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IBM Forum
Singapore
3 August 2005

Your hosts, IBM, asked me to speak about the world economy and the prospects for the prolongation of the current growth cycle. And how developments in China and India are central to its longevity.

We are now in the twenty third year of the current long wave of economic growth. It began in 1982. This wave, driven by micro-processing and communications, has, like all long waves before it, been overlaid by a number of business or investment cycles.

The first cycle in this wave occurred between 1982 and 1990, the second between 1992 and 2000, with the one we are now experiencing beginning in May 2003.

In the two previous long waves of the twentieth century, 1904 to 1929 and 1947 to 1974, after about twenty five years, the forces of technology which drove them and the macro economic conditions which sustained them, gave way to a less defined and uncertain period where no coordinated world growth was evident.

The long wave wind down becomes apparent when productivity slows and inflation begins to accelerate, where profits shrink and employment closes down. The current long wave has been unusual in that productivity has intensified as it has gone along, holding down inflation while lifting real incomes at the same time cutting unit labour costs.

In this, the third business cycle of this current long wave, there were portents not that long ago, which indicated that with deteriorating demographics in most OECD countries, as we reached full employment the real price of labour would rise and in the presence of slowing productivity we would see a discernible increase in inflation. As this scenario unfolded, so the argument went, central banks would reach for the monetary lever and slow the game up so as to achieve a better balance between supply and demand. Or at least, curb demand.

Much of this foreboding has not come to pass; not yet at least, because of other large and important factors at play in the world.

It is not that labour markets are not tightening as older workers leave, they are. It is not that people are not working longer, thereby augmenting labour supply, they are doing that too. And it is not that we are not seeing reasonable real income growth. We are.

The important point is that the forces in favour of inflation are being met by equally strong forces in favour of deflation and that both forces are and have been quite evenly matched.

Major motor economies; indeed most OECD economies, are service dominated and the service sector of these economies are naturally, replete with people. And generally, the price of people, that is, labour, rises especially if supply is faltering.

Perhaps we could say that inflationary 'rich world' labour has run into a wall of deflationary supply shock from countries such as China and India and the outcome has been, happily for us all, moderate ongoing inflation. It is why developments in China and India hold out the promise and the opportunity of changing the pattern of earlier long waves, thereby extending the current business cycle.

The trends in costs in respect of labour and goods generally have been associated with a profit share as a proportion of GDP at a thirty year high and balance sheets about as good as we can remember them. And, that is, despite the fact that as the ubiquity of information accelerates and pricing becomes more transparent, the price and cost elements of the production equation have remained positive.

But there are other influences afoot which have kept the ball in play around the world. A major one of these is the aggregate imbalance between saving and spending.

It is no news that we are seeing something of a paradigm shift in the price of money. Yields on US ten year government bonds have fallen over the past year to only 4.16% which compares with an average of just under 5.5% since the mid 1990s. And US and British inflation adjusted Treasury bonds are yielding only 1% which is less than half the rate they posted prior to the late 1990s.

To add to this, the risk premium on junk bonds and emerging market debt has also declined. Not only is the cost of money down, but so too are the spreads on returns between quality and risky assets.

Naturally, there is much divining going on trying to fathom these behavioural changes.

Alan Greenspan, for his part, has encouraged the idea that there is a cyclical 'global savings glut' which could in part explain the low bond yields especially in the context of the mercantilist policies of the Chinese government and the propensity of Japan to buy dollar assets to keep its currency competitive.

Mercantilism grows from a 'survival of the fittest' kind of hoarding policy which puts faith in national balance of payments surpluses where 'state' action and state control over macro-economic life transcend otherwise private instincts. Instincts which would use available

capital for diverse and higher productive purposes including and especially domestic investment in such things as housing and infrastructure and in higher levels of consumption and hence, living standards.

One may consider that this is a curious policy for the Chinese authorities to follow but we should bear in mind the searing impact the IMF's actions and prescriptions had in their application during the 1997-1998 financial crisis. The Chinese political system would be put under great strain in a Korean or Thai style downturn, let alone, an Indonesian style collapse of GDP. The Communist Party of China and its government will be wary about mortgaging their affairs to the IMF or any other Western dominated institution.

Mercantilist instincts aside, in the ordinary course of events, developing countries use national income to develop themselves, especially their domestic economies. The broad mass of the community grows wealthier as the world buys its product.

In China, this is happening far more slowly than might otherwise be the case. Rather, we have seen China's burgeoning output and competitiveness reflect itself in ever increasing levels of national reserves. These reserves passed the US$500billion mark last year and stood at US$711billion in June this year.

The peg of the Chinese renminbi to the US dollar in the context of a falling dollar has given China an extra level of competitiveness which has seen it dominate goods markets wherever it has chosen to exert itself. Coupled with the interventionist policies of the Bank of Japan in seeking to slow the dollar's slide, we have seen these two neighbours rack up a high proportion of the world's surplus savings. Between them they represent a large part of the flip side of the current account deficits of countries such as the United States, Britain, Spain and Australia.

Between 2002 and 2004, roughly 45% of the net funding of the US current account deficit came from central banks, predominantly in Asia. Indeed between 2002 and 2004 the foreign reserves of surplus countries rose by over US$1.5trillion to just under US$4trillion.

So, we have a picture of the accumulation of massive reserves in surplus countries weighing off massive deficits in particular OECD countries where the twain, kind of, never meets. Preferably, what should occur is that things happen in surplus countries to diminish their surpluses while in deficit countries spending takes a breather to let savings catch up. Including public savings.

Unfortunately, this is not happening but just a week ago, a shaft of light appeared on the scene.

The government and central bank of China announced that, in future, it would change the exchange rate regulation mechanism from a peg to the US dollar to a peg against almost

everything else. And they estimated that the immediate effect would lead to a 2.1% appreciation against the greenback. Not much in itself, but pointing to a preparedness to see some working out of the cliff-like hiatus which exists in the current savings-spending imbalance. Let's call it a start to global re-balancing. More domestic demand growth in China offsetting any decline in GDP from exports and a better nett export performance by the United States.

It is important to understand that this change by the Chinese monetary authorities is not a 'managed float' as has been suggested. In fact, there is no float about it. A float would see a change to a quantity-based system where the weight of buying and selling sets the value of the currency otherwise independent of the Central Bank. The new Chinese system is still a price-based system where the Central Bank buys all the foreign exchange at certain prices and adds the equivalent domestic currency to the domestic money supply.

As capital inflow picks up, so too does the domestic money supply which has then to be sterilised by the Central Bank with bond sales, so as to diminish the money surge under inflation. We already know that Treasury bond sales, by the People's Bank of China (PBOC) is not clearing the market by some large margin. And were China's recent move to encourage large hedge fund and other speculative inflows, the authorities would be put under additional pressure in respect of the bond-selling task. The cost of inflation getting away in China is simply too great to contemplate.

Which brings me to the issue of how sustainable the new currency arrangement is. The quick and ready answer is, not very. There is no doubt that the trillion dollars or more of hedge fund and speculative money sloshing around the world will target the RMB at some point. The government and the PBOC can feign indifference and watch it come in seeking to sterilise the funds as best it can in the domestic market place. As views about the currency are such that many believe it is undervalued to the tune of somewhere between 10 and 25%, the currency will inevitably come under pressure for a revaluation. The Bank can respond to this with discrete appreciative changes but a succession of them implies a changed level of export competitiveness and thus the makeup of the economy. In such a scenario, countries such as those of south east Asia and Australia would see exports accelerate as imports into China quickened in pace as China's current account surplus was shaved.

And if a series of discreet currency shifts, even large ones, did not satisfy the markets' lust for snappy profits or its expectations for value equilibrium, the authorities could be pressed into an earlier than expected float of the currency with all the attendant problems and, might I say, benefits.

A member of the PBOC's policy making committee, Mr Yu Yongding, said recently 'in the short term, pressure for yuan appreciation will increase further', he said 'the change to the currency regime and the small appreciation of the yuan <u>cannot</u> solve China's economic imbalances and the problems of the economy'. But he went on to say, 'a gradual controlled appreciation of the yuan in tight ranges could <u>win time</u> for the Chinese economy to adjust'.

And he went on to add, 'over the next five years, I do not foresee the renminbi becoming fully convertible'.

Mr Yu may be right, but there is every reason to believe that the full convertibility of a currency may happen sooner, we hope, other than under conditions beyond the easy control of the Chinese government or its monetary authorities.

In the end, of course, such a change would benefit China greatly with more of the wealth of its hard won markets and the sweat of its people being enjoyed by those who create it, thereby providing a much better balance in the economy, while facilitating a more equitable distribution of the wealth.

Putting one's currency in the market to be priced is very much like riding the tiger's back. But if the economic fundamentals are good and the macro economy well managed, private transactions end up in balance and the arbitrage opportunity for hedge funds and the like, evaporate.

Such a system would represent a sharp ride up the learning curve for the large domestic Chinese banks and the prudential system which govern them. This will never be easy; growing up quickly never is. But a mature set of institutions is China's best insurance against capricious behaviour by external organisations, whether it be the IMF or for that matter, private ones.

On the strategic front, China is already imbibing the confidence of its own growing power as it better aligns its foreign policy with its trade policies.

Much of China's confidence comes from knowing who it is and what it is. It sees itself as being at the epicentre of a growing and cooperative community of east Asian states. In this grander view it likely that China, displaying some real magnanimity will do more for its neighbours than its neighbours, left to themselves, would do for it. And by its wisdom, in opening itself up to the region around it and locking in structures, underwriting the longevity of its own reformation.

For instance, its encouragement in the development of ASEAN plus 3, which is in effect, China plus 2 plus ASEAN, with now possibly Australia, shows the kind of schematic which China is seeking to lay out.

And you will notice in these arrangements, there is no place for the United States. The two big dogs on this particular pavement are China and Japan and it is they who will run it. Gradually, strategic issues will come onto the table providing a further extension of Chinese policy ambitions.

The relationship with Japan remains a stumbling block. As we can see, while investment and trade between the two countries has grown, so too have the old enmities. When these threatened to bubble over recently, during anti-Japanese demonstrations in Beijing, the party and the government had to take the steam out of it. Prime Minister Koizumi for his part, did little to help with provocative visits to the Yasukuni Shrine where war criminals associated with atrocities in China are buried.

Japan is very apprehensive about the rise of Chinese power but has no inherent capacity to interact or deal with it. Or, for that matter, with the rest of region around it.

There are a great many tensions between nation states in various parts of the world, but none so large or potentially volatile as those between China and Japan.

India is a different case in point. It straddles the sub-continent, it has perennial tensions with Pakistan; though culturally, it seems able to work these crises through. Now, of course, both are nuclear armed, which is a real worry.

India came up in the world recently when Prime Minister Manmohan Singh was granted US technological cooperation on the peaceful development of Indian nuclear power. This was seen as the United States taking India more seriously, which it was. The problem is that the US is ingratiating itself with India as a way of belatedly balancing off China's influence in the region. The fact is, the US should have taken India more seriously many moons ago, most particularly as the Cold War ended in 1990. The US has waxed and waned in its relationship with India and maybe, just maybe, it now sees the opportunity of India joining China as the other important new motor in the global economy.

India, it seems, has also decided to help itself. Its otherwise autarkic structure is giving expression to private initiative which in the past would have offended its London School of Economics precepts and public ethics. Globalisation and trade are devices to accelerate national income but nothing beats helping one's self. There may be a certain culture shock in this for India but as it tries it, it might enjoy it.

The economists say that population is the principal driver of GDP and maybe that penny has dropped for US policy makers.

At any rate, what is happening in India and China knows no precedence in world economic history. Two and a half billion people lifting themselves from poverty, and at a solid pace. Not even in the industrial revolution in America in the nineteenth century did we see anything on this scale.

In the new international division of labour India holds out the promise of being able to do in service markets around the world what China has done in goods markets. India's long and solid investment in education is paying off in the kind of value added services the world is

hungry for. And, by that, I do not simply mean call centres. Rather, true intellectual value adding of a kind that takes advantage of the connectivity of the Internet, telecommunications and the magic of micro-processing.

And India will also make things. Goods production is capital intensive and there is no doubt, given the natural demand, that India will be a force in certain manufactures.

But whether it is services or manufactures, it augurs well for global inflation as that wall of deflation takes on greater proportion. After all, we want the price of wages going up and the price of widgets coming down and that is what we have been getting. And therefore, higher disposable income and living standards. With modest inflation overall. In this way, aggregate spending power rises and demand grows as living standards commensurately rise and services further sophisticate.

A better world order should include India and China more front and centre in world affairs. Globalisation is increasingly going to be a non-Western phenomenon allowing these former developing states to mark themselves out from strong positions. The United States and Europe will still be the great sinks of global product but we will have a better and healthier world when these two great states occupy larger and more competent places at the table of power.