

Consumer–Led China

March 22, 2010

Stephen S. Roach
Chairman, Morgan Stanley Asia

By now, the “China miracle” is deeply ingrained in the lexicon of economic development. And with good reason. Over the past 30 years, the performance of the Chinese economy has been nothing short of spectacular—surpassing even the most wildly optimistic expectations with respect to GDP growth, poverty reduction, and improved living standards in the world’s most populous nation. Long skeptical of China’s ability to stay the course, the global consensus has now embraced the China miracle with open arms—more than willing to extrapolate these stunning accomplishments well into the future.

If it were only that easy. As impressive as the past 30 years have been, there are no guarantees that the Chinese formula for economic development will work as well in the years ahead. In fact, China’s increasingly unbalanced macro structure—with a highly disproportionate share of national output being concentrated in exports and fixed investment—is already raising serious questions about sustainability. In the end, no economy gets special dispensation from the basic laws of supply and demand. If China were to stay its present course, there is a serious risk that its powerful growth dynamic would eventually succumb to overwhelming imbalances. The key word in that warning is “eventually”—leading to a false sense of complacency over a rebalancing agenda that can always be put off for another day.

In the post-crisis era, however, the time dimension of the “eventuality excuse” has been shortened. The sustainability question has taken on a new urgency. That’s because the external demand underpinnings of China’s growth model are likely to remain impaired for several years to come.

The reason: America’s over-extended consumer—long the dominant force on the demand side of the global economy—must now face the imperatives of deleveraging and saving. At the same time, China’s powerful investment impetus is now hitting key macro sustainability constraints. In short, Beijing can no longer afford the luxury of the endless give and take of the rebalancing debate. The crisis, and the lasting external demand shock it has spawned, is China’s wake-up call. The time is now at hand for a decisive transition to a new Chinese growth model—one that relies much more on the potential of internal consumer demand rather than on the vicissitudes of external demand.

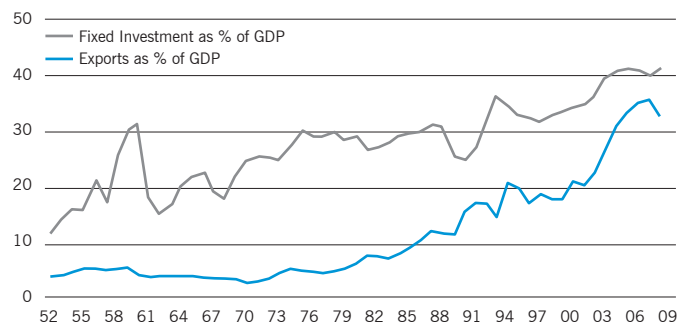
There is good reason to believe that this transition will be the defining theme of the upcoming 12th Five-Year Plan to be enacted by the National People’s Congress a year from now. A consumer-led China can thrive only if Beijing emphasizes new policies aimed at broadening the employment base, addressing the income disparities that threaten a more harmonious society, and providing a secure social safety net that tempers the excesses of fear-driven precautionary saving. These goals can best be achieved by a fundamental shift in China’s development model—moving away from capital-intensive, manufacturing-led growth toward labor-intensive, services-led growth.

If executed correctly, this plan could well be the answer to Premier Wen Jiabao’s famous critique of the old model as “unstable, unbalanced, uncoordinated, and unsustainable.” Well-designed pro-consumption initiatives have the potential to address these “four uns” head-on. Not only would a pro-consumer China offer better macro balance but it would also be much more effective in coping with the negative externalities of excess resource consumption, environmental degradation, and mounting trade frictions. The new model has the potential to turn China inside out—with profound and lasting impacts on the rest of Asia and the broader global economy.

A Tale of Two Models

China's formula for success over the past 30 years has been dominated by an externally oriented growth model. Two sectors—exports and fixed investment—more than doubled their combined shares of GDP by soaring from 34% in 1979 to a peak of approximately 75% in 2007. At the margin, the export dynamic was, by far, the most powerful source of incremental growth, going from 5% to 36% of Chinese GDP over the 1979 to 2006 interval. At the same time, the fixed investment share went from 30% to over 40% during this span of nearly three decades (see Figure 1).

FIGURE 1: CHINA'S GROWTH MIRACLE



Source: CEIC, Morgan Stanley Research

These two sectors are joined at the hip in driving the all-powerful Chinese export machine. Export flows, which increased nearly six-fold since the turn of the century—from about US\$250 in 2000 to over \$1,400 billion in 2008—recently surpassed those of Germany, making China now the largest exporter on the world. But the export surge didn't occur in a vacuum. It was facilitated by investments in state-of-the-art infrastructure and manufacturing facilities in coastal China. In other words, the investment surge was part and parcel of the export boom—providing the building blocks for the production, assembly, supply-chain logistics, and distribution of China's large and still rapidly expanding export platform.

China's externally oriented growth model also benefited from two important exogenous developments—the nation's accession to the World Trade Organization in 2001 and an unprecedented burst in global trade that took world exports from 24% of global GDP in 2001 to a record 32% in 2008. The Chinese export model was in the right place at the right time—resulting in a spectacular dividend for the economy as a whole. The export share of Chinese GDP nearly doubled in the short span of seven years—rising from 20% of GDP in 2001 to 36% in 2007. As a result, real GDP growth surged well above its 30-year average of 10%—hitting nearly 12% over the 2005-07 period and spiking to 13% in 2007, alone. The export-led China miracle was hard to deny. Who could ask for more?

In fact, none other than Premier Wen Jiabao has been quite vocal in asking for a good deal more from the Chinese

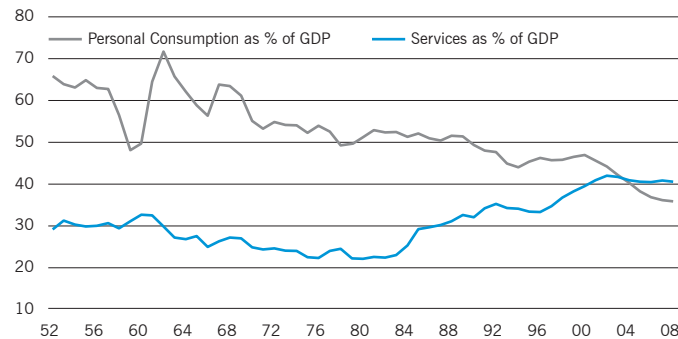
economy. And with good reason. While he has been quick to draw great satisfaction from China's top-down performance, the Premier has been equally frank in warning of an economy that looked far more problematic beneath the surface. In his view, as first publicly expressed three years ago, the export- and investment-led growth dynamic left the Chinese economy increasingly “unstable, unbalanced, uncoordinated, and ultimately unsustainable.” This critique reflected Premier Wen's well-placed concerns over excess resource consumption, pollution and environmental degradation, widening income inequalities, capacity overhangs, and a serious shortfall of internal private consumption. While the old growth model delivered spectacular top-down results over the past 30 years, the Premier has cautioned that it may well be incapable of taking China to the next stage of its development journey.¹

China needs to shift its model from export-and investment-led growth to consumer-led growth.

That poses the alternative of a very different approach to Chinese economic growth—a consumer-led growth model that would draw increasing support from the internal demand of 1.3 billion Chinese people. Not only would that allow China to wean itself from excessive reliance on external demand, but it would also shift the growth bias away from capital- and resource-intensive manufacturing activity toward labor-intensive services. This would be nothing short of a fundamental rewiring of China's long successful growth paradigm.

Two numbers underscore the open-ended upside of a pro-consumption Chinese growth model—a 35% private consumption share of GDP and a 40% services portion of the economy (see Figure 2). Both of these shares represent major shortfalls from the optimal macro structure of any major economy. China's consumption share—currently at a record low—was above 50% in the early 1990s. The services share was on an upward trajectory until 2002 before flattening out at the 40% level in the past several years—well below norms in the 50% to 60% range.

FIGURE 2: CHINA'S MACRO DEFICIENCIES



Source: CEIC, Morgan Stanley Research

1. See “Unstable, Unbalanced, Uncoordinated, and Unsustainable,” in Stephen S. Roach, *The Next Asia*, John Wiley & Sons, Inc., 2009.

China's rock-bottom consumption and services shares are a double-edged sword: They point to glaring deficiencies in the nation's macro structure but they also highlight the extraordinary potential of structural rebalancing. The pro-consumption model not only addresses these shortcomings but it also alleviates many of the stresses and strains of the old export-led growth model. The challenge for China is to seize the moment and finally embark on this critical transition.

The Wake-Up Call

There are two key underpinnings of an export-led growth model—export competitiveness and the state of external demand. China does not have a problem on the first count. Wage increases in export-led manufacturing industries have been matched by outsize productivity growth, leaving overall labor costs in a highly competitive position.² Infrastructure is first rate, as is the modern technology endowment of China's relatively new production platform. This enhances the logistics of an increasingly China-centric pan-Asian supply chain, with China drawing heavily on its Asian trading partners to source components and parts that are then assembled in the mainland and shipped overseas.³

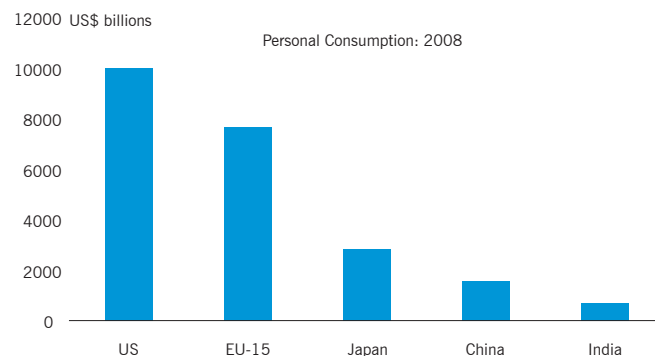
The crisis of 2008-09 is likely to impart a lasting shock to external demand and export-led Chinese growth.

But the old model has a new problem—the likelihood of a protracted post-crisis shakeout in external demand. After 12 years of excess, the over-extended American consumer is tapped out. Bubble-dependent US families are severely burdened by record levels of indebtedness and by saving rates that remain far too low to fund retirement lifestyles for an aging generation of 77 million baby boomers. And now they have been hit by devastating shocks—the bursting of property and credit bubbles, soaring unemployment, and a massive shortfall of labor income generation. As a result, real consumer spending growth in the United States is likely to average just 1.5% to 2% over the next 3-5 years—half the pace of the outsize 3.6% gains that were realized in the 12 years prior to the bursting of the subprime bubble in 2007.

Nor is any other consumer in the world likely to step in fill the void that is about to be left by a multi-year consolidation of the American consumer. That's especially the case for the Asian consumer, who is lacking the scale to play a role in driving post-crisis growth in global consumption. For example, while China and India collectively account for close to 40% of the world's population, their combined

consumption is only about US\$2.5 trillion. By contrast, while the United States contains only about 4.5% of the world's population, its annual consumption bill is running at about a \$10 trillion rate. Notwithstanding the likelihood of rapid demand growth of Chinese and Indian consumers, the scale differentials make it mathematically impossible for them to offset the foregone consumption growth likely in post-crisis America. The only consumer with the scale to compensate for protracted weakness in US consumption is the one least likely to do so—the European consumer (see *Figure 3*).

FIGURE 3: THE GLOBAL CONSUMER



Source: National Sources, UN, Morgan Stanley Research

All this paints a picture of a much slower growth rate in global consumption over the next 3-5 years—underscoring a post-crisis prognosis of a protracted shortfall in the external demand underpinnings of export-led economies such as China. Consequently, while Chinese export growth is currently rebounding after the precipitous collapse in late 2008 and early 2009, this improvement is likely to be temporary—driven mainly by inventory adjustments and the “base effects” of easy comparisons from crisis-induced weakness a year ago. With the largest consumer in the world likely to remain under pressure, the external demand underpinnings of the Chinese export machine should be impaired for years to come. This is likely to be a powerful headwind restraining China's export sector—the major driver of the nation's economic growth since the turn of the century.

China, of course, could elect to counter the shortfall in external demand by taking actions aimed at improving its export competitiveness. Currency depreciation and other mercantilist efforts to grab market share from competitors are possibilities in this regard. But those options underscore the dark side of the export-led growth model—the potential for trade frictions and protectionism. Worrisome concerns are already mounting on these counts. If China elects to go down this route and sustain its export-led growth dynamic through contentious trade policies, there is a distinct risk this approach could backfire—especially with its trading partners in the

2. See “China's Rebalancing Challenge,” in Stephen S. Roach, *The Next Asia*, *ibid*.

3. Research by the staff of the International Monetary Fund has found that, “Most intraregional trade in Asia is occurring within vertically integrated regional supply chains, that, by and large, ship intermediate goods that are then assembled in China into final goods for shipment to industrial countries.” See Chapter II of the IMF's *Regional Economic Outlook: Asia and Pacific*, April 2008.

developed world struggling with high unemployment and facing increasingly intense domestic political pressures.

China has another option if it wants to stay with the current growth model—drawing ever-greater support from fixed investment. This, in fact, was the focus of the latest pro-active fiscal stimulus that was enacted in the depths of the recent crisis. On the surface, this made a huge difference in keeping the Chinese growth miracle alive in the face of an unusually severe external demand shock. Funded by a record RMB 9.6 trillion surge of bank lending, gross capital formation surged 17% in 2009—enough to account for fully 70% of China’s 8.7% real growth for the year as a whole. Unfortunately, this investment-led impetus only compounded China’s already worrisome imbalances—pushing the already top-heavy investment share up to an estimated 47% of Chinese GDP. Not only is this a record for China but it could well be the highest investment share of any large economy in modern history. In short, upping the ante on already excessive investment-led growth raises the twin risks of excess capacity and a deterioration of bank loan quality. Needless to say, this is not a sustainable option for China in the years ahead.

There is limited upside for an investment sector that now accounts for 47% of Chinese GDP.

Consequently, there is good reason to believe that the Great Crisis could well go down in history as China’s wake-up call. It has given rise to a lasting external demand shock that provides enormous incentive to alter a long successful growth model. This shift could also be decisive in tempering that other dimension of China’s external risks—namely, the trade tensions noted above. By raising the consumption share of its GDP, China will reduce surplus saving—thereby cutting its current account and trade surpluses. In short, a pro-consumption growth model would be a powerful antidote to many of China’s “four uns”—providing much greater leeway for the nation to address its daunting saving, investment, and other structural imbalances.

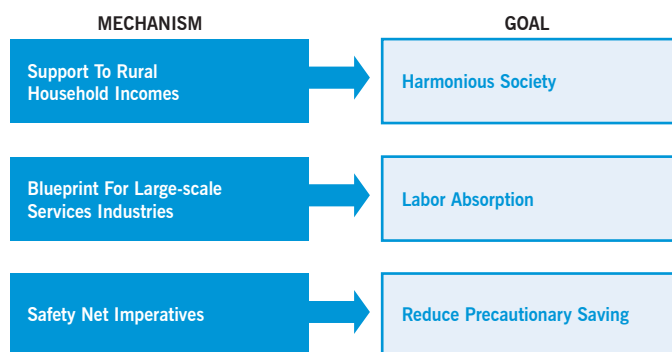
The 12th Five-Year Plan

Every five years, China has the opportunity to engage in a major rethink of its economic strategy. The upcoming 12th Five-Year Plan, to be enacted a year from now, could well be a watershed event in China’s development journey. It comes at a most opportune moment—when the old growth model, which has served China so well for the past 30 years, is being challenged as never before. Deliberations are well advanced as Beijing puts the finishing touches on the framework that will guide the economy over the 2011 to 2016 period. The post-

crisis wake-up call outlined above provides the Chinese leadership with compelling incentives to shift to a new course in the 12th Five-Year Plan—endorsing policies that promote the transition from an externally supported export model to an internally driven consumption model.

The new pro-consumption plan should feature initiatives in three major areas (see Figure 4): First, is the need to broaden the income base—essential to boost household purchasing power. China’s vast population of rural citizens is key in this regard. Estimates of China’s rural population range from 750 million to 950 million, or from 57% to 73% of its total population mass. On average, rural per capita income levels are only about 30% of those in more prosperous urban areas—underscoring enormous and widening income disparities that are very much at odds with the aspirations of what Beijing has called the “harmonious society.”⁴

FIGURE 4: PRO-CONSUMPTION AGENDA FOR CHINA’S 12TH FIVE-YEAR PLAN



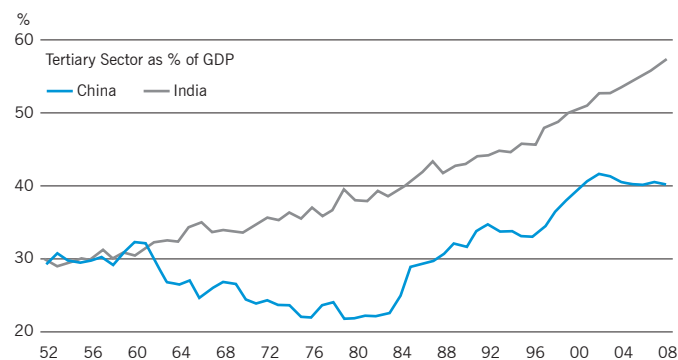
The 12th Five-Year Plan needs to be pro-active in unlocking the income generation potential of rural China. Several options are available: Tax policy—including the potential for rebates to rural households—and rural land reform should be featured. Efforts to enhance IT-enabled connectivity between rural communities and more prosperous urban centers could be important in boosting agricultural productivity. And actions should be taken to encourage rural-urban migration as a means to boost average incomes; the recent introduction of improved measures for the issuance of ID (identification) cards for migrant workers is encouraging in this regard.

Second, the new plan needs to lay out a specific blueprint for the establishment of large-scale services industries. As noted above, the 40% services share of the Chinese economy is woefully inadequate—not just compared with more mature developed economies, where services typically account for more than 65% of GDP, but also when compared with other large developing economies, such as India, where the services share is currently in excess of 55% (see Figure

4. According to estimates of the OECD, the ratio of nominal urban to rural income rose to a record 3.3 in 2007—a disappointing reversal following a decline in the urban-rural disparity ratio from 2.6 in 1978 to 1.8 in 1985. See *OECD Rural Policy Reviews: China*, 2009.

5). Emphasis needs to be placed on the development of traditional services, such as wholesale and retail distribution, domestic transportation and logistics, data processing, healthcare, and finance. Also needed are more sophisticated IT-enabled services “clusters”—centered on China’s rapidly improving higher educational institutions. This latter effort will also allow China to benefit from the higher end of the services value chain in areas such as software design, medical technologies, and a wide array of professional services in the legal, accounting, and consulting areas.

FIGURE 5: TWO SERVICES SECTORS: CHINA VS INDIA



Source: CEIC, Morgan Stanley Research

Shifting to services encourages China to “kill two birds with one stone.”⁵ As detailed below, services-led growth would help address China’s daunting labor absorption problem—a critical consideration for a nation long focused on the employment imperatives of social stability. Moreover, unlike the capital-intensive manufacturing model that lies at the heart of the export- and investment-led growth dynamic, labor-intensive services would tilt incremental output growth away from the negative externalities of excess natural resource consumption, environmental degradation, and pollution.

Third, the 12th Five-Year Plan needs to be especially aggressive in funding China’s social safety net. Only then, will insecure Chinese households feel confident in drawing down the excesses of “precautionary” saving. Professor Eswar Prasad of Cornell University estimates that the household saving rate in China (as measured on a flow-of-funds basis) soared from 27.5% in 2000 to 37.5% in 2008.⁶ There is good reason to believe that this reflects a “precautionary,” or fear-driven increase in saving. After all, more than 65 million layoffs have been associated with state-owned enterprise reforms over the past decade—spawning a deep sense of job and income insecurity. Compounding the problem has been a dismantling of the “iron rice bowl”—the cradle-to-grave support system of state-owned enterprises that used to provide broad-based subsidies to Chinese families in the form of labor and retirement income, medical care, shelter, and education allowances.

To address these fears, the new plan needs to focus on funding the expansion of a modern social safety net—specifically, social security, private pensions, medical coverage, and unemployment insurance. In recent years, China has taken surprisingly limited steps in that direction. For example, the National Social Security Fund currently has only about US\$115 billion of assets under management—enough to provide only about \$130 of lifetime social security benefits for the average worker. Similarly, the RMB850 billion nation-wide healthcare plan enacted a year ago provides only about US\$30 of benefits per person over the next three years. These initiatives, however well intended, are far too small to make a dent in the deep-rooted insecurity that biases the disposition of family incomes away from current consumption toward ever-rising precautionary saving.

There is, of course, no silver bullet that can be fired to promote a consumer society. In many respects, China is a victim of its own success. The spectacular results of the export model may have played an important role in allowing the development of China’s consumer culture to slip between the cracks. But consumerism is ultimately the endgame for any prosperous nation—especially those with large population masses, such as China and India. I reject the notion that Chinese people have a deep-rooted cultural aversion toward consumption. This is not about DNA. China’s predisposition toward saving is a rational response to the lack of a stable and secure social safety net. Consumption also suffers from low-income levels in China’s vast rural population and from an absence of new sources of higher paying jobs. If the 12th Five-Year Plan takes dead aim at these deficiencies, I am confident that the Chinese consumer will be surprisingly quick to follow.

Labor-Intensive Growth

The advantages of a pro-consumption growth model fit extremely well with the next phase of China’s development aspirations. Such an approach addresses both the internal, as well as the external pitfalls of mounting imbalances. It also offers a new recipe to overcome the critical medium- and longer-term sustainability issues raised by Premier Wen that lie at the core of his characterization of an unstable, unbalanced, and uncoordinated Chinese economy.

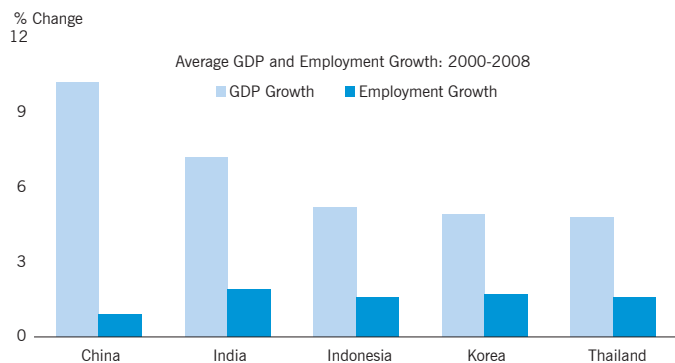
Perhaps the greatest potential benefit of the pro-consumption model is that it relies on a labor-intensive growth mechanism, thereby offering hope that China might be able to lower the GDP growth threshold required for social stability. That is a very difficult undertaking for any manufacturing-led economy. Ongoing improvements in manufacturing productivity often entail capital-labor substitution initiatives that inhibit job creation by endowing

5. See “Two Birds with One Stone,” in Stephen S. Roach, *The Next Asia*, op. cit.

6. See Eswar S. Prasad, “Rebalancing Growth in Asia,” Cornell University, July 2009.

fewer and fewer workers with increasingly powerful state-of-the-art capital equipment. This definitely appears to have been the case in China. While Chinese GDP growth averaged 10% since the year 2000—the fastest pace in all of Developing Asia—job growth averaged just 0.9% over the same period—the slowest pace in the region (see Figure 6). Given the anemic employment growth forthcoming from the old manufacturing- and capital-intensive growth model, there can be little wonder why China has had to churn out a 10% GDP growth rate in order to achieve the employment requirements of social stability.

FIGURE 6: CHINA'S LABOR-SAVING GROWTH



Source: Eswar Prasad, "Rebalancing Growth in Asia," Finance and Development, December 2009.

A shift to services could change that calculus. Services are the engine of job creation for any modern economy. By definition, they are a labor-intensive mode of economic activity that stands in sharp contrast to capital-intensive manufacturing. They provide opportunities for labor absorption and job creation at both ends of the value chain. While the lower value added transactions-intensive tasks of distribution, sales, and financial services involve increased deployment of powerful processing technologies, major headcount additions are required to staff the sheer scale of these operations in large population nations such as China. Moreover, the higher value-added tasks of knowledge workers—namely, professionals and managers—are very much embodied in the human capital of a well-educated workforce. In short, labor-intensive services are a very promising opportunity for China's next wave of job creation.

China needs to shift from capital-and resource-intensive growth to labor-intensive and resource-saving growth.

The upside of this job creation potential in services is illustrated by a comparison between the employment structures of China and the United States. Figure 7 highlights the differences in the employment composition of the US and

China's urban workforce—the latter being comparable to the configuration of a more modern economy. While these two economies basically are at opposite ends of the development spectrum, the comparison provides some hints as to what America's quintessential services-led growth model implies for the untapped hiring potential of China's nascent services sector. As seen from that perspective, China is especially understaffed in wholesale and retail trade, healthcare, professional and business services, and leisure and hospitality. In these four industry groupings, alone, the US employs over 47 million more workers than China does—underscoring the vast scale differentials between the two services sectors. In order to satisfy the job creation requirements of a pro-consumption growth model, China's 12th Five-Year Plan needs to pay special attention to the development of these key labor-intensive services industries.

FIGURE 7: EMPLOYMENT STRUCTURE: CHINA VS. THE UNITED STATES

	CHINA (Urban Workforce)	UNITED STATES
Total Employment (Millions)	120.2	131.6
Primary	8.0%	2.1%
Secondary	37.6%	13.0%
Tertiary	54.4%	84.9%
Government	10.7%	17.1%
Private Services	43.7%	67.8%
Wholesale & Retail Trade	4.2	15.1
Transportation	5.2	3.1
Utilities	2.5	0.4
Information Services	1.2	2.1
Financial Services (including Real Estate)	4.6	5.8
Education	12.6	2.3
Healthcare	4.5	12.4
Professional & Business Services	4.1	12.6
Leisure and Hospitality	2.6	9.8
Other Private Services	2.2	4.2

Note: For China, employment structure is for 2007; for the United States, data are for January 2010. Source: National Bureau of Statistics of China and US Bureau of Labor Statistics.

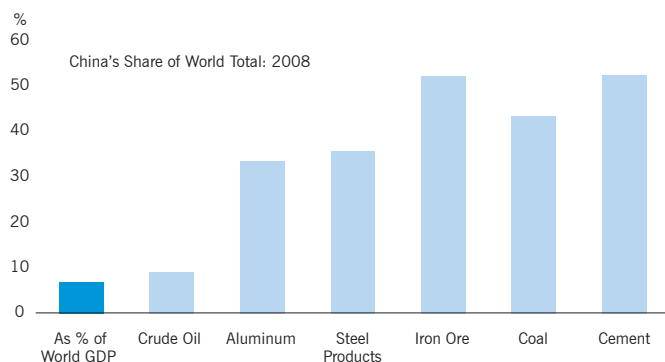
For surplus-labor economies such as China, there can be no mistaking the most critical benefit of a shift to services: Labor-intensive services will be much more effective than capital-intensive manufacturing in moving the needle toward greater job creation for the economy as a whole. With a more services-intensive macro structure, it is quite conceivable that trend Chinese GDP growth could be allowed to slow into the 7% to 8% range while the annual pace of job creation might actually accelerate to the norm of 1.5% evident elsewhere in Developing Asia. All it would take would be for China to raise the "tertiary" (i.e., services)

share of total employment by an average of about 0.4-percentage point per annum.⁷ That would allow the nation to increase its incremental employment growth per unit of GDP—the only way China can achieve social stability with slower GDP growth.

Such a shift in the mix of output and employment would go a long way in providing China with new opportunities to address its increasingly daunting sustainability constraint. Not only does services-led growth allow China to substitute labor for capital, but knowledge-based output is also far less reliant on natural resources than the physical output of the manufacturing model. This could be key in enabling China to address the twin problems of excess resource consumption and environmental degradation. As stressed above, the export-led growth model—together with its fixed investment underpinnings—is very much a manufacturing, industrial production story. That makes it exceedingly difficult for a large and rapidly growing Chinese economy to reduce its burden on the planet.

Compounding the problem is a Chinese industrial complex that is a very inefficient user of coal, oil, base metals, and other natural resources. Since the year 2000, China has been responsible for a highly disproportionate share of the growth in worldwide basic materials consumption. In 2008, our estimates suggest that China accounted almost 50% of the combined global consumption of aluminum, steel products, iron ore, coal, and cement (see Figure 8). At the same time, China continues to require more than twice as much oil per unit of GDP as the rest of the world. And, unfortunately, Chinese environmental degradation is in a league of its own. According to the World Bank, China accounts for seven of the 10 most polluted cities in the world and is leading the pack in terms of emissions of organic water pollutants.

FIGURE 8: RESOURCE-INTENSIVE CHINESE GROWTH



Source: IMF, WBMS, BP, CRU, Morgan Stanley Research

Unlike resource-intensive manufacturing, labor-intensive services have the clear potential to reduce the incremental

materials content of Chinese GDP growth. As such, there should also be some easing of demand-side pressures in global commodity markets—providing China and other commodity consumers with input pricing and cost relief. At the same time, the shift away from resource-intensive industrial activity to labor-intensive services will tilt the mix of Chinese economic growth away from environmental degradation and pollution. Unlike the old model with its open-ended claims on the global resource base, the new consumer- and services-led growth dynamic offers China meaningful hope for a lighter, cleaner, and even greener Chinese GDP.

For 30 years, China has benefited immensely from a capital-intensive growth model that powered exports and export-led fixed investment. But now the negative externalities of this approach are taking the Chinese economy into the danger zone, raising worrisome sustainability concerns. In the end, a shift to an increasingly services-led, labor-intensive growth dynamic is China's only way out. The 12th Five-Year Plan needs to take a major step in this direction.

China's Global Role

In an era of globalization, all nations have responsibility for stewardship of the global economy. That's true of developed and developing economies, alike. As one of the greatest beneficiaries of the globalization of trade flows, China is hardly an exception to that core principle. Quite simply, China's a powerful export-led growth dynamic couldn't have been realized without trade liberalization and surging world trade—two of the most important pillars of globalization.

While the globalization of trade and capital flows—to say nothing of the cross-border surge in information and labor flows—makes it hard to envision that that an increasingly interconnected world would ever reverse course, there are worrisome signs of just such a possibility. In this post-crisis era, the drumbeat of trade frictions and protectionism is growing louder. The developed world is facing years of exceptionally high unemployment and a seemingly chronic stagnation of real wages. Rightly or wrongly, it views trade-related pressures as central to this dilemma, and China has been singled out as a lightning rod in this debate. At the same time, the appetite for multi-lateral trade liberalization has waned, as evidenced by the lack of meaningful progress on the Doha Round. And the world's willingness to embrace the threat of climate change has been drawn into sharp question in the aftermath of a disappointing Copenhagen Summit. While global leaders continue to talk the talk of globalization, the self-interests of “localization” are more and more apparent.

7. It wouldn't take much of a shift in the mix of Chinese job growth—from labor-saving manufacturing to labor-intensive services—to produce a major acceleration in overall employment growth. According to the National Bureau of Statistics of China, total Chinese employment is around 770 million workers. That means an added 0.6 percentage point of annualized employment growth is equivalent to about 4.6 million new jobs. Under the extreme assumption that all the incremental hires went into services, that would raise the tertiary share of Chinese employment by about 0.4 percentage points relative to the baseline trend.

Despite these worrisome signs, the broad outlines of a new global policy architecture are now emerging out of the post-crisis carnage. Centered on the G-20, it represents a major shift away from the long dominant US- and European-centric G-7 global power structure. Most importantly, the G-20 is a far broader and more representative collection of large developed and developing nations, alike. In contrast to the G-7, which accounts for just 11% of the world's population and 42% of world GDP (as measured on a purchasing power parity basis), the G-20 accounts for about 65% of the world's population and approximately 75% of world GDP. As the largest developing economy in the world, China needs to embrace the leadership responsibilities that the G-20 construct now offers.

Yet as a poor nation, China has not always been comfortable in facing global challenges. With more than 750 million of its citizens still living in low-income rural areas, this is understandable. The ascendancy of the Chinese economy is not an excuse for the nation to turn its back on the imperatives of poverty reduction. Nevertheless, the global dimensions of its challenge have taken on an entirely different order of magnitude in the post-crisis era. It is up to China to walk the delicate line between these domestic and global considerations.

China must contribute to global rebalancing by reducing its massive saving and current account surplus.

To do that, China will also have to deepen its appreciation of the sources of the Great Crisis and the role that its economy played in this destabilizing turn of events. While there is a long list of culprits, there can be no mistaking the role of global imbalances as a major source of the problem. Asset and credit bubbles spurred a binge of “virtual consumption” in the world's largest deficit economy, the United States. At the same time, excess saving of a consumption-deficient Chinese economy kept China on a destabilizing export-led growth path that required a recycling of a massive reservoir of foreign exchange reserves into dollar-denominated assets. It remains open to debate as to which came first—the chicken (China) or the egg (the US). But when America's bubbles burst, all the other chickens certainly came home to roost. The rest of a tightly linked world economy was quick to follow—hit hard by a record plunge in global trade, a seizing up of global capital flows, and a run on the financial institutions that were most levered to this unbalanced strain of global growth.

Contrary to widespread belief, there was no decoupling in an era of globalization—especially as the world lurched toward the abyss in late 2008 and early 2009. For China, like all other externally-dependent economies, this crisis was an unmistakable warning sign. Persistent imbalances are hazardous to sustained prosperity. Rebalancing is an urgent post-crisis imperative.

Post-Crisis Pitfalls

A world that does not attend to its systemic imbalances is a world that is doomed to yet another crisis. As far-fetched as such a possibility seems in the aftermath of the Great Crisis, the post-crisis world does not seem committed to a serious rebalancing agenda. While American consumers have begun to prune excess debt, this deleveraging is being more than offset by massive government budget deficits—sufficient to have pushed the US net national saving rate into negative territory—down to a record low of -3.2% of national income in the third quarter of 2009. With outsize US government dis-saving likely to persist for years to come, America's current account outlook—the major source of imbalance on the deficit side of the global imbalance equation—remains extremely disconcerting. At the same time, as underscored by serious fiscal problems in Greece, Portugal, Ireland, Italy, and Spain, Europe also remains trapped in a quagmire of ever-mounting public sector indebtedness. And, of course, in Japan, the public sector debt-to-GDP ratio is 180% and still rising. In short, there is no credible post-crisis rebalancing agenda in the developed world.

In this context, it is both ironic and hypocritical that a crisis-torn developed world has singled out China as the source of the lingering tensions behind persistently high unemployment and relatively stagnant real wages.⁸ There is a growing chorus of complaints about an undervalued renminbi as one of the most important factors behind the pressures still bearing down on workers in the rich industrial economies. With a 10% unemployment rate in both the US and Europe, the politics of China bashing have taken on a new urgency. If only China would revalue the RMB, goes the argument, workers in the developed world would experience quick relief.

Unfortunately, nothing could be further from the truth. For any economy, employment growth is a “derived demand”—critically dependent on the state of end-market demand. In the United States, the likely persistence of subpar job creation is more an outgrowth of weak post-bubble American consumption prospects than the result of a mispriced Chinese currency. Ironically, if Washington were to impose trade sanctions on China in an attempt to relieve perceived currency distortions, such actions would backfire—putting new and worrisome pressures on the post-crisis world.

8. See Stephen S. Roach, “Global Rebalancing is America's Job, Too,” *The Wall Street Journal Asia*, January 28, 2010.

Two consequences of anti-China trade sanctions would be especially disconcerting for the US: First of all, a saving-short US economy doesn't just have a bi-lateral trade problem with China. In 2008, the United States had a multi-lateral trade deficit with over 90 nations. Yes, the biggest bi-lateral piece of America's trade imbalance was with China—32% of the total trade gap in 2008. But this is an outgrowth of deliberate outsourcing strategies of US companies as well as consumer preferences for low-cost products. Indeed, barring a surge in US saving that would alleviate the multi-lateral trade imbalance—highly unlikely in an era of trillion dollar budget deficits—trade sanctions aimed at China would have the effect of shifting the Chinese piece of America's trade deficit to other trading partners. That would transfer US imports to higher-cost producers—the functional equivalent of a tax hike on beleaguered American consumers. Secondly, China would probably retaliate against Washington-imposed trade sanctions by buying fewer dollar-denominated assets—putting sharp downward pressure on the dollar and upward pressure on longer-term US real interest rates. Such developments could then trigger the dreaded double-dip.

A consumer-led China could also temper the risk of global trade frictions.

However strongly China may disagree with the motives and logic of trade frictions, it cannot afford to ignore the politicization of the globalization debate. In a weak post-crisis climate, this saber rattling cannot be dismissed as an idle threat. China bashing is not about logic. Politicians need scapegoats, and the high-flying Chinese economy is at the top of Washington's list. It will take vision, determination, and leadership for China to navigate these treacherous waters. Significantly, the Chinese leadership cannot operate from a position of denial. Instead, it must start from the premise that it, too, has a problem—namely, the structural imbalances that have spawned massive current account and trade surpluses. If Beijing fails to address this key problem, the Chinese economy will hardly be spared the next time the world gets into trouble.

Actually, the new model should be very helpful in this regard. A shift to more of a consumption-led growth dynamic could go a long way in alleviating the external pressures associated with mounting trade frictions and a massive overhang of foreign exchange reserves. As noted above, if the excesses of precautionary saving can be tempered and recycled into domestic consumption, the current account surplus should shrink—setting the stage for a meaningful reduction in China's trade surplus. This could be important in countering

the increasingly worrisome build-up of anti-China angst in the developed world. And, of course, smaller external surpluses could also lead to a reduction in the accumulation of foreign exchange reserves. That raises an important question on the flip side of the global imbalances equation: How will the United States fund its external deficit if the Chinese have less surplus saving to send its way?

All in all, China has good reason to believe that a pro-consumption policy agenda of the upcoming 12th Five-Year Plan will not only help it address domestic imbalances but that it will also go a long way in addressing the surplus saving problem—the Chinese piece of the global imbalances problem. Like the US, China has made it clear that it believes a stable currency remains very much in its best interest. This is understandable—especially since a currency anchor is very important for a developing economy with an embryonic financial system. Moreover, as can be seen from Japan's experience of the late 1980s and America's record since 2002, the recent history of resolving current-account imbalances through currency adjustments is not exactly convincing. For a surplus-saving Chinese economy, pro-consumption policies encouraging structural rebalancing could be far more effective in fostering rebalancing than circuitous and potentially misguided currency adjustments.

China is at a pivotal moment in its remarkable journey. It has experienced unprecedented success in economic development and poverty reduction over the past 30 years. But this approach is not without costs and risks—namely, mounting imbalances that threaten sustainability from both domestic and global perspectives. Rebalancing is a clear and urgent imperative for China—especially in the post-crisis era. The occasion of the 12th Five-Year Plan affords China a unique opportunity to get on with the transition to a new and more sustainable labor-intensive, pro-consumption growth model. Long pragmatic and steadfast in its commitment to social stability, I am optimistic that China will seize the moment. There is no other good choice.

Stephen S. Roach is Chairman of Morgan Stanley Asia and author of *The Next Asia* (Wiley 2009).

This communication is not a product of Morgan Stanley's Research Departments and is not a research report but it may refer to a Morgan Stanley research report or the views of a Morgan Stanley research analyst. We are not commenting on the fundamentals of any companies mentioned. Unless indicated, all views expressed herein are the views of the author's and may differ from or conflict with those of the Morgan Stanley's Research Departments or others in the Firm. For additional information, research reports and important disclosures, see <https://secure.ms.com>.

The information provided herein has been prepared solely for informational purposes and is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities or instruments mentioned or to participate in any particular trading strategy. This information is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty can be given with respect to the accuracy or completeness of the information, or with respect to the terms of any future offer or transactions conforming to the terms hereof.

This report does not provide individually tailored investment advice. It has been prepared without regard to the circumstances and objectives of those who receive it. Morgan Stanley recommends that investors independently evaluate particular investments and strategies, and encourages them to seek a financial adviser's advice. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. Morgan Stanley Research is not an offer to buy or sell any security or to participate in any trading strategy. The value of and income from your investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized.

Permission from Morgan Stanley is required before republication of this essay. Contact: Noel Cheung at Morgan Stanley Corporate Communications at (852) 2848-6788 or noel.c.cheung@morganstanley.com

© 2010 Morgan Stanley. All rights reserved.

Morgan Stanley

www.morganstanley.com