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Weekly Economic Update

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I spent the last week traveling with a group of economists from around the world for three days in Shanghai and then three days in Hong Kong. My strongest impression from the trip was that Chinese business leaders were supremely confident in their government's ability to manage the economy. This was true not just in Shanghai were it might be expected, but it was just as prominent a factor in Hong Kong. The Chinese Government's success in using prompt and massive domestic stimulus to blunt the impact of a devastatingly large decline in the export sector has won kudos from a wide range of business leaders. They note the surge in speculation in equities and real estate, but feel that the government will be just as successful in cooling down these bubbles as it was in avoiding a deep recession. Meanwhile, the rich – that is the business leaders -- are only getting richer as the asset markets recover.

A significant byproduct of the Chinese confidence in their economic management is a rising and now overt nationalism. The normally reticent Chinese are clearly proud of their nation's quick return to robust growth, especially while the rest of the world is still struggling to various degrees. We had many discussions where the Chinese questioned the dominance of the US democratic/capitalist system given the crash after the Lehman collapse. Some merely voiced an opinion, which in itself is atypical of the Chinese culture which is rarely openly critical. Some were much more brazen in their support for a centrally planned or at least heavily regulated economy that limited volatility and especially unemployment. While many Westerners on the trip could not understand the Chinese acquiescence to an unelected (at least by universal suffrage) hierarchy, the Chinese could not understand how the West could allow more than 10% of its workers to be out of work. During the week, we frequently heard that China was now the number one exporter in the world passing Germany, the number one producer of cars passing the US, and would soon be the number two economy in the world passing Japan – with the US not far behind (the Chinese think in decades not quarters.)

The confidence of the Chinese business leaders in their government was most noticeable because it was in direct opposition to the situation in the US where business leaders worry about higher taxes, more regulation, rising health care bills and more environmental costs. While we were in China, the government began tightening credit by raising rates, increasing reserve requirements, and tightening loan terms. The moves came in response to stronger than expected growth in the trade sector – with exports moving higher year on year for the first time in many months – and much faster than expected loan growth in the first week of the year. Authorities had planned on roughly 1.0 trillion to 1.2 trillion Yuan in new loans in January, down from last year's torrid 1.4 trillion Yuan pace. However, in the first week they saw 600 billion Yuan in new loans made. It is unclear how much of this lending was simply a shift of off-the-books lending from late last year (when it was restricted) into the sunshine, and how much was simply pent up demand. Either way the government is taking no chances and has tightened significantly and indicted even more in the offing if credit growth does not rein in to the targeted pace. Moreover, as credit growth is now supposed to be directed more toward small and medium sized enterprises, they have raised down payment requirements on first and second homes. Business leaders seemed undeterred by the tightening of credit, taking it as a sign that the recovery was well underway.

The Chinese economy is expanding rapidly with already strong domestic growth now being accompanied by a rebound in the formally moribund export sector. Consensus among Chinese economists is for 10% growth in 2010 with inflation heating up to 5%. The expectation is widespread that if there is a miss in the forecast it will be to the upside on growth, with a smaller chance of an upside risk on inflation. Among the economists traveling on this trip from abroad there was general agreement with the growth forecast, but most expected inflation to be much higher – perhaps double digit – as a result of the massive lending and stimulus program in 2009. All of the Chinese economists we spoke with were certain that the current round of inflation would not be as severe as the round in 2007, which reached 8%. Many expressed the view that China's recent past experience in dealing with the extreme economic volatility caused by outside shocks had better prepared the government and businesses to deal with the current problems. They noted the Asian crisis in 1997, the breaking of the NASDAQ bubble in 2000, the SARS epidemic in 2003, and now the Lehman crash. They noted that Chinese business had learned to carry much larger reserves and to keep their balance sheets flexible and relatively debt free. For example, Hong Kong banks are capitalized at a stunning 16% in contrast to the 8% Basel II requirement that most Western banks can still not meet. Bottom line, previous problems have paved the way for better crisis management in China – a situation very similar to what we observed in Brazil last year.

Asked what they expected would be the biggest problem on China's horizon, the universal answer from local businesses was protectionism – not tighter credit or rising inflation. Virtually everyone was sure that both Europe and the US would impose broader restrictions on rebounding Chinese trade, and much more severe restrictions than in the past. They all seemed to accept that China would have a shrinking trade surplus with the rest of the world as they consumed more imported resources to build their domestic infrastructure. They have clearly abandoned a Japanese mercantile growth path for a domestic continental expansion like the US in the 1800s. Maintaining stability, especially in the agricultural sector, as they continue to move 1%-1.5% of their population into cities each year is the major concern. They are far less concerned about the heavy reliance of the economy on investment than they are about the rising inequality of income distribution. They anticipate another 200 trillion Yuan of infrastructure building is needed over the next 30 years (see they think in decades) so that investment will still make up one third to one quarter of GDP over that time frame. To balance incomes, more taxes are coming on the wealthy – with a property tax perhaps the most significant discussion – and more government aid on health care and education is planned, especially for farmers and former migrant workers.

Many analysts compare the rise of China in this century with the rise of America after the Great Depression. While similarities clearly abound, the critical difference is that the US was replacing the UK – a very similar democratic/capitalist economy -- as the dominant power around the world. It was not hard for the UK to accept US leadership especially after the long economic inter-relationship starting with lend-lease from even before the war. Nor was it hard for a normally nationalistic France to go along as it recovered from almost complete destruction of its economy. Germany, Italy and Japan had no choice as they were occupied and under US military control. Russia went its own way, and its absorption of satellite countries behind an Iron Curtain closed their economies to the world. China followed a similar isolationist path under Mao.

China's rise will bring with it a philosophy of growth that is still based on a centrally planned economy. The nation's state owned enterprises have used the global downturn to buy up resources around the world that were not available just a few quarters ago. They are expanding their influence through loans and infrastructure projects abroad, much as the US did during the Marshall Plan. One anecdote that reveals much about the future involves Secretary of Clinton's speech at Copenhagen where she argued that a global solution was needed and that the US would contribute $100 billion over ten years to help the process. The Chinese walked away from America's solution, and the next day the front page of the People's Daily noted that China would spend $440 billion on environmental issues in its next five year plan. When we discussed this response with many Chinese, they often asked "Where was the US going to borrow that $100 billion anyway?!" The Chinese know they are in the catbird seat and are likely to aggressively pursue their advantage, especially given the growing appetite for risk among confident business leaders.

Many analysts are quick to point out all the flaws in the Chinese economy – and there are many as it is still only a developing economy. However, the risk of a double dip or severe mistake in China over the next two years seems remote. The post-Lehman crisis has forced them to address their most critical imbalance – the reliance on an export led mercantilist model when they were already the biggest exporter in the world. In 2010, growth is likely to exceed 10% and inflation should add at least another 5% to nominal growth. No economy gets in trouble when it is growing 15%, at least not in the first year after a shakeout. Perhaps in two or three years when sustained strong income growth and greater distance from the last downturn allows businesses to abandon all caution, the seeds of a new crisis will be sown. In our view, this year's 15% boost in income will be used to help clear up the few remaining problems from the last mess. By comparison, the rest of the world will be trying to clear up their still significant woes with 5% nominal growth.

In reality, China's biggest problem over the next year may be how to keep the rest of the world from crashing the party. While they want the RNB to be a global currency somewhere down the road, they are more worried about uncontrolled appreciation in the currency in the near term. If they raise short term interest rates to cool of the surging economy, they will suck in a wave of hot money looking for better than non-zero returns. If they start to appreciate the RNB at a gradual pace like before the recession started, they face the same wave of hot money which will simply park in zero interest accounts and benefit from currency appreciation. What to do? Very un-American concepts like capital controls and finance taxes are being discussed. These have already been used in India and Brazil, and the biggest of the BRICs is watching.

Bottom line, for the next two year's we expect China's robust growth to be a solid underpinning to demand for commodities of all sorts, sustaining the growing global interest in them as an asset class. Unlike in the 1970s when peak oil was last a craze, this time the solution to short supply is not likely to be that higher prices call out fresh production (back then the North Sea and North Slope for oil). In the 1970s, the world was adding only Japan as a rising power, and later the NICs (Korea and Taiwan). Their incremental new demand for commodities could easily be met by new supply, at least over time. Today, the world is trying in address fresh demand from China, India, Brazil, the rest of Latin America, Eastern Europe and developing Asia. No matter how fast we find new supply, it is unlike to be enough to go around for long. In this cycle, higher prices will be the incentive for current users to curtail their demand through conservation, or switch to alternatives, or simply do without. Conflicts are much more likely to arise in this more contentious environment, resulting in occasional supply shocks that increase volatility especially to the upside on prices. It should be interesting! Keep reading for our latest updates on the economy at home and abroad.