

B. International Review and Outlook

This section of the March 2012 forecast was researched and written by Mark Ethen, a former Office of Economic Analysis intern and current Fiscal Analyst for the State of Oregon. The discussion contained herein does not reflect the views of the Office of the Governor, nor the Governor's Council of Economic Advisors.

Although the risk posed by the European debt crisis is the most widely discussed threat to the domestic economic expansion, many other sources of uncertainty are out there. In particular, the slowing growth in China is a rarely discussed subject that, potentially, has enormous consequences for the global economy. Best case scenario, the Chinese government successfully brings the economy in for a soft landing and avoids a financial route precipitated by excessive local government spending and a collapsing real estate bubble. Worst case scenario, slowing growth, or a significant real-estate correction, unveils a host of bad loans at China's state run banks which causes significant financial losses. Fortunately, China has the fiscal health to bail out its own banks and local governments, and a replay of the U.S. financial collapse in 2007 and 2008 is unlikely - especially in terms of magnitude. What is a primary concern is the effect a slowdown of China's economy will have on the global economy and Oregon, given that China is the state's largest trading partner.

Prior to the global recession, China did not have debt problems or a real-estate bubble. Home prices in China had actually been falling relative to personal income for several years, and Chinese households were far less leveraged than their American counterparts evidenced by their household debt being approximately 13 percent of GDP while the corresponding U.S. figure was 100 percent. China also had the healthiest fiscal position of any large economy with a high domestic savings rate, robust economic growth, and an enormous trade surplus. China's Achilles' heel, however, is that no one really knows what will happen between the ruling politburo, middle class, and business class during economic downturns. Americans debate a lot (sometimes acrimoniously) about the nature of the business cycle and government, but they have also been through brutal recessions and even world wars with little internal instability. The current Chinese political/economic system is relatively new and untested. When global trade plunged in 2008, the Chinese government preserved national aggregate demand via a two-part stimulus comprised of \$585 billion dollars in spending and easier lending from China's state owned banks. The relatively massive stimulus fit in to China's longer-run national strategy of fostering increased domestic consumption (counteracting a high domestic savings rate) in order to reduce their dependence on foreign trade. Developing China's financial markets and social insurance programs would also reduce its saving rate (at both the household and national levels), but those changes are more gradual and less impressive visually than building skyscrapers today. Government infrastructure and real-estate spending have now surpassed foreign trade as the biggest contributors to Chinese economic growth. In fact, fixed-asset investments (a statistic weighted heavily towards government and/or real-estate projects) is now 70 percent of the nation's GDP which is far above any large economy in recorded history (the current U.S. figure is approximately 20 percent).

China's current fiscal problems stem largely from their inability to control how the stimulus was eventually used. In China, most tax revenue flows to the central government, and local governments cannot legally issue bonds like they do routinely in the U.S. (leaving them starved for cash). Lower level members of the Chinese politburo have learned to become more resourceful in procuring funds (often flipping real-estate for revenue). Local Chinese politburo members compete to move up the party ladder by posting strong GDP figures and/or completing massive building projects within their district. Around 2008, these local Chinese leaders began financing their projects through co-axial special investment companies which could legally borrow from the central government's state-run banks since they were technically private sector corporations. The rate of lending increased substantially as more officials got in on the act, and even began competing among one another to spend the most money. China eventually ended up with 6,500 - 10,000 investment companies building almost everything (skyscrapers, bullet trains, airports, etc...) with loans secured by sometimes very questionable collateral. These loans pushed local real-estate prices higher, and that inflated property values which were then used as collateral for new larger loans to pay off the first loans. China's central bank estimated that local government debt had reached \$2.2 trillion (approximately 30 percent of GDP) by 2011. China's local debt may actually be closer to \$3 trillion (approximately 35 percent of GDP) after additional borrowing took place in early 2011, and by including more difficult to track figures. Almost none of this debt existed before 2008, and much of it can be very difficult to track since it is not on official public books, but rather on the books of the special investment companies. Including China's national government debt, the final tally is over \$5 trillion, resulting in a debt to GDP ratio of over 60 percent.

As China enters 2012, local government debt has become a major issue alongside various negative byproducts, ranging from a real-estate bubble to relatively high inflation. The greatest problem is not necessarily the size of local government debt, but the fact that many of those investments will never be profitable enough to repay the lenders. Arguably, they never really had to be profitable if those borrowers were competing to be somewhere else on the politburo ladder when the bills finally came due. However, these special investment corporations could generate up to \$460 billion in loan defaults over the next few years which would be a larger percentage of China's

Figure I.1

Figure 3. Investment growth has varied



Source: CEIC, World Bank staff estimates.

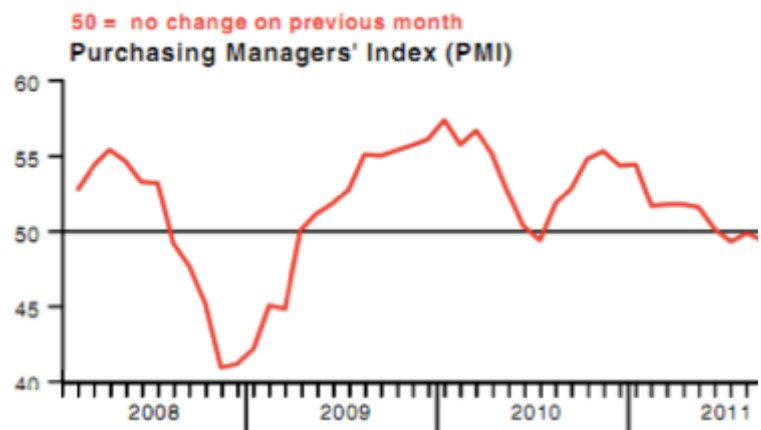
Figure I.2



GDP than the \$700 billion bailout program in the U.S. That means China’s growth from 2009 – 2012 was purchased at twice the intended price. Declining economic growth or a real-estate correction would expose even more non-performing loans, as the special investment corporations collateral plunges in value. Stimulus fueled building projects have not been the only factor driving up Chinese real estate prices, but also the government policy of keeping bank deposit rates below inflation. Individuals end up investing their savings in real estate since it is one of the few investments offering real returns. Overall, the valuation of China’s real estate market is difficult to gauge since historical data is limited (private property ownership only became legal in 1998), and because the websites/press releases can be very difficult to sort through.

China is now expected to see slower growth over the next few years and subsequent economic progress will be hindered by demographic changes. Not only does China have to deal with the original problem (low aggregate demand), but also the results of their stimulus which was considerable sums of non-performing debt. The Chinese central bank has already hiked interest rates 5 times (though they recently lowered reserve requirements) since October to tame inflation that (at roughly 5 percent) has far outpaced most of their trading partners (U.S., Europe, Japan, etc.). China is also reining in the real estate bubble with its first property tax and higher initial deposit requirements on second homes. Stimulus spending is also declining as the magnitude of the local debt crisis becomes clearer. When China’s financial system last faced a local debt crisis (the Asian financial crisis in the mid-late 1990s) investors footed the bill through sui-generous multi-billion dollar IPO’s of the largest Chinese banks (actually, the biggest banks in the world). China’s central government does not get a similar “do over” this time because a bank can only go public once. On the microeconomic level, businesses are also being slowed down by higher labor costs, reduced credit flows, and structurally high raw material prices. Exports of labor-intensive goods are slowing and China is losing market share among its major trading partners. China’s seasonally-adjusted Purchasing Managers’ Index (PMI) has been negative for the past 2 months. This could be just the beginning as China approaches a demographic crunch. Chinese aged 60 and over are now 13.3% of the population which is up from 10.3% in 2000, whereas those ages 14 or less have dropped from 23% to 16.6% over the same time frame. Moreover, more Chinese now live in cities than in rural areas (slowing the rural to urban migration of inexpensive labor).

Figure I.3



As a result, the Chinese demographic dividend is going to end this decade. Some manufacturers are already relocating from China to Vietnam, Africa, South America, and even the United States in search of more affordable labor. China attracted America and European manufacturers with low labor costs and high growth rates, and that loyalty can change quickly if the deal those firms bought into no longer applies.

Still, China is not expected to experience a financial implosion like the U.S., but rather slower growth. China has 3 trillion in foreign exchange reserves, their banks are built on the high savings rate of 1.3 billion people, and investors have come to trust in robust Chinese economic growth. In 2012, China is “changing the guard” by replacing hundreds of major decision makers in the

politburo’s upper levels which is the largest revamp in a decade – not usually a positive sign. The big question for China’s long-run economic health is whether this new generation of Chinese leaders will aggressively tackle the question of sustainable aggregate demand. China cannot bypass the sluggish growth rates of its major trading partners, the underlying bad debt floating around in its economy, nor a declining demographic advantage. And yet, the population has become very used to rapid and easy economic growth.

Recent International Developments

The global economy continues to struggle in recovering from the financial crisis. Described below are pressing economic current events including the European recession and rising tensions in the Strait of Hormuz.

Table I.1 shows IHS Global Insight’s country specific economic forecasts as of January 11, 2012. U.S. economic growth is expected to continue building steadily in the coming years, reaching its long run average of approximately 3 percent in 2014 and beyond once the recovery matures, however high household debt is still a concern in the near term while public sector debt is a concern over the longer term. China’s projected growth slows to approximately 8 percent in 2012 which could strain the country’s political/economic system. Latin America is expected to show healthy growth over the next half decade.

Table I.1

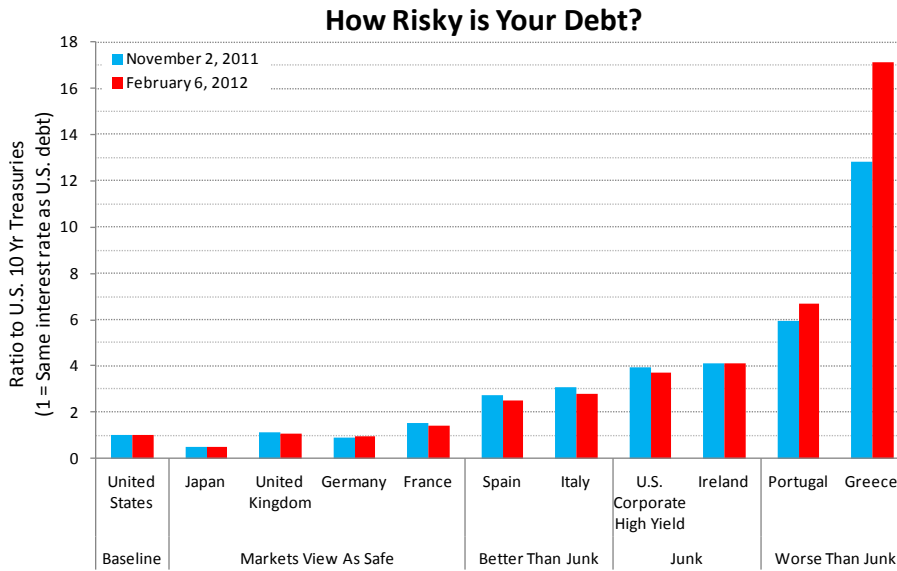
Projected Growth Rates of Real GDP (Percent)

As of 1/11/2012	2011	2012	2013	(Average) 2014-17
United States	1.8	2.0	2.4	3.1
Canada	2.3	1.9	2.6	2.7
Japan	-0.7	2.9	2.9	1.4
Eurozone	1.5	-0.7	0.9	1.9
Mexico	3.9	2.8	4.2	4.0
South America	3.7	3.2	4.6	4.6
Asia except Japan	6.7	6.2	7.0	7.0
China	9.2	7.8	8.6	8.0
World	3.0	2.7	3.7	4.1

Source: *Global Insight, January 2012*

The Eurozone, however, is in a mild recession and should see modest real GDP declines through at least the second quarter of 2012 with slow growth thereafter. The United Kingdom expects a mild downturn in 2012, but should receive some boost from the summer Olympics. The recession is expected to last longer in southern Europe than in the wealthier northern countries which will exacerbate the Eurozone’s North-South (core-peripheral) economic divide. At this point, Eurozone leaders are fighting to keep the union together. However, several of the most insolvent nations (see chart below) may eventually be let go, in particular Greece. In the meantime, the European Central Bank (ECB) is expected to continue reducing interest rates, and the Euro is projected to fall as low as \$1.25 by March 2012 before rebounding slightly in 2013. Graph I.1 illustrates the interest rate paid on 10 year bonds relative to the U.S. interest rate. The blue bars represent the data used for the same calculations in our previous forecast, while the red bars represent current borrowing rates.

Graph I.1

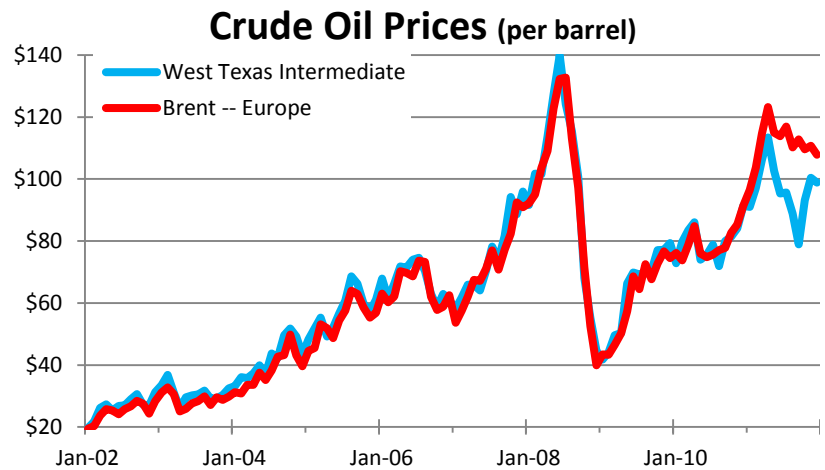


Finally, tensions also continue to rise near the Strait of Hormuz through which 35 percent of globally traded oil is shipped. The storming of the U.K. embassy by Iranian students on November 29, 2011, and the firing of surface-to-surface missiles into the Strait of Hormuz on January 2, 2012, has drawn the ire of Europe and the United States. However, European sanctions against Iran are moving slowly, in part because struggling

Southern Europe imports a good amount of Iranian oil. And America's various bans still allow Iranian oil to get out to parts of the global economy since the U.S. is hesitant to trigger an oil price

spike. The timing of any major oil price shock may depend on Israel since it is the most likely country to use military force against Iran, probably by bombing Iranian nuclear facilities. The timing of that Israeli decision will not be public knowledge. Nor do we know exactly how serious the Iranian leadership will be in its response. In any case, oil prices took a sharp dive during the recession, but have since recovered on the

Graph I.2



back of continued global economic growth. The declines seen in 2011 have to do mostly with the uncertainty of global growth including the recession in Europe and a slowing economy in China.

Oregon Exports

*** Please note that export data for 2011 Q4 is unavailable by publication date. Please contact the Office of Economic Analysis after February 15th for the updated information. ***

U.S. exports have increased quarter-over-quarter since 2009 Q1. With ten such increases in a row, national exports in 2011 Q3 set a new record in terms of total dollar value (nominal) of U.S. exports. Oregon exports have followed the same general pattern over the past two and a half years; however in both mid-2010 and mid-2011, Oregon exports declined slightly – primarily caused by a decline in high technology exports to Asia. Through the first three quarters of the year, Oregon

exports for 2011 are at their second highest level trailing only 2008. Exports have increased 5.1 percent compared to 2010 and are up 31.4 percent from their 2009 levels.

Exports are expected to continue to follow the global economy through the expansion, however, as economic expectations change, exports will similarly grow either faster or slower along with economic conditions. Besides economic growth (and consumer demand), exchange rates are another mechanism which will influence exports moving forward. Should the U.S. dollar appreciate against our major trading partners, exports will slow more, however should the dollar depreciate, exports should benefit and see stronger growth. Over the extended horizon, the dollar is expected to weaken vis-à-vis Oregon’s largest trading partners (particularly China).

Graph I.3 illustrates Oregon’s total exports and the Y/Y percent change from 1997 through 2011Q3. Oregon’s growth ranks 26th best. While it is true that Oregon typically experiences more volatile movements than the US overall – during booms exports increase more than the nation and during recessions they decrease more than the nation – the current expansion is somewhat different given the nature of Oregon’s exports. High dollar value computer and electronic product exports typically compose around 40-45 percent of the state’s total and thus movements within the high tech sector swing the statewide totals. As shown in Table I.4 and Graph I.4, these exports have fallen 17.8 percent in the past year. This large decline is primarily driven by decreased exports by Intel to its facilities in China (and Malaysia), and is more a function of within-firm movements than an overall industry decline.

Graph I.3

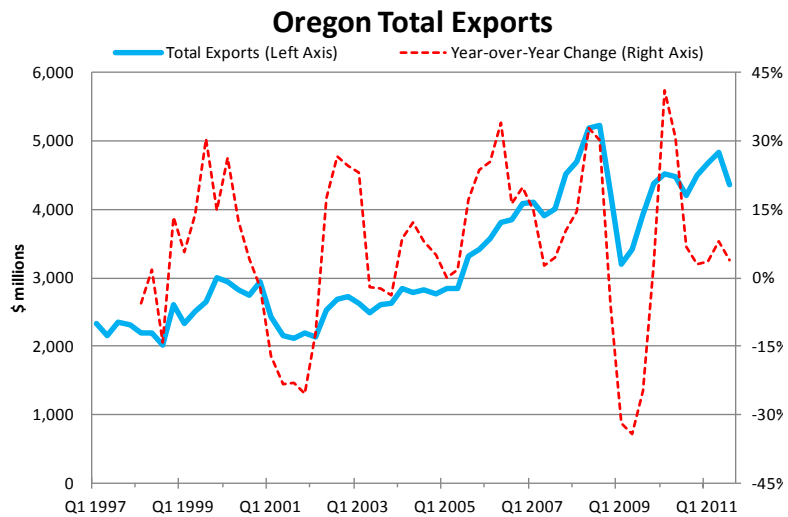


Table I.4 shows Oregon’s dollar value of exports and year-over-year growth rates for 2011 Q3. Graph I.4 illustrates quarterly exports by major industry since 1997. For Table I.4, these are the top fifteen industries by export volume (in value). Y/Y growth is positive for fourteen of the top fifteen export industries. As mentioned above, computer and electronic products have decreased over the past year. Exports in the industry are down to the top three partner countries in the past year – China, Costa Rica

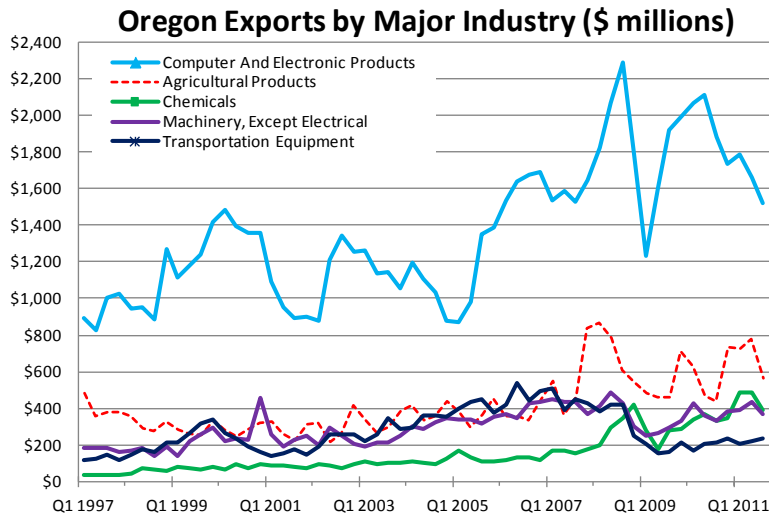
Table I.4

Oregon Exports by Industry (\$ millions, current prices)				
	2010 Q3	2011 Q3	y/y % change	Share out of Total
Total All Industries	4,193.6	4,351.1	3.8%	100.0%
Computer And Electronic Products	1,880.9	1,521.9	-19.1%	35.0%
Agricultural Products	439.2	564.9	28.6%	13.0%
Chemicals	334.4	390.3	16.7%	9.0%
Machinery, Except Electrical	334.0	369.2	10.5%	8.5%
Transportation Equipment	213.9	237.1	10.9%	5.4%
Primary Metal Manufacturing	173.7	176.8	1.8%	4.1%
Waste And Scrap	102.6	191.1	86.3%	4.4%
Wood Products	104.7	137.9	31.7%	3.2%
Food And Kindred Products	113.0	139.4	23.3%	3.2%
Paper	90.1	122.0	35.4%	2.8%
Miscellaneous Manufactured Commodities	67.0	70.8	5.7%	1.6%
Fabricated Metal Products, Nesoi	65.5	68.8	5.0%	1.6%
Electrical Equipment, Appliances, And Component	65.1	66.9	2.8%	1.5%
Plastics And Rubber Products	48.7	51.9	6.4%	1.2%
Forestry Products, Nesoi	3.6	40.6	1016.1%	0.9%

Source: WISER, November 2011

and Malaysia - which account for over 65 percent of the industry total. High tech exports to China fell 40.4 percent over the year in the third quarter. Industry totals fell nearly \$359 million, while industry exports to China declined over \$236 million and exports to Malaysia fell nearly \$259 million during the same time period. Overall, this industry is Oregon's largest and most important export sector, driven by the state's cluster of high technology firms and accounted for 44 percent of all exports in 2010.

Graph I.4



Forestry Products, Waste and Scrap, Paper and Wood Products all increased over 30 percent in the third quarter. Agricultural Products (benefiting from relatively high commodity prices), Food, Chemicals, Transportation Equipment and Machinery all increased at least double digits over the past year. These increases are indicative of the broad-based gains seen in many sectors during the recovery.

While high technology products dominate Oregon exports, it is useful to examine exports excluding the industry to gauge the overall health of Oregon's exports. This allows one to examine how widespread the increases (or decreases) are among all industries. Graph I.5 illustrates growth both for total exports and total minus computer and electronic products. While high tech exports are holding down the total export figures, non-computer and electronic products have increased over 22 percent, year-over-year.

Graph I.5

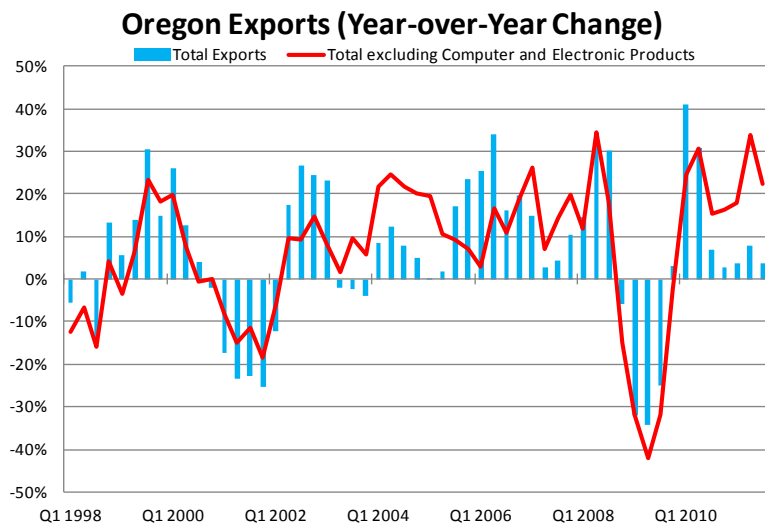


Table I.5 charts exports of Oregon products to major destinations. Out of the top fifteen export markets, three countries saw decreases in trade in 2011 Q3 year-over-year. Those countries are China, Malaysia and Brazil. Exports to China were strong in 2010; however the fluctuations quarter to quarter recently have been quite large (see Graph I.6 below). Exports to Japan have increased over 43 percent over the past two years and nearly 25 percent over the past year alone, primarily driven by agricultural products, however increases in computer and electronic products, chemicals and wood products also are contributing to the gains.

Graph I.6 shows the quarterly export trend for Oregon's top five markets since 1997. Exports to all top five destinations increased in 2010 compared to 2009; however developments in the most recent quarters vary across countries. Goods bound for China, Japan and Korea have generally been flat in recent quarters. Exports to Canada have steadily been increasing while exports to Malaysia have fallen for the past year. Given the fact that 96 percent of Oregon exports to Malaysia in 2010 were Computer and Electronic Products, fluctuations within this industry drive total exports to the country. A much welcomed development is the rebound in exports to Canada in 2010 and into the first three quarters of 2011. As Oregon's largest export market for much of the past two decades, the Great Recession took a heavy toll of Canadian bound exports as the dominant industries have traditionally been transportation equipment and wood products, two industries hit especially hard. Thus far this year, exports to Canada have been driven by increases in Primary Metal Manufacturing, Transportation Equipment and also Computer and Electronic Products, along with Food Products.

Table I.5

Oregon Exports to Major Trading Partners
(\$ millions, current prices)

	2010 Q3	2011 Q3	y/y % change	Share out of Total
Total All Countries	4,193.6	4,351.1	3.8%	100.0%
China	771.8	765.0	-0.9%	17.6%
Canada	616.9	715.1	15.9%	16.4%
Malaysia	742.0	489.1	-34.1%	11.2%
Japan	291.5	363.2	24.6%	8.3%
Korea, Republic Of	228.2	235.5	3.2%	5.4%
Taiwan	127.5	150.7	18.2%	3.5%
Brazil	108.1	79.0	-26.9%	1.8%
Germany	84.3	118.1	40.1%	2.7%
Costa Rica	117.4	126.6	7.9%	2.9%
Philippines	70.7	153.9	117.5%	3.5%
Singapore	69.1	116.7	68.9%	2.7%
Australia	67.7	82.0	21.1%	1.9%
Hong Kong	76.8	79.2	3.0%	1.8%
United Kingdom	51.9	61.0	17.4%	1.4%
Mexico	42.8	58.7	37.1%	1.3%

Source: WISER, November 2011

Graph I.6

