

# China Factor, ASEAN Business Cycle Synchronization, and Fickle Capital Flows

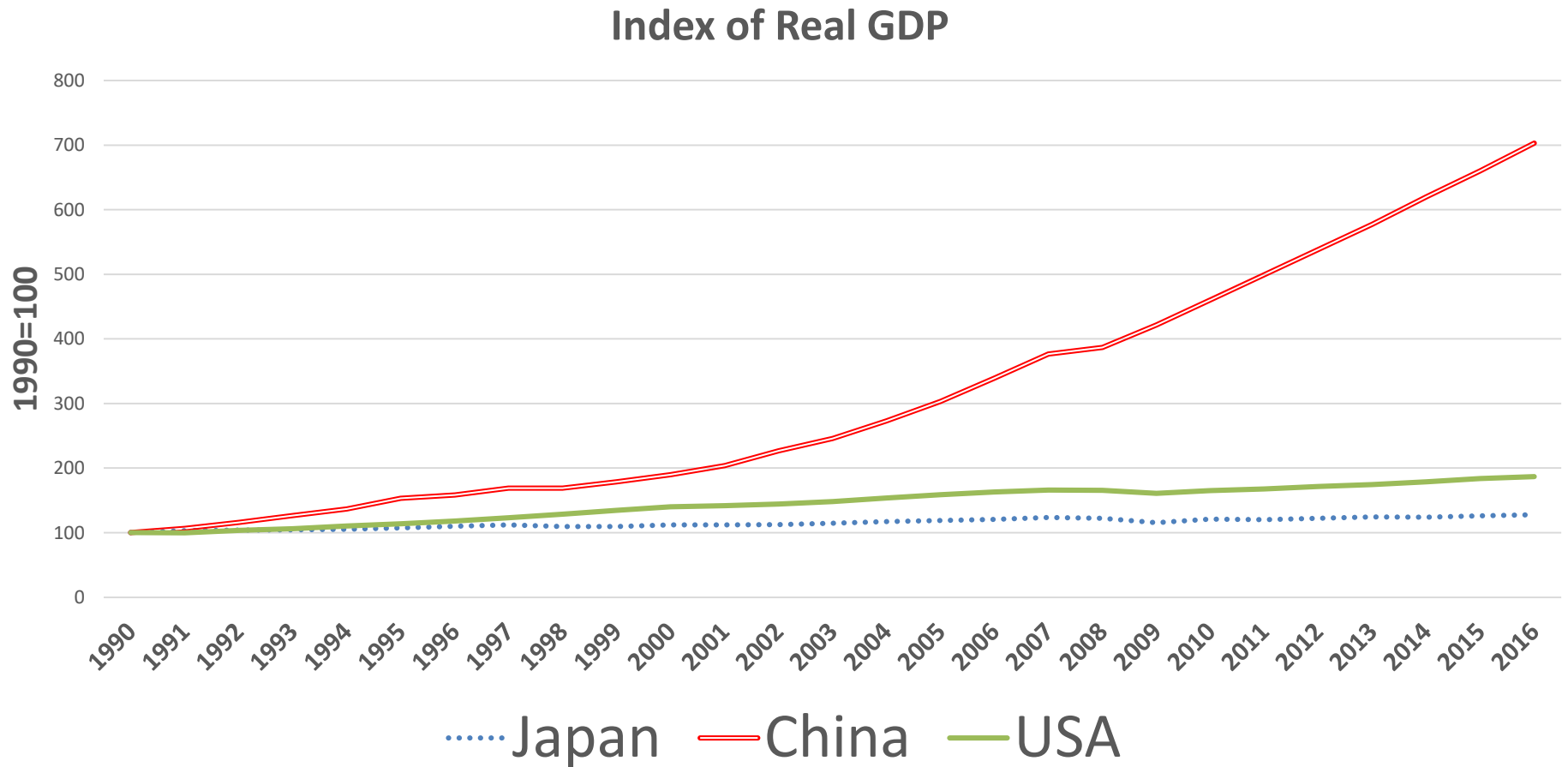
Bhanupong  
Lecture 21

***What are adjustment mechanisms for external disequilibrium?  
Are capital flows fickle?  
How important is the Chinese economy to Thailand?***

# Main themes

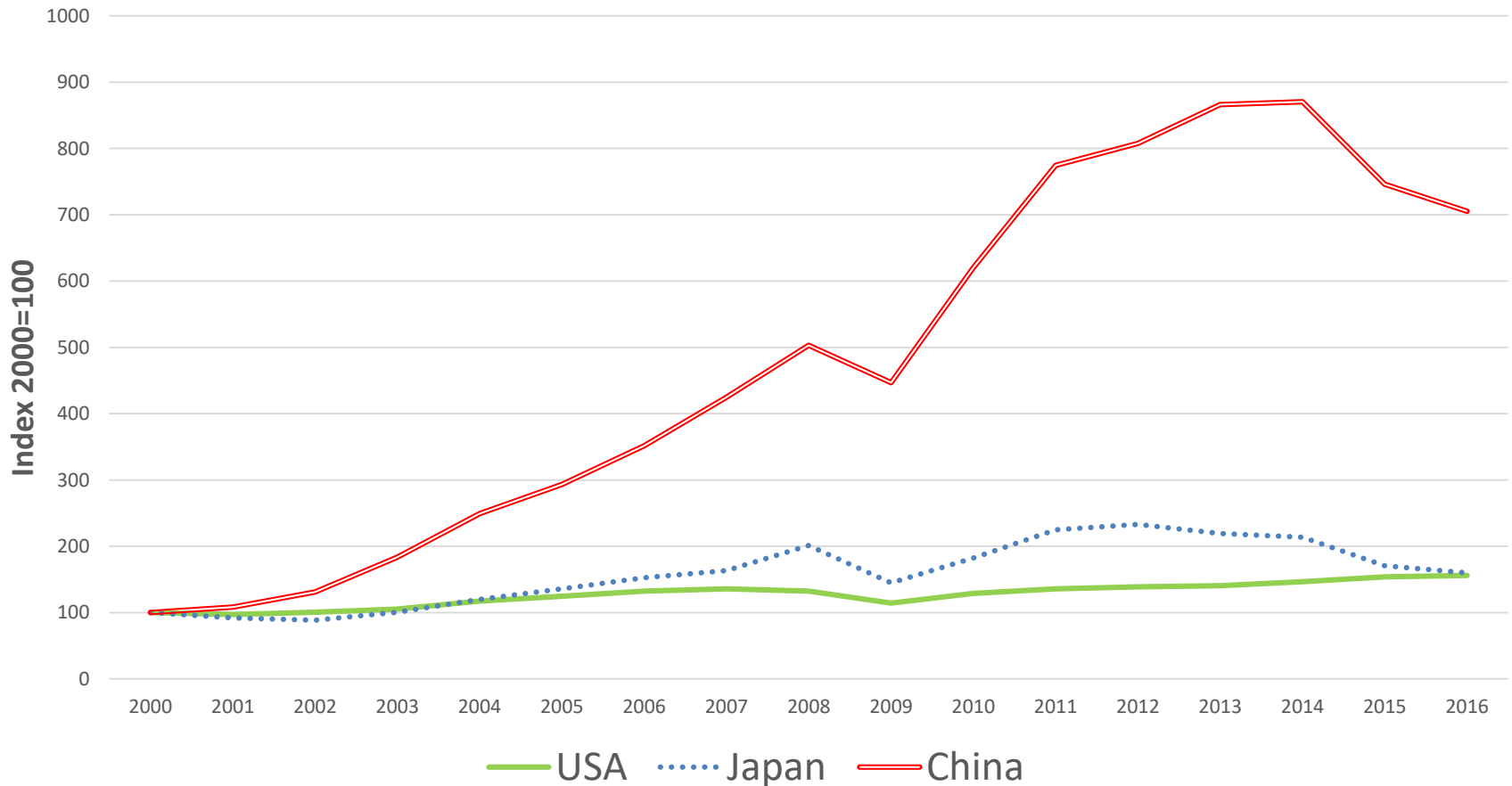
1. China factor affecting the Thai economy
2. ASEAN Business Cycle Synchronization
3. Current account disequilibrium:  
investment-saving gap
4. China's slowdown: 2018
5. Are capital flows fickle?

# 1. China Factor: China Rising

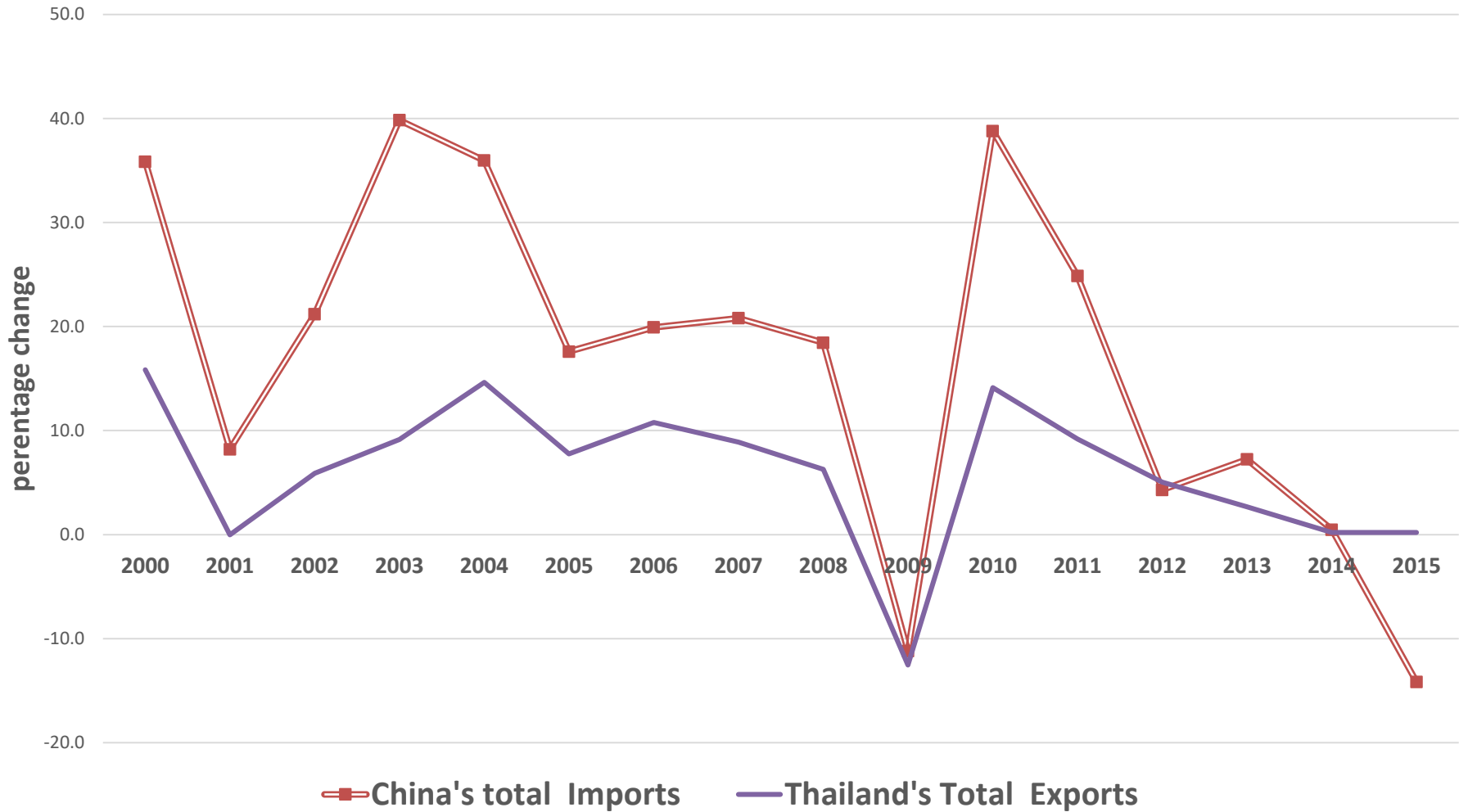


# Imports from the three largest economies

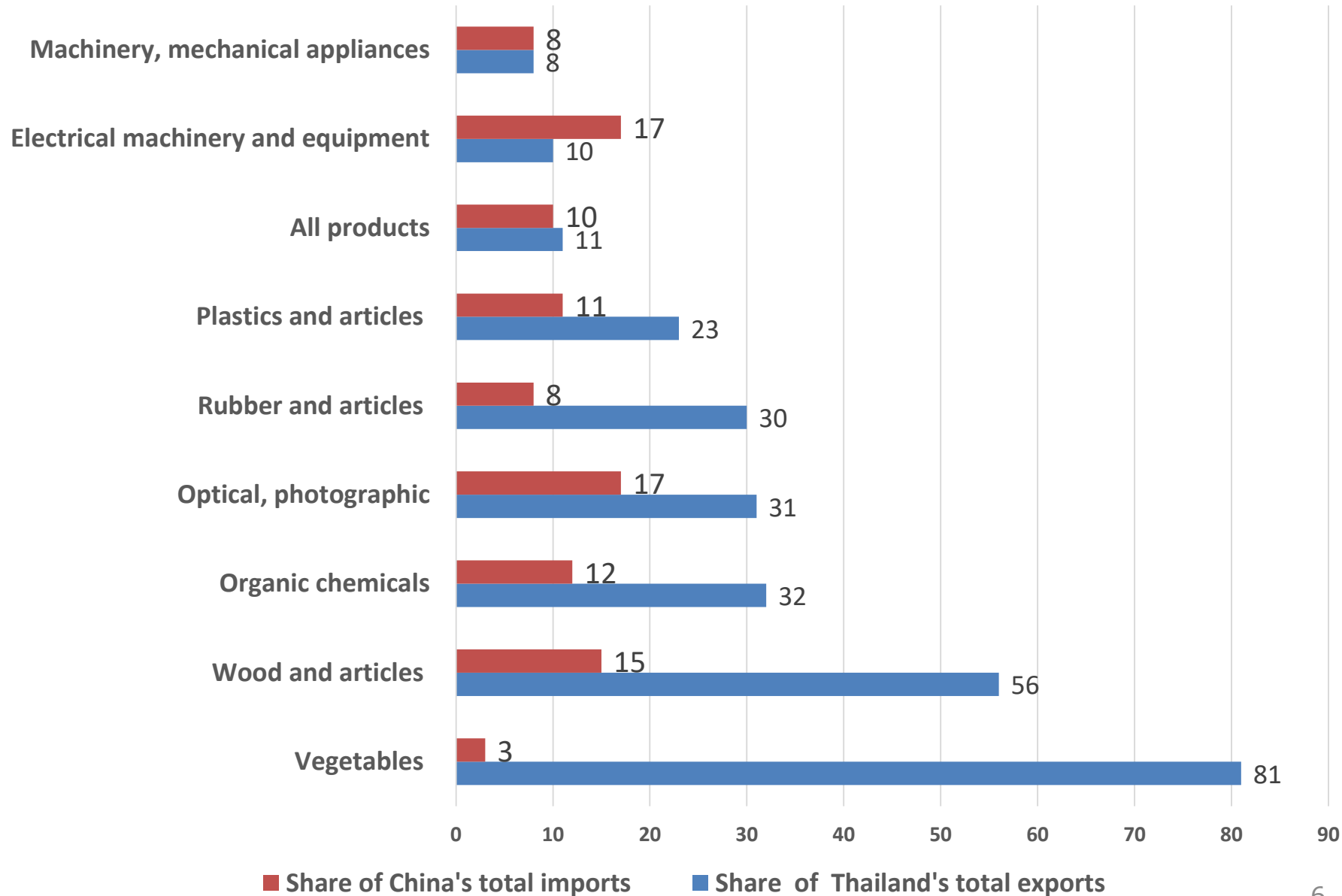
Real Values of Total Imports from China, Japan, and USA



# China's influence on Thailand's exports



# China's influence on Thailand's exports: 2016

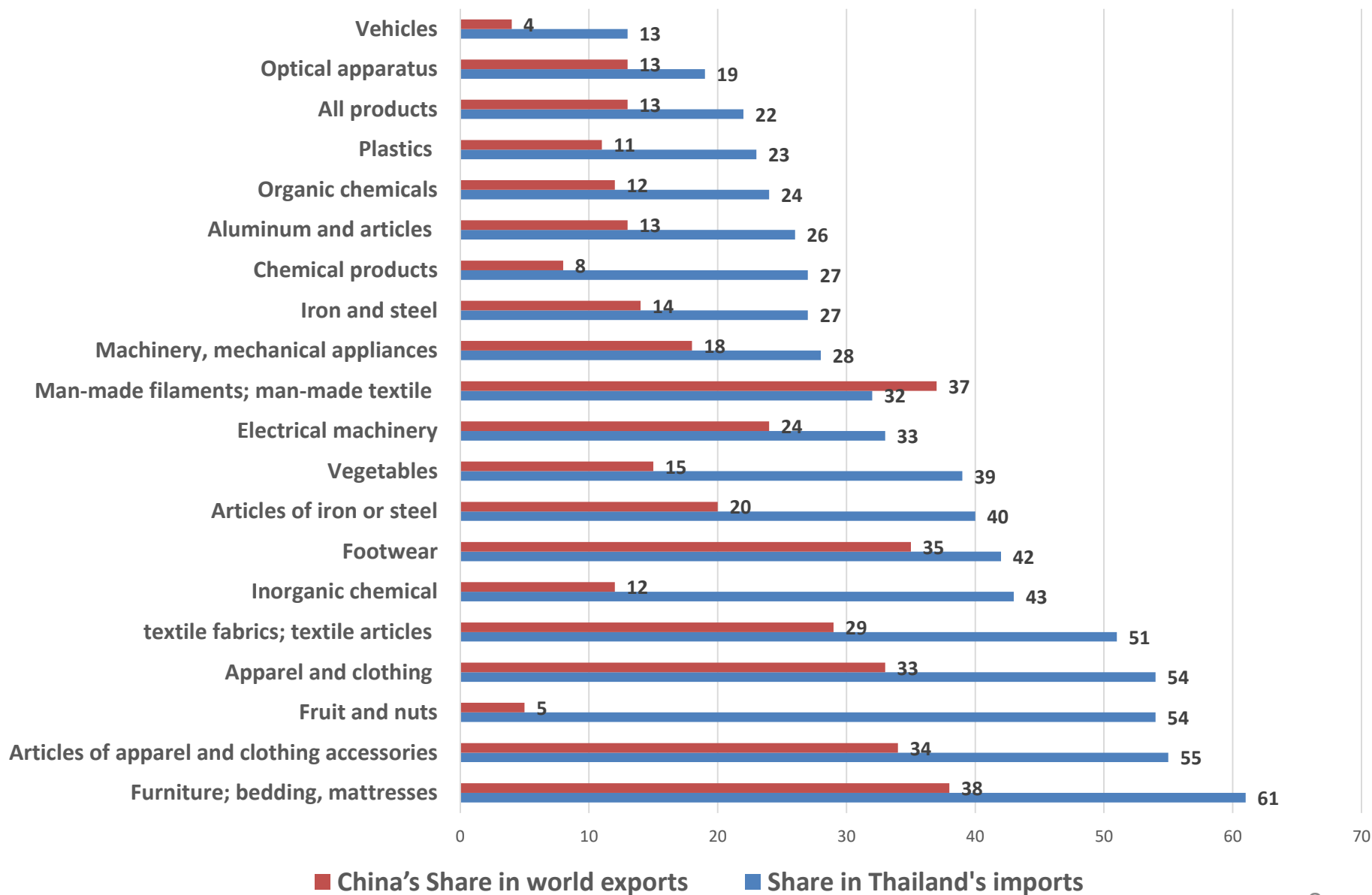


# Thailand's exports value elasticities

Source: FMOLS (2003-2016)

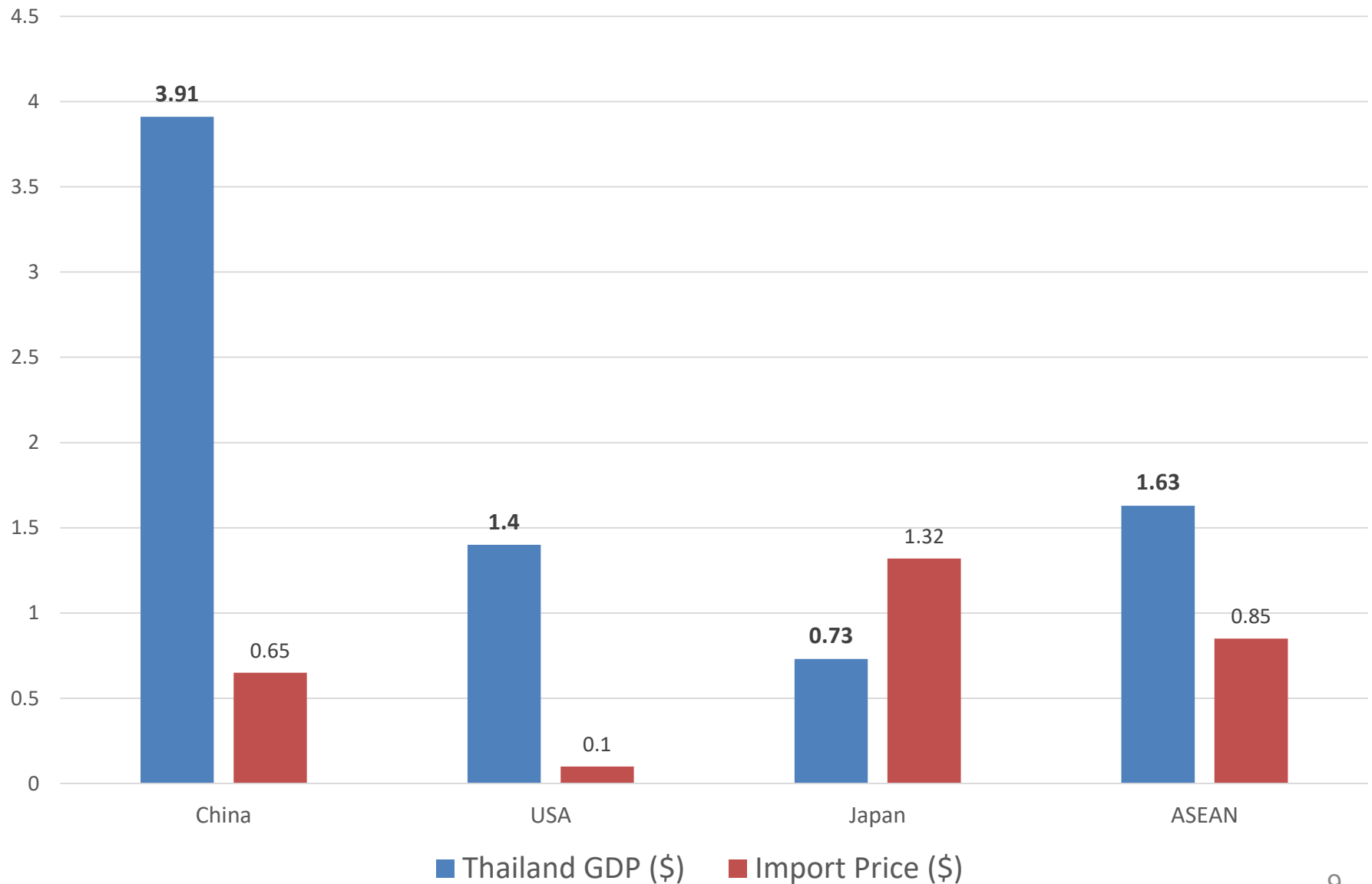


# China's influence on Thailand imports: 2016



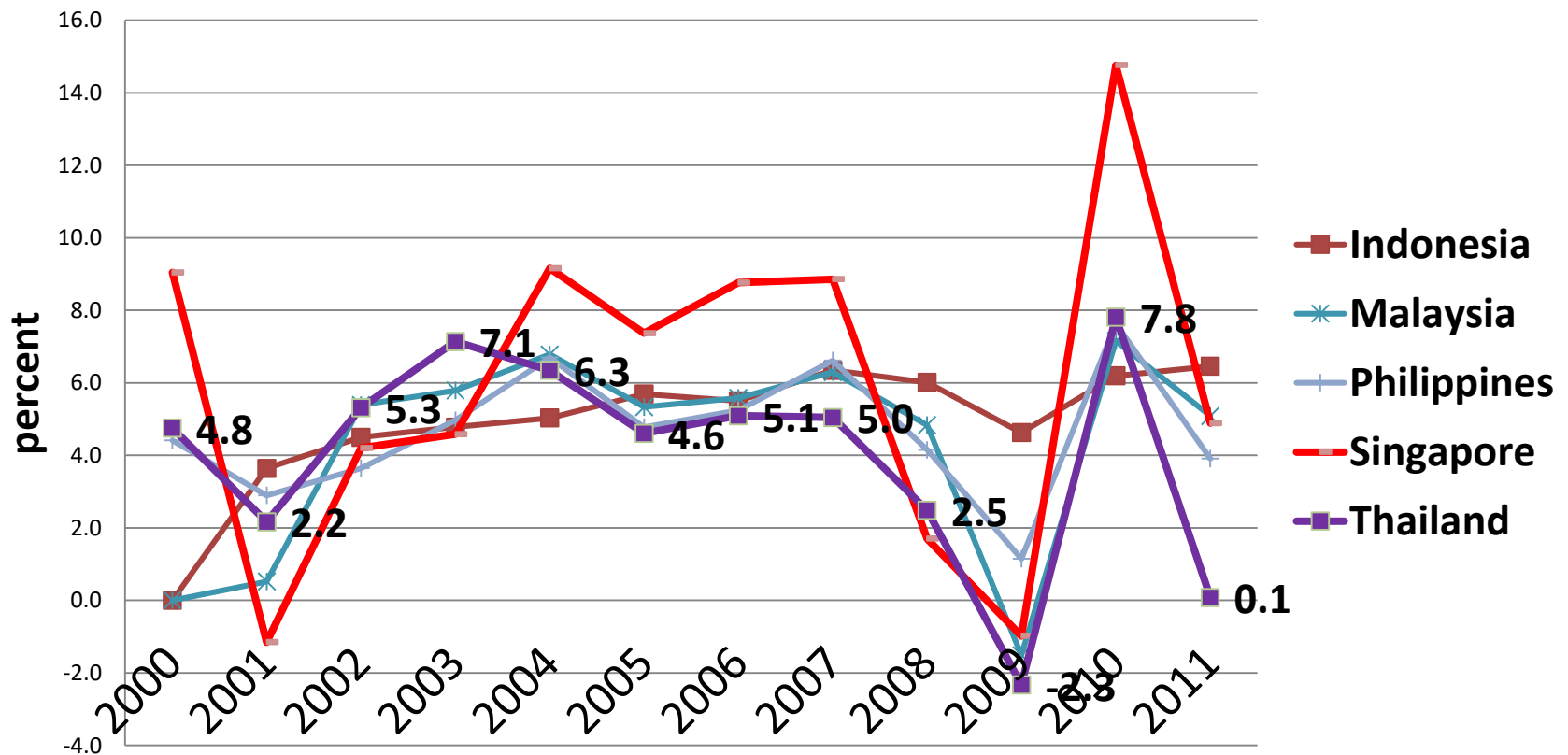
# Thailand's import value elasticities: 2002-2016

Source: FMOLS estimates



# 2. ASEAN Business Synchronization

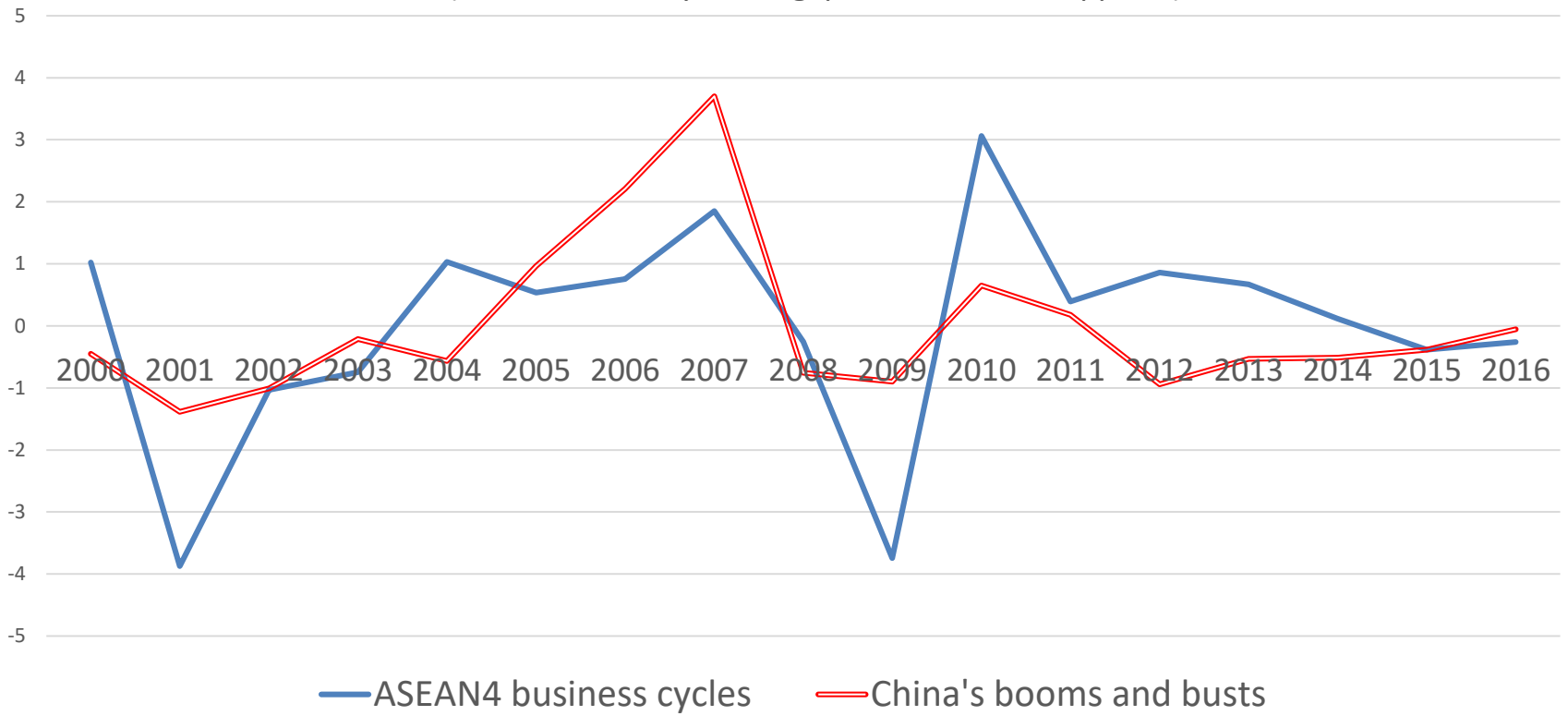
## GDP Growth: ASEAN 5



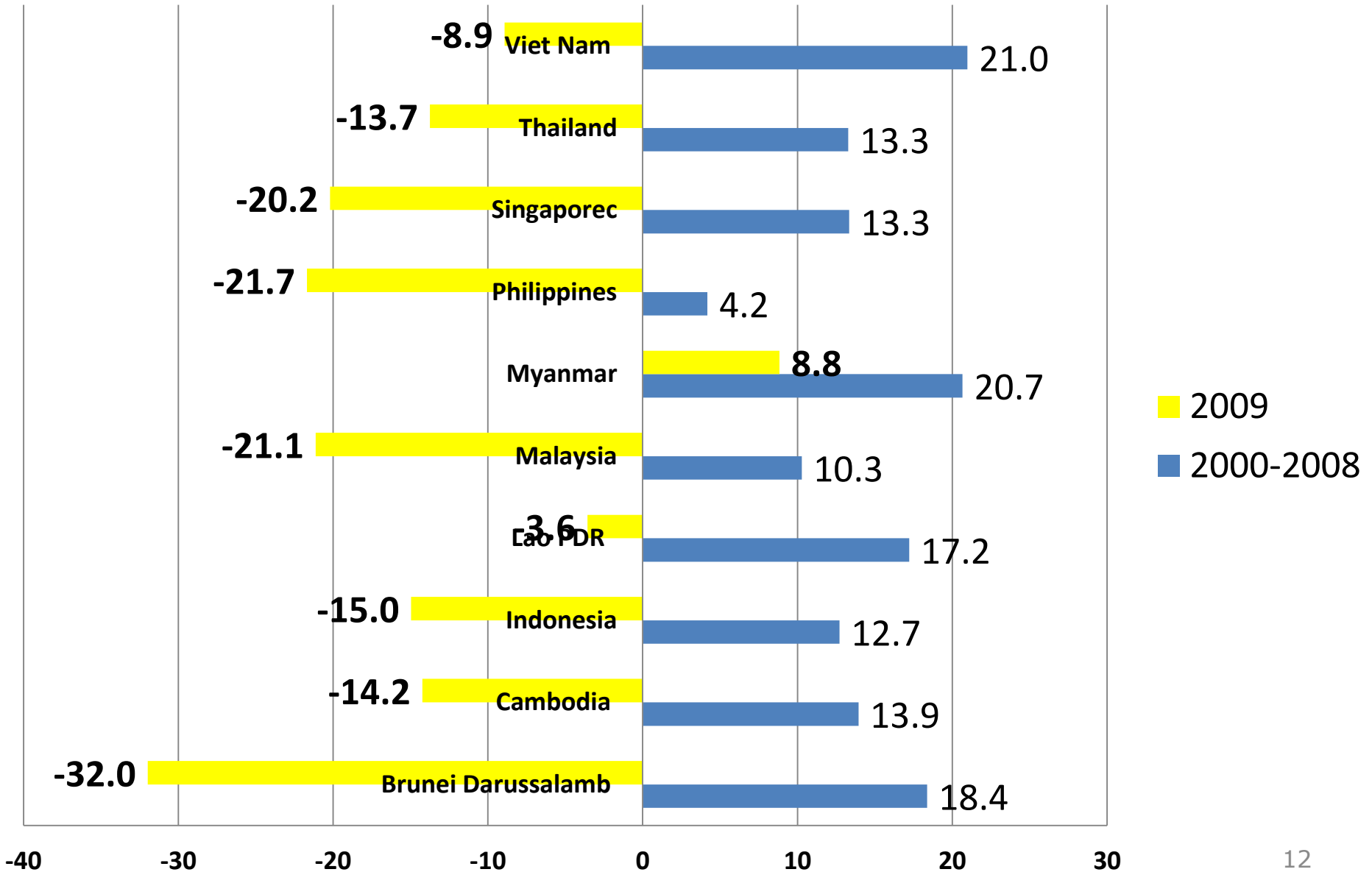
# China and ASEAN-4 Business Cycle

Business Cycles in China and ASEAN-4\*

(Deviation from trend growth path)  
(Indonesia, Malaysia, Singapore, and the Philippines)

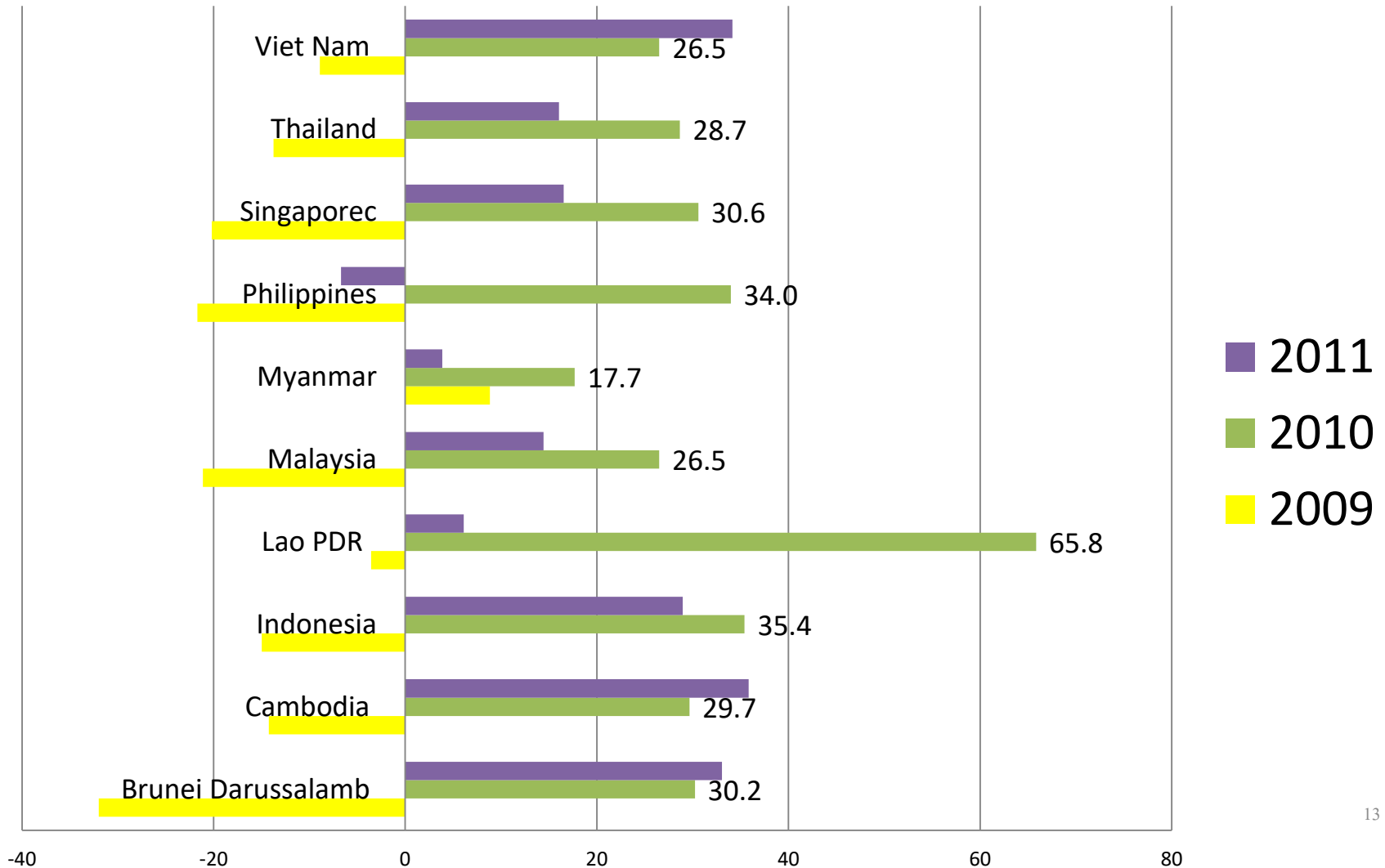


# The 2009 GFC's impacts on ASEAN Exports (% change)

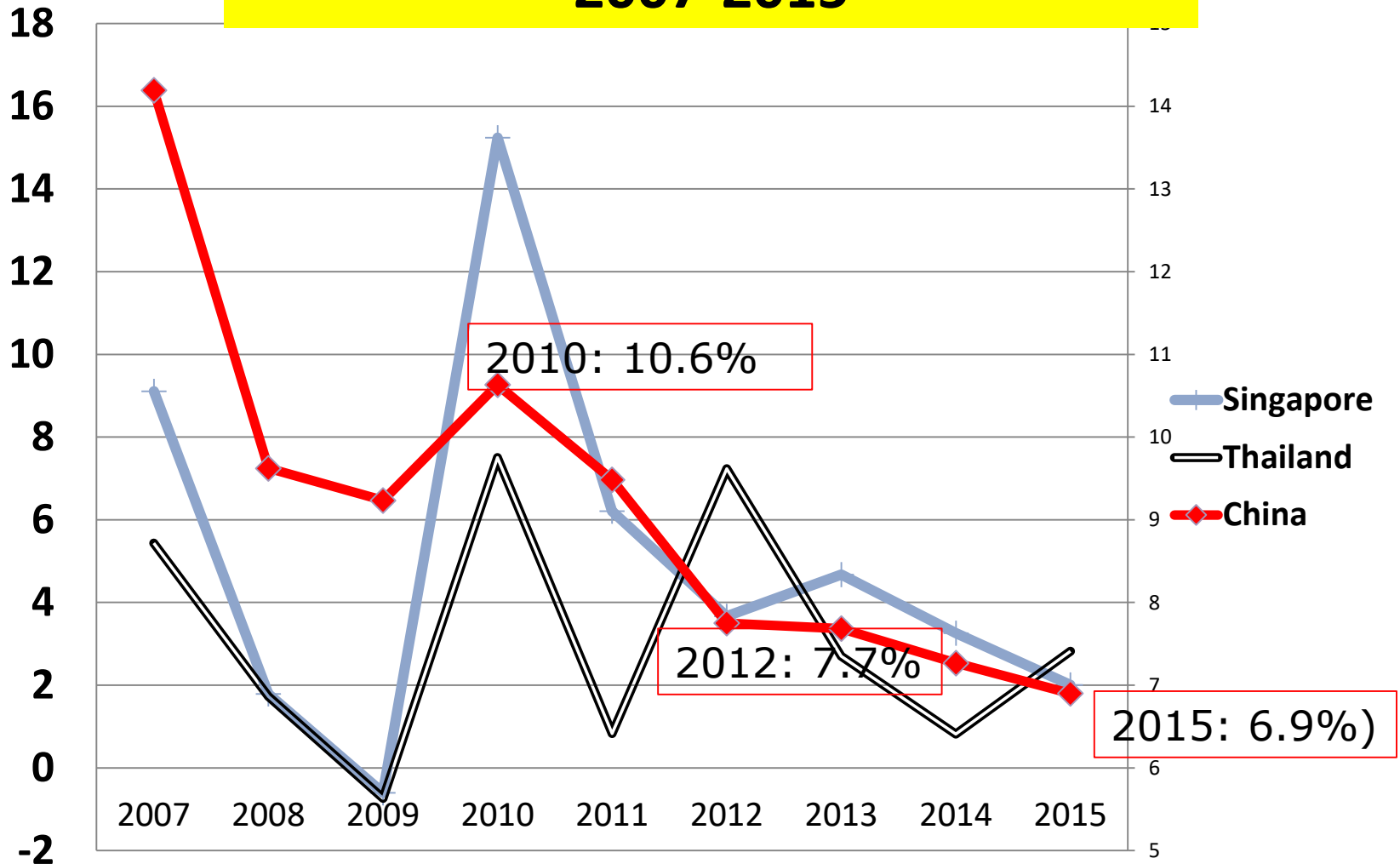


# What do ASEAN Exports have in common after the GFC?

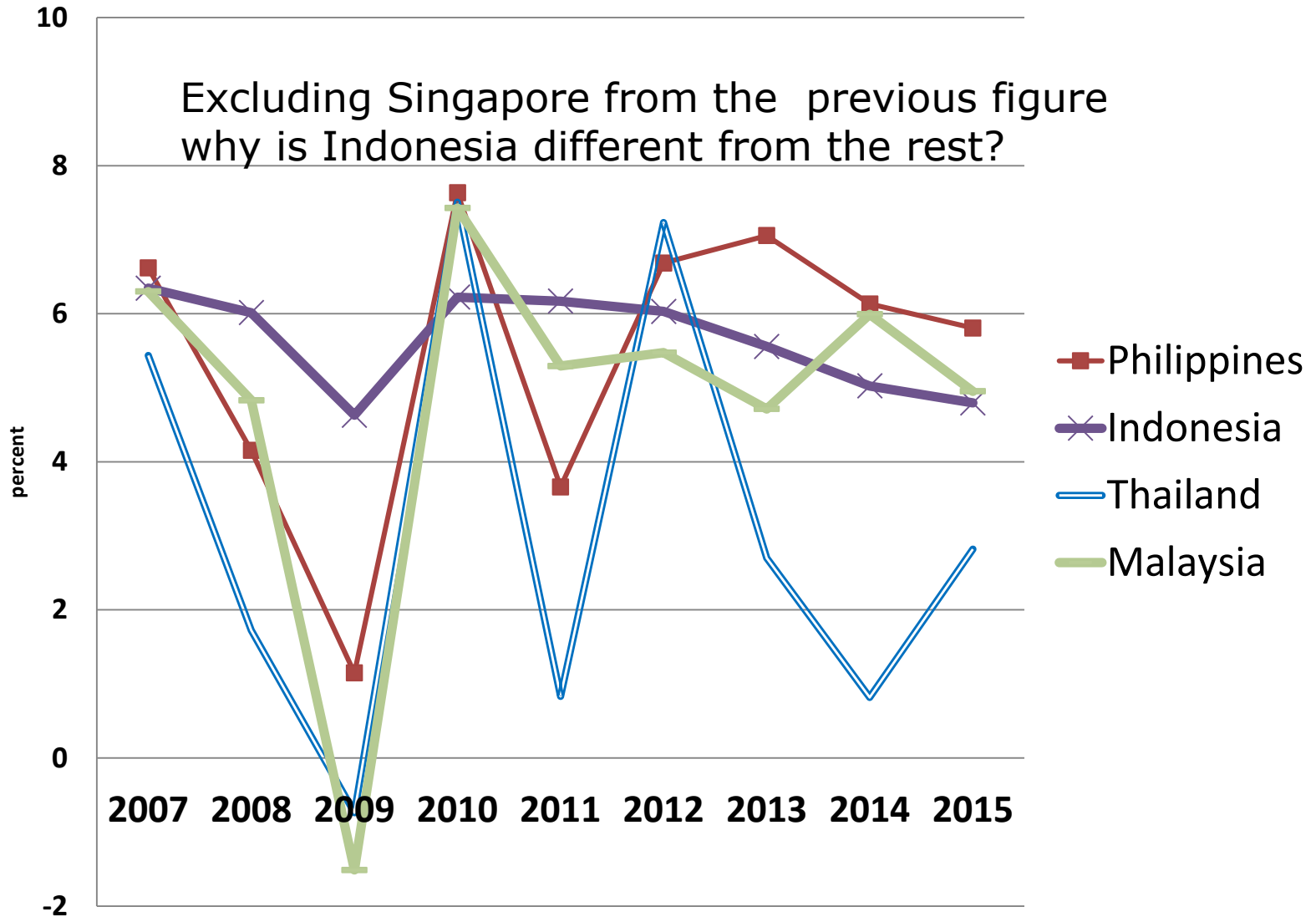
## Impact of GFC on Exports (% growth)



# China, Singapore, and Thailand: GDP Growth Rates 2007-2015

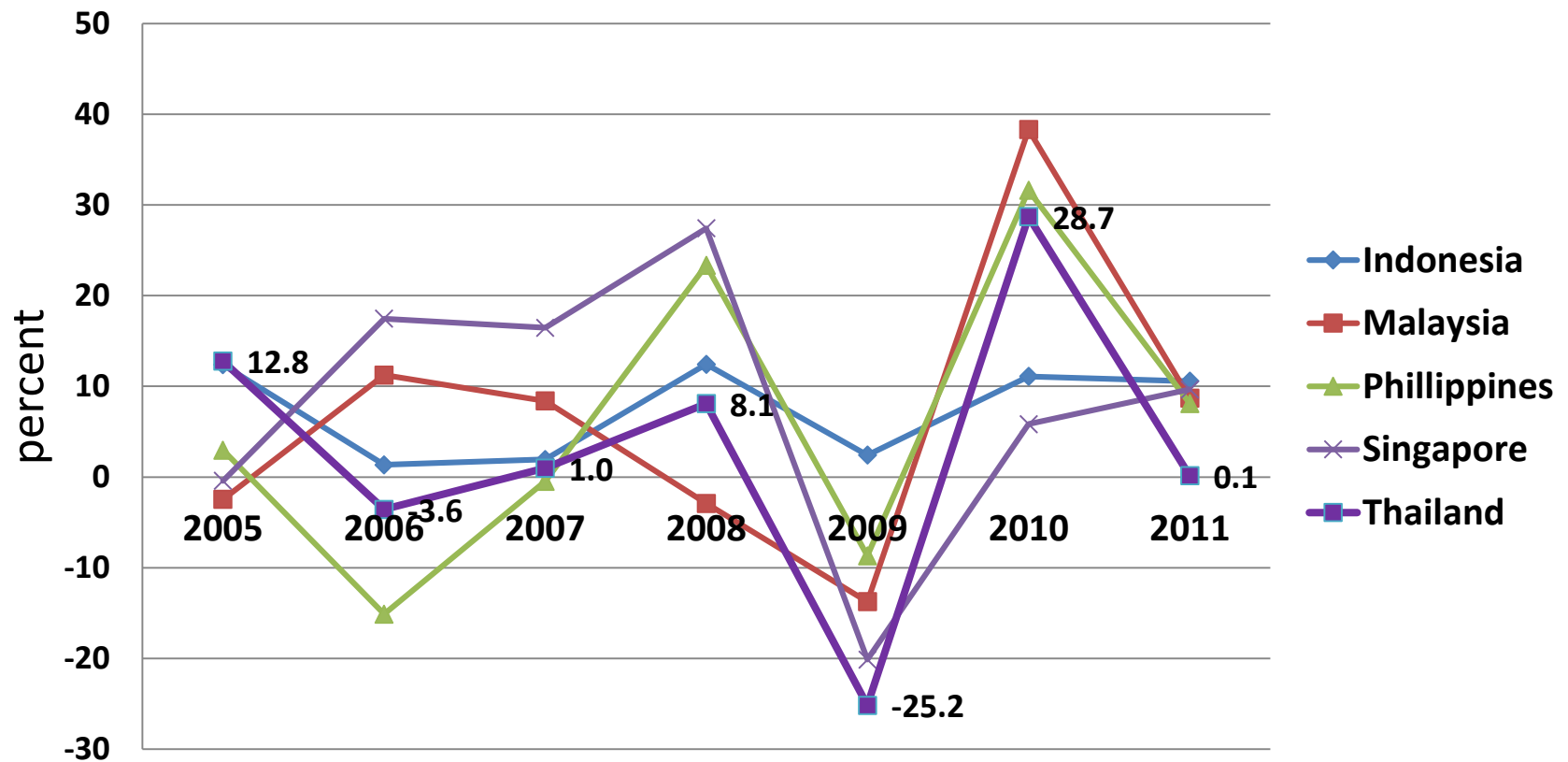


# ASEAN-4 GDP Growth Rates: High Volatility with synchronization

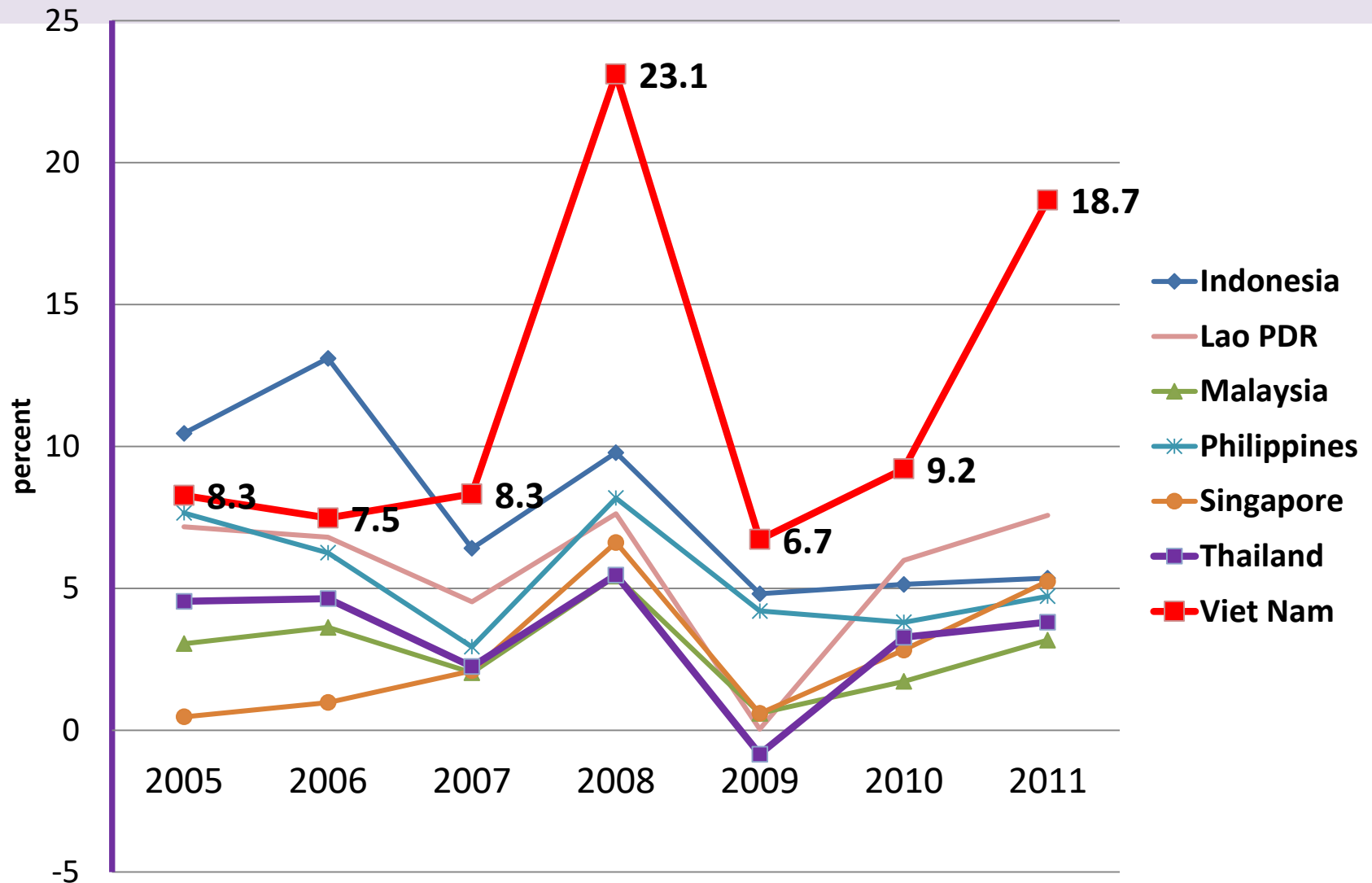


# ASEAN Investment synchronization

## Gross Domestic Investment

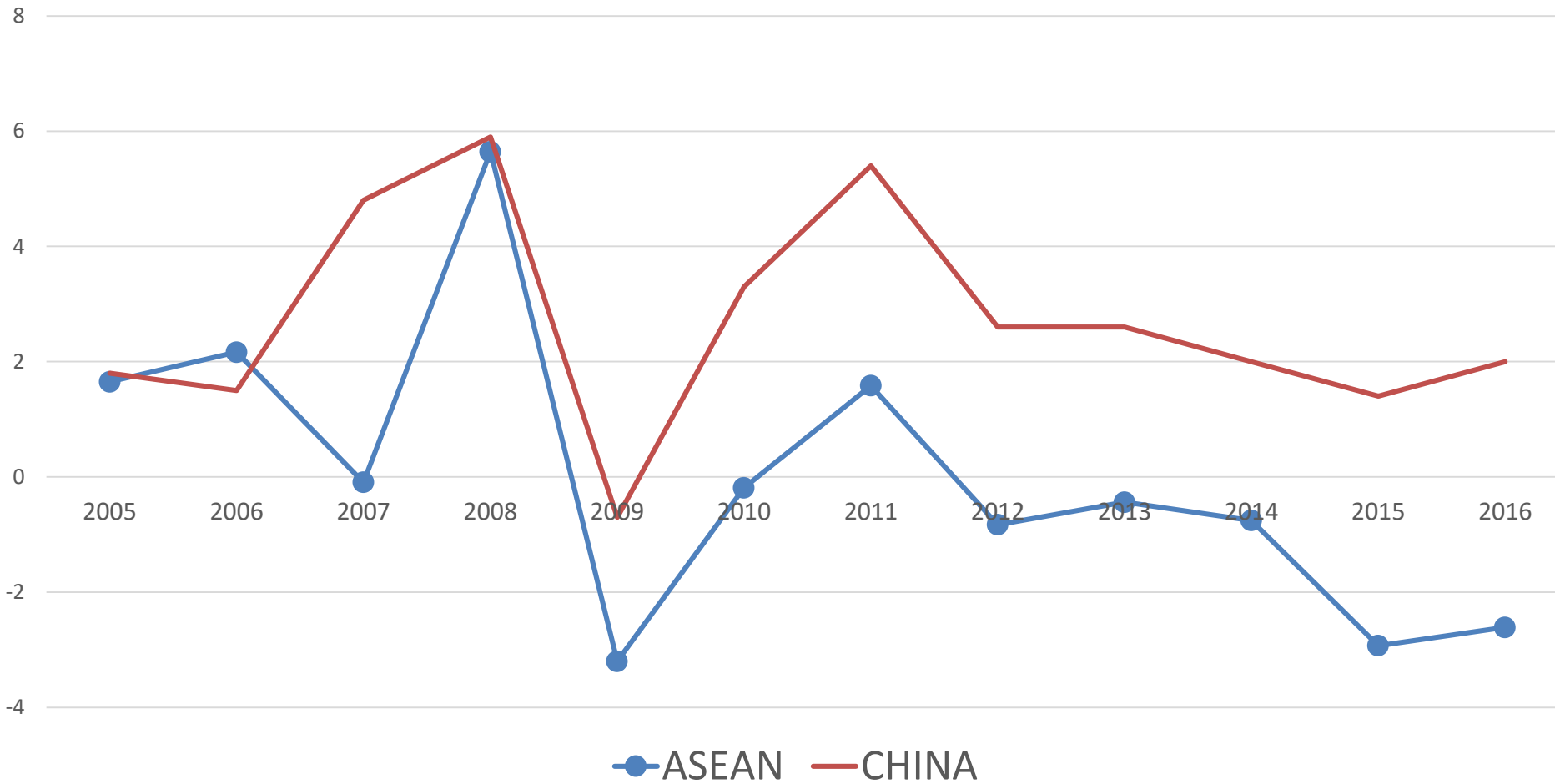


# Inflation synchronization in South East Asia

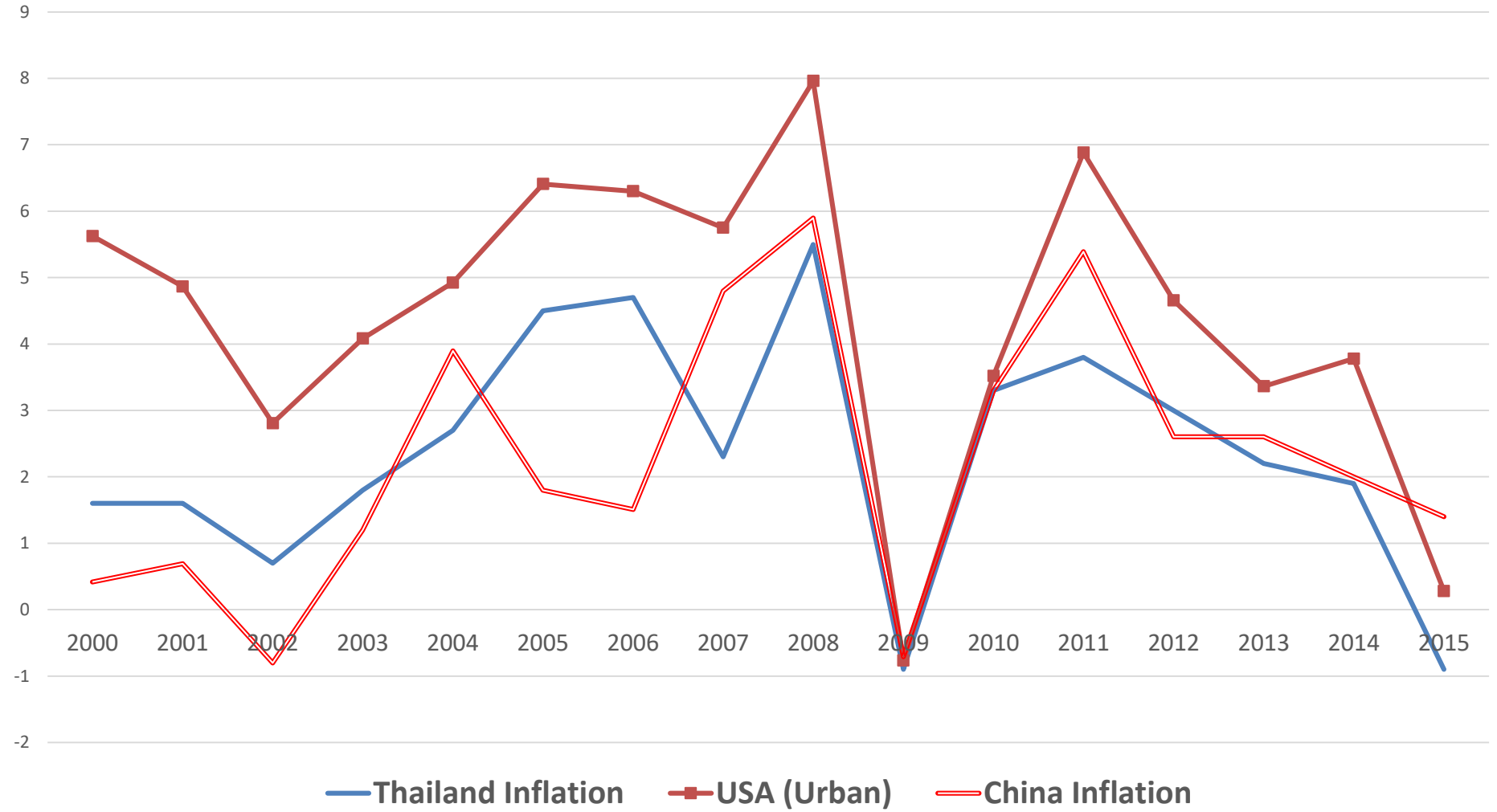


# China and ASEAN Inflation Synchronization (Principal Component of CPI inflation)

Source: ADB Key Indicators

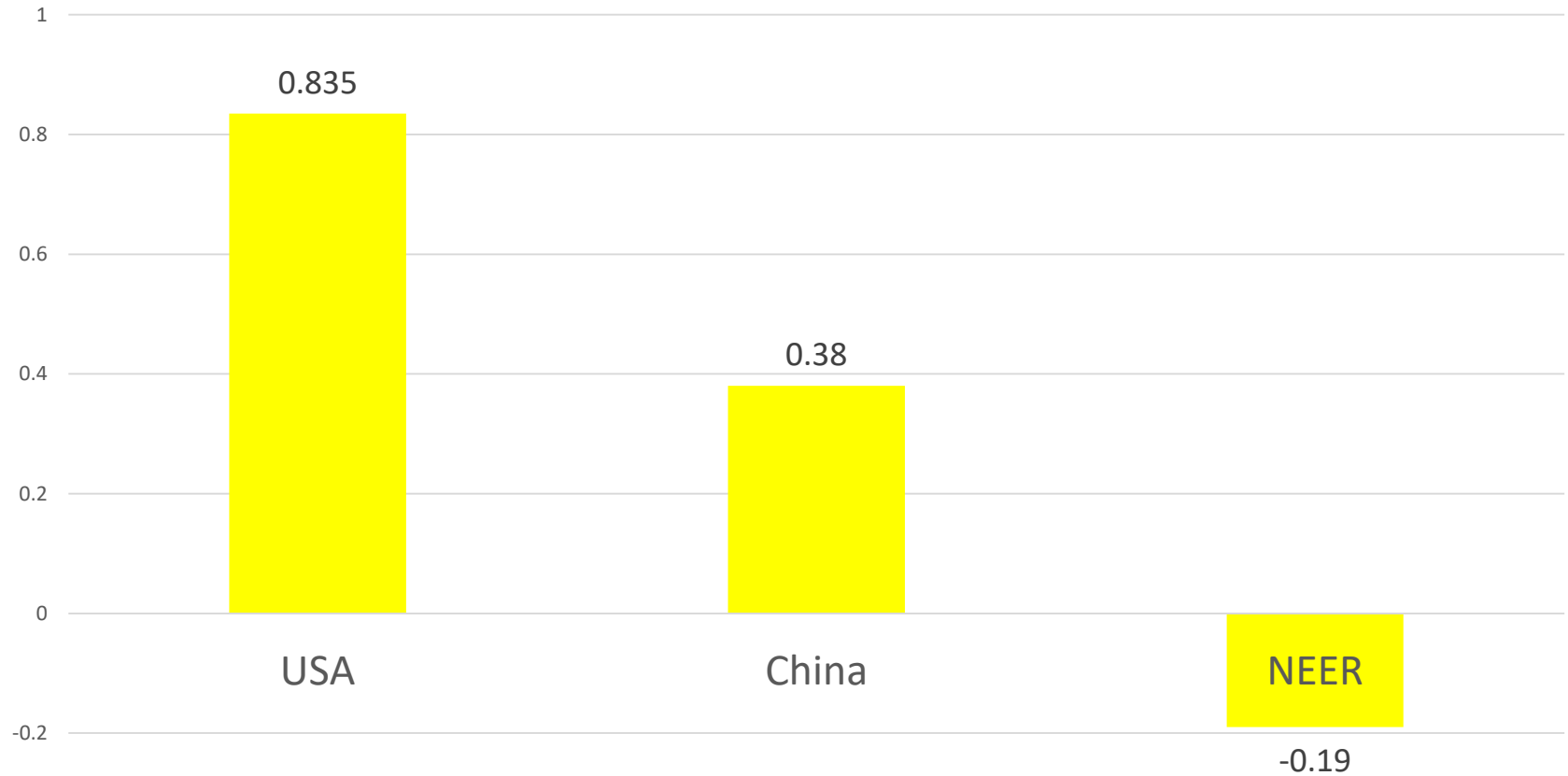


## Influences of Two Major Trading Partners on Thailand's inflation



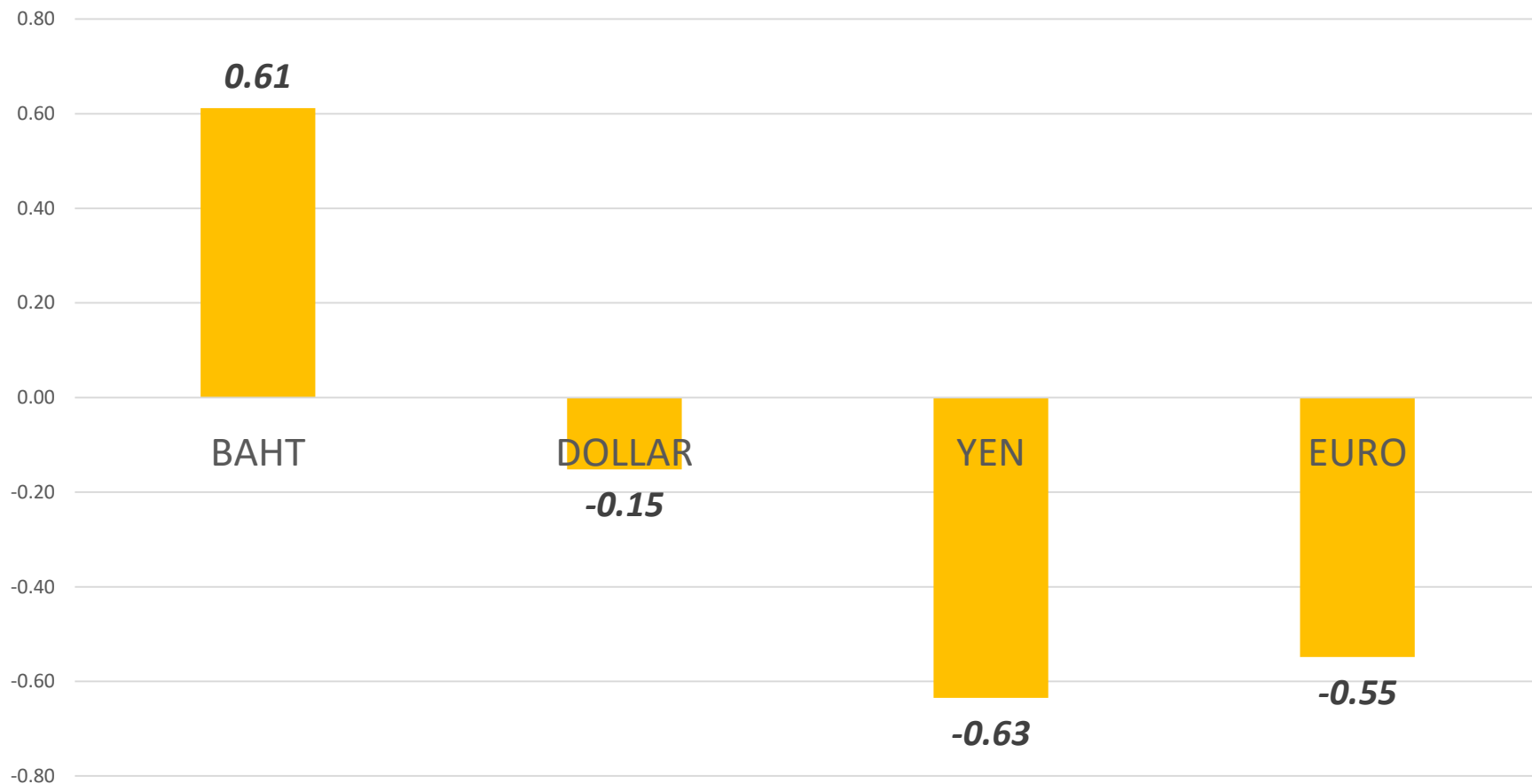
# Thailand's Consumer Price Elasticities

Source: Estimated coefficients obtained from Canonical Cointegrating Regression (Jan 1994 -May 2017)

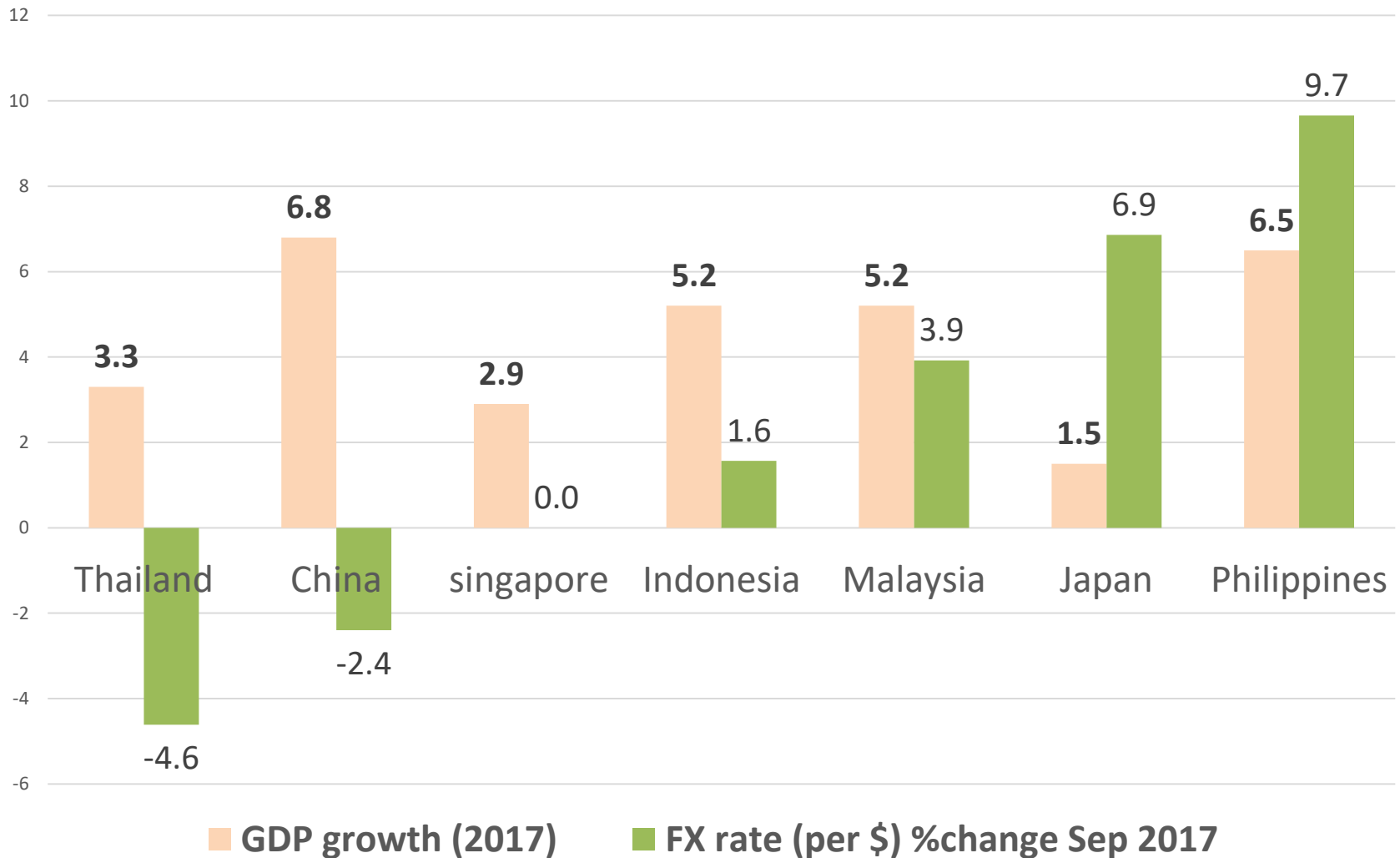


Nominal Effective Exchange Rate

# Correlates of the renminbi Broad Effective Exchange Rates (Jan 2000-July 2017)

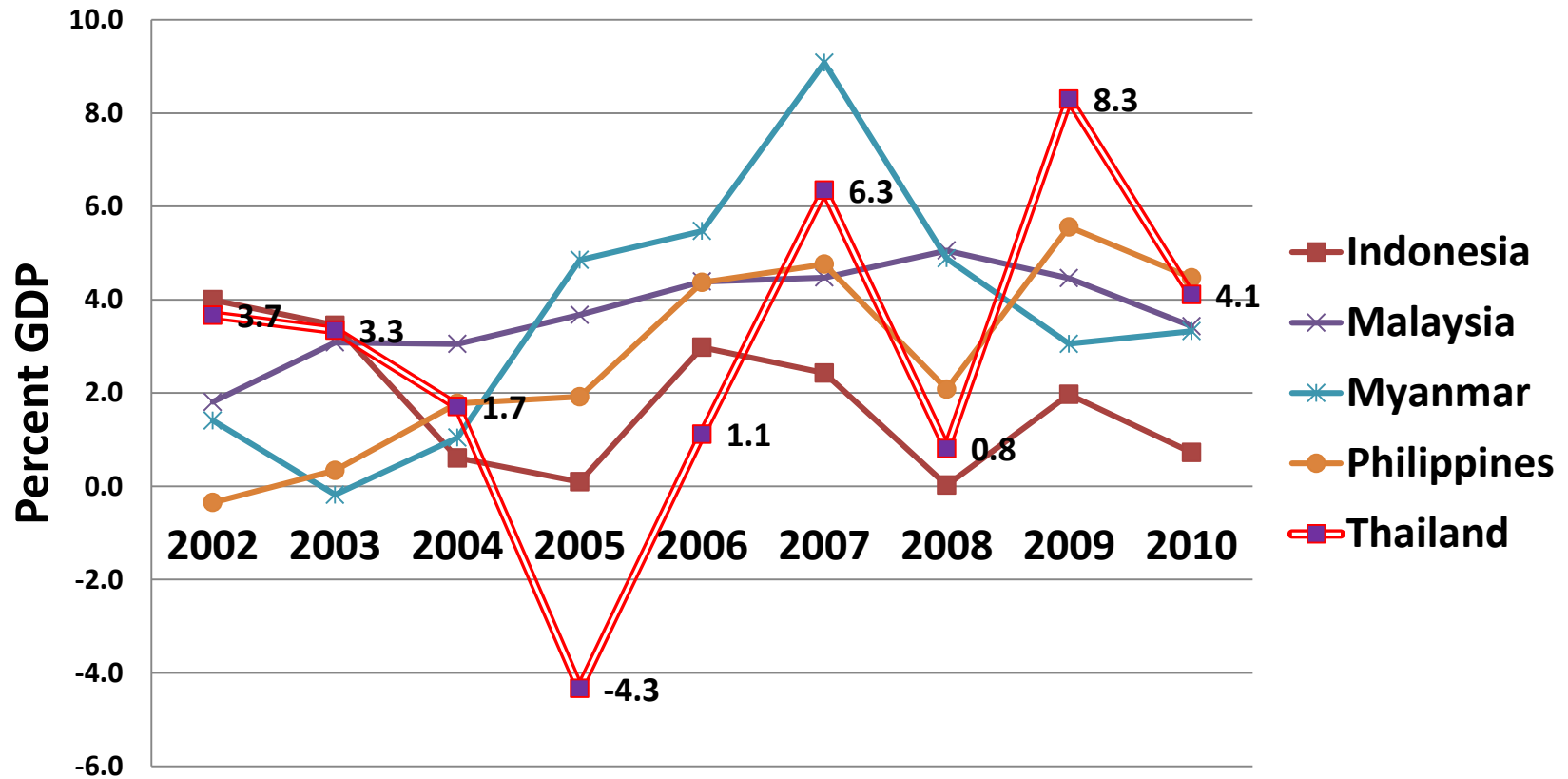


## Asian GDP growth and Currency Movements (2017)



# What do ASEAN countries have in common?

## Current Account



Strong growth leads to current account deficit

### 3. Explaining CA Deficit : Investment-Saving Gap

#### *Saving and Output growth*

- $S_t = \alpha + \beta Y_t$   
(implied by Keynes' absolute income theory of consumption)
- $(S/Y)_t = \alpha/Y_t + \beta$  (s=saving rate=S/Y)

$$s = \alpha/[(1+g)Y_{t-1}] + \beta \quad (g=\text{output growth})$$

Since  $\alpha < 0$ ,  $\partial s/\partial g > 0$

- There is a positive impact of growth on saving rate.
- High saving rate is driven by high economic growth and vice versa (saving generates investible funds)

***I/Y depends on S/Y***

## Current account deficit: Absorption ( $A$ ) approach

- $M-X = (I - S) + (G - T)$

### *The twin deficits*

- $M-X$  can be thought of as foreign savings (capital inflows) used to finance investment gap and budget deficit
- $Y = C + I + G + (X-M) = A + (X - M)$
- $(X - M) = Y - A$
- $(M-X) = A - Y$

When  $A$  exceeds  $Y$ , current account turns deficit.

## Absorption (A) approach

- To reduce trade deficit, domestic absorption (**A**) must be curtailed, if  $Y$  cannot be raised.
- However, the absorption approach *ignores* the price effect (i.e., exchange rate)
- Define net exports as:  $NX = X - M$
- $NX = 0$  at the trade balance equilibrium when  $X = M$ .

# Determinants of net exports

$$NX = X\left(Y_f, \frac{eP_f}{P}\right) - M\left(\frac{eP_f}{P}, Y\right)$$

$$\text{Real exchange rate} = \frac{eP_f}{P}$$

$$e = \text{Baht} / \$$$

$$P_f = \text{Foreign price}$$

$$Y_f = \text{Foreign income}$$

## Balance of Payments: Current Account and Capital Account (Financial Account)

$$BP = NX(Y, Y_f, \frac{eP_f}{P}) + CF(i - i_f - \frac{\Delta e}{e})$$

$\frac{\Delta e}{e}$  = expected depreciation

What are other determinants of CF?

Output growth, capital account openness, financial sector depth  
Business environment (ICRG rating on investment risk) VIX,

# ***Determinants of current account balances***

- Growth
- Real interest rates
- Capital inflows (FDI, portfolio investment)
- Inflation
- Exchange rates
- Fiscal imbalance
- *These determinants are intricately related.*

# Growth, financial resource, and current account deficit

- Higher expected growth generates higher demand for credit required by investors to expand their plants.
- Higher growth increases permanent income and raises saving deposits.
- If loan growth outpaces deposit growth, interest rates tend to rise.

# Why does strong growth lead to current account deficit?

- Output growth leads to strong demand for imports of raw materials and capital goods.
- If growth is not export-driven, growth can lead to deficit current account.
- On the other hand, weak economic growth is related current account surplus.

# A conventional growth strategy

- Growth is the first priority, in particular export growth.
- Capital inflows propel private investment.
- Exchange rate appreciation may be postponed as much as possible.
- Exchange rate competitive (though unrealistic) exchange rates to drive exports.

# Growth engines downed

- During period of growth acceleration, private consumption and investment play a leading role.
- During growth slowdown, with the absence of fiscal stimulus, net exports are the **only** growth driver.
- But during the period 2014-2016, with weak consumption and investment demand, unfavorable world trade conditions, fiscal policy remain the only option to the Thai government.

# Growth engines downed

- Compared to favorable external markets conditions and competitive exchange rates in 2007, next exports led the recovery in 2007
- But the revival of exports did not happen after China's slowdown after 2015..

# 4. China's Slowdown

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## The ASEAN business cycle and China's slowdown

Bhanupong Nidhiprabha

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The economies in the Association of Southeast Asian Nations (ASEAN) have been integrated through increasing trade relations intensified by tariff reductions and increasing openness to foreign direct investment. Rising volume of networks trade has deepened interconnectedness between ASEAN and China, a recent growth locomotive in the world. ASEAN business cycle is shaped by volatile China's trade volume. As China's expansion slows down, adverse consequences on ASEAN economies have become more pronounced. The extent of the damage depends on each member of ASEAN's trade exposure and China dependency. This paper identifies the most vulnerable ASEAN economies to China's business cycle. The slowing down of the Chinese economy would undoubtedly result in a decline in long-term growth of some ASEAN economies, unless appropriate policy responses can be implemented.

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# Global rebalancing

- When the issue of global rebalancing first emerged, it was focused squarely on the trade imbalance between China and the United States.
- However, the global economic turbulence of 2009-2010, and the subsequent economic fragility and uncertainty enveloping much of the global economy today, has begun to underscore how broad this issue really is.

# Global rebalancing

- China has taken steps to contribute to possible rebalancing.
- China's currency has ***appreciated*** by over 30 percent against the US Dollar since 2005.
- And it has experienced some decline in its trade surplus in recent years.

# Global rebalancing

- Nevertheless, the consumption share of GDP in China is still low (and even declined according to recent statistics).
- Further, the US still has a current account deficit amounting to about 3.1 percent of GDP.
- In 2011, the US maintained a trade deficit with at least 91 countries, most of which are in the developing world.
- Thailand is one of those countries on the watch list of the US government.

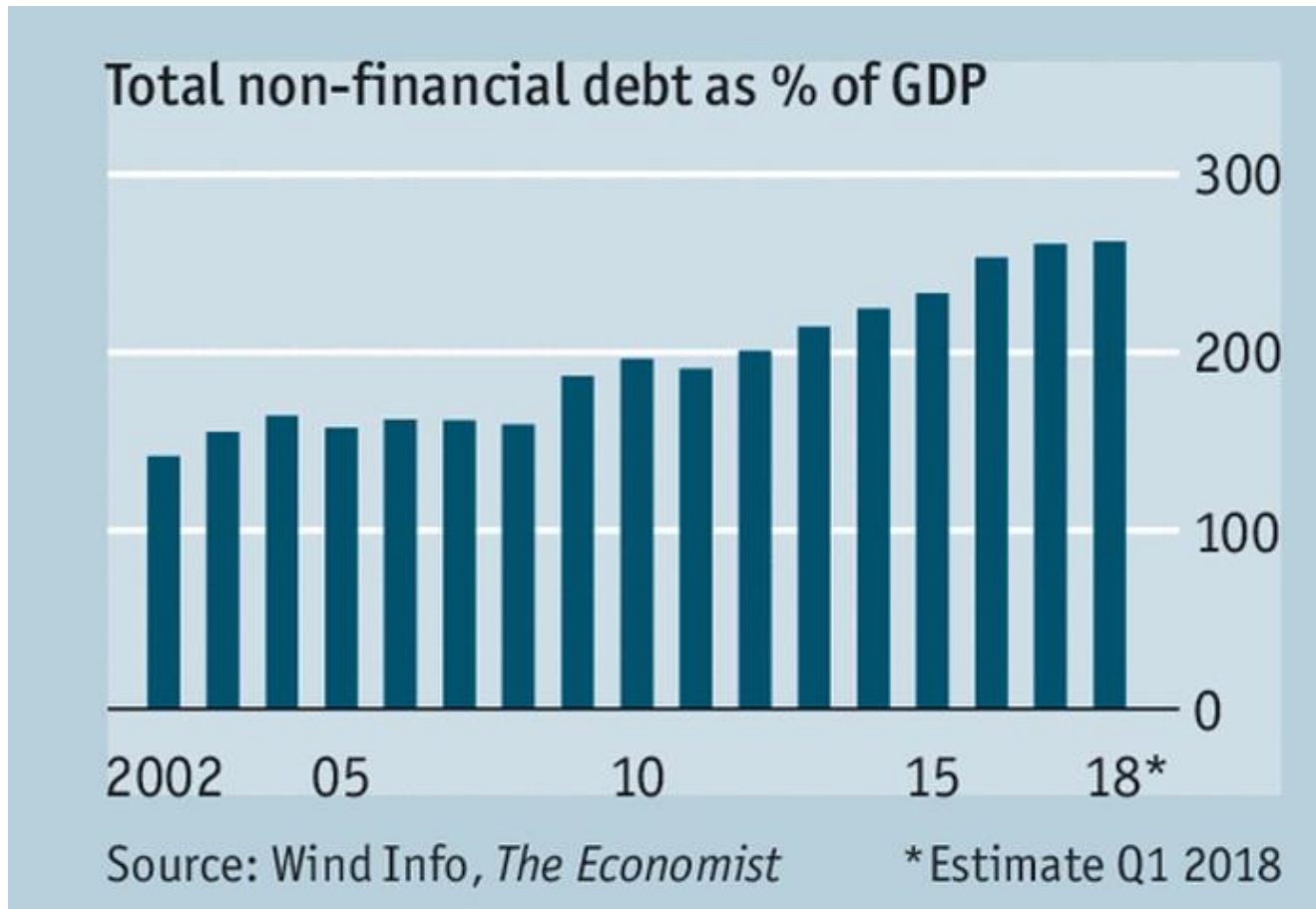
# China in 2018

- China's economy is in much better shape than was the case in late 2015. Then, the country was reeling from a stockmarket crash, suffering from capital outflows and accumulating debt at an alarming rate.
- But figures reported on April 17th showed growth of 6.8% in the first three months of 2018 compared with the same period a year earlier.

In nominal terms, growth was above 10%

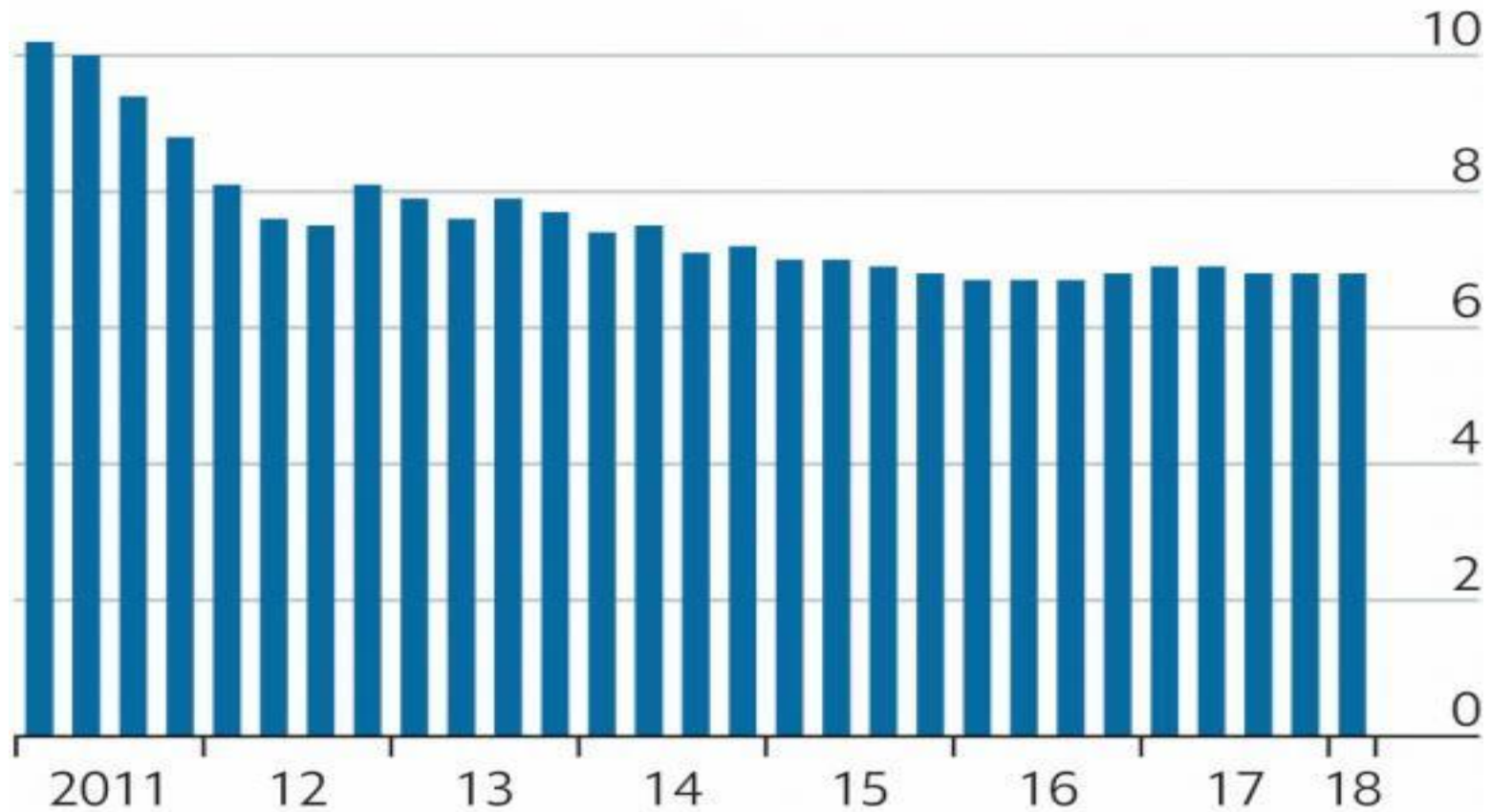


China's total debt-to-GDP ratio has stabilized  
The risk of China's financial crisis has receded.



## Defence fund

China, GDP, % increase on previous year



Sources: Haver Analytics; news reports

# The improvement in China's fortunes can be traced to three factors

- First, the government has started to tackle several ingrained problems.
- After a long period of overproduction of steel and coal, a campaign to close unused capacity restrained output and pushed up prices.
- To reduce the property overhang, local governments bought millions of unsold homes from developers and gave them to poorer citizens.

# Maturing Chinese Economy

- A second factor is that China's economy is maturing.
- Growth is bound to slow over time as China gets richer, but structural changes are also making growth more stable. Thanks in part to a falling working-age population, which peaked in 2011, incomes are growing more quickly than the economy is.
- This, in turn, is rebalancing the economy.
- Excessive reliance on investment is giving way to consumption.
- And heavy industry is giving way to services, which now account for more than half of GDP, up from a third two decades ago.

# Robust growth in America and Europe

- The final factor has been good luck. Robust growth in America and Europe has given Chinese firms a lift.
- After falling in 2016, exports have rebounded.
- The rise in global commodity prices has filtered into stronger industrial revenues in China, boosting miners and metal producers.
- That has helped them service their debts. And it has made the task of deleveraging for the broader economy less daunting.
- China has curbed outflows of hot money by tightening capital controls.
- It has also benefited from a weak dollar since the start of 2017, which has made the yuan more appealing.

# Fighting Fit: China's economy

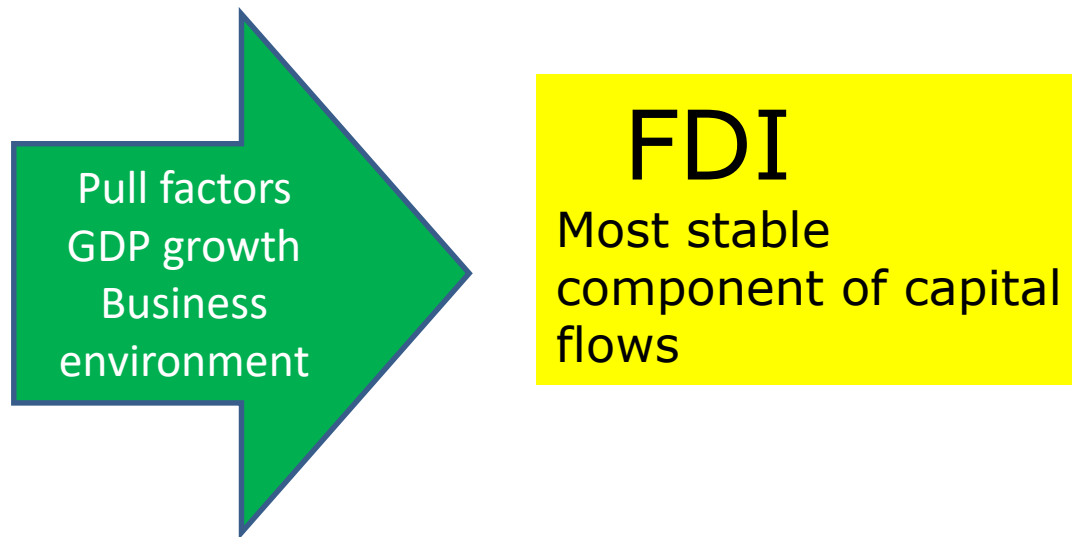
- The risk of a trade war between America and China looms ever larger. One determinant of how the countries might fare in a conflict is the state of their economies going into it.
- GDP grew 6.7% in the first quarter of 2018 compared with the same period a year earlier, marginally slower than its pace in 2017.
- The government has used a strong economic backdrop over the past two years to begin the difficult task of defusing financial risks.
- It has whittled down excess capacity in the industrial sector and worked to stabilize debt as a percentage of GDP.
- A deceleration in credit growth is likely to weigh on the economy in the coming quarters. But if President Donald Trump ratchets up the pressure, China should have enough fiscal space to absorb the impact.

# 4. Are Capital flows Fickle?

## *Eichengreen's Three Research Questions*

- How do magnitudes, persistence, and volatility of various capital flows compare?
- How have they evolved over time?
- What are correlates of different flows?

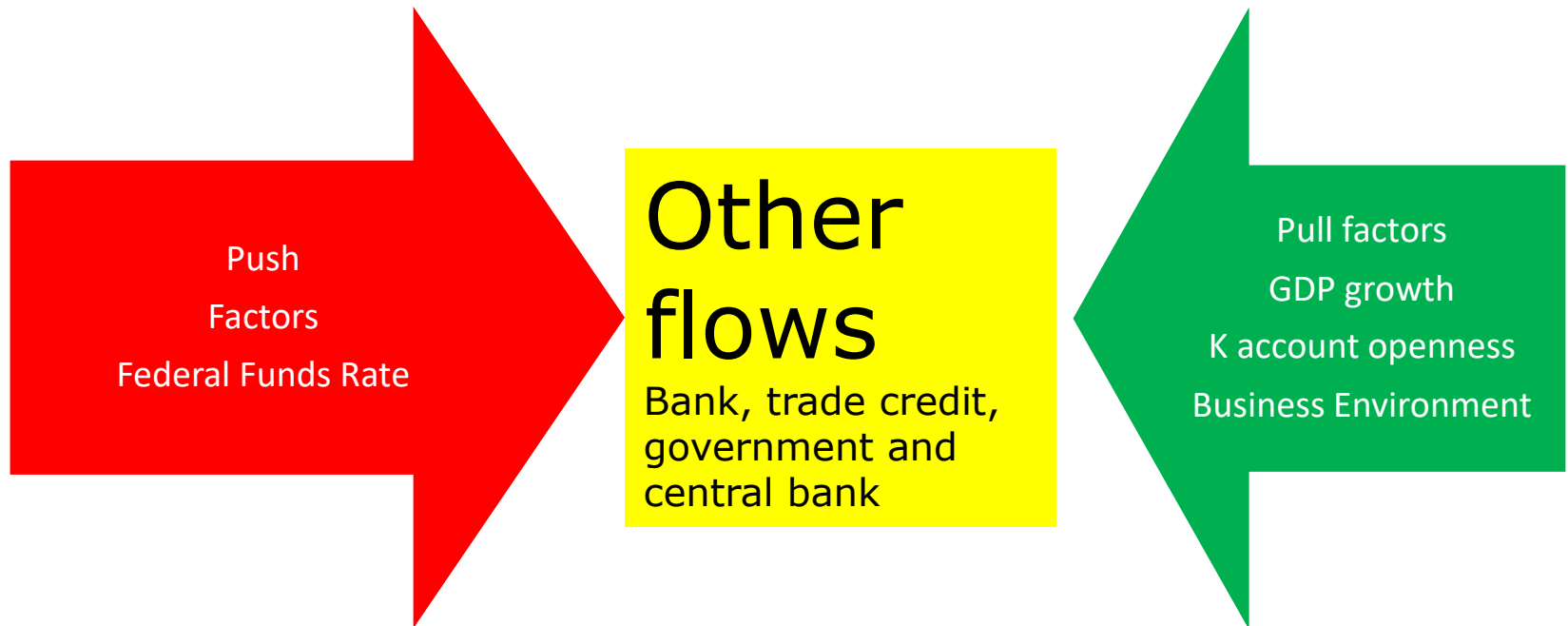
# Eichengreen's findings





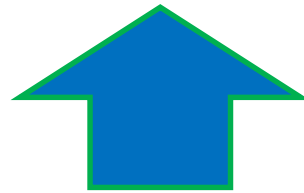
Push  
Factors  
(Federal  
Funds  
Rate)

Portfolio  
(Debt & Equity)  
Most volatile component



# Less widely appreciated, FDI outflows from emerging markets rose strongly in 2011-2015

Last year, China was the third largest outward-investor globally, with big spending in Brazil, Germany, and Spain



FDI outflows from emerging economies:  
Rising trend

# From capital surges to capital flight

## There are four stages

- 1. Capital surges** (booming economy, rising foreign borrowing, stock market or commodity booms)
- 2. Sudden stops:** when the reversal in financial flows is more than 5 % of GDP
- 3. Global stops** are deepen and more persistent than sudden stops.
- 4. Retrenchments:** Reduction of capital inflows
- 5. Capital flights:** capital outflows, no more charming economies

# Global stops: Global FDI dropped 13% in 2016

- Global FDI declined by 13 % in 2016
- However, USA was the top destination with \$385 billion, an 11% rise from 2015
- UK was second with \$179 billion, up almost six-fold because of three big M&A deals.
- China third with \$139 billion.
- India and Africa FDI dropped by 5%, Latin America by 19%,
- Europe by 29%, due to low tax regimes in Switzerland, Ireland, and the Netherlands.
- China's boom in FDI outflows would slow down due to policies to reduce capital flights:
- ***Home and host countries' FDI policy matters***

# Correlates of capital inflows

- FDI depends on corporate income tax rates, which explain Ireland's success in attracting FDI.
- Expected exchange rate depreciation also drives capital outflows
- Flows reacts to the interest rate differentials (not just the level of the Fed Funds Rate, unless domestic interest rates move in line with the Fed funds rate to keep the interest rate gap constant)

# Concluding remarks

- There are equilibrating mechanisms, through exchange rate channel, to bring the economy back from imbalances to external balances.
- Exchange rates should be allowed to play the equilibrating role in external balance adjustments.
- The yuan appreciation helps the process of global rebalancing.

# Concluding remarks

- Delay the exchange rate adjustments would lead to substantial changes in output and exchange rates in the long run.
- FDI outflows in emerging economies are growing source of capital account volatility.
- There are three factors responsible for China's improving economic conditions in 2018, despite a new normal growth.