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THINKSPACE

PERSPECTIVES ON

The Changing World Order

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This article presents takeaways from a session at GIC Insights 2019 with panellists Kevin Warsh, Shepard Family Distinguished Visiting Fellow in Economics at the Hoover Institution, Stanford University; Dr. Zhou Xiaochuan, President of China Society for Finance and Banking and former People's Bank of China Governor; and Dr. Weijian Shan, PAG Chairman and CEO. It was moderated by GIC Chief Economist Dr. Prakash Kannan, and also drew from interesting perspectives from the crowd, including Piyush Gupta, CEO of DBS Bank, and Xavier Musca, Deputy CEO of Crédit Agricole. GIC Insights is our annual flagship event that gathers a select group of prominent business leaders to deliberate over long-term issues pertinent to the international business and investment community.

The world economy is undergoing dramatic shifts with China surpassing the US to be the world's largest economy based on purchasing power parity. Rising trade tensions have dampened global trade and investment flows and increased volatility in the financial markets. China's evolution, from being the world's factory to global entrepreneur and innovator, is being met with international security concerns and protectionism at a time when Beijing seeks fresh balance between its growing global role and national aspirations.

EVOLUTION OF CHINA'S ECONOMY

The growth of China's economy over the last 20 years has been remarkable, with China's share of global GDP (in PPP terms) rising from about 7% to 19%. It has overtaken the likes of Japan and the US to become the world's largest economy since 2015.

Accordingly, China's growth model has evolved, starting with exports as a key driver in the early 2000s. Following the Asian Financial Crisis in the late 1990s and China's entrance into the WTO (World Trade Organization) in 2001, manufacturing and exports picked up rapidly. China was able to accumulate significant trade surplus and foreign exchange reserves.

China subsequently moved from export-led towards more domestic demand-based development, with the latter helped by large rural-urban migration flows. Back in 2000, only about a third of the population lived in urbanised areas; fast-forward to today, it is close to 60%. In essence, this has created huge demand for goods, services and housing as about 350 million people – or roughly the same size as the entire US population – moved into towns and cities over the period.

> **THERE WILL BE MANY RESPONSIBILITES, AND LIABILITES, IF THE RMB IS USED AS A RESERVE CURRENCY. MORE INTERNATIONAL DISCUSSION AND CO-ORDINATION, AS WELL AS NEW FUNCTIONS AND INSTITUTIONS, WILL BE NEEDED TO MOVE INTO SUCH A NEW AGE.**
>
> ***Dr. Zhou Xiaochuan***
> ***President, China Society for Finance and Banking***

In recent years, China has taken on a "high-quality development" growth strategy, comprising three focus areas:

1. *Technology*: Using science, Artificial Intelligence and other technology to transform the manufacturing and services sectors.
2. *Environment*: Strongly supporting the Paris Agreement in terms of climate change and other environmental protection, and
3. *Income distribution*: Reducing the income distribution gap through greater efforts to create jobs for those with low or no incomes or living in rural areas, as well as the minorities.

Looking forward, China has significant room for internal-based growth. China's savings rate is relatively high at 45% of GDP, as compared to circa 20-30%[1] in the US, Japan, and core Europe, reflecting considerable capital that can be invested. The urbanisation trend will continue to rise to ~70%[2], in turn driving further robust domestic demand. There is also room for catch-up in the services sector, which at 52% of GDP, remains lower than other developed economies and even other large emerging economies like Russia, Brazil, and India. While the trade war remains a challenge, China's growth will continue to be domestic-led. But China needs further reform, a domestic incentive system, and a strong vision to support this development strategy.

IMPACT OF US-CHINA TRADE WAR

The trade war is widely viewed to be the largest risk in the global economy today, but the actual direct impact on China has been less than expected as exports are no longer a major engine of China's economic growth, falling from 36% of GDP in 2006 to 18% in 2018. China is also paying more attention to the Belt and Road Initiative (BRI) to target other markets to diversify their exports over time. For the US, the loss in exports was about US$79 billion per year, or 0.4% of the US GDP, but in China the impact has been limited as the tariffs only targeted US commodities, which China could still buy from countries outside of the US.

For example, China imposed a 25% tariff on US lobsters, which saw its exports to China fall by 70%. However, China's import of lobsters doubled and import prices also dropped as China lowered the lobster tariffs from Canada.

> **[ON SCALING A COMPANY IN CHINA]**
> **THE KEY DIFFERENCE WITH CHINA IS THAT THERE ARE 800 MILLION MONTHLY ACTIVE INTERNET USERS – LARGER THAN THE US AND THE EU COMBINED. THAT IS THE POTENTIAL CHINA OFFERS.**
>
> ***Dr. Weijian Shan***
> ***Chairman & CEO, PAG***

The economic impact of the fallout in exports could potentially trigger a US downturn and an end to the trade war. One immutable fact, however, regardless of whether the trade war

[1] *Gross Savings (% of GDP), World Bank*
[2] *World Urbanisation Prospects 2018, United Nations Population Division*

ends, is that the US-China relationship has become fundamentally different from before.

INCREASED GLOBAL CENTRAL BANK COORDINATION

As the global reserve currency, the role of the dollar has become more consequential over the last 25 years, in both value and invoicing. Hence, any US monetary and fiscal decision will have huge implications on global capital flows and growth.

For example, when the US ran massive trade deficits in the 1990s, it led to a swelling of foreign reserves by other countries, especially those in Asia, following the lessons learned from the Asian Financial Crisis. These reserves were recycled back into the US economy, contributing to the real estate bubble, subprime crisis and ultimately the Global Financial Crisis in the late 2000s. Such lessons indicate that more policy discussion and cooperation is needed amongst the world's leading economies. This would not only help countries avoid framing policies that can be perceived as confrontational by other nations, but also give more credence and impact to monetary policy decisions.

> **[THE US AND CHINA] MAY DISAGREE FROM TIME TO TIME, BUT THERE HAS TO BE TRUST, BECAUSE THE TRUTH IS THAT THE MONETARY POLICY WE SET IN THE US AND CHINA HAS AN INFLUENCE ON THE REST OF THE WORLD.**
>
> ***Kevin Warsh***
> ***Shepard Family Distinguished Visiting Fellow in Economics, Hoover Institution, Stanford University***

DOLLAR TO REMAIN THE GLOBAL RESERVE CURRENCY

Will the US Dollar, as the world's reserve currency, be possibly replaced by a global digital alternative backed by a basket of major currencies?

This was recently suggested by Bank of England Governor Mark Carney, who said that such a move would protect emerging economies from swings in the US economy and unlock dollar funds that governments currently stockpile to guard against capital outflows. However, for such a global digital alternative to work, a global central bank would be needed, and there is currently no such authority. There is still some way to go before a consensus in this area can be reached.

Additionally, competition from other major currencies should help drive better decisions as policymakers think more about the long-term consequences and leakages.

However, the dollar would likely remain the global reserve currency, at least over the course of the next generation.

OUTLOOK FOR OTHER KEY ECONOMIES IN THE FACE OF RISING US-CHINA TENSIONS

INDIA

Further afield, India has significant long-term potential but also many challenges. The Indian economy is still not very large at US$2.7 trillion, about a fifth of China, which means that for every percentage point slowdown in China's growth, it would have to grow by four or five percentage points at the margin to have a similar impact. India is also going through some really important structural reforms that while beneficial in the long term, will also create headwinds in the short term.

For example, the reforms focused on eliminating crony capitalism and corruption resulted in credit contraction. The newly implemented goods and services tax reform resulted in lower purchasing power and weakness in domestic spending. The prospects of these negative headwinds turning around soon are rather limited.

Nonetheless, one potential opportunity India has is in the shift in global supply chains. While other Southeast Asian countries do not have the scale and resources to fully capitalise on this, India's ability to benefit from this is limited by the reforms needed in land, labour, and manufacturing. These challenges also make it difficult for India to participate in free trade agreements like the Regional Comprehensive Economic Partnership (RECP).

However, over a 10-year horizon, there is still considerable long-term potential for consumption, services, and other domestic sectors.

EUROPE

Europe's challenges are more internally than externally driven. Based on key economic indicators, consumption and credit flows are positive, and yet inflation and employment are declining. Unlike Asia and the US, Europe went through not one, but two financial crises over the last 10 years. The Euro debt crisis over 2011 to 2013 was a particularly difficult period for Southern Europe. One key concern for Europe was on how to avoid a "Japanification" scenario of low growth and deflation. However, Europe still has two potential positive levers at its disposal:

1. *Structural reforms:* There has been progress in some countries, earlier in Germany, and later in Spain, Portugal, Ireland, and France;

2. *Fiscal policy:* Gross public debt in the Eurozone fell from 92% to 86% between 2014 and 2019. However, the mobilisation of these reserves is another issue as capacities differ from country to country, while the coordination of fiscal policies and resolution of the immigration policy remain key hurdles.

CONCLUSION

Overall, three investment implications come to mind:

1. China has a long runway for domestic consumption-led growth and policymakers will likely continue to encourage this in the coming years.

2. China offers tremendous scale and an unparalleled domestic market for products and services, and companies who are able to tap into and maximise this opportunity will stand to benefit.

3. The US-China relationship will be fundamentally different from before, and companies need to adjust to this new reality.