

A U.S. Recession: Chinese Impact, Saudi Consequences.

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More than anything else, the spotlight was on China's economic performance during the recent International Monetary Fund/World Bank meetings in Singapore. Compared to a mere decade ago, we are now in a world where China is vastly more important, and how it deals with any forecasted U.S. economic recession will have consequences for beyond China's own economy. The impact on Saudi Arabia can be positive for both parties if some forward planning is made.

Recent International Monetary Fund (IMF) reports indicated that inflation risks and global trade imbalances meant that the world economy was "facing testing times." This has not been helped by the deadlocked WTO Doha Round of trade talks. The IMF predicted that the global economy would grow by 5.1% in 2006 and 4.9% in 2007. The gloomy news was for the U.S. economy, which was predicted to grow at a slower rate of 2.9% in 2007, compared with 3.4% in 2006. Global trade imbalances, China's roaring trade surpluses with the U.S.A. and the ballooning U.S. budget deficit were key components for this unbalanced situation.

How will the world adapt to a less buoyant U.S. economy, or more precisely, how will the Chinese economy fare in the face of a U.S. recession, and what is the likely impact on the Gulf and Saudi economies?

The U.S. position on China was made clear during the recent Singapore IMF and World Bank meetings. China, according to the Americans, faced a number of critical, and immediate challenges involving putting into place widely accepted market-based tools to prevent the economy getting out of control, and a much more flexible market-driven exchange rate for the Yuan. This lack of flexibility in the Chinese foreign exchange rate makes Chinese goods comparatively cheap, boosting Chinese exports.

The figures are staggering and illustrate the problem. For the month of August, China posted a record \$18.8 billion trade surplus with the rest of the world. By contrast, the U.S. economy has seen its trade deficit reach \$64 billion for the same month, mostly an imbalance with China. The Chinese however, counter that the U.S.A. needs to set its own house in order, starting with managing excessive domestic demand and U.S. consumer hunger for cheaper imports. A tighter monetary and fiscal policy needs to be visited as well as a reduction in the run-away U.S. budget deficit. In order to allay some U.S. concerns, China is now more focused on how much and when to widen the Yuan band against the dollar. Further flexibility in China's foreign exchange regime would signal greater two-way Yuan volatility and take some political heat out of the currency issue on Capital Hill, where increasing U.S. trade protectionist measures are being mooted against China.

The U.S. has to tread carefully though, as the Chinese meanwhile are growing increasingly unhappy with the poor returns on their dollar-heavy foreign exchange reserves, and are looking at reserve diversification, with all that implies for a further weakening of the U.S. dollar and similar questions being asked by the GCC countries.

The astonishing surge in Chinese exports over the past decade should not be underestimated. If one adds invisible and visible exports together (and add Hong Kong's invisible exports into consideration), China has now passed the U.K. and Japan. In terms of visible exports it is now ranked at number three, and some forecast that by 2010 China's share of visible exports will have risen to 10% of the global trade and pass Germany. It might take a little bit longer to surpass the U.S.A., but the trend is clear.

Is this necessarily so however, and are some of the U.S. criticisms valid? The Chinese economy is still an administered one, where much of the investment decisions are determined by an administrative order, rather than a free market process. State owned Chinese banks make loans because the Central Party says they must make a loan, and have a different culture from commercial banks. Some financial reform of the banking sector is beginning, and foreign banks are making an entry into China. The Saudi banks, with many years of first class commercial and investment banking experience, can be in a position to assist China by exporting their expertise to joint venture Chinese-Saudi banks. It will be in China's self-interest to liberalize its economy, but this will make China more vulnerable to any fall-off in growth of world trade and recessions in the U.S.A. There are also environmental and resource concerns, whereby China's record on environmental management is not up to international standards and this will add pressure on Chinese competitiveness if other trading nations insist on environmental friendly product standards.

The other concern is resource based, whereby Chinese economic growth has imposed some costs on the rest of the world, especially in its demand for more oil. World prices have risen due to many factors, one of which has been China's insatiable demand for that commodity. As such, the present slight fall in oil prices seems unlikely to be sustained in face of forecasted Chinese demand, but a recession in the U.S.A. could cancel out some of the oil price rises.

The world's economic cycle seems to be now determined by China and the U.S.A., and both are much more important than Europe to many aspiring world economic players. The Chinese will be watching very carefully for the beginning of a downturn in the U.S. economy, and the most likely signal will be a burst in the bubble of house prices in America, whereby consumers had borrowed against rising house prices. There would be a disruption in the Chinese economy, until substitute markets are found, leading to some disruption in South East Asia. The Chinese are not waiting for this to happen, and have moved to other areas of the world, especially Africa and the Middle East.

According to a recent World Bank report, China and India's growing trade and investment in Africa holds great potential for both sides. China and India now get 27% of Africa's exports; triple the amount in 1990, while Asian exports to Africa are now growing 18% per year, faster than any other global region.

For Saudi Arabia, it would be prudent to expand yet further its economic ties with China, with joint ventures both in the Kingdom and in China. This will meet regional demand for consumer goods in a more predictable manner, as well as satisfy third party country demand from the joint ventures operating out of China. Investments not prone to cyclical world recessions should be identified and oil energy conservation technology should be a priority for both parties' interest in the long run. The Saudi financial sector should seriously consider the establishment of joint Saudi - Chinese operations to cater for the financing and investment advisory requirements of projects. This could open the door for innovative capital market instruments and further listings on the Saudi and Chinese stock markets. In this manner, both Saudi Arabia and China can shield themselves from a looming U.S. economic downturn.

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