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How Fast Is China Really Growing?

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What Could Make Consumers Stop Spending?

Consumers maintained their spending growth in 2002 despite a severe industrial recession and a huge loss in global equity wealth, but they enter 2003 in a fragile position. The difference between a gradual slowdown in spending and an abrupt one is the difference between a gradual economic recovery and a renewed global downturn

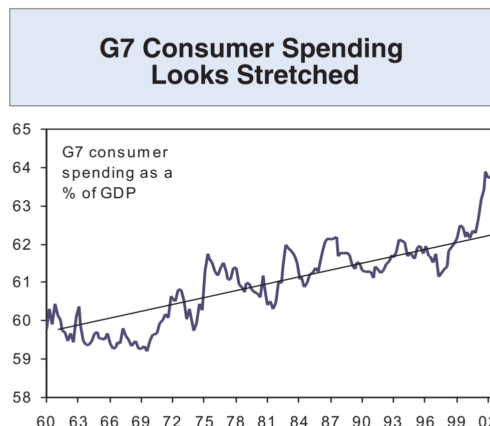
Although the corporate sector has made significant progress in reducing its reliance on external borrowing, the household sector has not done nearly as well. Household financial positions (measured as the difference between what households earn and what they spend) are well below the historical average in many countries.

A crude but striking way to illustrate the extent of the adjustment necessary is to look at real consumer spending as a proportion of GDP across the G7. Even allowing for a gentle upward drift in this ratio over time, it stands well above its trend levels. Unless there has been a sharp structural break in this ratio since late 2000 (something for which we find no plausible rationale), global consumer spending is likely to significantly underperform global GDP growth for a time.

The big question for the global outlook in 2003 is how that adjustment occurs. Our forecasts assume a gradual unwinding over several years—but it could occur suddenly if consumers attempt (or are forced) to increase their savings rapidly. If so, spending growth might drop sharply, damaging employment and the broader economy.

It is therefore instructive to analyze what has triggered previous sharp retrenchments in consumer spending.

G7 Consumer Spending Looks Stretched



Lessons From History

We have identified nearly 50 consumer slowdowns across the OECD since the move to floating exchange rates in 1973. While modest declines are not unusual, collapses in consumer spending are relatively rare. We find only seven episodes since 1973 that meet our definition of a consumer crisis —in which year-on-year spending growth falls below -4%. In these cases, the fall in consumer spending growth is extremely severe and invariably accompanied by a very serious recession.

We draw several interesting lessons from history:

1. It is unusual for a consumer slowdown to occur in only one place at a time. Most past slowdowns fall into four buckets: the oil shock of 1973-74, which hit consumers in many markets; the oil shock and real interest rate rises of 1980-82, which also caused widespread damage; the monetary tightening cycle in the English-speaking and Scandinavian economies in 1990-91; and the European exchange rate crises of 1992-93.

2. The shocks that trigger sharp adjustments are rarely specific to one country. In fact, the most likely culprits are global—or at least regional—in nature. The instances where crises have been more specific are the exception rather than the rule.

3. Consumer slowdowns have usually, though not always, been preceded by rising real interest rates. In the early 1980s, the early 1990s and the 1992-93 ERM crises, the proximate cause of consumer distress appears to have been sharply rising real interest rates, which hit employment, credit repayment and asset prices simultaneously. On average, real rates rose by five to ten percentage points.

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Important disclosures appear on the inside back cover of this document.

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What Could Make Consumers Stop Spending?

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4. In several of the worst cases, real interest rate rises and consumer damage have been the consequence of defending fixed exchange rates. Under a fixed regime, capital flight tightens financial conditions automatically. The resulting current account adjustment can crush consumer spending.

5. When rising real rates were not the trigger, oil prices were. Sharp declines in spending followed the first oil price shock in 1973-74. Even though real interest rates remained firmly negative, the near-tripling in real oil prices forced a significant adjustment in consumer spending in many economies. Higher oil prices were also part of the backdrop to consumer slowdowns in the early 1980s and early 1990s.

6. Rising unemployment and credit excesses rarely triggered the problem, but often made it worse. The nastiest episodes of consumer crisis often occurred when slowing spending and tighter credit conditions seriously damaged balance sheets, prompting widespread financial distress.

Looking for a Trigger

What does this tell us about the possibility of a sharp consumer adjustment in 2003?

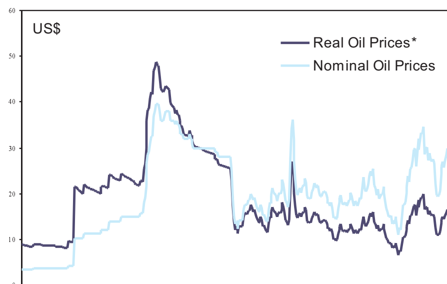
The bad news is that if a sharp consumer slowdown does materialize, it will probably occur in many countries. The good news is that one of the key triggers for past retrenchments—a significant rise in real interest rates—is unlikely to occur. We expect nominal rates to fall further, and the slow decline in inflation should not push real rates up significantly. With floating exchange rates now the norm, there is little risk that exchange rate pressures will tighten financial conditions.

But if real rates are not a likely trigger, what is? Several issues still worry us:

- **Rising oil prices.** As we discussed in our last issue, we think the market is underestimating the risks of higher oil prices and overestimating the world's ability to manage them, particularly if a war disrupts wider Middle Eastern supplies. With demand for oil inelastic, higher prices act as a tax on consumers that reduces real disposable incomes.
- **Further deterioration in the labor market.** History shows that labor-market weakness generally lags consumer slowdowns. Still, higher unemployment might trigger spending reductions or financial difficulties.
- **Tighter credit conditions** are a risk, although this seems more likely to emerge as a response to some other weakness than as an independent event.
- **Increased geopolitical risk or another sharp decline in equity prices** might damage consumer confidence and prompt a pullback, though there are surprisingly few historical precedents for this.

What is clear is that the kinds of shocks that have derailed consumers in the past are less likely to occur over the next year. Even if oil prices were to rise sharply, the direct impact is likely to be significantly smaller than the hit in the 1970s.

In Real Terms, a Large Oil-Price Shock Would Probably Be Smaller Than the 1970s



* Using CPI 1982-84=100

The main worry seems to be that a disturbance that is small by historical standards sets off a chain reaction leading to a spiral of weakening spending, rising unemployment and deteriorating credit.

Assessing Vulnerability

Where credit is freely available (or unnecessary), or where savings are high enough to provide a cushion, even large hits to income may be manageable. The economies more likely to be vulnerable are those where dependence on credit for spending growth has been high, savings are relatively low and the income and employment outlook is deteriorating.

While consumer spending around the world is vulnerable to lacklustre economic growth and slowing income growth, some countries may be at risk of something more prolonged and profound. Our analysis of household leverage, savings behavior and unemployment and income growth suggests that Australia, the UK, Spain, Portugal, Korea, Malaysia and the US are most at risk of a sudden and deep consumer retrenchment. Germany, France, Finland, Switzerland and Singapore are least vulnerable.

If consumers can survive the next six months or so, they may be past the point of maximum danger. If not, it seems unlikely that a consumer slowdown will be confined to a single economy. ■

Sinners and Saints: Ranking Consumer Vulnerability

High Vulnerability		Medium Vulnerability		Low Vulnerability	
Country	Score	Country	Score	Country	Score
Australia	56	Korea	46	France	34
UK	54	Malaysia	46	Finland	32
Japan	52	Poland	46	Netherlands	32
Spain	52	Portugal	46	New Zealand	32
Norway	50	Brazil	42	Mexico	30
US	50	Canada	42		
Denmark	48	Taiwan	42		
		Hong Kong	40		
		Thailand	40		
		Belgium	38		
		Chile	38		
		Italy	38		
		Singapore	38		
		Sweden	38		
		Switzerland	38		
		Germany	36		

Scores are based on Goldman Sachs Consumer Vulnerability Index. Scale ranges from 12 (lowest vulnerability) to 60 (highest).

Further information on the topics in this report is available on the GS Financial Workbench[sm]. For access, please go to www.gs.com/ceoconfidential

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GS CEO Confidence Index: Clouds Parting?

Our (slightly revised) survey of business confidence reveals a tentative turn for the better

Our slightly refitted CEO Confidence Index provides a more optimistic view on the business outlook this quarter. Our global index gives a reading of 51.5, indicating that more than half our respondents see business conditions as the same or better than the fourth quarter of 2002.

Each quarter, we survey our investment bankers as to their clients' views on the business outlook. We report the results as a diffusion index, so that a reading of 50 indicates an equal balance between those who think things are improving and those who think they are worsening.

Change in methodology. This quarter, we changed the questions slightly to add a third option to the previous two (better or worse): whether conditions are the same as last quarter. We hope this will avoid the dramatic swings in readings seen between our first and second surveys. Although our findings this quarter are thus not directly comparable with earlier scores, we are confident that this will produce a more robust survey going forward.

Readings vs. anecdotes. Although both the US and Europe yield overall readings above 50 (58.3 and 51.9 respectively), anecdotal comments suggest that this reflects more of a 'same as before' outlook —with no signs of significant deterioration —rather than any notable improvement. Geopolitical uncertainties, weak equity markets and caution about major strategic commitments weigh heavily on CEOs. One US banker notes that 'phones were never quieter than in the second half of December.'

But when asked about the prospects for consolidation, bankers respond more favorably. At 68.5, the overall consolidation reading is very high, with the majority of respondents seeing horizontal consolidation as significantly more likely than last quarter. US bankers give this the highest reading overall (86.7). Expectations for vertical consolidation are still relatively low, in line with last quarter.

One European banker asked about consolidation notes a sense that 'the period of maximum anxiety may be over; now is the time for cautious progress.' Others say their clients are wary of international acquisitions but more willing to consider deals closer to home. US bankers are particularly reluctant to make overseas acquisitions (16.7, the lowest reading in the survey), but somewhat more optimistic about domestic deals (43.3).

Some bankers say their clients are 'constantly' looking for small deals and are now more open to major transactions. But on the whole, 'bolt-on' rather than transformative deals are the norm. While one Japanese banker notes that firms are pressed to make 'bold' consolidation moves, balance sheet constraints make major capex commitments 'very unlikely.'

The CEO Confidence Index results are broadly in line with the findings of our GS Analyst Indices (discussed on the following page), in which we poll our equity research analysts each month. The US and European surveys both show some recovery from the lows seen late last year, while the Japanese GSAI remains weak. ■

CEO Confidence Index

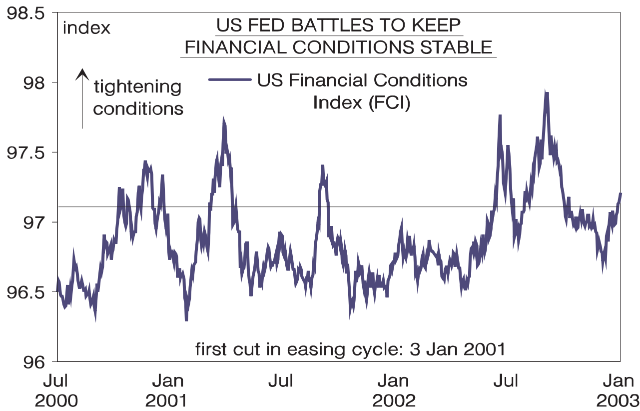
index	General Business Outlook			Overall Consolidation			Vertical Consolidation			Horizontal Consolidation			Capital Investment in Domestic M&A			Capital Investment in International M&A			Capital Investment in Existing Assets		
	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03	Jun-02	Sep-02	Feb-03
Global	43.5	15.4	**51.5**	61.0	36.5	**68.5**	--	34.6	**35.4**	--	63.5	**83.1**	39.1	21.2	**38.5**	26.1	13.5	**20.0**	39.1	40.4	**51.5**
US	33.3	20.0	**58.3**	55.6	40.0	**72.2**	--	46.7	**33.3**	--	60.0	**86.7**	33.3	13.3	**43.3**	22.2	20.0	**16.7**	22.2	33.3	**43.3**
Europe	41.7	13.9	**51.9**	66.7	33.3	**72.2**	--	27.8	**40.7**	--	63.9	**77.8**	33.3	22.2	**29.6**	33.3	11.1	**25.9**	41.7	41.7	**56.7**

A Bottom-Up View of US Capital Spending

A survey of our US equity research analysts shows that capital spending in their industries is still declining. They estimate that spending will fall 10% this year, following a 15% drop in 2002. Although our analysts cover only one-third of the US economy in terms of capital spending, this suggests downside risks to our forecast of roughly unchanged spending in the economy as a whole—even though our number is the lowest among all 53 forecasters in the *Blue Chip Economic Indicators* survey. Our statistical top-down model of capital spending also points to a small drop this year.

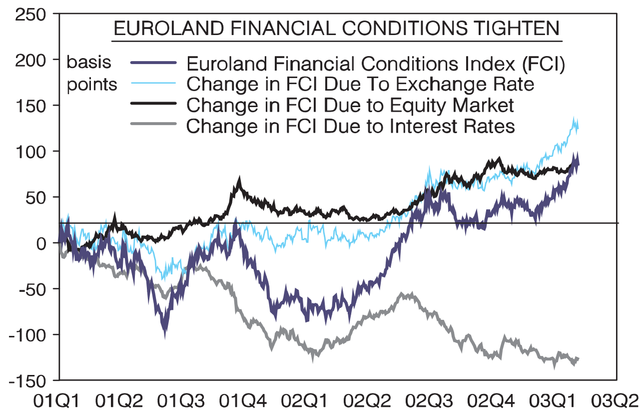
The projected decline is concentrated in a few areas, particularly oil, natural gas, electric utilities, airlines, telecom carriers and cable. In contrast, materials, health care, financials and consumer sectors are projecting small spending gains. The biggest improvement is expected in the materials sector, mainly chemicals, paper and steel.

Concerns that capital spending in the economy as a whole is 'undershooting' are unfounded. The real capital stock is still growing at about 1.5%, similar to rates seen in the early 1990s. And current manufacturing capacity utilization is only 73.5%—eight percentage points below the long-term average. However, underinvestment in energy appears to be continuing. According to our survey, the oil and natural gas sectors are set to cut their spending significantly this year, despite elevated utilization rates. Accordingly, as we noted in our last issue, lack of supply is likely to keep energy prices higher for longer than is generally expected. ■



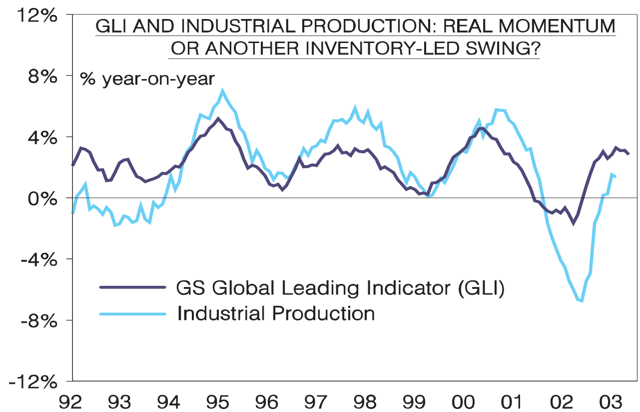
US Fed Battles to Keep Financial Conditions Stable

- US financial conditions are very close to the same level as when the Federal Reserve Board started to cut interest rates 525bp ago in early 2001. The decline in stock prices since then, along with the modest decline in the trade-weighted dollar and lower corporate bond yields, have offset the drop in short rates.
- Unless the dollar weakens markedly and the stock market soars, financial conditions will not ease much. We think more fiscal stimulus is needed now. The US administration can also encourage dollar weakness by shifting away from the 'strong dollar' policy.



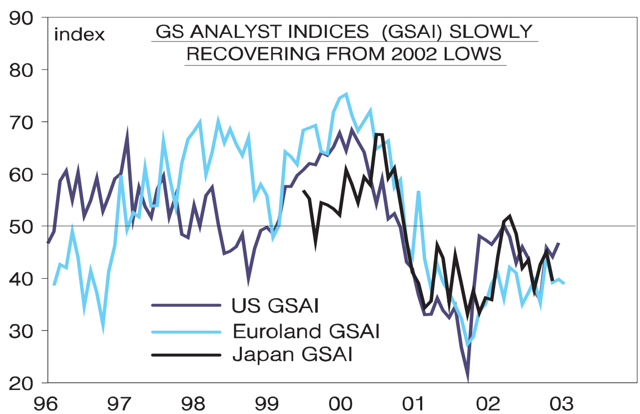
Euroland Financial Conditions Tighten

- Although equity markets play a less important role in the transmission mechanism in Euroland than the US, their importance has grown. Since the last ECB rate cut on December 5, financial conditions in Euroland have tightened by about 50bp due to the appreciation of the euro and the continuing slump in equity markets.
- Unless financial conditions improve, both the US and the Eurozone face downside risks to our GDP forecasts, especially for the second half of 2003 and 2004.



GLI Shows a Positive Change in the Industrial Sector

- January's 0.3% month-on-month increase is the fourth consecutive monthly rise in the GS Global Leading Indicator (GLI). The year-on-year increase fell slightly to 2.8% (against 3.0% last month). The labor market showed encouraging signs in January, although the consumer still looks weak.
- Although the pace of increase has moderated, this does not change the overall picture painted by the GLI. Short-term momentum in the industrial sector has clearly seen a positive change.



Analyst Indices Are Slowly Recovering from 2002 Lows

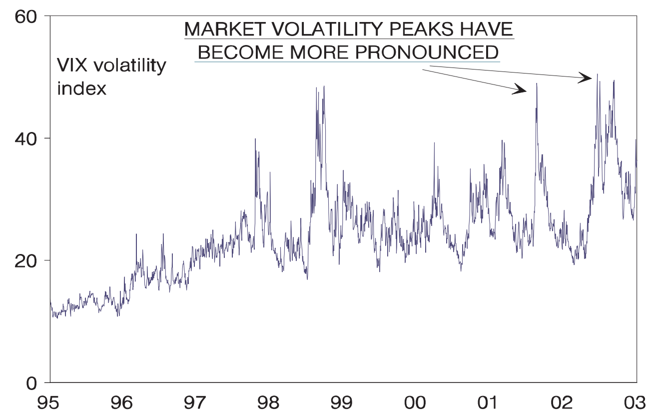
- The US Goldman Sachs Analyst Index (GSAI) rose modestly in January, to 46.8% from 44.2% in December. This marks the third month that the index has been in the mid-40% range. Analysts' anecdotal comments reflect an uneasy business environment in which profitability depends mainly on cost cutting.
- Our analysts see Euroland business conditions as stable in Euroland but worsening in the UK. Although they think a strong euro may limit revenues and profits, they see its impact as non-critical.

Source: Goldman Sachs.

Equity Volatility Peaks Are More Pronounced

- The recent ramp-up in volatility across most equity exchanges has boosted the relative demand for equity derivatives as hedging instruments. Although the end of 2002 brought calmer markets, volatility spikes —with the VIX volatility index nearing 50—have become more frequent.

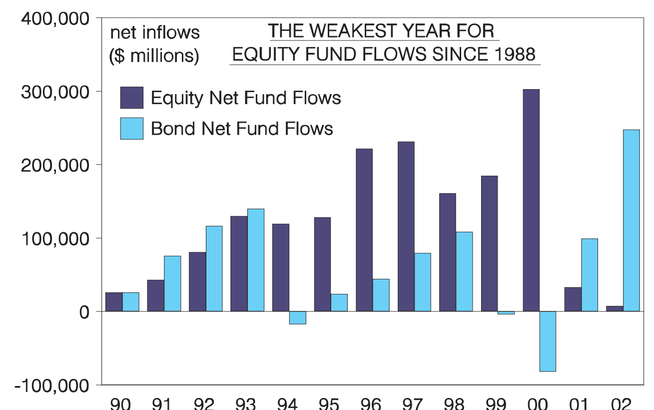
- We think periods of heavy market gyrations are to be expected in 2003. Geopolitical risk remains a concern for investors, and corporate bankruptcies are likely as long as the economy shows few signs of strong improvement.



Weakest Year for Equity Fund Flows Since 1988

- Equity fund net inflows fell to their lowest level since 1988 last year, and overall equity mutual fund assets under management fell about 22% during 2002.

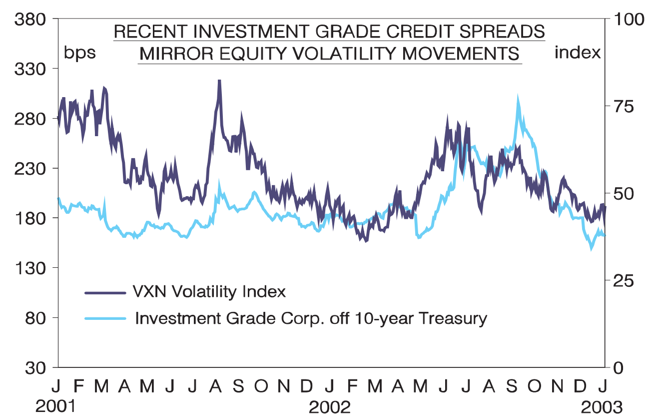
- While money market funds saw net outflows of $39 billion in December, bond funds finished a record year as investors sought income and principal protection. Long-term bond mutual funds drew $140 billion in net new money in 2002—36% ahead of the previous record set in 1996.



Credit Spreads Mirror Equity Volatility

- Without the spectre of additional rate cuts, trading levels could easily moderate in 2003. Aside from falling interest rates, a dramatic spike in the volatility of the credit market drove last year's activity in customer portfolios, as well as increased demand for credit derivative products.

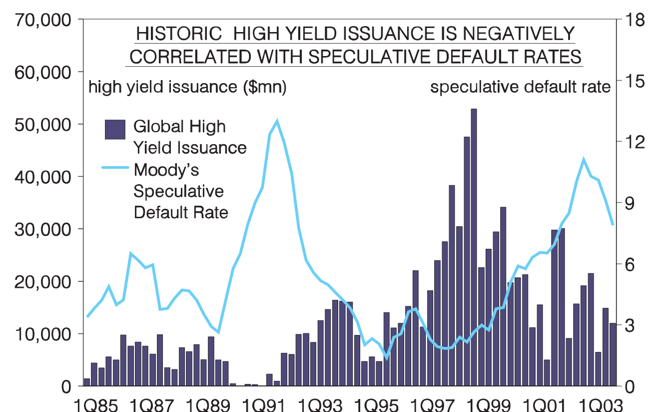
- Reflecting equity investors' extreme focus on credit in this part of the cycle, the credit markets have become more correlated with equity market movements, a trend likely to be just as pronounced in 2003.



High Yield Issuance to Rise as Default Rates Fall?

- Moody's speculative default rate forecasts appears to have peaked in mid-2002. The rating agency is still forecasting a measurable drop in the default rate, predicting that it will fall by about 200bp over the next ten months to 6.7%.

- Traditionally, the default rate has been a reliable indicator of high yield issuance. Underwriting volumes, which picked up slightly toward the end of 2002, could accordingly improve if Moody's forecast proves accurate.



Source: FactSet; ICI; Moody's; Dealogic; Thomson Financial Securities Data; Goldman Sachs.

THE WORLD IN A NUTSHELL

	Outlook	Key Issues
United States	Although industrial production data are coming in better than expected, we doubt this marks the start of a fundamental pickup. Much of the strength likely involves a temporary inventory cycle rather than a more durable upturn. And, with energy prices rising and stock prices falling, the fundamentals are deteriorating. We see growth slowing down to 2.0% in 2003 from 2.4% in 2002. Growth should pick up to 3% in 2004.	We do not think even a quick and 'successful' resolution to the conflict with Iraq will fundamentally improve the outlook for the global economy, for four reasons: 1) geopolitical problems, including the risk of terrorist attacks, will persist; 2) consensus economic forecasts are too high, especially for the US; 3) global financial conditions remain stubbornly tight; and 4) oil prices are likely to stay high.
Japan	The economy seems to be slipping back into a recession. October-December GDP rose 2.0%, sustaining positive growth for four quarters. However, with the twin engines of consumer spending and private-sector capex lacking momentum, GDP should turn to negative growth for the January-March quarter. Capex remains substantially below cash flow.	Deep-rooted structural deflationary pressures mean that it would be difficult for the BOJ to attain an inflation target unless its efforts were accompanied by a shift to fiscal expansion or sharp yen depreciation. Expanding outright long-term Japanese government bond purchases without an accompanying fiscal expansion would have virtually no stimulative effect on the economy.
Europe	We project Euroland GDP growth of 0.9% in 2003, rising to above-trend growth of 2.7% in 2004 as economic activity benefits from a recovery in the world economy and a more pragmatic monetary policy stance from the ECB. Since the last ECB rate cut, financial conditions in Euroland have tightened by about 50bp. The ECB cannot ignore this; we expect rates to fall to 2.0% this year.	The core of the Euroland's difficulties is Germany, which has underperformed the rest of Euroland for eight successive years. Although Germany will remain a serious drag on Euroland's overall performance, elsewhere in Euroland an unwinding of geopolitical risks and further aggressive easing by the ECB will help to boost growth towards year-end and in 2004.
Non-Japan Asia	Apart from China, we expect another year of sub-par growth in non-Japan Asia in 2003. Our forecasts are above consensus in most of developing ASEAN and below consensus in Korea, Australia and China. 2004 offers much brighter prospects—but first Asia must cope with oil, a weaker dollar, and the question of whether global (and Asian) capex will revive before the consumer collapses.	Going beyond China's official GDP figures, we look at two alternative indicators: 1) expenditure-side GDP estimates, and 2) our own proxy index of economic performance. These show a more pronounced V-shaped growth pattern, with a sharp slowdown from 1996 through 1999 and a rapid recovery since 2000. Real growth last year was well in excess of the official 8% figure.
Latin America	At our forecast of -0.7% real GDP growth in 2002, the region continues to weather the effects of Argentina's financial crisis, Brazil's political uncertainty and most recently Venezuela's oil crisis. Countries such as Chile and Mexico have shouldered the shocks reasonably well. We see a cyclical upturn to 0.8% in 2003 on the back of a global economic recovery.	Although Venezuela's oil production rose to one-third of capacity, further increases could run into technical and capital constraints. Without higher oil production, the balance of payments and fiscal conditions will worsen. This has already required stifling FX controls. Deep economic depression and low oil revenues raise risks that the government could experience debt servicing problems by mid-year.
Central and Eastern Europe	We see growth gradually recovering in 2004 to 4.6% from 3.7% in 2003. The recovery will be driven by stronger exports, fueled by stronger EU domestic demand. With EU performance split between poor performance in Germany and robust growth elsewhere, Central and Eastern European growth will reflect each country's relative dependency on Germany.	Ten Central and Eastern European countries are set to join the EU in just over a year, and most of them will proceed straight into ERM-2 with an intention to adopt the euro two years later. Between now and mid-2004 we see increasing tension between the underlying fundamentals, which will push the Central European currencies stronger, and policymakers' efforts to prevent this.

KEY ECONOMIC AND MARKET FORECASTS

	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2003: 2.0 2004: 3.0	2003: 2.3 2004: 1.5	3m: 1.3 12m: 1.3	Current: 3.9 12m: 4.5	-- --
Japan	2003: 0.7 2004: 0.4	2003: (0.5) 2004: (0.3)	3m: 0.1 12m: 0.1	Current: 0.9 12m: 1.0	3m $/JPY: 121 12m $/JPY: 111
Euroland	2003: 0.9 2004: 2.7	2003: 1.7 2004: 1.7	3m: 2.7 12m: 2.2	Current: 3.8 12m: 4.1	3m EUR/$: 1.08 12m EUR/$: 1.18
UK	2003: 2.2 2004: 2.8	2003: 2.8 2004: 2.4	3m: 3.8 12m: 4.4	Current: 4.2 12m: 4.2	3m GBP/$: 1.66 12m GBP/$: 1.66
Non-Japan Asia	2003: 6.1 2004: 6.8	2003: 1.2 2004: 1.4	3m: 4.3 12m: 4.3	Current: 7.3	3m $/KRW: 1200 12m $/KRW: 1075
Latin America	2003: 0.8 2004: 3.2	2003: 12.0 2004: 11.9	3m: 8.5 12m: 9.1	Current: 10.6 12m: 10.1	3m $/MXN: 11.15 12m $/MXN: 11.00
Central and Eastern Europe	2003: 3.7 2004: 4.6	2003: 4.6 2004: 2.6	3m: 6.1 12m: 5.0	Current: 5.5 12m: 5.0	3m EUR/PLN: 4.10 12m EUR/PLN: 4.05

* 3-Month Rates: Euroland: average of Germany and France; Non-Japan Asia: Korea; Latin America: Mexico; Emerging Central Europe: Poland.
** Bond Yields: US: 10-year Treasury note; Japan: 10-year JGB; Euroland: average of Germany 10-year Bund and France 10-year OAT; UK: 10-year Gilt; Non-Japan Asia: Korea 5-year sovereign; Latin America: Mexico 5-year sovereign; Emerging Central Europe: Poland 5-year sovereign.

GS Roundtable: China's Role in Asia

Continued from page 8

The good news is that most of the NPLs are old legacy stuff, dating back over the last 15 years when Chinese banks acted as de facto treasury agents, taking household deposits and reallocating them into the hands of state-owned enterprises without much thought as to the viability or quality of the borrower. In the last few years we haven't seen state banks pouring money down the throats of unprofitable SOEs.

This means that the debt workout—if China can get it right—will be much less onerous than in Korea, Indonesia, Thailand and potentially in Japan. In many crisis countries most households and enterprises are hocked to the gills to the banking system, whereas in China it's only SOEs who have ever really borrowed from banks. Consumers have virtually zero leverage into the banking system, and most small to medium enterprises—which have been the main drivers of Chinese growth for the past decade—have been financing growth mostly on retained earnings and informal credit arrangements.

Once you do a carve-out of the NPLs, banks can easily turn around with new liquidity and find hundreds and hundreds of qualified vibrant borrowers who can use credit to intermediate new growth.

JO'N: Is there a possibility that Japan, Korea and China, say ten years from now, will effectively attempt to manage their exchange rates against each other as a prelude to some ultimate monetary union?

JA: For China it's probably premature. The renminbi is not even a traded currency, and China does not have an open and free capital market. I would guess we're at least a decade away from seeing external liberalisation sufficient to even consider the issue. Also, although China is increasing its presence on the regional stage, the leadership is still inward looking and not very comfortable with putting a regional agenda ahead of what it sees as a fragile economy at home. So it's far too early to talk about real union initiatives from China's side.

TY: We see political talk and a strong incentive for Japan to play a leadership role, but I think this is going to take a very, very long time. The economies across Asia are not as mature as in Europe, and labour mobility is limited, especially in Japan.

JO'N: How soon—if ever—will the G7 include China?

TY: I think it will probably be much earlier than people used to think, given the change in perceptions of China. Probably within the next couple of years, not ten.

JA: Let me answer with a question: whatever happened to Russia? Two or three years ago we used to talk about the G8; that seems to have dropped off the map.

JO'N: Russia does participate in the annual summit.

JA: That's probably the key to answering the China question. My guess is that within a few years you will see China playing a similar role. I find it difficult to imagine China stepping in to play a full co-ordinating role in the G7 next year, given its low international focus and the renminbi's status.

JO'N: Last question, and this one is really going to test you. By 2010, where will the renminbi be against the dollar?

JA: Good question. A lot depends on China's ability to achieve significant inflation at home. Assuming price growth of 2%-3% by the middle of the decade, with continued productivity increases and relatively rapid trade growth, my best guess is around 6.

TY: I have to agree with that.

JO'N: And dollar/yen?

TY: 100.

JA: I was going to say 200—but what do I know? ■

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GS Roundtable: China's Role in Asia

A conversation between our Chinese and Japanese economists on China's role in Asia and the world and the outlook for the renminbi and the yen

Jim O'Neill, ***Head of GS Global Economics and moderator*****:** Why did former Japanese vice minister of finance Kuroda recently go out of his way to criticize China about deflation? And do you agree with his argument that China must either revalue the exchange rate or raise its domestic price level—or do you think it's a bit more complex?

John Anderson, ***Senior Asia Pacific Economist*****:** I was surprised, because most people see deflation in China as a structural issue, with the authorities helpless to reflate, which implies that only exchange rate adjustment can resolve problems with the external balance. We think deflation is a monetary issue; the credit system is not working very well, and China can and should undertake reflationary policies, allocating more resources to people who can best use them to boost demand.

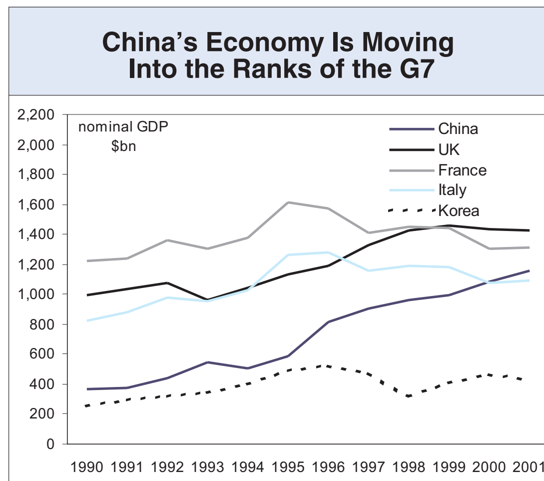
But because this involves a fundamental clean-up of the banking system, we don't see any real possibility for strong reflation in the near-term. In the meantime, we agree that this is an opportune time for China to move to a more flexible exchange rate regime.

Tetsu Yamakawa, ***Co-Director of Asian Economics Research*****:** Certainly Kuroda has been quite vocal in pushing Japan to adopt inflation targeting and in guiding the yen lower. I think he also wanted China to assume some of the burden of the adjustment to a weaker dollar. From Japan's standpoint, both reflation and revaluation would be desirable. It would be a big help for Japanese export competitiveness, especially in these very difficult circumstances where Japan cannot just keep on relying on yen weakness against the dollar.

JO'N: Would it be preferable for China to move to a floating exchange rate regime or to have a one-off revaluation?

JA: The Chinese leadership is afraid of doing something large and discrete that might disrupt the economy. To the rest of the world, China has rapidly growing exports, very large FDI inflows and foreign reserve accumulation. But the leadership at home sees a fragile transition economy with export margins that are potentially very low. It's difficult to gauge where the 'proper' rate should be, and they are concerned about overshooting. So the logic is to widen a bit and then gradually move toward a more flexible regime. I think the key is speed; moving 1% a year, for example, is certainly too slow.

TY: Gradual, step-by-step change would also be much more desirable for Japan.



JO'N: People now seem to recognize that China is not just a deflationary force, but actually quite an opportunity for countries and companies that are successful in penetrating Chinese demand.

JA: We've seen a sharp pick up in growth, and 2002 is probably one of the first years we can honestly say that actual growth was likely at or even higher than the official statistics. We think China is going to have high and stable growth over the next few years, not to mention further external liberalisation with the removal of trade barriers for commodities and agricultural products. Broad raw materials imports could easily grow by 25% per year on average for the next three years.

TY: We've seen a 180-degree change in Japanese perceptions of China. In the past most manufacturers saw it as a source of deflation, but they now see it as a source of demand shock. This shift in perception will be important from an investment standpoint. The Chinese equities and fixed income markets are still fairly limited, so many people try to trade with China through Japan and Taiwan.

JO'N: As you know, our forecasts show that by 2005 China's GDP will exceed that of France.

JA: It's not surprising, although it is a very different quality of GDP, since China's per capita income is much lower. For many people in Asia the surprise is that China's economy is *only* the size of France—the perception is that China is much bigger. But by the end of this decade and perhaps much earlier, depending on how fast China can grow and whether Japan can recover, China should overtake Japan as Asia's major trading power in terms of export and import dollar value. That's impressive, considering that China's economy is still only one-fourth the size of Japan's.

TY: That's quite intimidating for Japan! I have to say it is probably likely. But rather than trying to compete, many Japanese companies are now finding ways to live with China taking a big role in Asia. The next five years will be critical, and we will see a clear distinction between winners and losers.

JO'N: Could the non-performing loan (NPL) problem, which is very hard to get a handle on, undermine the whole China story?

JA: Our best guess is that 40% of outstanding state bank loans are currently non-performing—and this does not include the 10%-15% of loans which were removed from the books in 1999. At the same time, we are more optimistic than the raw NPL figures would suggest.

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