Asia's Rivals: The implications for the world economy of developments in China, India and Japan
Transcript

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ASIA'S RIVALS:

THE IMPLICATIONS FOR THE WORLD ECONOMY OF DEVELOPMENTS IN CHINA, INDIA AND JAPAN

Bill Emmott

Thank you all for doing me the great honour of coming out this evening to listen to me. Editors of the Economist have not always been listened to me with enthusiasm. The first editor of the Economist, James Wilson, was a bit of a dry stick. He ended up his life as Finance Minister in India, for the Viceroy in India, in 1866, and it is said that when he died his last words were "Please look after my income tax"! I hope that I can give you more food for thought than that!

These are times when it is very difficult to look ahead; very difficult to look beyond what looks like the immediate abyss that we stand in front of. Even chancellors of the exchequer have been known to warn us that we are in terrible times. This evening, I am going to perhaps seem as if I am talking about a parallel universe: Asia, an area of the world with rapid growth, with growth rates varying between seven and twelve percent, with no banking crisis, with no credit crunch - how can these worlds be connected together? It is as if Asia is watching us from the other side of this abyss that stands between us. The mention of an abyss reminds me of a story though not of a chancellor of the exchequer but of a candidate for a presidential election, who was unwise enough to give a speech about economics in which he said that, under the present president, the country had come to the edge of an abyss, and if he was elected, we would take a bold step forward...!

If you step far enough forward, you reach Asia, an area of rapid growth, an area of completely different current preoccupations: a baby milk scandal in China, where four babies have died, 13,000 babies have been hospitalised, 53,000 have been declared to have fallen ill as a result of this baby milk scandal; a new Prime Minister in Japan - I doubt that many people in the audience noticed that Japan elected a new Prime Minister on Monday, given the way the news has been dominated. But of course this world across the valley from the abyss is not a parallel universe; in fact, it is intimately connected to the economic and financial situation that we see.

Behind the credit bubble in the United States and in parts of Western Europe lay the excess liquidity that has been coming out of Asia and other emerging markets. The huge imbalances that economists have railed against in the world economy for much of this decade: between current account deficits, growing current account deficits, in countries like America and Britain, and growing surpluses in many Asian countries; the capital flows from the poor to the rich that have financed these deficits; and the belief, in part justified, that the arrival in the world economy of billions of cheap workers, particularly in China but also elsewhere, were meaning that inflation was going to be low for the foreseeable future, that this cost pressure meant that monetary policy could afford to be loose because globalisation meant that inflation was gone. That foreseeable future, it turns out, was not very long ahead of us; the foresight was, shall we say, lacking, because inflation has of course come back to hit us.

But on the side of the valley of Asia, while the connection through provision of liquidity, through the global capital flows, is there, and should be recognised as having been there, in some of the cause of this credit bubble and now credit bust that we are living through, there is also, I would suggest, some shafts of light: first of all, in these capital balances, the sources of recapitalisation, of rescue, as we have seen with Nomura Securities and Lehman Brothers? European and Asian operations today, and yesterday, with Mitsubishi UFJ's 10-20% stake in Morgan Stanley, and so on and so forth; but also, I would suggest, in the fact that we are interested, preoccupied and affected by Asia tells us that we do not live in a world economy that is restricted to the transatlantic economies. Globalisation provides, I would suggest, a ray of optimism in this cloudy time because of the alternative sources of demand, the alternative sources of capital. The opportunity for rebalancing that can come from it.

We are going to have a discussion after these remarks between me and Michael Mainelli about Asia and about the countries that I am talking about - China, India and Japan - so rather than pre-empt that whole discussion, what I am going to do now is offer you what I think are the five things that you should know about China, India and Japan and the Asian scene, preparatory to debating them and getting your questions.

1. Asia is a scene of excess liquidity

The first of those five things, I have already intimated: that Asia is a scene of excess liquidity, not a scene of a credit crunch. The glut of savings, combined with negative real interest rates across much of Asia, means that Asia is characterised not by deflation but by inflation; by wholesale price inflation of more than 12% in India, 10% in China, 25% in Vietnam, and the shocking figure of 2% in Japan. Inflation is the crucial issue for Asian economies, despite all the expectations that cheap labour would mean deflation forever.

China is suffering from, or adapting to, structural cost pressures as well as inflation being driven by money, growth and traditional sources of inflation. Structural cost pressures represented by demographic change that appears to be producing a fall in the number of young workers available to work cheaply in low cost manufacturing, a general rise in wage rates that is now going faster than productivity, and, thanks to government efforts to try to balance better rural and urban areas by producing an agricultural policy to raise farm incomes, wages that are having to go up higher in order to tempt people to migrate from the rural areas to the farms. So China has both a money-push inflation and a more gradual, long-term structural-push inflation.

As a result of that, and of the monetary, liquidity-led inflation in the rest of Asia, Asia is in a tightening cycle. This persists despite a small cut in interest rates in China last week, because the main mechanism of monetary control in China is direct regulation of loan volumes rather than interest rates as such. I would suggest, because of this tightening cycle across the region and in China, that this is also why, if you ask the question "Which equity market has fallen the most among the big equity markets in the last 12 months?" the answer is not the United States or Britain, but China. The Shanghai market is down almost 60%, depending on which day you look at, in anticipation, I think, of tightening money; and the property market has begun to fall as well in China. What this is a long way of suggesting is that these economies, by definition, are rapidly evolving economies. If we think we know them, almost certainly we are already out-of-date. Economies that are growing at 8-10% a year are economies that are doubling in size every five to seven years. Their GDP per head is doubling at a similar rate. They are economies in a state of rapid and disruptive transformation.

But, as we map that transformation, we have an advantage, which is that the economic trends of development have moved from country to country across East Asia, and we can get some clues as to the future of the current rapid developers from the paths followed by previous rapid developers, such as Japan and South Korea.

2. China today resembles Japan in the early 1970s

My second point that I think we should all at least think about, for Asia, is the observation that increasingly China today is coming to resemble Japan in the early 1970s. China is known as the world's manufacturing powerhouse, the world's pollution powerhouse, the world's biggest sinner in terms of currency management and manipulation, one of the remaining strong capital control countries among the big economies. That is exactly the way Japan was in 1970: a country that was building up a current account surplus, that had done so on the back of cheap capital; a rapid move into heavy industry in the 1960s, with growth rates of 8-10% a year throughout that decade; with huge pollution problems spreading across the country, most notoriously with Minamata disease from mercury poisoning, but also seen in the disgustingly dirty air of Tokyo and Osaka and Kitakyushu and other industrial cities; a country though that was hitting a problem of inflation in the early 1970s. Its cost advantages were going. It, as a result of the oil price hike of 1973, combined with its structural cost problems, Japan suddenly faced 25% inflation in 1973/74.

China today has many of those characteristics: a huge current account surplus, nearly 10% of GDP; a currency widely acknowledged as undervalued and artificially held down, at least in the last five years; inflation rising; a growing number of public protests about pollution, safety issues, like the baby milk scandal that we have seen this week; but also, I think, an increasing awareness among policymakers that the current model in China cannot be carried on unchanged into the infinite future. There is desire to shift the economy upmarket towards higher value-added products and, in particular, to try to deal with both the inflation and the environmental consequences of recent Chinese growth in order to prevent public protests from being a threat to the Communist Party.

So I would suggest that, in a country where slogans are often put in numerals that the right way to think of China is the "Four R's":

- *Reform* - to try to deal with the regulatory system and particularly the environment.
- *Revalue* - to try to get back control of monetary policy by revaluing the Yuan, steadily and more rapidly than has been the case in the last couple of years.
- *Restrain* - to try to prevent some of the abuses of companies, particularly state-owned companies, from producing these sorts of public protests that we are seeing.
- *Restructure* - restructure the economy towards a higher value-added sort of industry.

Japan was the dirtiest country in the industrial world in 1970. Within ten years, it was one of the most energy efficient and one of the cleanest, at least in terms of air and water pollution. That is not to guarantee that China will do the same, but my point is that China needs to try to do the same and can, in principle, do that.

3. One needs to look at India

My third thing is that one needs to look at is India. India, I would suggest, is turning East Asian. What I mean by that is that, in the past, we have thought of India as somewhat separate from Asia: a country dominated by services rather than by manufacturing, a country with relatively weak trading links, to the rest of the world generally but certainly to Asia, and a country summed up by Tom Friedman's New York Times Bestseller "The World is Flat", which he observed looking at video screens at Infosys in Bangalore and talking to their Chief Executive really about outsourcing. India was a country that we characterised, thanks to Tom, as an IT-led country, leapfrogging in some industries on the basis of the ability to compete on unequal basis with companies all around the world.

However, I believe that picture of India to be out-of-date. It is based on an India that had terrible infrastructure and was doing nothing about it, that had a resistance to manufacturing within the political classes, and that had unstable macroeconomic policy which deterred private sector investment. It was because of these factors that India failed to follow the sort of economic structure that the East Asian countries had enjoyed, of very high investment rates - up to 45% of GDP in China's case - financed by very high domestic savings rates. In India, during the 1990s, the investment rate fluctuated between 20 and 25% of GDP, a rate that is more typical of a mature economy than a developing economy, but in the last five years, that has changed. India's investment rate has shot up to 35% of GDP as infrastructure has begun to be built, and, as a result of that, companies have gained more confidence in building manufacturing plant, as some of the logistical blockages to export have reduced, and as some of India's demographic advantages, in terms of the reservoir of young workers based on the high birth rate that India has had, have also come to play a part in businesses' calculations.

This does not mean that India is suddenly going to overtake China in manufacturing, but it does mean, I think, that India, or a reasonable route map for India during this decade may well be the sort of route that China took in the 1990s. If you looked at China's infrastructure in 1993 or 1994, it looked inadequate. Shanghai was dark part of the time. The task of building all these roads and power plants seemed impossible. That is the case with India today, but the infrastructure is being built, manufacturing is growing faster than services, or at least it has in two of the last three years, and the politics of reform and of enabling manufacturing and enabling enterprise has gradually become entrenched as a consensus view in India. The politics are tangled, but at least the left parties are now out of the Indian Government and have no chance, or virtually no chance, of getting back in the next five years. So India, I would suggest, is a country that should be thought of as having a real potential to move into both low-tech and higher-tech manufacturing. The new symbol of India should not be the flat screens at Infosys but rather the Tata Nano car, the world's cheapest car, due to roll off the production lines this year. That also symbolises the political problems of India, since full production of the Nano has been delayed by protests from farmers claiming that their land has been seized from them, either illegally or at an unacceptably low price, near the main plant in West Bengal. That is India's politics for you, but I do not think it affects or, in the long-term, eliminates the basic structural trends.

4. Don't count out Japan

The fourth point concerns Japan, the third of my three countries, the third of the three great powers of Asia, but actually of course the largest and richest of the three in economic terms. The important point to make about Japan is a simple one, which is: do not count it out. Japan is capital rich, hence the Mitsubishi UFJ investment in Morgan Stanley, hence the Nomura acquisition, opportunistic acquisition, of parts of Lehman Brothers. Japan is also the country in the G7 that, since 2002, the last six years, has in fact has the fastest growth in GDP per head of all of the G7 in that time. That is in part because the number of heads in Japan have begun to shrink and therefore GDP per head, i.e. strengthening of living standards, has been faster there than in demographically expanding countries like the United States. It is a country beset by demographic problems, of an aging society, but also by a political stalemate: the freezing of the market-based reform process by elections for the Upper House of Parliament in 2007, which put a majority in that House in the hands of the opposition, enabling it to block all legislation being proposed by the ruling coalition led by the Liberal Democratic Party.

That stalemate is, I would suggest, likely to be broken by a general election in the main Lower House of Parliament in Japan, which will happen sometime during the next two months. It will be broken either by the opposition actually winning a majority in the Lower House and, for the first time really in the last fifty years, having a durable opposition-led government in Japan, or it will be broken by a party realignment that would follow from an inconclusive lower House election. That means, I think, that there will be in Japan a new push for reform, or at least a new push for decisive government, once a government with some form of majority in both houses emerges. Those reforms would not necessarily be ones, all of them, that I would approve of, but nevertheless, what matters is that the process of change is resumed. Once that begins again in Japan, and at least some market-based reform is begun again, then I think Japan basically has the potential for a very strong acceleration of productivity growth based on an increase in the competitiveness inside the economy that should enable Japanese industry to have a strong period of catch-up productivity growth based on the lagging nature of their productivity during the 1990s and their long stagnation. So Japan - don't count it out.

5. The Rise of Asia is not a matter of East v's West

As I have indicated, the three great powers of Asia are what we should think about: Japan, China and India. There is a tendency, particularly in Washington and occasionally in Western Europe as well, to think of the rise of these powers in Asia as being in some way a matter of West versus East; a matter of power shifting from the Western powers to the East. My belief, and the essence of the argument that I have made in my new book, *Rivals*, is that this is actually wrong. We should recognise this process as being one that is bringing about a rivalry, a competition, not between West and East, but between East and East, because these three powers are intrinsic rivals to one another.

In economic terms, they are becoming more integrated: trade between all the Asian countries is increasing as a share of their total trade, up to close to 50% now, which is lower than the European Union's 65% but above, or just above, the intra-regional trade inside in the North American free trade area. The Asian countries are also more integrated because they are also keenly conscious of each other as commercial competitors and therefore, I think, stimulating the reform process in all three countries. This is particularly the case for Chinese competition stimulating the reform process in both India and Japan.

They all though harbour strong political feelings about their neighbours. Politically, these are rivals with long histories of bitterness and of suspicion between them. India and China fought a border war as recently as 1962, and still have two, or three really, very large areas of territory disputed between them. Japan of course invaded China in the 1930s, and the legacy of that still lingers on in Chinese politics, culture and thinking. It is a region full of flashpoints and, even if the countries of Asia do not confront one another directly, these have the capability of producing either opportunistic or accidental confrontations between them and involving the United States. Two of the big flashpoints in Asia have been flashing danger even this year: Tibet, with the brief uprising in March; and North Korea, with the news or speculation recently that the leader, Kim Jong-Il, might have had a stroke and be seriously ill. That matters because he has no successor, and the question of who or of what regime follows Kim Jong-Il matters for the stability of that region. North Korea has been a two-person dynasty, his father and now the son, but there is no serious candidate in the Kim family to take over from him. If he were to die suddenly, then the possibility either of civil war or of Chinese intervention to preserve it as a buffer state or of something untoward happening between North and South are very large.

Therefore, inherent in the relationships between these three powers is a mixture of economic competition, growing commercial relationships and integration, but also political rivalry. One of the people I spoke to during my research for the book was someone who then became Japan's Foreign Minister, and I asked him what I think should about tensions between China and Japan, which had been strong at the time I was speaking to him, with violence at football matches, big protests about visits to the Tokyo War Shrine, and things of that nature. He had an interesting response. He said, "Ah, I don't know why you Westerners are so surprised by all this tension between China and Japan; after all, China and Japan have hated each other for a thousand years - why should it be any different now?" I mentioned this because that man was elected Japan's Prime Minister on Monday of this week, Mr Taro Aso.

In other words, this is a region that is of great hope for us economically, that is reducing poverty at a faster rate than anywhere in economic history, that is a region now rich in capital, that can produce some upward momentum at a time when the world economy is clearly going to be needing such support and needing something to prevent us all going into recession, but it is a region that has severe political question marks hanging over it. It is a region that has potentially a wonderful future, but I cannot resist finishing with Groucho Marx's response to someone when, in one of the movies, when he was asked whether he'd had a wonderful evening, and his answer was that he'd had a wonderful evening but this wasn't it! That is the danger for Asia.

Discussion

Michael Mainelli,

Mercers' School Memorial Professor of Commerce at Gresham College

Bill, that was absolutely magnificent, thank you. I have taken away five really good points.

One of the things I would now like to do is get some feedback from the speaker and I have a few questions which have been provided to me by members of the audience that I would like to take the opportunity to throw at you. But first, anybody who has been to a Gresham Commerce event knows that there is no such thing as a Commerce Lecture without a commercial, so I would just like to plug Bill's book, *Rivals*. It is available at all good bookstores and I highly recommend it.

But, Bill, why another book on Asia? What did you want to say that wasn't being said elsewhere?

Bill Emmott

I think the first honest answer, Michael, and I think it's the right motive for perhaps all intellectual thought, but certainly for journalists, is that I wanted to teach myself more about Asia. I felt I knew quite a lot about Japan, since I had written books about Japan in the past and I had been living there as a correspondent, but I didn't know China and India as well as I wanted to, and it seemed to me that, if there are two countries in the world that the well-informed person needs to know about, it's China and India, given the changes that are taking place there. So the first answer is it was selfish - I was wanting to teach myself; but the second reason, and the idea of the book, is that I think that virtually all other books look at one or other of the countries individually. We see them in isolation: books about China's growth, books about India's growth, books about Japan's troubles, occasionally, recently, books about China and India, even calling them Chindia, and seeing commonalities between and differences between China and India. But they do not seem to be looking at the whole picture in Asia, and how they are relating to one another and particularly picking up on the politics, which I think, and my whole kind of journalistic life has been about, the fact that you cannot separate politics from economics; that you have to think of them together. Each influences the other, and you must see the political relationship in order also to have some sense of the economic possibilities.

Michael Mainelli

To quote from the book, you said that: "Economic growth at a pace that doubles an economy's size every seven or eight years is not a process that simply requires a country to maintain a steady course and constant pressure on the accelerator. It is a process that requires a country to maintain itself in a constant state of radical transformation." Have Western countries lost this ability for radical transformation and are there things that we can learn from China and India?

Bill Emmott

Speaking crudely, the cycle of dynamism and then sloth in many developed countries is a cycle that is driven by complacency. Sometimes the forces of building up that come with wealth, that produce interest groups that then are able to be conservative and block change, that out of success comes then complacency and then the new rigidities that then get in the way and we fight against them. I remember once talking to a French central banker, who shall remain nameless, but he said, "Oh of course," he said, "we French, we're all revolutionaries!" My response was, "Well, why do you keep saying no to reform in that case?" He said, "Ah, you don't understand! We're conservative revolutionaries!"

Now, I think the second half of your question, which is "can we learn something from China and India?", that is harder to answer. I think they are at such different stages of development, but the task of trying to facilitate change is something that clearly is what is preoccupying their leaders: how do you kind of make flexibility possible? A few years ago, we might have recommended following America. That answer is going to be harder to get people to agree to for at least a while now, so I think that perhaps what we can try to look at in countries that are changing as rapidly as China and India is how they prevent this from causing social explosion and how they deal with interest group politics. In some cases, they may fail to, and we may get explosions, and that is also something that we can look for.

Michael Mainelli

You mentioned in the lecture that China today looks like Japan circa 1970. Looking ahead, both for China and India, do you see them continuing to follow a Japanese style model or peeling off towards a European model or perhaps, as you perhaps alluded to there, potentially peeling off towards an American model? Or are they going to create something completely different?

Bill Emmott

In simple terms, I think that nobody ever creates something completely different. I think that "we are all variants on a theme," would be the first thing I would say. When I went to Japan in the 1980s, so many people who were writing about Japan as being a place from a different planet, and this is partly because they were Americans and they were looking at a very extreme contrast, and I always thought, well actually, Japan is not that different from France and Germany in the way the economies work. Having the awareness of the different varieties of our models is important. So I don't think they are going to have a completely different model.

I think that China is in a situation in which the Government feels the need to build some sort of a welfare state model, but they are also rather reluctant to take on those obligations and being unsure what effect it might have on the economy, the government, on dynamism and so on. I think that China is in that situation where it dismantled the iron rice bowl of state owned companies under Mao, and then it had a considerably loose form of directed capitalism over the last twenty years. It is seeing pressure on it to increase the public spending, to increase welfare provision in different respects, big pension questions, issues about health, issues about education, and I think that the Chinese Government is seeing that it needs to expand the state in that public spending, but "How?" is its question. The country that I think that many Chinese people admire more than any is America. Enemy in a way, but also number one country, the great country to emulate, and I think that the leadership probably are struggling in how to build this without failing to emulate America.

Michael Mainelli

That is actually a good point to move onto a question that Deepak Lalwani, who is the Director for Indian Investments at the broker Astair, asked me to put to you, which was that already we have got these very high US fiscal deficits, we have obviously got the credit crunch - things have ballooned by a staggering trillion dollars or more in many ways - and if we are going to solve this current banking crisis, Asia's foreign exchange reserves have funded deficits to a significant extent so far, so what's the future? Is Asia's rise in influence going to accelerate or decelerate because of the US banking crisis and is Asia actually the way out?

Bill Emmott

I think that in some ways Asia's prominence is going to be accelerated by the US banking crisis, partly because of recapitalisation. If you are going to recapitalise banking systems, where do you get the capital? It is going to come from the public purse, but, in the end, the public purse will be financed and some of that will come from surplus countries, not only Asia, but including Asia, and secondly, because it provides opportunities to anyone who has got capital. Cash is king at such times, and if you've got cash, if you've got capital, you can buy things up, and I think that will strengthen Asia. Thirdly, I think that, at least in the case of China this whole period is likely to bring about a currency revaluation and, though maybe not a full relaxation of capital controls, an evolution in that direction. Now, the oddity about the balance of the world economy in the last twenty years is that China has been growing hugely fast, but actually, its share of the world economy that it represents has been, in a way, artificially reduced by its own currency policy, and if you have got an accelerated revaluation of the Yuan, in fact, China will look even bigger at the end of it, and its purchasing power, in terms of using its own capital, will also be increased by that revaluation of the renminbi. So if you get a shift in balance between the dollar and the renminbi, that is going to strengthen China out of this in terms of its at least purchasing power. Now, this is not the end of

American leadership, by any means, but there is some shift I think and a strong opportunity for Asian companies and funds with capital.

Michael Mainelli

If you had to put all your money on the rupee, the renminbi or the yen, where would you put it?

Bill Emmott

If I had to put all my money on one thing, it might be the renminbi. I do think that, if you take a five year view or something like that, the renminbi is destined to be re-valued, so I think that that is probably a more solid place to put it. The rupee has been falling rather substantially in the last year, so maybe that is a more short-term trade.

Michael Mainelli

We have probably got time for just two other questions. We got this one from somebody who has styled himself a Buddhist trader. "In 2007, the Chinese Government announced new regulations to govern the reincarnation of Tibetan clergy. Essentially China has said it will have the last word in determining whether someone has been reincarnated or not. In other words, atheist Communist Party officials will govern Tibetan spiritual decisions." That's from your book. The question is: how aware do you think the Chinese are of this irony and does that awareness make any difference at all?

Bill Emmott

It's a nice question! I think that the reality is that Communist Party officials don't do irony. This power, or at least this right, as they take it, to have the final choice in who is the reincarnation of the Delhi Lama is one that also the Qing Emperors, the last imperial dynasty of China, had as well. So the Communist Party's spin-doctors say, "Oh, no, this is nothing new; don't think this is anything surprising - this is also something that we've had for years." This is partly because the Qing were the Manchu invaders of China, and they in fact shared some of the Buddhism that Tibet had, so there was, in a way, more of a reason then than there is now, but the fact is it is about raw power. I think that this could cause problems in the end because it produces a very direct grievance, and lightning rod for that grievance, in Tibet at a time when the Delhi Lama dies and needs to be replaced. But the basic answer is that they don't do irony.

Michael Mainelli

So, to ask a final question: You've put in the book nine recommendations, and I thought some of them were fascinating, particularly I think pointing out to businesspeople that relying too much on recent history and that trajectory would probably lead to bad decisions. But since its publication, the book has been very well-received and you have been travelling the world chatting with the very same people that you used to do your research. What would you change about those rules now since this book was published in April?

Bill Emmott

I don't think I would particularly change the recommendations, but I would change some things about the book. I think that I under-estimated the inflationary forces that were underway in several Asian countries, for example, and I think that that would merit greater explanation and in particular analysis from the point of view of business. I mean, what is the long-term effect for a business strategy of an apparent structural force for inflation inside China, and indeed, probably a more cyclical inflation burst in India? I think that is something that, from a business point of view, in an area that has been characterised by cost destruction, is quite a switch around, and I think I would devote more space to that if I was writing it now.