



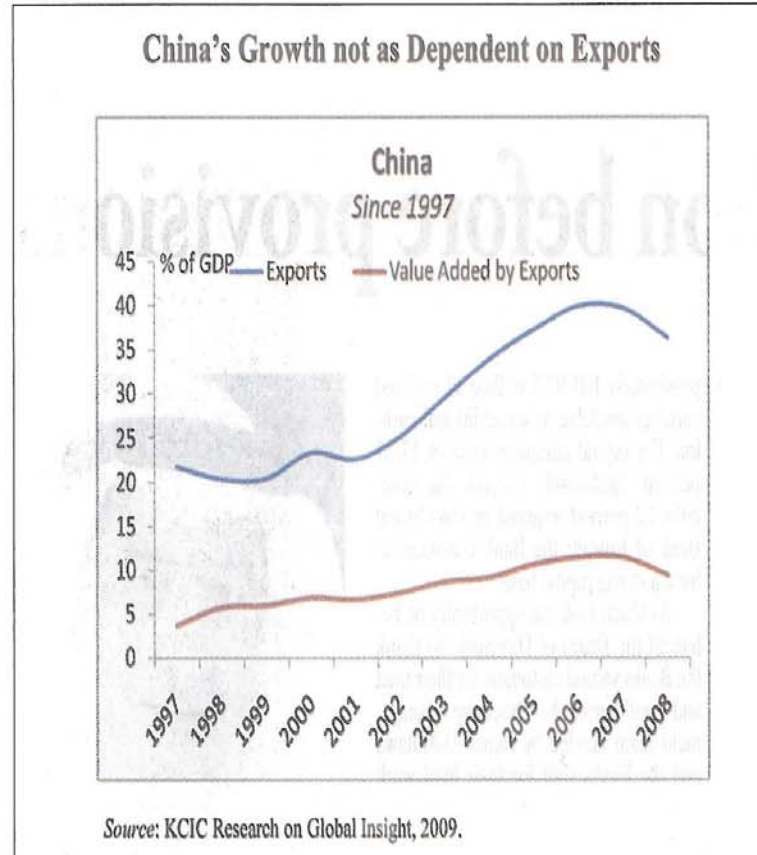
China's growth not as dependent on exports

Why is this graph important?

This graph shows that China's economic growth is not "all about exports." In other words, the role of exports in the country's economic success might not be as large as commonly believed. To clarify, here is a very simple example: the iPod. While Apple Inc. is based in California, its iPod (the widely known portable device for storing and playing audio files) is assembled in China - and then exported to the U.S. and the rest of the world. When an iPod ships out of China, its value is recorded as an export in the country's trade statistics. In 2006, the export value of one iPod was set at 150 U.S dollars. Still, only an estimated \$4 was directly attributable to Chinese producers. In technical terms, the "value added" to the iPod within the Chinese economy was only a fraction (less than three percent) of its total value. Hence, the key question is: when China ships out an iPod, what is the contribution of that export to the country's GDP? Its total value (\$150) or just the value added in China (\$4)? The relevance of this question is shown in the graph: if exports are measured in "total value" (the value of all goods and services exported in a given year - indicated with the blue line), the ratio to GDP is high; conversely, if exports are estimated in terms of "value added" (the value added in the Chinese economy to these same goods and services - indicated with the red line), the ratio is significantly lower. As the "value added" methodology reflects more accurately what is happening in an economy, the widespread conventional wisdom about the importance of Chinese exports for the country's economic growth might overstate reality.

What do these indicators tell us?

The first indicator - shown with a blue line - is very well known to investment professionals. It illustrates China's "exports" as a percentage of GDP. "Exports" are calculated as the total



Source: KCIC Research on Global Insight, 2009.

value of all goods and services generated in the economy for overseas sale or consumption. The indicator highlights a progressively bigger role for China's exports: between 1997 and 2008, they rose from 20 to 40 percent of GDP. According to the conventional interpretation of these data, the rising exports-to-GDP ratio implies an increased importance of exports in China's economic performance. In other words, the world's growing appetite for Chinese goods gradually brought the economy to over-rely on exports for its growth. However, this point of view can be challenged by observing that the 'exports-to-GDP ratio' is not a fully reliable indicator - and might overemphasize the real role of exports in the economy - because:

- 1) It is methodologically inaccurate. Indeed, exports (the numerator) are expressed in "total value," while GDP (the denominator) is expressed in "value added terms." In other words, the ratio mixes "apples and oranges."
 - 2) Manufactured goods constitute over 90 percent of China's exports. As in the case of the iPod, manufactured goods are mostly just assembled in China. As a consequence their local 'value added' tends to be low.
- To get a better picture, we need a better indicator, able to estimate the value that was added in China to these exports. This second indicator - depicted with the red line - shows the "value added by export", as a percentage of GDP. Here, the "value added" is calculated by

eliminating the amount of domestic and imported inputs that were utilized when producing the exported goods. In this case, as both the "value added by exports" (numerator) and the GDP (denominator) are expressed in "value added terms," the ratio is methodologically accurate and it clearly identifies the value added by exports to the Chinese GDP.

What are the implications for China's economy and for the global markets?

On the world economic stage, China's growth is sometimes viewed with skepticism because of its perceived export-dependence. According to conventional wisdom, if China's economic growth comes merely from exports growth, the country inevitably depends on foreign demand; and given the global economic downturn and the ongoing retrenchment of Western consumers, the sustainability of this growth model is at stake. This is only partially true.

No doubt, the Chinese government has actively promoted exports for decades. Deng Xiaoping (China's Vice Premier from 1975 to 1983) pushed for the adoption of an export-led growth model, to fully exploit China's comparative advantages in labor-intensive industries and to earn foreign exchange. In 2002, China accessed the World Trade Organization (WTO). As for any other developing economy, exports are crucial for China.

They attract foreign investments, generate employment, spur domestic production, help to attain economies of scale, and earn the foreign exchange needed to finance all imports required by domestic consumption and production. In short, they contribute substantially to the country's economic growth. Before the 2008 crisis, China's trade statistics recorded an impressive total value of exports: almost 40 percent of GDP. And because of the crisis, these statistics have suffered significantly in 2009.

However, as indicated above, the value added to the economy by those exports is likely to be significantly lower than generally perceived. Let us go back to our iPod example: if Western consumers buy one less iPod because of the crisis, China's exports will decline. Yet, China's GDP will not lose the iPod's total value (\$150), but just its value added (\$4). The impact on the Chinese economy will be smaller in size and possibly more manageable than expected. If the government is able to put in place adequate policies to cover for this loss - for example by training and relocating the affected workers or by subsidizing their consumption - the country's economic performance will not suffer dramatically.

Also, China's growth is not only about exports: in 2005, the 49 Export Promotion Zones (EPZs) were spread on 584 square kilometers (only 0.006 percent of China's surface), and contributed 3.8 percent of China's GDP and 8 percent of China's Gross Industrial Output (GIO).

In conclusion, the current global economic slowdown and the resulting drop in world demand for exports is hitting the Chinese economy hard, but for China the crisis might not end up being as severe as commonly perceived. Additionally, as the government is heavily intervening in the economy with its fiscal and monetary stimuli, domestic demand is likely to rise, and become over the next few years an increasingly robust engine of growth. Finally, despite the existing short-term uncertainties and medium-term risks, China's demographic structure and macroeconomic fundamentals are bound to support the country's growth. In the long run, China is likely to serve as an export market for the other Asian economies.

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