

## Inside:

**China at the Dawn of a High-Growth Era: Lessons From Japan**

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## A Bright Start to 2004

*We end 2003 on a very optimistic note. Best wishes to all our clients for the holidays and the new year*

The world economy looks good as 2003 draws to a close. In some ways, the outlook has not been this strong since the mid-1990s. We expect strong economic growth in the US in the first half of 2004 and above-trend growth in Euroland and Japan. Our optimistic growth forecasts notwithstanding, we think the lack of inflationary pressures will allow the major central banks to remain extremely accommodative.

Our forecast of strong growth in Europe, Japan and China will help to ease the burden on the US of driving the world economy. More balanced growth should in turn allow for a more sustainable global recovery. In fact we have pegged 2004 as the year of Asian self-confidence, in which Asia, led by China, plays an increasingly important global role, and Japan continues its structural recovery.

### **US: Strong Growth in the First Half, Slowing in the Second**

We have become more optimistic on the US outlook for 2004, raising our real GDP forecast to 4% in the first half and 3% in the second half. The improvement in profits, business investment and the labor market all imply that the recovery looks more sustainable than before. In addition, the further easing in financial conditions due to the falling dollar and the rising equity markets boosts the growth prospects for next year.

Better financial conditions and a US labor market that appears to have turned decisively toward stronger job creation have brightened the outlook

for capital spending. Recent revisions to the national income and product accounts data indicate that the business sector is in even better shape than we previously thought. We have sharply raised our forecast for business capital spending, which we now expect to increase nearly 12% over the course of 2004.

Residential investment and consumer spending are likely to post a more muted performance, largely because the improvement in the labor market has been limited. We still think jobs creation is likely to fall well short of the 250,000-plus per month needed to offset the fading influences of tax cuts and mortgage refinancing on consumer spending.

We still see several reasons why growth should slow during the second half of 2004:

- Fiscal policy will move from a modest stimulus early in the year, as people collect retroactive pieces of the 2003 tax cuts via refunds, to a brief but significant restraint, as the absence of those refunds makes tax burdens look larger.
- The effects of cash-out refinancing on consumer liquidity and spending should dissipate progressively through the year, unless long-term interest rates fall substantially.

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GS GDP and Inflation Forecasts												
% year-on-year	GDP		CPI		2004 GDP				2004 CPI			
	2003	2004	2003	2004	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	3.1	4.3	2.4	1.5	4.8	5.0	3.8	3.5	1.6	1.7	1.4	1.1
Japan	2.2	1.6	-0.3	-0.8	1.9	1.7	1.6	1.1	-0.6	-0.8	-0.9	-0.8
Euroland	0.5	2.6	2.1	1.7	1.7	2.6	3.0	3.0	1.8	1.8	1.7	1.6
China	8.7	9.5	1.0	3.5	8.5	11.9	9.1	9.1	2.5	3.0	3.8	4.7
UK	2.1	3.0	2.8	2.5	3.0	3.1	3.0	2.9	2.4	2.5	2.6	2.7
Emerging Markets	5.4	6.4	6.3	6.1	6.2	7.4	6.4	6.2	4.3	4.7	5.3	5.8
World	3.2	4.4	3.4	3.0	4.2	5.0	4.4	4.2	2.2	2.4	2.5	2.5

## A Bright Start to 2004

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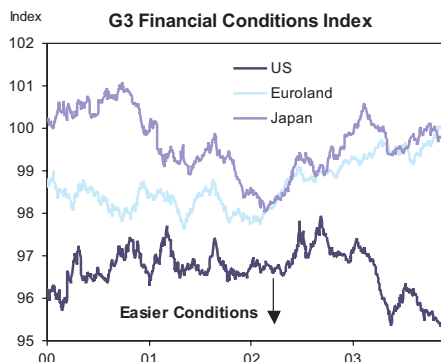
■ Efforts to rebuild inventory will have a front-loaded effect on growth, especially if growth in consumer spending slows. Although we do envision a pickup in business spending toward year-end, this is unlikely to offset the slowdown in consumer outlays and inventory investment.

Despite the positive growth outlook, we maintain our inflation forecast of 1.5% for 2004, down from 2.4% this year. The growth we anticipate still leaves the US economy with a large margin of excess productive capacity next year.

Neither the unemployment rate nor the capacity utilization rate should come close to the level usually associated with full usage of resources. Most people would peg full employment at no more than a 5% jobless rate. We do expect the unemployment rate to drop—but only to about 5.75%. We also expect capacity utilization to rise, but to only about 77% in the manufacturing sector—far from the 82%-83% rate normally seen as ‘full.’

Dollar depreciation and higher commodity prices may suggest some inflation, but these factors are much less important to the inflation rate than is the degree of spare capacity.

Given all this, and despite market expectations of a rate increase in the first half of 2004, we think the Fed will stay on hold until 2005. Inflation is lower than the Fed desires; the output gap will not be exhausted next year; and growth is likely to slow in the second half. That, plus the



presidential election in November, should be sufficient to delay tightening until 2005.

### ***Euroland: Recovery at Last***

Our 2004 forecast of 2.6% GDP growth in Euroland has been above the market consensus for some time. Data is at last beginning to bear out our expectations of a recovery in late 2003 that will extend into 2004. The pickup in the third quarter (after a marginal contraction in the second) was driven by exports, but we expect final domestic demand to improve as well next year.

Our leading indicators suggest the economy has picked up further momentum in Q4, with good chances that growth has reached potential (2% annualized). Hard figures, including industrial production data, are finally corroborating the upturn that business surveys have signalled for several months, and business sentiment continues to improve. We see inflation declining below 2.0% in 2004 on the back of a strong euro, spare economic capacity and oil-related base effects.

We currently expect the European Central Bank to raise rates before either the US Fed or the Bank of Japan. While our forecast is for rates to rise 100 basis points in the second half of 2004, the euro's strength is complicating the outlook. If the euro continues to rise on a trade-weighted basis, the ECB may refrain from hiking rates to avoid choking off the recovery.

### ***Japan's Structural Recovery Takes Hold***

We expect the economic recovery that is already underway in Japan to continue in 2004. Thanks to diminishing deflationary pressures, we are forecasting a return to positive nominal growth for the first time since 2000. Our real GDP forecast is for an above-trend 1.6% growth. Although we think growth will slow slightly from 2003, on the back of a weaker second half in the US and a stronger yen, we see this as a pause before a stronger pickup in 2005.

The factors that underpinned the expansion this year—capital spending to replace the aging capital stock, Chinese demand and the declining saving rate—should continue in 2004. Moreover, Japan

GS Major FX Forecasts			
	3-Month	6-Month	12-Month
EUR/\$	1.26	1.30	1.30
\$/¥	105.0	95.0	95.0
EUR/¥	132.3	123.5	123.5
EUR/CHF	1.57	1.59	1.59
CHF/¥	84.3	77.7	77.7
\$/CHF	1.25	1.22	1.22
EUR/£	0.72	0.73	0.73
£/\$	1.75	1.78	1.78
£/¥	183.8	169.2	169.2
£/CHF	2.18	2.18	2.18
EUR/NOK	8.20	8.25	8.40
EUR/SEK	8.80	8.70	8.70
AS/\$	0.75	0.79	0.76
NZ/\$	0.64	0.67	0.66
\$/C\$	1.28	1.25	1.25

will benefit from the global capex recovery that we anticipate.

Our Japan equity strategist argues that Japan's structural problems are being resolved much faster than the naysayers will admit. Excess capacity and deflation are easing; non-performing loans are shrinking and loan growth is in sight; corporate governance is improving; and restructuring could boost return on equity to a record high.

Risks to our outlook in Japan include a rapid yen appreciation, a hasty fiscal contraction and an abatement of restructuring pressures. We think further yen appreciation will remain manageable as long as it occurs at a moderate pace.

The Bank of Japan has indicated that it will not tighten monetary policy until it sees sustained evidence of positive inflation. We see tightening as unlikely throughout 2004.

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## *A Bright Start to 2004*

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### **China: A Key to Asian Self-Confidence**

China is a key story for both Asia and the rest of the world. We think market fears of Chinese overheating are overblown. In fact we expect GDP growth in 2004 to be 9.5%, well ahead of the market consensus. Our own indicators suggest that Chinese growth is currently about 11%, and although it may slow, it is unlikely to slow by much. We expect Chinese private consumption to accelerate in 2004 as part of a structural shift in the economy. (We discuss this further on page 4.) This would be a very welcome shift as it would broaden the base of the upswing and might allay some market fears of an investment bust.

We expect Chinese inflation to rise next year. While the central bank could tighten monetary policy across the board to counter inflation, this is a blunt instrument that the government would like to avoid. In this case a currency revaluation would be entirely appropriate. Indeed this is our forecast, as we discuss below.

### **Dollar Decline to Continue**

We view further US dollar weakness over the next six months as almost inevitable. Our forecasts are for the euro to reach 1.30 against the dollar and the yen to reach 95. After that, the outlook becomes trickier; at the moment we could lay out equally compelling scenarios for a dollar recovery and for a further decline.

The near-term outlook is certainly weak given a US current account deficit worth roughly 4.8% of GDP. Foreign direct investment flows recorded another net outflow in the third quarter, as did our own M&A pipelines and net activity in equities. In terms of relative valuation and earnings outlook, it seems difficult to build a strong case for rising equity inflows into the US in the near future.

We expect China to widen the trading bands for the renminbi—effectively allowing the currency to appreciate—by 2.5% in six months and by 5.0% in 12 months. This will allow other Asian currencies to strengthen against the dollar, broadening the dollar's trade-weighted decline and easing some of the pressure on the euro and the Canadian dollar.

We see dollar weakness as a positive—not a negative—for the world economy. It will add to the pressures for rebalancing and will help to make global growth more sustainable.

### **Risks to Our Outlook**

Along with the unquantifiable risks of another major terrorist attack or other geopolitical disturbance, we see three risks:

- US consumer spending could fall sharply as the impact of mortgage refinancing and tax cuts fades, especially if jobs growth weakens and confidence is shaken.
- Structural reform efforts in Euroland and Japan could disappoint, although we think this is more a concern for 2005.
- Protectionism is likely to remain an issue, especially in the runup to the US election. But as long as we see a strong demand impetus for the next few quarters, the risk of protectionist measures hurting asset markets is low. ■

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# China at the Dawn of a High-Growth Era: Lessons From Japan

*While China is already recording rapid growth, it still appears to be at the dawn of a full-fledged high-growth period, judging from Japan's growth experience of the 1960s*

China's rapid growth echoes Japan's high-growth period of the 1960s in many ways. China's per capita GDP stood at \$966 in 2002, nearly the same as Japan's at the beginning of the 1960s, when the Japanese economy was on the brink of its high-growth period. Per capita GDP growth in Japan accelerated rapidly in the second half of the 1960s and the 1970s, reaching \$8,705 at the end of the 1970s, up 18 times from the beginning of the 1960s (a 96% annual growth rate).

Second, rapid labor supply growth in both countries is underpinned by population migration from agricultural to urban areas, which provides a supply of cheap, high-quality labor as workers move from the traditional agricultural sector to the modern industrial sector.

In Japan, population migration from agricultural areas to the three major urban regions picked up in the second half of the 1950s, peaking in the early 1960s and continuing at a high rate throughout the 1960s. This translated into major compositional changes in employment. In the mid-1950s agriculture and other primary industries accounted for 38% of the labor force, but this steadily declined, falling to 19% at the end of the 1960s. The corresponding share in China is still high, at 45%, but is declining at nearly the same pace as in Japan's high-growth period.

Third, changes in China's consumption structure mirror those that took place in Japan decades ago. Major changes occur in

household consumption structure in step with the rapid rise in per capita GDP and population concentration in urban areas.

The ratio of spending on food to total consumption follows a secular downward path during a high-growth period. In Japan, this ratio fell from 47% in the mid-1950s to 35% at the end of the 1960s, and it is declining at an even more rapid pace in China. At the same time, the consumption structure expands to include a broader range of goods, including consumer durables.

### *A Key Difference: The Pace of Capital Accumulation*

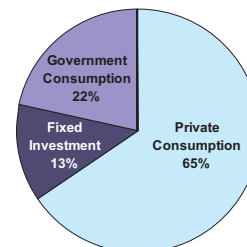
China differs crucially from Japan with respect to the capital accumulation process. In addition to China's high domestic savings rate, steady advances are being made in capital accumulation—as seen in an already high investment ratio—against the backdrop of a production shift from Japan and other countries to China and accelerating direct investment into China. These factors were not seen in Japan's high-growth period.

Analysis of the components of final demand in GDP shows that in mid-1950s Japan, the share of personal consumption was extremely high at 65%, while capex accounted for only 13%. In China, by contrast, personal consumption's share is lower than in Japan during its high-growth period (at 44%) and capex already far exceeds the level during Japan's high-growth period (at 38%).

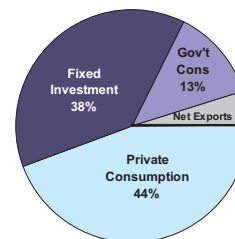
### *Still at the Dawn of China's High-Growth Period*

During Japan's high-growth period, which took off in earnest beginning in the 1960s, mass production of industrial goods grew, fueled by a significant population inflow into urban areas that provided an abundant labor force. This, coupled with a decline in prices of consumer goods, sparked a consumption boom centered on consumer durables. Additional momentum gathered from the

GDP Breakdown: Japan 1955



GDP Breakdown: China 2002



Tokyo Olympics in 1964. Beijing will host the Olympics in 2008.

The late 1960s to early 1970s saw a rapid rise in Japanese ownership of refrigerators, washing machines, and color TVs. This occurred first in urban areas and spread gradually to agricultural areas. At the end of the 1950s the penetration rate for consumer durables in agricultural areas stood at just 3% for refrigerators, 24% for washing machines, and 24% for black-and-white TVs, but all three rose to 100% or higher by the mid-1970s. In China, penetration rates for these goods have already risen significantly in urban areas but remain low in agricultural areas. As the penetration rates for these goods rise, the pace of growth in demand for consumer durables will be vastly higher in China than it was in Japan, given the difference in population.

China has already achieved rapid growth and is on the verge of making a sudden transformation from a global production base into an enormous consumer market. Judging from Japan's high-growth experience, however, the Chinese economy is still at the dawn of its high-growth period. China is not nearing the end, but rather is on the very brink of a full-fledged high-growth period on the back of a consumption boom. ■

