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Dancing with the enemy: can China be a viable alternative for U.S. investors?

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ABSTRACT

This paper examines the impact of Global Financial Crisis on the United States of America vs. China. Specifically, the authors contend that despite the relatively higher risks related to investing in China, U.S. individuals would benefit from increased investment in this market due to its strong economic indicators and growth opportunities. Results suggest that during the post-Global Financial Crisis period, despite the inherent higher risk, China may provide a viable alternative for U.S. investors mainly due to the higher growth rate of the Chinese economy, lower unemployment rate, higher consumer confidence, better-adapted regulation & corporate governance reform, and China's position as an emerging market. These factors will help China recover relatively more quickly from the global economic downturn, making it a potentially attractive market for U.S. investors.

Key Words: Global financial crisis, Chinese market, growth rate

INTRODUCTION

This paper examines the impact of the current Global Financial Crisis on U.S. vs. China. Casual observations suggest that the economic downturn has caused many U.S. investors to lose confidence in U.S. stock markets, and they need feasible alternatives to invest. There is growing evidence to suggest that this financial crisis has caused many investors to make an unprecedented choice: whether to invest their money in the United States, or to look to foreign countries, such as China, as a viable alternative, at least partially.

The authors argue that the Global Financial Crisis has presented China with the opportunity to attract more investments from foreign nations. China's position as an emerging market over the last few decades, coupled with improved regulation and governance reform, has allowed the country to develop into a reasonable alternative to the United States for investors looking to invest (Shapiro and Sarin, 2009). Instead of investing in U.S. stock markets, some investor clientele can assume higher levels of risk for higher potential returns by investing in Chinese stock markets instead.

China's position as an emerging market allows for higher potential levels of growth, despite the economic downturn experienced throughout the world. The major impact of the Global Financial Crisis on China has been a contraction of foreign demand, however, the impact on other sectors have left China relatively unscathed in comparison to other nations and will still allow the economy to experience growth in 2009 (Xinhua's China Economic Information Service, 2009). In addition, the regulations of the Chinese stock market differ from those of the United States which has allowed China's stock markets and financial sectors to bounce back quicker than the rest of the world despite its initial downturn at the beginning of the crisis in early October, 2008 through the end of the calendar year.

The paper is organized as follows. Section 2 briefly describes the Chinese market. Section 3 examines regulation of the financial industry in both countries, Section 4 contains an assessment of potential risks and Section 5 concludes and summarizes the findings.

CHINESE MARKET

China as an Emerging Market

China's position as an Emerging Market plays a considerable role in its investment position. According to Agtmael (2009), an emerging market is "an economy with low-to-middle per capita income". Such emerging markets are often associated with transitional economies and large growth opportunities, but are frequently plagued by poor market transparency and accountability issues. Striving for economic reform and development can prove promising for many countries as they aspire to increase economic performance levels and improve efficiency in capital markets.

Along with the subject of investing in Emerging Markets comes the closely related concept of increased risk. Investors turn towards Emerging Markets as a way to increase potential gains due to higher risk. While greater risks can lead to greater rewards, this paper must keep the potential volatility of these returns in mind when

discussing the case of China. Higher levels of risk are normally associated with Emerging Markets primarily due to political instability, poorly established markets for trading and low confidence in the national economic systems, such as currency stability or banks. This imbalance and often turbulent behavior can cause relapses in the country's economic progression and result in severe losses on investments for foreign investors.

With the hypothesis of China serving as a reasonable alternative investing option throughout the Global Financial Crisis, the authors must analyze China's position as an Emerging Market, including the risks associated with it. The first factor that the authors must consider in China's case is the historically high levels of economic growth experienced by the country over the last few decades. China's GDP has increased from \$1,019.459 billion dollars in 1998 to \$3,205.507 billion dollars in 2008 (trading economics, 2009). Secondly, this study must examine whether China has the ability to maintain this growth despite the Global Financial Crisis.

China has emerged from the economic downturn in a stronger position compared to most of the developed nations of the world. The strongest impact of the crisis on China are the lower levels of foreign demand for products produced and assembled there, but the influence on other areas is small. It is speculated that China's position as an emerging market and its relatively closed financial system created a "protective shield" against the financial turmoil. China's large growth rate and government spending policies placed China in a position in which it has ample liquidity and spending on infrastructure to support the economy throughout the crisis (Channel News Asia, 2009). Table 1 suggests that the impact of Global Financial Crisis is the lowest in China among many countries and the growth rate of China is the highest. This minimizes the risk of China plummeting into a severe or prolonged depression or economic decline similar to many developed countries.

Additionally, according to Zhang (2009) with the Development Research Center of the State Council, China's huge potential demand of its vast population, adequate supply of labor force and appeal to technology transfers from developed countries will allow the country to sustain relatively strong economic expansion (Xinhua's China Economic Information Service). Zhang further states, "I'm fully confident that China's economy will expand by 8 percent year on year, or even faster than that, in 2009." These economic conditions and forecasted growth only help to diminish the probability of a severe economic crash in China.

Economic Indicators

As an indication of economic stability and growth, the following indicators were identified and used in the analysis: Gross Domestic Product (GDP) Growth Rate, Unemployment Rate, Stock Market Indices, Consumer Confidence, and Purchasing Managers Index (PMI). By compiling a comparison of these economic indicators of the United States versus China, the authors were able to draw a conclusion of the current situation of each economy.

TABLE 1: GROWTH IMPACT OF GLOBAL FINANCIAL CRISIS

Country	Pre-Crisis	Crisis		Decline in growth 2008-09 (percent of 2005-07 growth)	Decline in growth 2009 (percent of 2005-07 growth)
		(avg. 2008-09)	2009		
	(avg. 2005-2007)	(avg. 2008-09)	2009		
Italy	1.3	-1.4	-2.1	205.1	263.6
Japan	2.1	-1.5	-2.6	167.6	221.2
United Kingdom	2.6	-1.1	-2.8	139.8	206.0
Germany	2.1	-0.6	-2.5	128.8	220.2
France	2.1	-0.3	-1.9	114.4	191.3
United States	2.6	-0.4	-1.6	113.6	162.0
South Korea	4.8	-0.6	-4.0	111.5	183.9
Canada	2.9	-0.3	-1.2	108.6	141.4
Spain	3.7	-0.3	-1.7	106.7	145.7
Mexico	3.7	0.8	-0.3	80.0	108.0
Russia	7.3	2.8	-0.7	62.3	109.6
India	9.4	6.2	5.1	34.2	45.9
China	11.3	7.9	6.7	30.5	40.7
Brazil	4.1	3.8	1.8	7.5	56.2

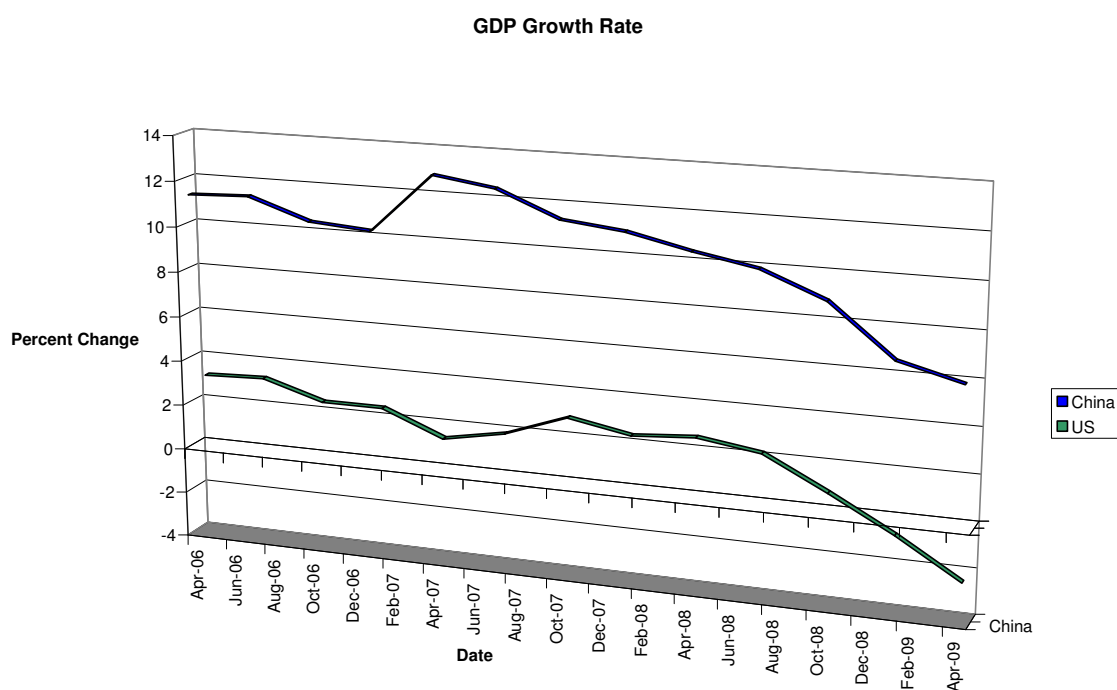
Source: Bergsten, Fred. "Needed: A global response to the global economic and financial crisis." 28 March 2009. < <http://www.voxeu.org/index.php?q=node/3359>>

Gross Domestic Product Growth Rate: The economy of the People's Republic of China is a rapidly developing market economy, and is the second largest in the world after that of the United States with a GDP of \$7.8 trillion (2008) when measured on a purchasing power parity (PPP) basis. It is the third largest in the world after the US and Japan with a nominal GDP of US\$4.4 trillion (2008) when measured in exchange-rate terms. China has been the fastest-growing major nation for the past quarter of a century with an average annual GDP growth rate above 10%. China's per capita income has grown at an average annual rate of more than 8% over the last three decades drastically reducing poverty, but this rapid growth has been accompanied by rising income inequalities. The

country's per capita income is classified in the lower middle category by world standards, at about \$3,180 (nominal, 104th of 178 countries/economies), and \$5,943 (PPP, 97th of 178 countries/economies) in 2008, according to the IMF.

The Growth Domestic Product Growth Rate, recorded in annual growth percentage adjusted for inflation, was documented for both the United States and China on a quarterly basis beginning in April 2006 and ending in April 2009. These statistics reported in Table 1 and other statistics drawn from Trading Economics (2009) give an indication of China's superior growth rates in comparison with the United States and other countries.

FIGURE 1: THE COMPARISON OF GROWTH RATE BETWEEN U.S. AND CHINA

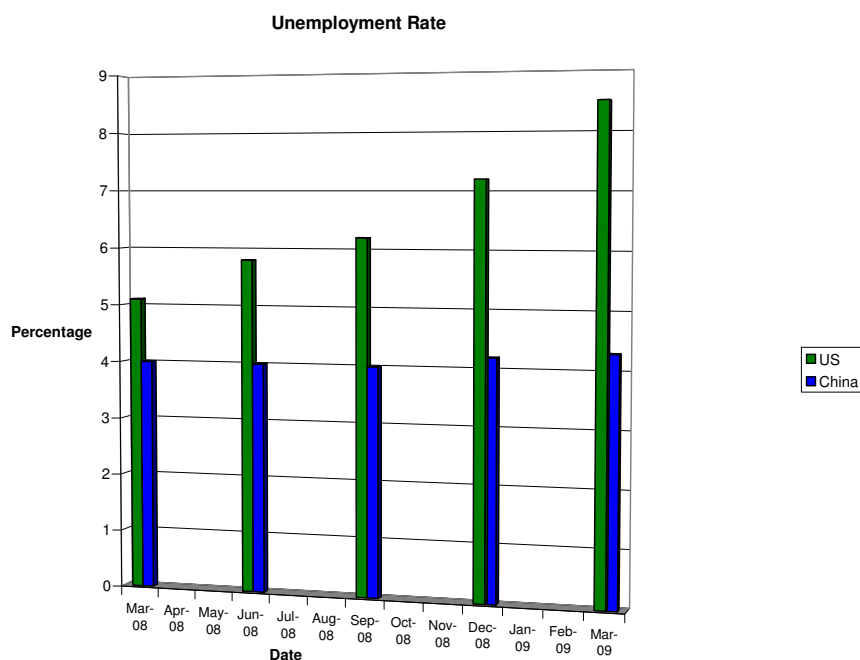


From Table 1 and Figure 1, the authors can draw two conclusions. One, China's annual GDP growth rate is consistently exceeding the annual GDP growth rate of the United States by over three times. This is largely due to China's status as an emerging market, and the steady growth rate and economic opportunity it has experienced over the past few decades as China develops its infrastructure. Two, while both countries experienced a decrease in annual GDP growth at the beginning of the crisis around October 2008, China fared far better than the United States. The United States' annual GDP actually declined, reaching negative growth. While China's growth rate has decreased, the annual GDP growth is still over 6.7% at its worst. These two points indicate that China maintains a stronger position in growth throughout the economic crisis than the United States, and will continue to expand economically although at a slower rate than previous years.

Unemployment Rate: A comparison of unemployment rates in both the United States and China reported in Figure 2 were drawn over the duration of one year, in quarterly increments beginning in March 2008. Recorded as the number of unemployed as a percentage of the total labor force, China has maintained a steadier unemployment around 4%, which slightly increased to 4.3% by March of 2009. This is minimal in comparison to the United States unemployment rate increasing from 5.1% in March 2008 to 8.5% in March 2009 (10.2% in November 2009 in U.S.). Furthermore, this data illustrates a trend, and predicts these rates may only continue to worsen for the United States as the Global Financial Crisis deepens.

Unemployment rate is one of the closest watched economic indicators, as it gives a reflection of the overall economy. According to Business Dictionary (2009), “a rising rate is seen as a sign of weakening economy that may call for cut in interest rate.” According to this quote, higher unemployment rates may be one important factor which can lead to interest rate cuts by the central government. These lower interest rates discourage foreign investments, a problem that occurs in the United States as unemployment rates increase.

FIGURE 2: THE COMPARISON OF UNEMPLOYMENT RATES BETWEEN U.S. AND CHINA

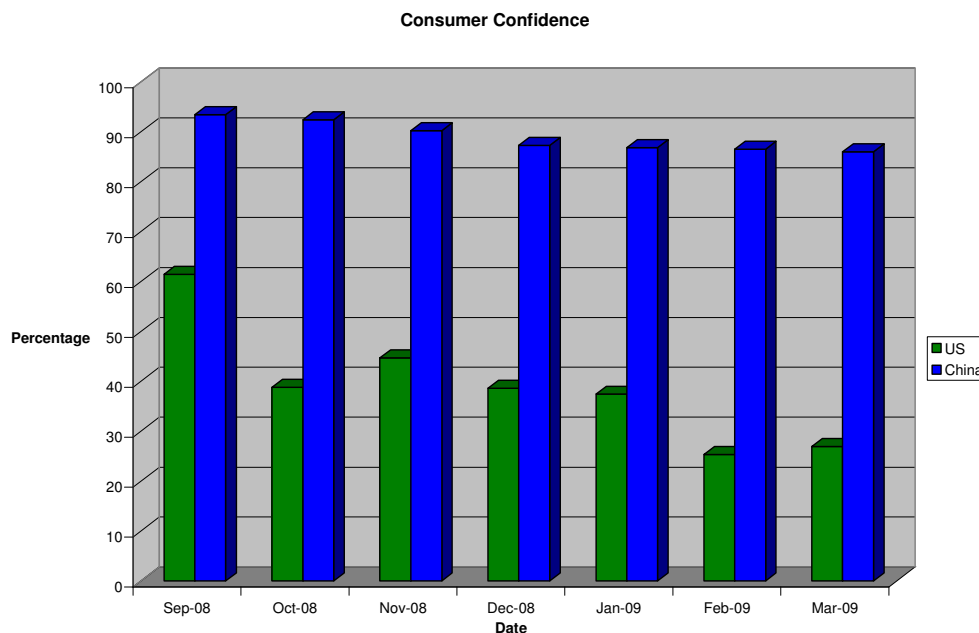


Foreign Exchange Reserves: The rise of Chinese economy and finance has been accompanied by a continuous rise in its current account surplus, and subsequently, its accumulation of foreign exchange reserves. China’s foreign exchange reserves quintupled between 2002 and 2006, from \$200 billion to \$1 trillion (Moffett, Stonehill, and Eiteman, 2009). China’s foreign exchange reserves further increased to \$1.88 trillion (Financial Times, August 2008).

Consumer Confidence: Consumer confidence is a measure of consumer optimism on the state of the economy based on household savings versus expenditure. This can be a strong indication of economic trends, used for the prediction of consumer behavior in the marketplace. A comparison of Consumer Confidence was drawn on a monthly basis beginning in September 2008 continuing through March 2009. The following results were recorded.

From Figure 3, the authors can see that Consumer Confidence in China is much higher than that of the United States. In addition to the significantly higher values in China, the United States is also experiencing a contraction in Consumer Confidence. The data shows a downward trend, an indication of lower levels of consumption and anticipated future earnings. This trend indicates a feeling of current and expected future slowing economic growth. In comparison to the relatively stable levels shown by China, the United States appears to forecast lower levels of expenditures, a sign of a possibly weakening economy and low confidence in an imminent recovery.

FIGURE 3: THE COMPARISON OF CONSUMER CONFIDENCE BETWEEN US AND CHINA



Purchasing Managers Index (PMI): The Purchasing Managers Index is a composite index based on the following five sub-indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. This index is highly representative of the manufacturing industry, and while it is not a widely used indicator in the United States due to the relatively small manufacturing sector, it is often regarded as an important indicator of the beginning or end of recessions and was thus relevant for the analysis given the current global recession. The following data was constructed based on March 2009 results (Carnegie Endowment for International Peace, 2009):

TABLE 2: PURCHASING MANAGERS INDEX (PMI)

	March 2009	% Change from 3 Months Ago	% Change from 1 Month Ago
United States	36.3	10.3%	1.4%
China	52.4	27.2%	6.9%

Based on a scale of 0-100, a reading level of 50+ indicates an expanding industry, whereas anything reading below 50 indicates a contracting industry. As shown above in Table 2, although experiencing a major fluctuation in PMI from 3 months ago, China still rests above the 50 level. In comparison, the United States only obtained a level of 36.3 showing a downward turn in the economy, primarily in the manufacturing sector.

REGULATION AND CORPORATE GOVERNANCE REFORM

An important aspect to consider when analyzing the investment environment and opportunities of China and the United States are the effects of different levels of regulation in the two markets. After the downfall of many large financial firms in the United States, individuals across the world have made calls for stricter regulation of the industry by the United States government. One of the major proposals to improve transparency in the financial sector is the Basel II charter, drafted by the Basel Committee on Banking Supervision in June of 2004 and subsequently updated in 2005, 2006, 2007 and once more in 2008 (see <http://www.bis.org/publ/bcbsca.htm>). The aim of the charter is to offer a base structure for financial regulation which can be applied to all international markets. This regulation will help increase the uniformity of banking oversight for large, multi-national banks and create a framework which will help investors better understand the varying types and degrees of risk these banks face.

The three main pillars of the accord are intended to improve market stability and tools available to regulators who oversee these banks. The first pillar focuses on capital adequacy requirements, while the second pillar deals with centralized supervision. The third pillar centers on improved market discipline and corporate governance (see <http://www.bis.org/bcbs/events/b2earoc.pdf>). The combination of these three efforts will help boost investor confidence in the financial markets and organize the international financial system into a more stable and uniformly organized market. The Basel II Charter will help to prevent any one country's financial instability or irresponsibility from spilling over into other markets and causing a repeat of the 2008 Global Financial Crisis which originated in the United States.

While the United States has dragged its feet with the implementation of the Basel II reforms, China has taken many aggressive steps to move up its timetable for widespread implementation of the reforms. The United States' slow implementation of these reforms has centered mostly on disputes between the Federal Reserve and the FDIC. The United States was finally able to establish a universally agreeable version of the accord on June 26, 2008 although many aspects of the agreement are still optional and are simply meant to "Provide these (internationally active) banks the option of using a more updated capital framework without unduly increasing regulatory burden." In contrast, China has

recognized the need to improve regulation and transparency in its markets in the face of this unprecedented Global Financial Crisis. To achieve these goals, the China Banking Regulatory Commission actually moved up the implementation of the accord for domestic banks from 2010 to October 10, 2008 (Wenluo, 2009). In comparison, the United States has actually postponed implementation of Basel II for its large scale banks until 2009 (see <http://www.federalreserve.gov/newsevents/press/bcreg/20080626b.htm>). This move is of particular importance to international investors because most of the regulations included in Basel II are focused on large internationally active banks which all come from large, developed market countries.

Eun and Resnick (2009) suggest that emerging stock market, such as China, is highly imperfect, reflecting inadequate disclosure and regulation, opaque legal and government framework, and ownership restrictions (p. 88). In the case of China, however, government has made many positive improvements to corporate governance structure by revising its securities and company laws (Cheung, 2007). Notable changes include more transparent financial disclosure requirements, improved protection of minority shareholders' rights and clearer guidelines on the role of supervising boards. By implementing these initiatives early before and during the beginning of the international financial crisis, China has positioned itself as a more attractive market for foreign investment than in the past. China's willingness to carry out the policies of Basel II is a sign to many investors that Chinese markets are becoming a safer place to invest internationally and demonstrate the country's dedication to attracting international investment. The combination of China's emerging economy's potential for growth in conjunction with improved efforts to regulate and protect investors make China a potentially attractive market for non-risk adverse investors especially during difficult economic times.

RISK

While the contention has been drawn that China can possibly serve as an alternative investment market for individuals during this economic downturn, this study must approach this conclusion with a level of skepticism as well. First, it must be taken into account that the current Global Financial Crisis is an unprecedented historical event. Because it is the first crisis of its kind, there is limited historical data and research from which to draw a comparison of this data to. Furthermore, there is no evidence to provide a backing for future expectations of the crisis. With incomplete knowledge it is difficult to predict future investment patterns with high levels of accuracy.

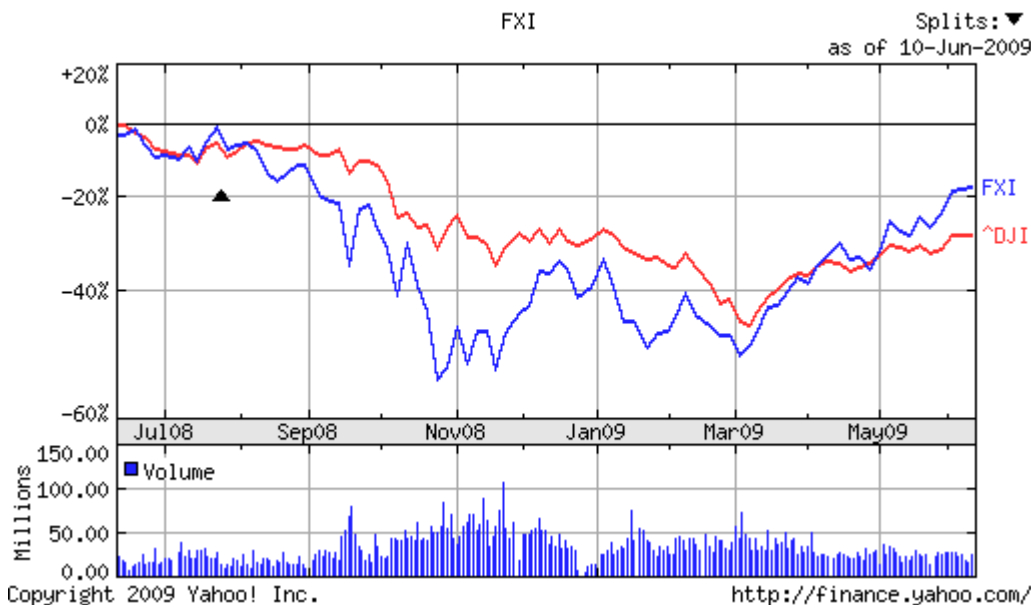
Second, the risk must be addressed. While the authors have shown that China could possibly pose as a good investment due to continual growth rates and different regulation standards, it must be acknowledged that along with these benefits come increased levels of risk. China's position as an emerging market is an indication of high market risk. According to Cheng (2009):

“The consumer base of China is also beginning to emerge, which is favorable to those corporations who are seeking a resource that has been virtually untapped by foreign investment for many years. However, when considering entering a developing country such as China; political, economic and financial risks must always be considered.”

Another factor of risk is volatility of returns. A good example of the volatility of returns in China vs. the United States is a comparison of two major stock indices, the Dow Jones Industrial Average and the FTSE China 25 Index. These two are comparable stock indices to compare because the Dow tracks thirty of the most important and largest publicly traded companies on the NYSE while the FTSE China 25 tracks the twenty five largest publicly traded companies in China. The FTSE China 25 is made up of both B shares and H shares. B shares are available to citizens of mainland China and select international firms (usually large internationally active banks like Goldman Sachs or JPMorgan, etc.). H shares are shares of companies from the Chinese mainland that are also listed on the Hong Kong exchange, which is available to all international investors (Eun and Resnick, 2009, and Hogan, 2009).

Eun and Huang (2007), in particular, suggest that domestic Chinese investors pay higher prices for local A-shares of those Chinese firms that offer B- or H-shares to international investors, indicating the possibility that Chinese government permits indirect financial incentives for international investors in order to boost up the Chinese stock market.

FIGURE 4: THE PERFORMANCE OF FXI VS. DJI



Based on Figure 4, one can see a clear example of the volatility of the Chinese ETF tracking the FTSE and the Dow Jones Spider. This graph shows that when the worst of the financial crisis hit, the Chinese index was affected more negatively than the United States index. However, around March 2009, one can see the quick rebound of the Chinese ETF. This graph demonstrates the potential risk of investments in China and also the larger magnitude of gains and losses here. While investors who had their money in China prior to the Global Financial Crisis would have been big losers, investing money in the Chinese market now shows the potential to capitalize on high potential growth in China and a rapid recovery from the economic turmoil which has consumed the globe.

A final precaution to consider is that this conjecture of an alternative investment opportunity in China has a limited time horizon. As mentioned previously, the current crisis is an unseen event in history, and therefore makes it hard to predict the duration of its effects. The global economy will recover in time, and presumably lead investors to revert back to their original investment behaviors, primarily causing U.S. investors to invest more domestically. In addition, China's position as an emerging market will not last forever. While developed countries often signify stability, the exponential growth China has experienced in the past will be curved, and the conjecture will thus be nullified in the long term.

CONCLUSIONS

Overall, the authors' examination into the economic indicators, regulation and risk involved with investments in both the United States and China has revealed some interesting trends. Prior to the economic crisis, emerging market investments were most often viewed as a way to increase portfolio risk and were not seen as a viable alternative to domestic investments for many investors. With the current Global Financial Crisis, this study has seen that some of the disadvantages of emerging markets during normal economic periods can actually be advantageous during severe recessions. China represents a viable alternative investment for individuals looking for a place to invest as the global economy begins to show signs of economic recovery. China's strong, positive economic indicators coupled with the high potential for growth represent a good opportunity for investors to more rapidly recover from large losses during 2008. As the United States slowly begins to recover, China's fiscal policies, improved regulation and large domestic demand for goods and services will help its recovery process. Despite the fact that China is an emerging market, investing in Chinese markets may be considered as a viable alternative by U.S. investors as the world slowly begins to recover from the Global Financial Crisis.

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