Commentary

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BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

China's Inexorable Economic Ascendancy

China's economy has the highest growth rate of any major nation, currently more than three times that of the United States, and now ranks seventh in terms of gross domestic product. Projections of GDP growth indicate that China may become the world's largest economic superpower around 2050. China's current ranking is based on a fixed renminbi-dollar exchange rate that many observers consider as artificially low. At a more realistic market exchange rate, China would rank as the world's fourth or fifth largest economy, ahead of some of the nations in the G7 group of leading industrial democracies. On this adjusted exchange rate basis, the Chinese economy is estimated currently at about 70% the size of the U.S. economy.

China's population, estimated at between 1.3 and 1.5 billion, represents one-fifth of all humanity. China has over one hundred cities with populations over one million. The number of China's children under age 14 exceeds the total U.S. population. China already dominates many industries and has become the world's workshop, reflecting its location in a stable geographic region; it offers the world's manufacturers a productive workforce at very competitive labor rates. China's embrace of market capitalism, combined with population migration from rural areas to the cities, has a profound impact on the global economy. Estimates of this migration over the last two decades range around 200 million, a number whose significance is evident when compared to the magnitude of the U.S. workforce. How China and other nations use the potential of this low-cost manufacturing resource will inevitably influence national economies around the world and make the twenty-first century the Chinese Century, just as American industrialization and expansion made the twentieth century the American Century in economic and geopolitical terms. China's expanding cities have created unprecedented demand for steel and cement. China is also the world's fastest growing market for automobiles. Shanghai is the showcase city for the new Chinese economy, firmly established as the leader in culture, finance and industry. The skylines of Shanghai, Beijing, Shenzen and Guangzhou are changing dramatically as each expands at a frenetic pace; in Shanghai in 2004, more than 300 new buildings over fifteen stories tall appeared on the city's skyline.

China's economic ascendancy is having a powerful impact in other countries. Interest rates, commodity prices, wage rates, unemployment rates, trade balances and current account deficits are all affected by China's surge in economic development and, importantly, by its exchange rate policy. In the September 2003 edition of Commentary, we wrote: "Although there are increasing international calls for China to revalue the renminbi, a move is not expected in the near term. China has already rejected calls for a free float of the renminbi. A free float of the renminbi would be a dangerous policy since it would require China to abandon controls that influence demand for the currency and undermine the stability of China's whole financial system. From the U.S. perspective, China has been beneficial in helping with financing the current account deficit and providing support for a policy of declining interest rates through investment of its trade surplus in U.S. treasury securities. As an alternative to a free float of the renminbi, China could allow a wider band for the pegged exchange rate around the existing 8.278 level. China is very unlikely to revalue the currency, as its critics would like. China knows only too well the influence of speculators in the Asian currency crisis of the late 1990's and the destabilizing effect of large short-term money flows. A revaluation would have the effect of reducing the trade surplus and curbing the country's economic growth. Revaluation would trigger a downturn in the worldwide level of demand for goods and services, thereby risking global deflation. China's current inflation rate is only 0.3% and revaluation would certainly create a deflationary effect. China's policymakers will focus on deflation risks before embracing any revaluation policy rather than reacting to international pressure. China will consider its own economic situation in setting policy regarding currency valuation and only when China's economy experiences significant inflationary forces, excessive monetary growth or economic overheating, might China be expected to consider a revaluation of the renminbi."

Our analysis has proven correct and today the renminbi remains fixed at exactly the same dollar exchange rate as twenty months ago. China's first step in changing policy might be to substitute a basket of international currencies to replace the U.S. dollar, followed by an increase in the permitted width of the currency trading band and finally, the adoption of a crawling peg system of continuous valuation adjustments. The inexorable economic ascendancy of China is a reality that still has a long way to go and whose effects will be reflected in a major realignment of the economic power and geopolitical influence of other nations.

Buffin Partners Inc.

P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067
Email: commentary@buffinpartners.com