual level. Which means I do not have anything very useful to say about China at the moment. Rather than saying something supid I prefer to remain silent.

Certainly I am now convinced that simplistic versions of the life cycle theory don't help much, this is a complex problem, and needs to be understood in all its aspects.

I have just surfaced from writing a draft of something which may help to get the problem set up right, but whose relevance won't be immediately apparent to most observers:

http://www.edwardhugh.net/Demogrpahic_Dividend_Additional__Mechanisms.pdf

The idea that we need to understand how our underlying biology (menarche age, mortality schedules) is endogenously impacted by economic growth processes won't win me many friends among economists at this stage (although biologists of ageing and evolutionary anthropologists are a little more receptive).

I think we all need to get out of the box, and do some hard thinking. Of course I think the empirical work you are doing is terrific, I just have my doubts about the theoretical framework. I will mail you with something more thoughtful later in the week.

June 20, 2006 at 4:10 am

9. ***Edward Hugh*** *responds:*

I'll give you a hint:

"As China's demographic transition continues, the OADR is projected to rise in the
coming decades, exerting downward pressure on private saving."

This is a very dubious idea, there is no real evidence for this anywhere as far as I can see. This is just simplisticly lifted from the Modigliani model, and asiac just won't do. Of course I am not in any position to demonstrate this yet. This is for the summer. See you, as they say, in September.

Incidentally, this: Fehr, Jokish, and Kotlikoff (2005), is a completely ridiculous paper, and is a good example of what not to do.

Till later.

June 20, 2006 at 7:33 am

10. ***Guest*** *responds:*

If Chinese households believe that the present boom is a transient phenomenon that must surely end in Hard Times, rational expectations seem to go a long way towards explaining Chinese savings. Among China's middle-aged, the Great Leap Forward and Cultural Revolution are very much within living memory.

June 20, 2006 at 7:58 am

11. ***Guest*** *responds:*

Looking at DOR's points and subsequent posts, perhaps a good start to a much longer list. Along with the problem of how dividends are allocated, the costs of development. If there is any truth to reports of growing pollution and food safety problems, then money for both healthcare and consumption could quickly be absorbed by the costs of nutritional and environmental degradation related problems. Not to say this isn't a problem in other nations as well. I know nothing about tax policies in China – if workers are better paid, how much of that income is lost to taxes. How small and medium sized local businesses and their workers, are treated in relation to state owned and foreign owned enterprises.

June 20, 2006 at 7:59 am

12. ***FR*** *responds:*

Guest: you wrote -
"US and Chinese workers unite, you are underpaid relative to your productivity by those capitalist monopsonies on the labor market, they offer to lend you money, they try to tell you that housing is a perfect investment opportunity and to convince you to cash in on your illusory wealth.
Don't get fooled.
Or you'll pay the price.
A country where the central bank is happy when wages do not rise in par with productivity is a sick country. "

Bravo!

Thats what I've been trying to say, only you said it better. Now, lets take action on that and massively email our elected reps in support of the current AFL-CIO complaint about China's labor practices.

June 20, 2006 at 8:06 am

13. ***Guest*** *responds:*

re: "If Chinese households believe that the present boom is a transient phenomenon that must surely end in Hard Times…"

Then wouldn't that money be in coffee cans and mattresses – anywhere which may be beyond the scrutiny of government statisticians?

June 20, 2006 at 8:11 am

14. ***MTC*** *responds:*

Stormy -

I only have time to whiffle through, but could any of the following significant?

1) trade is both exports and imports, so it is not 57% of 64% but 57% of something nearer to 34%, with the result somewhere near 17% of GDP.

2) FDI in China is still culmulative in impact, i.e., virtually all the productive capacity bought and installed through FDI is still in use somewhere

3) FDI was a larger % of GDP in the past (guessing, I do not have the figures)

Sorry, have to run.

June 20, 2006 at 8:15 am

15. ***Guest*** *responds:*

"…The difficulties and challenges associated with managing the global supply chain in emerging markets might surprise those non-retailers among us: listeners were regaled with horror stories of Russian bribes (and guns), Indian truck drivers who turn off the freezer when they've left the store, and the near impossibility of transporting goods across China's vast and poorly connected expanse…" http://www.just-food.com/blogs.aspx

June 20, 2006 at 8:29 am

16. ***Iasius*** *responds:*

"If Chinese households believe that the present boom is a transient phenomenon that must surely end in Hard Times, rational expectations seem to go a long way towards explaining Chinese savings. Among China's middle-aged, the Great Leap Forward and Cultural Revolution are very much within living memory."
Isn't that an argument for capital flight?

June 20, 2006 at 8:31 am

17. ***Guest*** *responds:*

"…India, widely considered to be the largest recipient of money transfers from migrant workers overseas – commonly referred to as remittances — is expected to receive nearly $22 billion, according to World Bank figures, with China close behind in international receipts.

Jennifer Isern, [Consultative Group to Assist the Poor (CGAP), a consortium of 31 public and private development agencies housed within the World Bank] CGAP's lead microfinance specialist who commissioned the study, said she isn't surprised that China's domestic remittances market is bigger than what it — or any other country — receives from abroad. "It takes a certain amount of capital to be able to travel the long distance, say from India to the U.K. or from the Philippines to Saudi Arabia, and a lot of people may not be able to gather that, at least initially, so they're migrating a shorter distance for labor," Isern told IPS… The report also suggests that 75 percent of China's domestic remittances are sent through the China Post, commercial banks and rural credit cooperatives, but pinpointing a precise proportion channeled through the country's formal sector poses complications similar to those found in other markets. "Any figures with regard to remittances are very hard to come by," said David Landsman, executive director of the National Money Transmitters Association. For China specifically, its centuries-old system of transferring money outside of formal channels over large distances makes the task all the more difficult. "Looking at remittances elsewhere in the world, there are a lot of informal remittances happening and some sources would say they're as high or higher than formal remittances globally," said Isern. "I still question the [75 percent] figure… if there isn't just more out there, a kind of hidden side of the iceberg." http://cgap.org/press/press_coverage31.php

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June 20, 2006 at 8:41 am

18. ***Guest*** *responds:*

This September '02 CIO article is dated. Would be interesting to see an update:

"…Eighty percent of all Chinese Internet users are located in large cities, while more than 80 percent of China's population resides in rural areas, where the telecommunications infrastructure lags far behind the urban areas… only 20 percent of Chinese households have a telephone line, compared with 97 percent in the United States. And only 2.5 percent of urban Chinese households own a computer, compared with 55 percent in the United States. Just under 6 percent of urban Chinese have access to the Internet, compared with 59 percent in the United States. Likewise, there is a "digital divide" between large and small corporations in China. Large corporations may have advanced information technology but small companies lack both technology and expertise. A national survey by the China Internet Network Information Center (CNNIC) shows that most small- and medium-sized Chinese companies do not have their own websites. Furthermore, most Chinese companies, including large multinationals, spend little on ITâ€"less than 1 percent of their investment spending per year. State-owned enterprises spend even less…. The lack of a mature national credit system and distribution channels, and tight regulation of both, hinders e-commerce and requires multinationals to adopt new ways of collecting payments and delivering goods in China. There are virtually no credit cards in China… the most frequently used payment methods are cash on delivery and postal remittance (most Chinese don't have personal checks, either)…" http://www.cio.com/archive/090102/china.html

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June 20, 2006 at 8:50 am

19. ***Guest*** *responds:*

"Two years ago, I had the opportunity to speak with the deputy chairman of China's Central Bank. I had been warned in advance that the officials in charge of Chinese fiscal policy would never officially admit to a policy of trying to hold down the value of the yuan. Indeed, the closest the deputy chairman came to such an admission was when he stated Beijing could not allow the yuan to rise in value. I came away puzzled not by the Chinese government's reluctance to discuss this policy openly, but by the economic logic. As one Chinese economist explained it, the government encourages Chinese businessmen to invest abroad because this helps hold down the value of the yuan. Encouraging Chinese investment abroad to weaken the yuan makes no sense, however. Governments normally suppress the value of their own currencies to encourage investment at home. But not all forms of investment are alike. The Chinese authorities are interested in attracting foreign investment because it injects "smart money" into the economy. For one thing, foreign investors are much better than their local counterparts — and far better than the state — at identifying promising companies. Strategic foreign investors also back their money with technology inputs, which are indispensable for countries such as China and Russia that are playing catch-up with the developed world…" http://www.moscowtimes.ru/stories/2006/06/20/007.html

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June 20, 2006 at 10:21 am

20. ***bsetser*** *responds:*

Wow — I knew i would generate a bit of a response by framing Kuijs in a provocative way, but this exceeded my expectations. I agree with the argument that FDI provides "intangibles" — including political support for trade with China on current terms since lots of the profits go to non-Chinese MNCs — that are not captured in the data. I sort of alluded to that.

But I also think it is true that:

a) FDI accounts for a declining share of chinese investment. fDI has been stuck at @ $60b a year, while investment has surged in $ terms.
b) Banks also finance a declining share of Chinese investment. Certainly relative to to say 2003, when credit really really grew fast and the investment base was much smaller. q1 this year sort of changes the picture, but I doubt banks will finance more than say $400 of the $1.3 trillion in investment.

ergo, more and more investment seems to be financed out of reinvested earngings, business savings, you name it.

two other points

One: the "Foreign invested enterprises" that generate 50-60% of Chinese exports seem to include not just FDI, but the investment of the Chinese joint venture partners of the of foreign firms. See Roach:

"In addition, nearly 60% of total Chinese exports are generated by "foreign-invested enterprises" — Chinese subsidiaries of foreign multinationals and joint venture partners, who rely on Chinese sourcing as a critical part of their global efficiency solutions."

Two: If a foreign firms buys parts locally for assembly and export, the export would I think count as an export by a foreign firm, even if a lot of the total investment needed to produce the components that went into the final export was done by domestic Chinese suppliers.

June 20, 2006 at 11:05 am

21. ***Joseph Wang*** *responds:*

HZ: Overseas listed companies tend to be subsidiaries of a Mainland parent company. The policy for the Mainland parent company has been "no dividends" although that policy is under a lot of dispute now.

The bottom line in all of this is that the reforms that started in 1998 are basically working. There are now profitable SOE's sitting on top of reasonably healthy banks.

Also, the fact that news of corruption scandals are popping up right and left is probably a good thing. If you look at the dates of most of those scandals, they tend to be in the past. What I think has happened is that the government has cleaned up some of the worst of the scandals, and now that no one in power right now is in danger of losing their jobs over corruption, they have a free hand to bash the people that are out of power.

Also, it's not clear to me that from a social justice point of view the money from SOE's should go to SOE workers. SOE workers are a rather privileged bunch, and I can think of people who probably deserve the money more than workers in SOE's (namely the rural poor and workers in private non-state plants). My own sense is that the profits from SOE's should be invested back into improving China's health and education infrastructure. (Then again I'm an academic so there is some self-interest here.)

Finally, I would be interested in Roach's definition of a "normal" economy. Just because one doesn't understand how it works, or it doesn't fit one's preconceived categories, doesn't mean it is "abnormal."

June 20, 2006 at 11:18 am

22. ***DF*** *responds:*

First off, a normal economy is a neither booming nor busting economy, were growth is domestic revenue led and not export led or debt led.

That leaves very few normal economies in the current era, exactly what Roach is saying. The path is suicidal, yet all of us lemmings go on walking it, and very few policy makers dare make some changes. It seems some percentage of the population must see the disaster, probably live it, before leaders can get support for the necessary action.
Sad.

June 20, 2006 at 1:45 pm

23. ***Guest*** *responds:*

Wouldn't a 'normal' economy also have to operate with sufficient transparency to generate the data sets required for analysis and 'good' administrative decisions?

June 20, 2006 at 2:47 pm

24. ***Guest*** *responds:*

Hmmm Last time I looked, Factset Research Systems (FDS) was second on today's list of NYSE top gainers and among the handful of that exchange's new highs. Looks like there's gold in that data if the markets think its good. Guess that has to be accompanied by a pipeline that can deliver the data on time and to the appropriate destination.

Third on the list of top gainers was PCCW (PCW), one of Asia's leading integrated communications companies. Off its high, but looks like the dividend yield is about 5%.

June 20, 2006 at 3:57 pm

25. ***Movie Guy*** *responds:*

Appreciate the references, Brad.

In the case of China, it is to be expected that domestic production, savings and reinvestment are running at high levels. Similarly, domestic consumption is progressing with a high rate of annual growth (though some don't acknowledge it).

There appears to be a common error among many economists and others who write about or discuss FDI investment in China – grossly underestimating its economic impact as a multiplier of economic engine growth, savings growth, and subcomponent supplier reinvestment growth – all of which contribute to the economic expansion of China.

I am not confident that the paper writers fully appreciate the long term benefits and residuals of FDI investments in China. Not really. Well, "not close" would be a more appropriate way to say it. In making this statement, I am not overlooking China's domestic investments nor domestic production gains and efficiencies. But those who continually underestimate the near term and 'go forward' effects of FDI flows and to what end (purpose) will be writing with substantial confusion. A few steps behind, so to speak. Always trying to catch up. But still confused.

The effects of FDI and technology transfers to China have been consistently underestimated by analysts. It's a major part of the reason why many analysts can not successfully project future economic growth and global trade imbalances. It might have helped had such individuals worked on serious economic development projects at the local level. They would understand the near term and long term multiplier effects. But it's apparent that they lack this background and level of hands on experience (or forgot it). Same story for understanding manufacturing. If you have worked in that environment, you should understand it. Otherwise, you're far behind the production and logistical support power curve, and you possibly would have a hard time grasping the full scope and effects of FDI production transference to another nation.

My thanks to DOR for making the FDI distinction and noting the mistake between "counting the dollars flowing in while ignoring the technology, management know-how, financial savvy, logistics expertise, quality-control systems, customer relations management and wholesaling and retailing distribution chain. Oh, and marketing, merchandising, advertising and branding." DOR is correct and it doesn't stop there.

FDI flowing into the production of goods (manufacturing and component assembly) also does much more than that. In many cases, it creates an explosion of economic growth because of the demand for supporting operations – suppliers, raw materials, energy, and operations maintenance, among other considerations. Once the FDI project, say a very large production plant is constructed, is in place, the FDI contribution to the Chinese economy doesn't stop there. It's just beginning. And it's a serious mistake to fail to understand and acknowledge the individual FDI investment projects' contribution to subsequent economic growth.

The next wave of high tech goods and knowledge flowing into China will create another huge explosion of growth. The U.S. will lead that effort and drag others like Taiwan along for the ride. (I posted links posted last week; see http://www.rgemonitor.com/blog/setser/132106#readcomments)

Economic Hydrology Theory (EHT) is working quite well. We're now at the stage where we will witness an almost complete capitulation on giving away the Crown jewels of high tech production and knowledge, including future reverse engineering efforts. And it's only a matter of time until more R&D centers are also moved overseas.

June 20, 2006 at 4:00 pm

26. ***Movie Guy*** *responds:*

Stephen Roach's article is entertaining.

Stephen Roach is starting to understand the full effects of Economic Hydrology Theory (EHT). But he doesn't a have a magic bullet solution. Nor does he appear to realize that China can readily absorb more global production of goods.

Joseph Wang takes the wind out of his sails – *I would be interested in Roach's definition of a "normal" economy. Just because one doesn't understand how it works, or it doesn't fit one's preconceived categories, doesn't mean it is "abnormal."*

Good point, Joe. Plenty of people don't *really* understand China, let alone its economic plans and economic performances. I doubt that they would understood the explosive growth of some of the western U.S. towns and cities back in the day… We may very well be watching a reversal of "Easterners" and "Westerners", as applied in the U.S. well over 140 years ago.

Still, there is some good data in Roach's article. It appears that he read Yu Yongding's draft paper or used similar sources.

Here's a heads up for Roach. Eat healthy and check your bloodpressure. There' s more to come, buddy.

One global trade economist who grasps this is Peter Morici, who states that the U.S. has already surrendered at least $1 trillion in GDP annually due to U.S. and WTO trade policy initiatives – primarily offshore production transfers. And, no, U.S. trade policy inbound resulting job gains have not made up for the loss. The issue is also loss of hard skills.

June 20, 2006 at 5:22 pm

27. ***Stormy*** *responds:*

MTC,

Is imports part of GDP? Kuijs says "external trade," which I take to be only exports. According to his figures, 64% + 3% (external trade and FDI), account for 67% of GDP. The remaining 33% is internal activity within China. Some of that 33% will be FDI engaged in non-export business in China.

Unless I am missing something, I would still assert that FDI in terms of exports is around 34% of GDP. Total FDI, when we toss in non-export business inside China, would only increase that 34%.

I suspect there is growing friction between indigenous Chinese firms and foreign firms flush with capital and know-how.

Regarding your second point, I would agree: FDI is cumulative in impact.

Regarding your third point, I would suspect the opposite: FDI may grow. However, there already is growing friction between indigenous Chinese firms and foreign firms flush with capital, know-how, and tax advantages. That friction, from my reading, is increasing, but so is foreign desire to leverage cheap labor up and down the skill ladder.

June 20, 2006 at 9:33 pm

28. ***MTC*** *responds:*

Stormy -

China GDP 2005 = $2279 billion
China total trade = $1422 billion
China exports = $762 billion
China imports = $660 billion

All figures from Xinhua

Total trade as a % of GDP = 62.4%
Exports as a % of GDP = 33.4%
Exports produced by foreign-invested firms as a % of GDP = (33.4) X 0.573 = 19.1%

June 20, 2006 at 10:10 pm

29. ***DOR*** *responds:*

Brad,

Foreign-invested enterprises (FIEs) do indeed include companies with local equity, but JVs have become so unfashionable that I'm confident in asserting that the local equity role in FIE exports is pretty small. JVs as an investment vehicle were necessary in the 1980s, easier in the 1990s and . . . absent now, excepting highly strategic sectors such as transport, energy, resource extraction and communications.

Components would be counted in the FIEs export share. The classification is based on the company registration of the enterprise that makes the export. However, there is little reason to assume that the majority of the value-added would be from non-FIEs. Export quality products need export quality components.

"fDI has been stuck at @ $60b a year, while investment has surged in $ terms."
—I'm not sure who started the now conventional wisdom that China has been pulling in $60 billion a year for several years. The figure is accurate for exactly one year, 2004, and none other.

Utilized Foreign Direct Investment (US$ Bn)

1992 ___ $11.01
1993 ___ $25.76
1994 ___ $33.77
1995 ___ $37.74
1996 ___ $41.73
1997 ___ $45.26
1998 ___ $45.46
1999 ___ $40.32
2000 ___ $40.77
2001 ___ $46.85
2002 ___ $52.74
2003 ___ $53.51
2004 ___ $60.63
2005 ___ $72.40

Movie Guy nailed the impact of FDI on China.

What's the dollar value of shifting from "Good enough for government work" to "Zero defects" ?

MTC,

Repeat after me: "Assuming any of the data are close to accurate . . ."

The 57% figure is the percent of exports – only – arising from foreign invested enterprises in China in 2004.

For 2005, ___ Exports ____ Imports
Total _____ $762.00 bn __ $660.12 bn
FIEs _____ $444.21 bn __ $387.51 bn
% share _____ 58.30 _____ 58.70

Note that FIEs' exports rose $105.60 bn during the year, equal to 62.6% of the $168.63 bn rise in overall exports (imports side: 63.77%).

FIEs are the driver of the engine of the economy.

When FDI arrivals were above $50 billion a year (2002-05), they averaged 3.3% of nominal GDP. At the $30-49 billion level (1994-2001) the average was 4.6%. In the 10 years before 1994, it was 1.5%. But, remember that the earlier FDI was really, really inexpensive.

Repeat after me: "Assuming any of the data are accurate . . . "

Stormy,

64% + 3% doesn't look right, unless the 64% includes domestic transactions between component suppliers and assemblers, and other things like that.

"I suspect there is growing friction between indigenous Chinese firms and foreign firms flush with capital and know-how. "
"However, there already is growing friction between indigenous Chinese firms and foreign firms flush with capital, know-how, and tax advantages. That friction, from my reading, is increasing, but so is foreign desire to leverage cheap labor up and down the skill ladder."
—Not sure of your sources on this, but I would be interested as friction between local and FIEs hasn't come across my radar.

Everyone,

Repeat after me: "Assuming any of the data are close to accurate . . ."

.

June 20, 2006 at 10:26 pm

30. ***MTC*** *responds:*

DOR -

Thank you for the more precise figures for 2005. I was just trying to whittle Stormy's surmise down to a decent approximation of reality.

June 21, 2006 at 1:54 am

31. ***psh*** *responds:*

'Assuming any of the data are close to accurate . .,' More of that so-called FDI will be seeping in as PE funds-of-funds through Liechtenstein or Luxembourg & Guersey etc. where it's not so easy to add up.

June 21, 2006 at 3:46 am

32. ***Stormy*** *responds:*

MTC and DOR,

My point was that Kuijs' remark seemed bizarre to me. Kuijs has external trade at 64% and FDI at 3% of GDP:

"Its regime for trade and FDI is open, and external trade and FDI are quantitatively important in the economy, amounting to 64 and almost 3 percent of GDP in 2005, respectively. "

Ma's numbers make a great deal more sense.

Frankly, I worry about whose numbers to trust. Determining FDI, for example, is tricky in itself, let alone in China with "round-tripping."

Regardless, I agree with DOR that Movieguy nailed it.

(I was trying to nail Kuijs.) To date, FDI is moving steadily upward. (See DOR's numbers.)

DOR–

We absolutely agree that FDI has been *the driver* of China's economy.

Regarding the "friction," I have read about it for some time–usually in Asian or Chinese papers. I view them as natural growing pains.

Here are some of the points of "friction." I can provide you with links if you wish.

1. Labor and environmental conditions. Foreign firms (and local firms) use both as leverages for profit.

2. Inequality of taxation between FDI and indigenous firms. To attract FDI, China set up a two-tier system: One for FDI and another for indigenous firms. In some cases, foreign firms received a ten-year tax amnesty if they "set roots."

3. Concerns that not everything should be for saleâ€"similar to the U.S. flap over the Dubai port deal–, national security, etc.

4. Concerns that the breadth and depth of FDI will smother indigenous firms. While FDI is a great starter, you certainly do not want to sell the store. Foreign firms are more sophisticated, richer, and more powerful, even though they comprise only 3% of the total number of firms. (See the Ma comment.)

Again, these are very natural concerns for a poor country.

On the other hand, large enterprises have enormous spillover effectsâ€"as any U.S. city knows. Local businesses do much better when a big company moves in. Unfortunately, FDI never measures this effect. (Nor do those economists who see simply a certain number of U.S. jobs)

Conversely, when a large firm in the U.S. decides to go overseas, the loss is not merely in those firm's jobs but in all the ancillary benefits those jobs bring to local businesses and tax revenues.

Again, regardless of the understandable friction, I suspect FDI will grow. Movieguy is absolutely right.

Sorry for being long-winded. Kuijs was not worth that effort.

June 21, 2006 at 4:39 am

33. ***DF*** *responds:*

Brad, I love your blog, the fresh info, the nerd community commenting. THere's one question that bugs me, I'm always ranting about the same stuff : debt/GDP ratio, falling share of wages in GDP, Central bank money/credit based money ratio… I guess those are the 3 ratios I relish. Based on those ones I fear debt deflation bacause of excessive debt, excessive credit based money, and too low wages to sustain revenue based consumption.

So here is my question.
You rarely answer to my repetitive remarks, is this because :
a THey sound too political or gloomy to you
b You focus on international imbalances, not domestic ones
c You have already adressed those issues somewhere (Where ?), and since I keep coming up with the same ideas, no use to answer twice.
d You disagree with the reasonment that follows from above (we're in the midst of a long terme global credit boom (which started in the 80's), once that one stops, and it has to, because it is becoming obvious that borrowers won't be able to fulfill their promisses to repay, later, lot's of things will change (end of dollar hegemony, closing of borders, stronger regulation of financial activities))…

The question goes indeed for others than Brad : am I being too repetitive in pointing out those aspects or is that each time (or most) interesting as when DOR points to aging societies, or Chiang to exploitation, or … I get lost on who says what, but here are other common recurring points : China is attracting industries and know how, China is doing well at boosting the standard of living of its people (wang) etc.

I mean if that's becoming annoying, please tell me.

June 21, 2006 at 4:43 am

34. ***MTC*** *responds:*

Stormy -

DOR's numbers do not show FDI moving steadily upwards.

Growth in FDI in %

92-93 134.0
93-94 31.1
94-95 11.8
95-96 10.6
96-97 8.5
97-98 0.4
98-99 -11.3
99-00 1.1
00-00 14.9
01-02 12.6
02-03 1.5
03-04 13.3
04-05 19.4

That's not steady–that's tipsy.

Kuijs is worth the effort–he is trying to demonstrate that demographic, structural and developmental shifts alone will not save China from having to bite the bullet over the management of the CYN.

As for the concept that FDI is the driver of the economy –the numbers do not appear to support this view. Claiming that $70-80 billion of FDI will have a greater economic impact than $1.3 trillion of domestic investment is not sensible. While I agree that FDI provides intangibles of the tremendous value to the Chinese economy (so do China's leaders, I reckon) the real economic impact of FDI in any one year must be small.

June 21, 2006 at 4:52 am

35. ***MTC*** *responds:*

DF -

If Dr. Setser does not respond to comments, it must be only because he has to breathe, sleep and eat from time to time. Mayhap I am hallucinating, but he tends to address concerns raised in the comments in later posts.

Keep on pointing out the inconsistencies, where you see them.

June 21, 2006 at 6:19 am

36. ***DF*** *responds:*

I don't see any inconsistancies, well very rarely, and indeed when that happens, Brad is quick to answer. The fact is I often comment on other things than Brad's main point. He adresses most of the time international imbalances issue, and financial risks, and often short -mid term view, and I keep coming back with comments on domestic imbalances, real sphere risks, long term view. So I'm just asking if that is a useful reminder of the other side of the coin, or useless on here.
The fact is with my own limited time I tend to read only 3 blogs regularly. Do any of you know of a blog adressing the wage/productivity gap issue, the risks of the global asset and credit bubble… I'm not sure there is much better elsewhere.
In fact, my question comes from the fact that I feel that there is a huge uneasyness of most economics to clearly state, when that is true, that wages are too low for a sustainable growth.

It seems economists have rejected the wage setting issue out of economics. It goes something like : inflation is bad, CB fight inflation, if inflation goes higher, so will real interest rates because of CB antiinflation policy, this will hurt debt accumulation and growth, if wages go higher, this will create inflaiton, therefore : higher wages are bad, higher profits are good.

This seems to be exactly what the Fed thinks and approximatively what most economists think. And I wonder why, especially why neokeynesians like Brad seems to be would buy those lines. How come there are so few economist pointing out that wages are too low in the USA to provide a sustainable level of spending. I mean it is very worrying that so much spending relies on equity extraction, while a so small percentage of productivity growth goes into higher wages.

(there I am repeating again)

June 21, 2006 at 7:40 am

37. ***Guest*** *responds:*

As usual, another interesting article from psh. Here's a teaser for those who may be interested:

"…Lavish praise for this stream of expatriate FDI, however, misses its deep flaws. Yes, expatriate-invested firms produce many Chinese exports, but they often do it by seizing control of export-oriented businesses from indigenous Chinese. Two ratios tell the story. One is the export/GDP ratio, which rose from 15% in 1990 to 20% in 1999, an increase of 5%. The other is the share of exports by foreign firms of total Chinese exports: this rose from 15% to almost 40% during the same period. So, foreign firms may create exports for China, but they also divert a big slice of the export pie away from indigenous Chinese entrepreneurs. Expatriate control of so much export-oriented businesses reflects a fundamental failing in China's financial system. China may have the second highest savings rate in the world, lagging behind only Singapore, but these funds are usually wasted on inefficient state-owned enterprises (SOEs). These investments have failed to increase the competitiveness of Chinese SOEs, yet have starved efficient local entrepreneurs of the credits they need… China's ability to attract so much export-oriented FDI is thus a warning that there is something very wrong with the financial system. Discrimination against indigenous private entrepreneurs in China goes beyond finance…" http://www.project-syndicate.org/commentary/yashengh1/English

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June 21, 2006 at 8:13 am

38. ***Guest*** *responds:*

Oh DF, you are one of those who make this blog as wonderful as it is. Please do keep posting. Its always a pleasure reading you.

June 21, 2006 at 8:24 am

39. ***Guest*** *responds:*

Re: wage gaps. Might the definition of 'earned income' be getting a bit distorted?

"…Eight out of ten, more than anywhere else, believe that though you may start poor, if you work hard, you can make pots of money. It is a central part of the American Dream….Today's rich, by and large, are earning their money. In 1916 the richest 1% got only a fifth of their income from paid work, whereas the figure in 2004 was over 60% … The proportion who think you can start poor and end up rich has risen 20 percentage points since 1980. That helps explain why voters who grumble about the economy have nonetheless failed to respond to class politics. John Edwards, the Democrats' vice-presidential candidate in 2004, made little headway with his tale of "Two Americas", one for the rich and one for the rest… Americans tend to blame their woes not on rich compatriots but on poor foreigners….But every measure shows that, over the past quarter century, those at the top have done better than those in the middle, who in turn have outpaced those at the bottom…"

http://economist.com/world/displaystory.cfm?story_id=7055911

June 21, 2006 at 8:42 am

40. ***Guest*** *responds:*

And it's very difficult to believe that the ongoing privatization and consolidation of global wealth can't be facilitating a corresponding increase in insider trading and market manipulation.

"…Developing countries are experiencing a rapid emergence of a new elite of super-rich individuals as their economies expand and mature… The report also suggests the world's super-rich are starting to move their money out of the United States… transferring assets to emerging markets such as Asia-Pacific and Latin America. There was also a shift away from hedge funds to "alternative investments", in particular private equity, which is now more popular than at any time since the dotcom boom…"
http://business.guardian.co.uk/story/0,,1802373,00.html

"…The CIBC executives who sat on Global Crossing's board "acted together with others to repeatedly violate their fiduciary duties of loyalty to Global," the suit said…" 'CIBC hit with insider-trading lawsuit'
http://www.globeinvestor.com/servlet/story/RTGAM.20060621.wcibc0621/GIStory/

"Sales of luxury residential homes have hit an "unprecedented level" in Canada, with percentage increases ranging from 8 per cent in Halifax to 177 per cent in Edmonton, according to a report on Wednesday…"
http://www.globeinvestor.com/servlet/story/RTGAM.20060621.wremax0621/GIStory/

So as the super-rich become ever more private, everyone else will try to do the same in their own way – they have to eat and live somewhere – which is why the shadow economy is so interesting, at least to me.

June 21, 2006 at 10:21 am

41. ***Guest*** *responds:*

Thinking about that smart money, a while back, DOR raised the possibility of a 'schooling bubble'. Looking at this morning's news about the ongoing standoff at a Chinese college in Zhengzhou and the reference to the 'quality of a degree' below, what exactly that means:

"Police have occupied a college campus in central China after riots involving thousands of students, reports said. Students at the college, in Henan province, were angry at the college's move to award less prestigious diplomas, local media said… Higher education in China is expensive and many families go into debt to pay tuition fees. With competition for jobs intense, the quality of a degree can make all the difference… Riot police have now confined the students to the campus, according to media reports. The Chinese authorities are increasingly worried by incidents of social unrest, which they see as the biggest threat to their rule. Endemic corruption and a growing divide between rich and poor have sparked an increase in public disturbances in recent years…" http://news.bbc.co.uk/2/hi/asia-pacific/5098204.stm

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June 21, 2006 at 10:26 am

42. ***OldVet*** *responds:*

DF, don't stop ranting about the wage/consumption link in the US – because it also directly impacts the export/development story in China. Two halves of the same coin. When US worker/consumers hit the wall, as they are now doing at the mid- and lower- income levels, China will suffer too. The difference is that China, flush with cash and foreign reserves, can turn its factories to making stuff for Chinese domestic consumers. You know, beat the drum, raise the flag, and say it's patriotic to buy stuff. America won't have the same option, so it's workers will simply have falling living standards. Talk about an "asymetric strategy!"

June 21, 2006 at 10:40 am

43. ***psh*** *responds:*

Yet Yasheng is barking up the wrong tree a little, maybe out of tact. The present system does not hinder Chinese entrepreneurs, only unconnected ä¸ç˜±äº¤é™…çš„ peasants. Let's say Lao Fourpockets sees an exciting investment opportunity in Guangdong. He is not discouraged by the deplorable discrimination against local investors. With some discreet overseas friends he goes to, say, LGT Singapore, offering not only his hard-earned pelf but intriguing prospects for its fund managers along with indispensable knowhow needed to execute the transaction. In this situation party status is a secure source of domestic value-added and round tripping a vital complement to foreign investment.

June 21, 2006 at 11:19 am

44. ***bsetser*** *responds:*

DOR — I apologize for the $60b in fDI meme, i haven't quite seized on the revised $72b for 05. But change $60b to $50-70b, with a slight upward trend over the past few years. as a share of GDP, it remains @ 3% i think. not huge. And certianly not rising as fast as overall investment. The surge in overall investment comes b/c primarily b/c of a huge increase in the $ value of domestic investment, not b/c of a $20b increase in FDI. Yes, there are intangibles. but it still seems to me that to explain China's recent dynamism, you need to explain the surge in Chinese investment, not a surge in FDI. I think this is Kuijs point.

Df– there is a limit to the number of comments that i can respond to, so i tend to pick and choose. I think i have addressed the falling share of wages v. GDP/ stagnation of real wages in various posts, tho usually as a secondary point. I have tended to focus on external debt to GDP not household debt to GDP, but the rise in household debt to GDP is an important point. Defenders of the current system note rising debt has been matched by rising assets (i.e. homes) — I am not so sanguine. Central bank money / credit based money isn't my thing, so i don't usually comment on it. I have talked extensively about rapid growth in both central bank money and credit based money in China. I do worry about

a debt/deflation scenario — that is why I woudl rather real adjustment come from rising prices/a nominal appreciation in China, not falling prices (including wages) in the US. But right now, I think the deflationary impact of China has been a bit overstated. China has had a big impact on relative prices, but it has pushed some prices (say of most commodities) up even as it has pushed other prices (manufacturing assembly) down. That sucks if you are in some sectors (and are not in China), but not if you are in others.

June 21, 2006 at 12:49 pm

45. ***Guest*** *responds:*

Fed Paper: $800 Billion Intangible Investments Uncounted In Data

Sorry if this has already been posted... don't have time to read all the comments

http://news.morningstar.com/news/DJ/M06/D20/200606201631DOWJONESDJONLINE000680.html?Cat=WashWire

Brad : this is the kind of stuff that could make you jump. Too bad they don't give a link to the paper.

Raphael Kahan

June 21, 2006 at 12:50 pm

46. ***Dave Chiang*** *responds:*

Why Dollar Hegemony Is Unhealthy: The world's dangerous dependence on the US dollar risks hurting all
http://www.globalpolitician.com/articledes.asp?ID=1901&cid=1&sid=45
Thomas I. Palley – 6/21/2006

With US Federal Reserve chairman warning about inflation, the US dollar is in the news these days, and there's a sense that the world economy has become excessively reliant on the dollar. This reliance smacks of dysfunctional co-dependence whereby the US and the rest of the world both rely on the dollar's strength, but neither is well served by it.

The US dollar is the world's premiere currency, with approximately two thirds of world official foreign-exchange holdings being dollars. Moreover, many countries appear willing to run sustained trade surpluses with the US, supplying everything from t-shirts to Porsches in return for additional dollar holdings. This willingness to exchange valuable resources for paper IOUs represents a form of dollar tribute.

Many foreign policymakers complain about the special advantage for the US, allowing the nation to run enormous trade deficits without apparent market sanction. Whereas balance-of-payments considerations constrain other countries to run tight economic policies, no equivalent constraint appears to hold for the US. This advantage is rooted in the dollar's special role as the world's reserve currency.

For the US, one major benefit of the dollar's reserve-currency role is that it increases the demand for US financial assets. This drives up prices of stocks and bonds and lowers interest rates, thereby increasing household wealth and lowering the cost of borrowing money. Additionally, the US government gets seignorage, or an interest-free loan, from the hundreds of millions in dollar bills held offshore. Printing a $100 bill is almost costless to the US government, but foreigners must give more than $100 of resources to get the bill. That's a tidy profit for US taxpayers.

Increased foreign demand for US assets also appreciates the dollar, which is a mixed blessing. On one hand, consumers benefit from lower import prices. On the other, it makes US manufacturing less competitive internationally because an overvalued dollar makes US exports more expensive and imports cheaper. Reserve-currency status therefore promotes trade deficits and de-industrialization.

US Dollar hegemony is based on US military power and the Pax Americana. The argument is that US military power provides the security that protects the global market system, and New York is the new Rome. Countries, such as Saudi Arabia, hold reserves in dollars because New York is a political safe haven and because that helps cover the costs of enforcing the Pax Americana.

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Comment – While benefitting the narrow economic interests of Wall Street speculators, US Dollar hegemony is at the root of global economic imbalances, not China. Critical resources especially oil for Far Eastern nations are sold in US Dollars and only US Dollars. Critical trade supply lines for China remain under the control of the forward based US military. The Chinese are unfairly scapegoated for US foreign policy that enforces US Dollar hegemony at the expense of Asian economies. – Dave Chiang

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June 21, 2006 at 1:32 pm

47. ***Guest*** *responds:*

China blocks search engines, Correspondents in Beijing, JUNE 21, 2006, "CHINESE authorities have blocked the search engines of two of the country's most popular web portals as part of their efforts to censor the internet..."
http://australianit.news.com.au/articles/0,7204,19540623%5E15404%5E%5Enbv%5E15306-15322,00.html

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June 21, 2006 at 2:03 pm

48. ***Guest*** *responds:*

My point in posting the link to one of many stories about the shutdown of 2 major search engines in China, which seems to have been deleted,

was only to question if some issues may be coming to a head, given the many stresses to that economy which have been discussed on that site.

June 21, 2006 at 2:05 pm

49. ***Guest*** *responds:*

Apologies – there it is.

June 21, 2006 at 2:38 pm

50. ***Guest*** *responds:*

"Is China about to start exporting inflation to the rest of the world, along with plastic toys and laptops?…" Lex, 'Chinese inflation', June 19, 2006

Can it be argued that much of China's recent dynamism has been facilitated, at least in part, by dollar hegemony – the question being the ways any number of authorities, entities and individuals may have exploited that system to their own advantage – and whether the associated risks can be managed and the resulting imbalances reduced in some way without precipitating a major crisis.

June 21, 2006 at 3:08 pm

51. ***Guest*** *responds:*

Donald Kohn: "[T]he fact that China and some other emerging-market economies have resisted upward pressure on their exchange rates and are running trade surpluses has undoubtedly contributed to their disinflationary effects on the rest of the world. The prices of their exports are lower than they would be if market forces were given greater scope in foreign exchange markets, and they are supplying more goods and services to the rest of the world than they themselves are demanding. These imbalances are not likely to be sustained indefinitely. The elevated rates of national saving in these economies–and, in some, relatively restrained rates of investment–are not likely to persist in the face of ongoing improvements in the functioning of their financial markets, increases in the depth of their product markets, and fuller development of economic safety nets. As individuals in these countries are increasingly drawn to investing at home and consuming more of their wealth and as their real wages catch up to past productivity gains, the upward pressures on their currencies will intensify, their demand will come into better alignment with their capacity to produce, cost advantages will decline, *and these economies will exert less, if any, downward pressure on inflation in the United States*." [/em added :]

cheers!

June 21, 2006 at 3:13 pm

52. ***Guest*** *responds:*

Inflation Ravages U.S. Wages, Fueling Angst at Bush's Economy: Adjusted for inflation, the median income for the top 10 percent of U.S. households rose 2.3 percent between 2001 and 2004, covering much of Bush's first term in office, according to the Federal Reserve's Survey of Consumer Finances. For the other 90 percent of households — which earned less than $184,800 in 2004 — the median fell 0.5 percent over the same period.

Inequality in America: The rich, the poor and the growing gap between them – The rich are the big gainers in America's new prosperity.

June 21, 2006 at 3:15 pm

53. ***Movie Guy*** *responds:*

Brad Setser – "DOR — I apologize for the $60b in fDI meme, i haven't quite seized on the revised $72b for 05. But change $60b to $50-70b, with a slight upward trend over the past few years. as a share of GDP, it remains @ 3% i think. not huge. And certianly not rising as fast as overall investment. The surge in overall investment comes b/c primarily b/c of a huge increase in the $ value of domestic investment, not b/c of a $20b increase in FDI. Yes, there are intangibles. but it still seems to me that to explain China's recent dynamism, you need to explain the surge in Chinese investment, not a surge in FDI. I think this is Kuijs point."

You don't know what you're talking about as relates to FDI effects.

Kuijs' paper was weak.

June 21, 2006 at 3:16 pm

54. ***Movie Guy*** *responds:*

China Economic Net

An excellent source for economic news stories – short and to the point. One page per article is the norm. Plenty of summary data, and governmental quotes or source identification. Easy on the eyes. Easy on those who have limited extra reading time.

China Economic Net

China Economic Net – Business / Macro-Economy

China Economic Net – Business / Enterprise

China Economic Net – Industries

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June 21, 2006 at 3:19 pm

55. ***Movie Guy*** *responds:*

FDI and High Technology Imports

Interested, open-minded, or experienced enough enough to grasp the value of Foreign Direct Investment (FDI) and high technology transfer in China? These very brief articles help provide an economic appreciation regarding FDI's initial value and extensive 'go forward' multiplier effects on the Chinese economy. Similarly, one can examine the substantial growth of high technology import contracts and patents.

China's Foreign-Funded Manufacturers and Other Enterprises

2006-05-21: China Has Approved the Establishment of Over 500,000 Foreign-financed Enterprises

2006-04-18: 'Sanzi' Firms (Joint Venture, Private and Totally Foreign-Owned) Take Up 75% of High-Tech Sector Income

2006-04-13: What Makes China's Foreign Trade Surplus

2006-04-13: U.S.-China High Level Talks – Trade Deals Reflect Resolve to Cut Surplus

China's High Technology Trade Goals and Performance

2005-12-28: High-Tech Trade Boosts Import-Export Business

2006-06-20: Imported Technologies vs Independent Intellectual Property Core Technologies – Percentages Identified

2006-01-11: China Maps Out High-Tech Development Plan

2006-04-18: China Aims for 20% Rise In High-Tech Goods Trade

2006-04-18: 'Sanzi' Firms (Joint Venture, Private and Totally Foreign-Owned) Take Up 75% of High-Tech Sector Income

Import Technology Contracts in China

2005-11-25: Technology Market Trade Volume and Technology Contracts – 2004

2006-01-09: Technology Import Contracts – 9,902 Contracts in 2005

2005-12-12: Trade of High-Tech Products in 2005 Up 26.8% Year-On-Year

2006-06-20: China Signed 4,630 Technology Imports Contracts To Date in 2006 – An Increase of 57.2 Percent Year-On-Year

Patent Applications in China

2006-05-29: Comparison of Foreign and Domestic Patent Applications

2006-02-05: China's Patent Applications Rocket in 2005

2006-05-15: Patent Applications Over 115,000 in First Quarter, 2006

Automobile Manufacturing Industry in China

2006-06-01: China Encourages (Requires) Independent Innovation of Auto Industry, Including Foreign-Funded Manufacturers Direct Support

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June 21, 2006 at 3:33 pm

56. ***Guest*** *responds:*

Emerging Markets Watch: According to the IMF, emerging economies account for 48% of global GDP (in PPP terms), and these economies are growing at an average rate of 7% versus 3% for the developed economies. Thus their share of the global pie is large and growing.

With their economic importance increasing one would expect the fixed income markets to move at least roughly in line with economic activity. That is, increased economic activity should go hand in hand with a broadening and deepening of fixed income markets, and investments in these countries would be expected to be an important component of any global fixed income allocation.

But at present these countries are significantly under-represented in relation to their economic importance. Chart 2 shows the IMF estimates for share of global GDP compared with those countries' representation in the Lehman Global Aggregate index (as a proxy for fixed income investors' exposure). Amazingly 96% of investments are concentrated in countries that make up only 52% of world GDP – and the slower growing countries to boot!

India: The SEZs Rush – India has witnessed a huge rush from private sector companies keen to set up Special Economic Zones (SEZs). The new SEZ law was approved in February 2006, and the government has already received over 100 applications.

Despite the recent pick-up, India's share in world goods exports has been very small – at 0.9% for 2005 – due to the widely known gaps in the business environment. SEZs, however, can quickly help create high-quality infrastructure in pockets, providing a liberal and supportive business environment, and thus kick-start the much-needed push for manufacturing exports.

Although SEZs as a concept appear to be the right solution to encourage India's manufacturing exports, the government's current approach may not be the best way to achieve the much-needed push to boost India's manufacturing.

We believe that a large number of new SEZs being planned are primarily aimed at winning tax benefits; losing tax revenues at a time when the government's fiscal deficit is already high is not the best idea.

The new SEZ law is unlikely to address the critical issue of labour flexibility. The most restrictive central government regulation is that which requires all employers with more than 100 employees to gain compulsory government approval (normally a long drawn-out process) before retrenching workers or closing part of an enterprise. This provision has not changed since 1982. The original draft of the new SEZ law intended to give state governments the freedom to allow implementation of flexible labour laws within the SEZ area. However, before the final approval from the lower house of parliament, the government was forced to drop this clause in the face of leftist opposition.

The government has also indicated that it will not allow the movement of existing businesses into SEZs. We believe that given the tax savings, companies may choose the new SEZ route for expansion plans that they otherwise would have pursued outside the SEZ area. Many proposed investments could be mere substitution of investments that would have otherwise taken place outside the SEZ area. The new SEZ investments are unlikely to provide the much-needed fillip to Indian small and medium manufacturing sector competitiveness.

June 21, 2006 at 3:59 pm

57. ***Dave Chiang*** *responds:*

To Brad,

It almost seems to me that your website Blog has overly-focused on China's macro-economics. Regardless of what Western pundits criticize, the Chinese aren't going to follow the dictates of the US Treasury, IMF, or World Bank (ie. all based in Washington DC). For the past 30 years, the IMF Neo-liberal Economists and their Western media pundits have always been proven wrong and completely biased against the Asian Industrial model.

A more productive economic Blog topic would involve informing Americans to prepare for the inevitable stagnant economic growth and rising inflation. As a result of Bush's tax cuts and deficit spending and Greenspan's rock-bottom interest rates of the early 2000s, the US economy is at risk of a stagflationary cycle.

A more productive topic for US residents would be a discussion on how to protect one's personal wealth from economic mismanagement policies by the US government and Federal Reserves. The intellectually dishonest attempt to blame the Chinese for fundamental US Economic issues does a disservice to the Economic profession. The Chinese economy should be banned from further discussion by American Economists.

Regards,

June 21, 2006 at 4:05 pm

58. ***bsetser*** *responds:*

MG — Investment has gone from something like 40 to something like 50% of Chinese GDP (subjct to DOR's caveats about the stats) over the past few years. FDI has maybe gone up by 1% of GDP over that time (I haven't done the calculation, but i am reasonably good at eyeballing data). It explains maybe 1% of the 10% increase …

and if DOR is right and JVs are out of style, that implies one $ of FDI is no longer leveraging an additional $ of investments by Chinese JV partners. It may be doing the same thing through indiret channels.

I fully accept that there has been a huge shift in electronics assembly and increasingly electronics components manufacture over the past few

years, largely due to FDI (mostly Taiwanese).

But domestic investment has increased substantially at the same time — and that is worth exploring too. cheers

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June 21, 2006 at 4:06 pm

59. ***Movie Guy*** *responds:*

Going forward, direct and accountable FDI in China should decline, but high technology imports and their effects on the Chinese economy will increase substantially. Both situations are to be anticipated.

It doesn't matter if FDI in China declines somewhat as long as high technology import contracts increase, as technology growth is performing as expected and called for in China's five year plan. The multiplier effects are immense and widespread, driving a noteworthy portion of domestic investments and savings.

Those who attempt to compare FDI to domestic investment totals with a simple accounting numbers to numbers spreadsheet comparison are lost from the start. It doesn't work that way. You have to kick in the projected and known multipliers for the FDI numbers. Those experienced in economic development projects know this, but apparently the point is lost on some economists and analysts who lack the hands on experience.

Similarly, those who attempt to compare, as a gauge, FDI investments in the United States to those of China are equally incorrect in their assumptions in many instances. New FDI in the USA which does not involve the introduction of new technology and products or new manufacturing/backrooom operations will typically not match the FDI performances in China. Not even close. Why should it?

Let's say that a foreign firm buys a U.S. corporate asset or three such corporate assets. What happened? Ownership transfer and the typical downsizing or growth changes applied to such an FDI transaction. No big deal in terms of massive economic growth. China is an entirely different story for most FDI projects. New capital, construction, technology, markets, products, you name it. Huge growth. Potential for significant modification of the economy.

How many FDI firms, FFE, or FIEs are in China? Thousands upon thousands. The impact is significant and growing.

How many FDI firms or FIEs has China authorized to be put in place? More than you can imagine. See one of the links above. Over 500,000.

This is not an attempt to slight domestic investments or improvements in China. Certainly not. Rather, this is posted in an effort to open a few to the world of FDI reality. It's time to catch up.

If you hire an economist to run your forecasting and analysis in your corporation (just assume you own one), you want that economist to understand economic development initiatives (inbound and outbound) including FDI projects. If your economist doesn't even make an attempt to understand FDI reality, cut him or her loose and hire another one. Quickly. Otherwise, you will lose money.

FDI in China is a very big deal.

And, yes, it is my opinion that China's FDI dollars will decrease, but the stage will already been set for substantial continued growth. It's similar to setting a forest on fire. Try to put out if you wait too long.

The game going forward is high technology information and product imports. The next surge in growth will be evident.

June 21, 2006 at 4:44 pm

60. ***Guest*** *responds:*

DF: Do any of you know of a blog adressing the wage/productivity gap issue, the risks of the global asset and credit bubble…

Check out this missive of Andy Xie at Morgan Stanley, more on the latter topic than the former.
http://www.morganstanley.com/GEFdata/digests/20060620-tue.html

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June 21, 2006 at 4:55 pm

61. ***Joseph Wang*** *responds:*

I'd argue that the biggest thing that China can get from FDI isn't technology, its management know how. Once you have Chinese figuring out how to run a high-tech company like IBM or a stock market, there is more than enough indigenous talent to produce its own technology.

June 21, 2006 at 5:24 pm

62. ***ReformerRay*** *responds:*

David Chiang can be counted on to revert to "dollar hegemony" as a key reason for trade imbalances.

Apparently, the term refers to the tendency of economic agents all over the world to continue to possess dollars and seek additional ones.

If that is the meaning of the term, it is clear that the U.S. military, the Federal Reserve Board and any other U. S. agents are absolved from blame in creating the situation he deplores. Independent economic agents make their own decisions as to which currency to hold. Official Washington has done nothing to really influence these decisions since the Paris Accord in 1985.

Economic agents seek dollar denominated assets for a variety of reasons of their own choosing, depending upon their objectives, not the objectives of the U. S.

I happen to agree that the continued strength of the dollar encourages the U. S. trade deficit and that this trade deficit is bad for both the U. S. and its trading partners. But currency value is beyond the control of the U. S. government, even if it wanted to influence the value.

The only action open to the U.S. government, aimed at reducing the trade deficit, is to restrict imports.

June 21, 2006 at 8:52 pm

63. ***Guest*** *responds:*

"…Last summer, the government raised the [qualified foreign institutional investor] QFII ceiling from $4 billion to the current $10 billion–but Zuo says that's not likely to be repeated in the near future. One reason is that China doesn't need the cash. "Money isn't the driver for the regulators to speed up QFII approval," she says. Instead, the major reason for QFIIs is educational–local investment firms can learn about stock markets from their foreign counterparts…" http://www.globalcustody.net/ca/securities_industry_news_latest_14/

June 21, 2006 at 11:23 pm

64. ***DOR*** *responds:*

Stormy,

Ah, now I see the FIEs-local conflict in a better light. Yes, the tax incentives for FDI are not available to local firms, which explains some of the round-tripping FDI. The "not everything for sale" (a la Dubai Ports in the US) is, I believe, an op-ed type of commentary rather than an FIE-local disagreement. Haven't heard the concerns about smothering local firms and the labor and environment don't seem to be an FIE-local disagreement at all.

MTC,

PRC FDI in 12 out of 13 years maintained forward momentum, vs. one reversal. If that isn't moving steadily upwards, we face different gravitational forces on this side of the Pacific.

"Claiming that $70-80 billion of FDI will have a greater economic impact than $1.3 trillion of domestic investment is not sensible."
—What would you offer as an alternative? Exports are the key job creator and MNCs are the key to exports. Oh, and regarding $1.3 trillion, repeat after me:

"Assuming any of the data are close to accurate . . ."

DF,

"How come there are so few economist pointing out that wages are too low in the USA to provide a sustainable level of spending."

Why would anyone think that the US standard of living is sustainable? Let's face it: the typical US employee is overpaid (in a low cost-of-living economy) relative to the alternatives, and equally important, costs his employer too much relative to the alternatives.

Oh, and DF, if you stop commenting, we all lose.

Guest (whoever you are),

RE: "Yes, expatriate-invested firms produce many Chinese exports, but they often do it by seizing control of export-oriented businesses from indigenous Chinese"

Ha! That's the best joke I've seen in years!

Clearly the author (I realize it wasn't you) has no idea who foreign investors in China are, nor the pre-FDI state of China's manufacturing-for-export industry (non-existent, or close to it).

Thanks for the laugh!

Movie Guy,

Thanks for the reminder: 552,700 foreign investment projects in China in 1979-2005.

But, I want to repeat something else I said above: What is the dollar value of "Good enough for government work" vs. "Zero defects" ?

ReformerRay,

Welcome back!

.

June 22, 2006 at 1:07 am

65. ***DF*** *responds:*

Thanks for support.

DOr of course the US worker is more expansive than it's alternatives (chinese) so is the chinese worker (vietnamese).
Yet and that's the point, both are UNDERPAID.
THey are underpaid not relative to a moral standard, hey are underpaid relative to their productivity. They produce 100 and get paid 80.
SO tell me how are they going to buy the 100 produced ?
Answer, well they'll produce more for the asset rich or the asset rich will lend to them, betting on their wage growth… Well since that wage growth is falling because of the arbitraging power of employers … The all system heads for a crash.

June 22, 2006 at 10:54 am

66. ***Joseph Wang*** *responds:*

DF: The trouble with that argument is that you'd expect if this were the case that Chinese workers would end up in debt to the United States when the opposite is happening.

It's also going to take a bit of convincing to argue that an assembly line worker is underpaid relative to their productivity. (But this argument is a bit circular since a lot of economists would argue that the amount that a worker is paid is by definition the value that they add to the product. To really make the argument, you are going to have to define how you are calculating productivity.)

June 22, 2006 at 12:34 pm

67. ***DF*** *responds:*

1 it is normal for chinese producers to lend to the US consumer.
One reason why savings are so high and household borrowing in china quite low is probably because productivity gains are so high in china that wages are rising fast even though they do not match productivity gains.

2 Productivity is the value added divided by the head count. As simple as that. All I'm saying is that companies in the USA and in china have too much money after they have paid wages, so they either over invest or overlend or overpay their asset holders

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June 22, 2006 at 1:36 pm

68. ***Guest*** *responds:*

the biggest thing that China can get from FDI isn't technology, it's management know how

Doing business in China: China has the raw materialâ€"smart, driven, educated peopleâ€"it needs to push its high-tech ambitions. Yet managing those people while navigating an opaque bureaucracy and an unpredictable business environment matters just as much as writing code or designing hardwareâ€"and will determine whether China can move from the world's workshop to becoming a serious force in global technology.

June 22, 2006 at 2:30 pm

69. ***Joseph Wang*** *responds:*

DF: Question: You can solve this problem of companies having too much money by cutting a nice big check to the CEO and senior management. Would that be an acceptable solution to the problem you mention? I'm trying to understand whether your objection is about labor vs. capital or if it has something to do with income distribution. The two are very different (and I'm more sympathetic to arguments complaining about the latter). For the purposes of bookkeeping, money paid to CEO's in the form of bonuses are counted as "wages" to "labor".

June 22, 2006 at 7:05 pm

70. ***DF*** *responds:*

The problem is income distribution and production distribution.
More and more goods are being produced for people that do not have the means to pay them, more and more people are having money with no spending use available, few goods for them.

June 22, 2006 at 11:06 pm

71. ***DOR*** *responds:*

DF,

Value of product = 100.
Worker pay = 80
Remainder = 20

20 covers investment, cost of employment (beyond compensation), taxes, interest, profit.

If you want an industry where 100% of the value goes to the worker, you're looking for substance farming, nothing more. Pulling weeds with BOTH hands is an excellent way to double productivity.
.

June 22, 2006 at 11:07 pm

72. ***DOR*** *responds:*

I meant "subsistence farming".

June 23, 2006 at 9:23 pm

73. ***groucho*** *responds:*

"The problem is income distribution and production distribution.
More and more goods are being produced for people that do not have the means to pay them, more and more people are having money with no spending use available, few goods for them."

DF, who needs money when you can get credit? If Bernanke can keep Greenspan's serial bubble blowing system intact, US households should easily be able to extract another 10-20 trillion in wealth from their "portfolios". The trick is not to wait till assets have collapsed like in Japan. As soon as Bernanke sees inflation expectations consistently dropping he will have to put "the pedal to the metal". If he blows hard enough, US consumers should be able to soak up all the excess production that china can muster. It's the US consumer must out-consume all

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June 24, 2006 at 2:18 am

74. ***DOR*** *responds:*

DOR, I don't think you read me.
THe historical mean of the share of wages / GDP is 60, right now it is closer to 50 in the USA and many european countries.
10 points is a lot, and the worst thing is that it has been going on for a while now.

DF, who needs money when you can get credit? If Bernanke ….

You said it. If Bernanke … But Bernanke can't … You need money because you can print money ad infinitum, but you can't borrow ad infinitum. Sooner or later you have to stop adding to your debts.

BWS note — this post was not from the usual "DOR" but from someone posting a comment in response to the usual "DOR"

June 24, 2006 at 9:29 am

75. ***wimpie*** *responds:*

"Sooner or later you have to stop adding to your debts"

DOR,

Unless you keep rolling them over at continually declining interest rates. How much credit can everybody handle at 0%. How about @ .01%, .001%, .0001%. Keynes objective was to bring capital to transaction costs only (0%+ fee). With all the automation in todays lending process, transaction fees are already becoming negligible and soon they will approach nil. At that point asset prices could approach infinity and wealth extraction could go on indefinitely. Central Banking has created a perpetual wealth creating machine. Now let me go look for a burger joint.

I will gladly pay you tuesday for a hamburger today!

June 25, 2006 at 10:13 pm

76. ***DOR*** *responds:*

OK, this is getting spooky . . . a post to me, about my post to DF that is signed DOR (but, without the e-mail address behind it).

Wasn't me, honest.

wimpie,

Implicit in your assumption about debt roll-over is that the lender never, ever wants his money back. Realistic?

June 26, 2006 at 12:30 am

77. ***wimpie*** *responds:*

DOR, I re-read that post. I think DF might have written it.

"Implicit in your assumption about debt roll-over is that the lender never, ever wants his money back. Realistic?"

I'm no fan of central banking. But they certainly don't need their "money" back. On the other hand, with this current global credit cycle, we can see that CB's will take back what they have given and it can/will cause some serious adjustments. Under the current CB monetary system to keep debtors rolling over their liabilities at lower and lower rates you would have to adopt a more Friedman type money supply growth system instead of the current price inflation scheme.

June 26, 2006 at 9:12 pm

78. ***DOR*** *responds:*

wimpie,

You may be right. I can certainly envisage a lender demanding repayment of a 3% loan and then turning right around and lending to the same borrower at 8%. Implicit is that the borrower isn't as safe as before, which is certainly true in this case!

.

June 27, 2006 at 1:07 pm

79. ***wimpie*** *responds:*

DOR,

"I can certainly envisage a lender demanding repayment of a 3% loan and then turning right around and lending to the same borrower at 8%. Implicit is that the borrower isn't as safe as before, which is certainly true in this case!"

That is already happening in the US, where homeowners are doing cashout refi's at higher rates. Obviously, they have a cashflow problem or expect one soon. So why not take out some more income from the best job on the planet…home refinancing.
I do expect a credit crunch over the next 12-24 months. At that point the musical chairs stop and all players will have to look for a chair. I expect a tsunami of homes will quickly enter the market as players realize the game has changed. At that point the US should enter into a major recession with anybody's guess how the global econmy will react and adjust.

June 27, 2006 at 10:31 pm

80. ***DOR*** *responds:*

wimpie,

Many thanks for the very good news! I'm heading to the US this summer to shop for a place to live in my retirement. I don't plan on buying for 6-18 months, and now look forward to a nice discount.

June 29, 2006 at 8:40 am

81. ***DF*** *responds:*

Yeah Dor, the post was from me, I don't understand why I signed DOr…

I'm glad you admitted that debt can't rise forever and that you need real earned money to repay your debt once your creditors stop lending you. This is true for the individual consumer or for the USA as a whole.
(real earned money meaning in this case exports)

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