Application: Global imbalances & rebalancing

Outline

- Defining "Imbalances"
- Overview of Global Imbalances and the 2008 Global Financial Crisis (GFC)
- Rebalancing: Why does Asia need rebalancing?
- What does rebalancing entail?
  - Challenges for Asia
    - Boosting investment
    - Managing corporate savings
  - China's challenge
    - Boosting private consumption
- Prospects for Global Rebalancing

Global Imbalances

Global Imbalances

There is a tendency in economics to regard anything that is *not indefinitely sustainable* - *not* in steady state - as an 'imbalance'.

Following this usage, the following would represent imbalances:

- Any positive population growth rate
- A trade surplus/deficit
- Your life

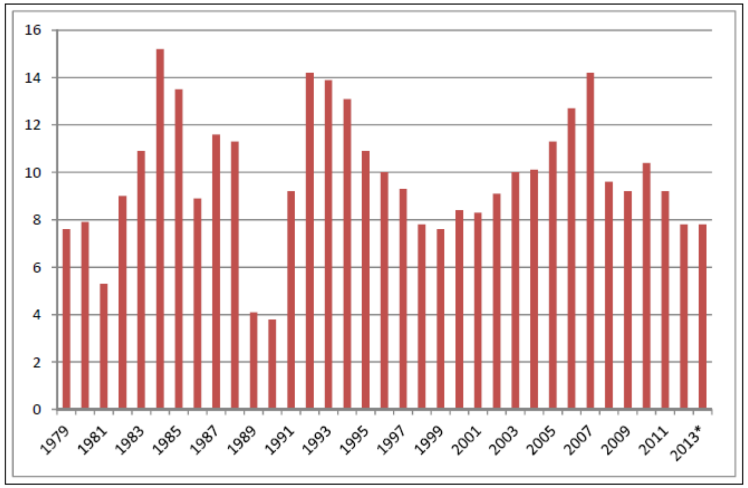
Preferred definition of 'imbalance': a process that:

- Is unsustainable
- Is unlikely to be corrected spontaneously without 'painful' adjustment (particularly after the GFC)
- requires policy/institutional changes for orderly/least cost correction

WHAT IS SO SIGNIFICANT ABOUT CHINA & THE US IN THESE IMBALANCES?

Chinese Real GDP Growth: 1979-2013

percent

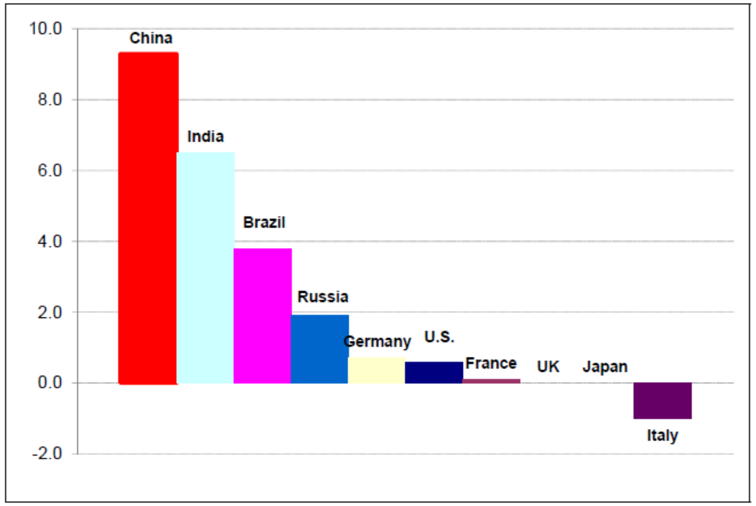


Source: IMF.

Note: * Data for 2013 is the IMF's projection made in July 2013.

Average Real GDP Growth Among Major Global Economies: 2008-2012

(percent)



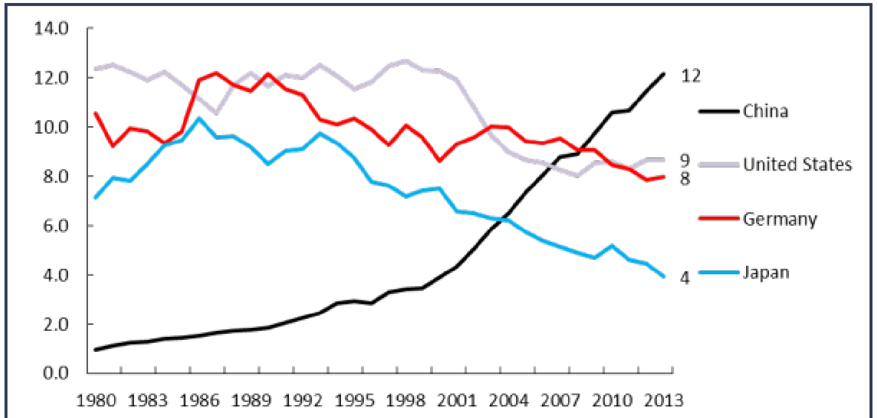
Source: Economist Intelligence Unit database.

Note: Japan and the UK experienced negative growth of less than 0.5%

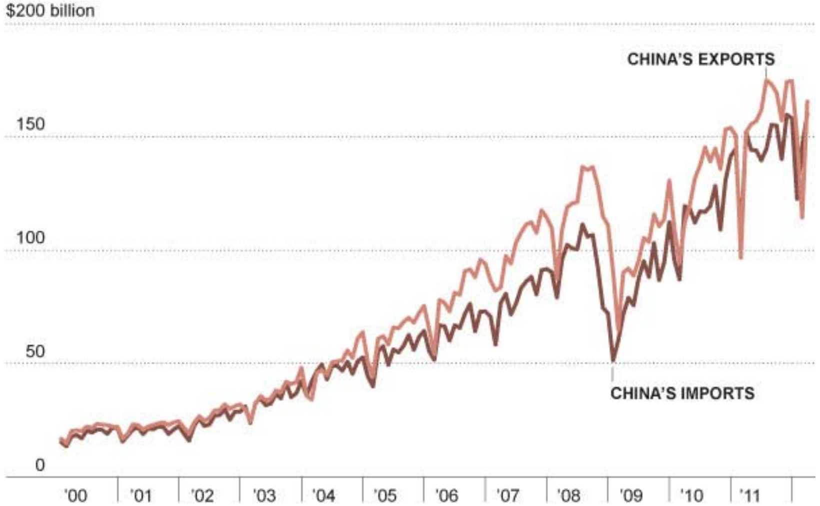
The China Effect

- International trade
- Global capital flows
- Global supply and demand for commodities and raw materials
- Generating global growth

Percent of global exports by country, 1980-2013



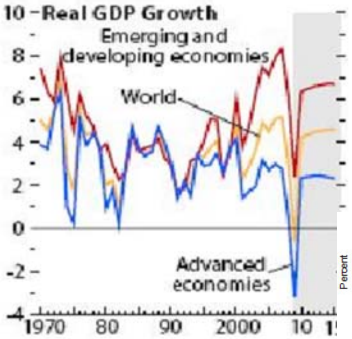
Source: IMF Direction of Trade Database; World Trade Organization

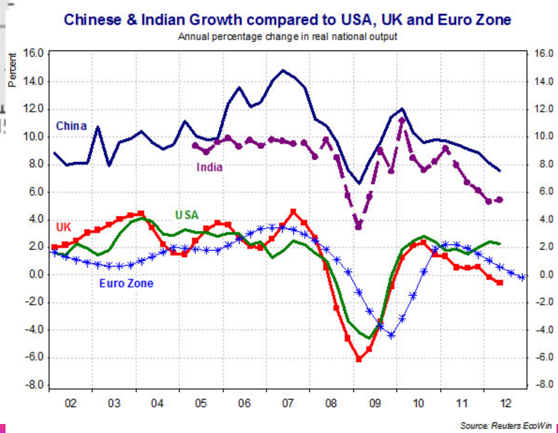


Source: CEIC Data

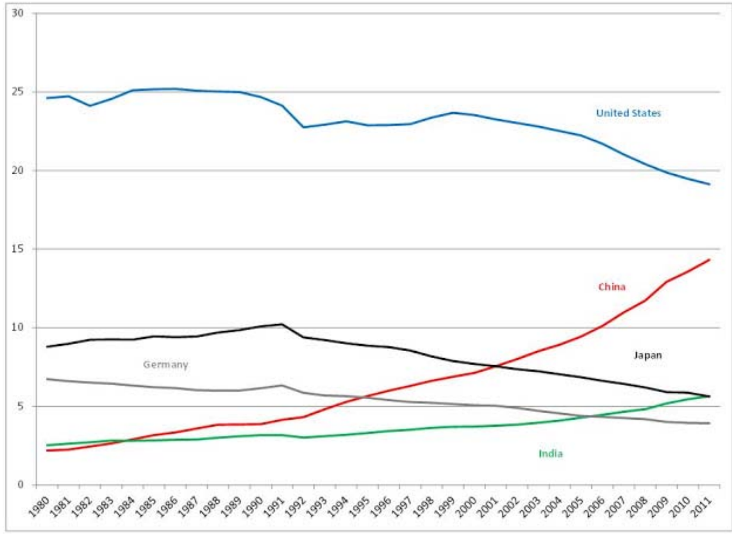
China and the Financial Crisis

- Indirect role via –
  - Globalisation: inflation and the 'Great Moderation'
  - Global imbalances: savings glut vs. consumption via borrowing; trade surplus vs. trade deficit
  - Foreign exchange reserve accumulation and the appetite for US debt
  - Exchange rate policy and global re-balancing



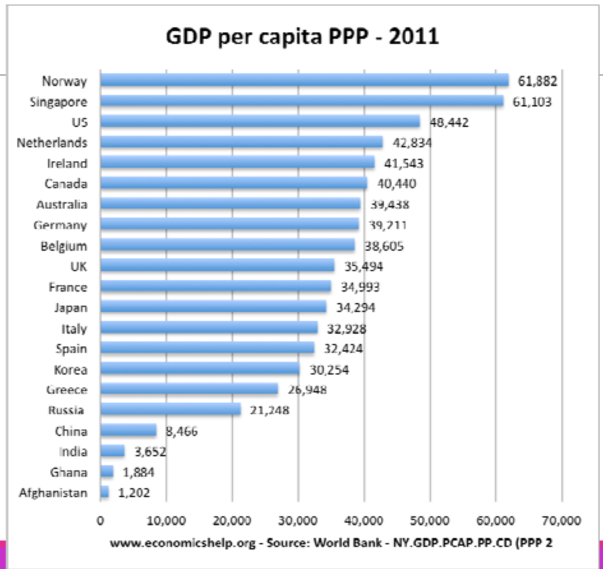


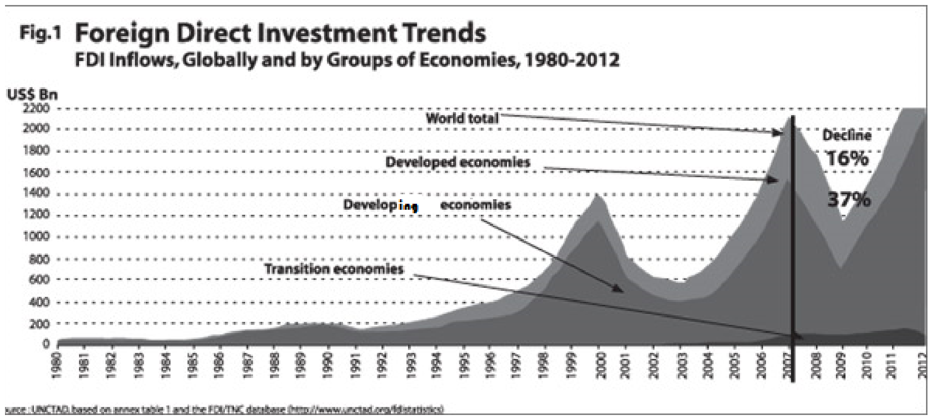
Countries Share of Global GDP, PPP, 1980-2011



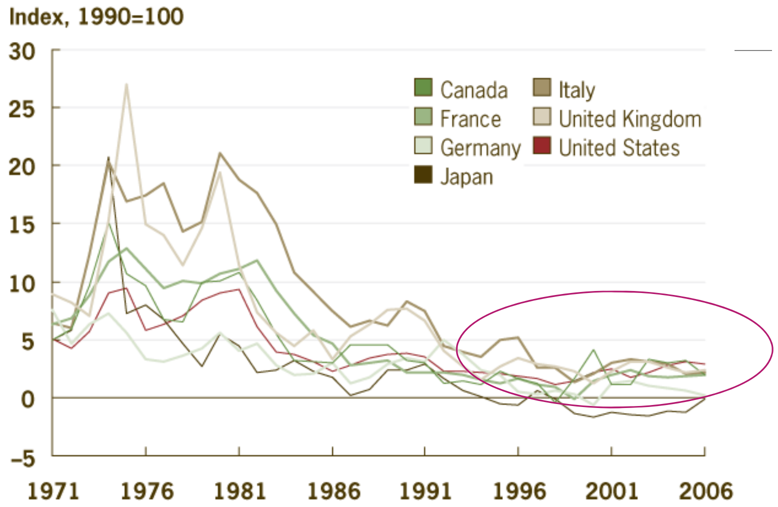
Source: IMF (2012) *World Economic Outlook* Database

But… GDP per capita remains low in China

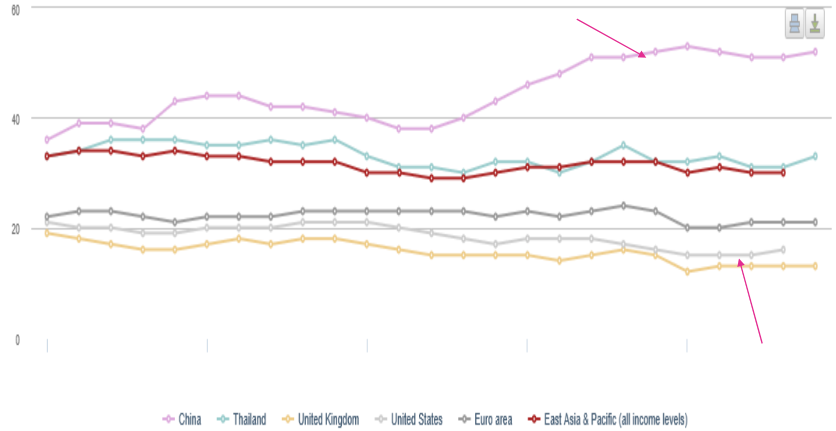




Low inflation during the Great Moderation

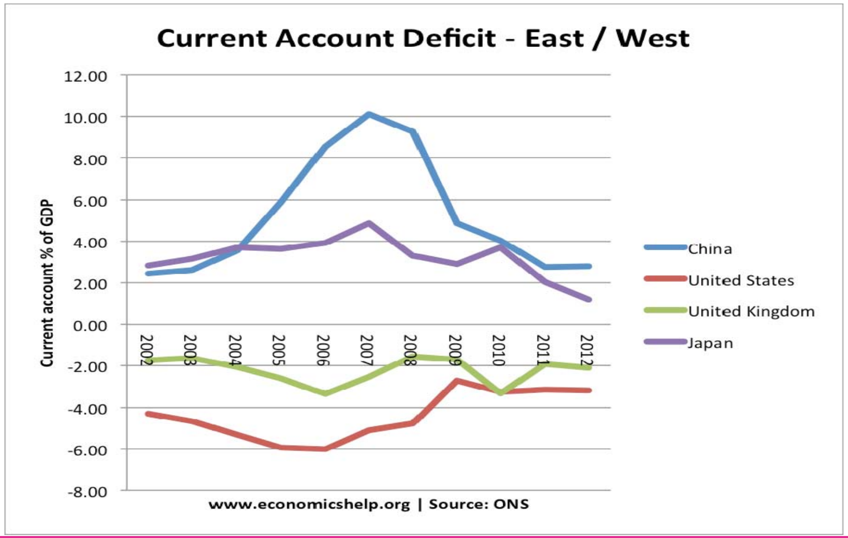


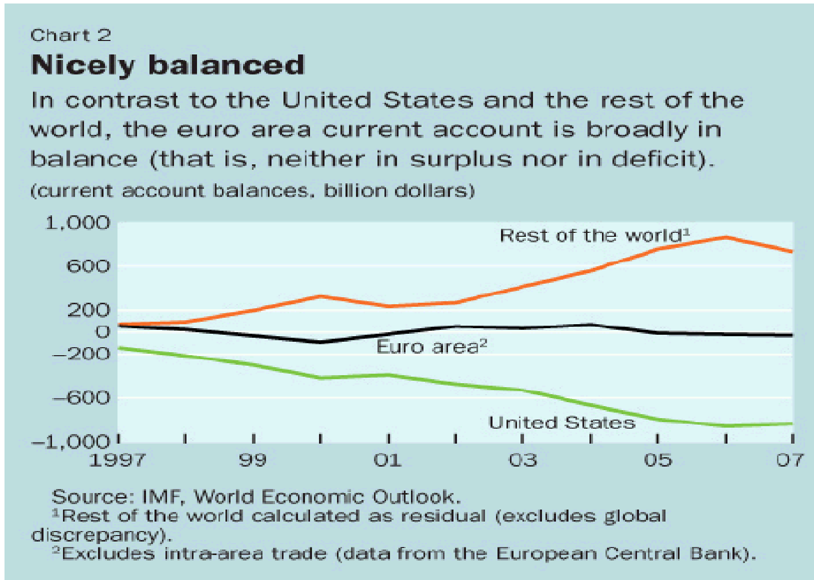
Gross domestic saving, % of GDP



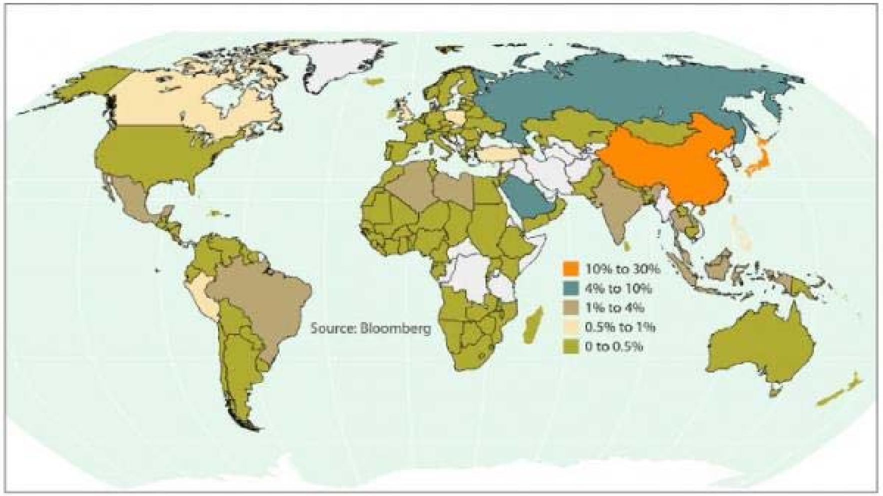
Source: World Development Indicators

Current account balance, % of GDP





FX Reserves as Share of Total



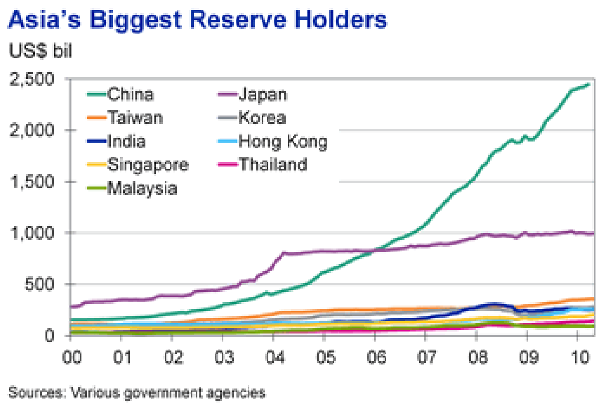
Foreign Reserves (Asia overall)

Over-spending in the US had led East Asian countries to run current account surpluses. That is, upon more and more exports, the region is forced to acquire more and more dollar assets in order to avoid exchange rate appreciation and deflation. (McKinnon, 2003)

- It was seen that low exchange rates would keep export demand up.
- Moreover, governments may wish to have larger reserves to defend their currencies from being attacked.

As a result of such regimes, industries were able to compete with the world and attract FDI.

But… the amount of reserves appears to be higher than what is needed.



- Asia holds the biggest proportion of the world's foreign reserves, and they have surged in recent years.
- Asia's nine biggest reserve holders collectively hold around US$5 trillion of the world's $8.4 trillion in foreign reserves. China holds the most and accounts for most of the growth in reserves, but reserves have also grown from a low base in other countries.
- Moreover, these official reserves exclude those held by sovereign wealth funds and, in the case of China, by state banks and companies.

Costs of Foreign Reserves

Estimates of the opportunity costs of having high foreign reserves was around 0.3-1.0% of GDP for China, Indonesia, S. Korea, Malaysia, Philippines and Thailand.

First rationale for accumulating foreign reserves

- *Safety (Precautionary Motive)*. After the 1997 financial crisis, Asia began building substantial foreign reserves as an insurance policy, and despite Asia's rapid development and improved regulation and economic policy since then, reserves are still helpful in times of market uncertainty.
  - South Korea used a quarter of its reserves in 2008 to supply liquidity to firms that had borrowed in dollars and needed to roll over loans.
- Although Asian foreign reserve funds began shifting away from the dollar and towards the euro around 2003, dollar holdings remain the biggest portion for most countries.
  - An estimated 70% of China's reserves are dollar-denominated. Despite their desire to diversify away from the dollar and Europe's debt problems, Asia's foreign exchange managers have few options that could accommodate the large amount of reserves their policies generate.

First rationale for accumulating foreign reserves

Precautionary Motive (cont.)

- However, the level of reserve accumulation in some of the Asian countries may have become higher than the conventional level based on economic size, level of imports, export volatility and exchange rate flexbility.
- According to the general "rule of thumb", it should be approximately 3-6 months of imports.

Ratios of Foreign Exchange Reserves in Selected Countries

Country	2004/1996 (Times)	Cover Ratio of Import[1] (Months)	Short-term debts/Foreign Reserves[2]
China	5.7	12.1	5.6
India	6.3	11.0	20.9
South Korea	5.9	8.9	2.6
Thailand	1.3	5.9	3.8
Malaysia	2.5	6.7	5.0

- China, India, S. Korea's cover ratio of import seems to be above the conventional level.
- Countries where service sector is strong as China and India tend to have current account surplus supported by service trade surplus.

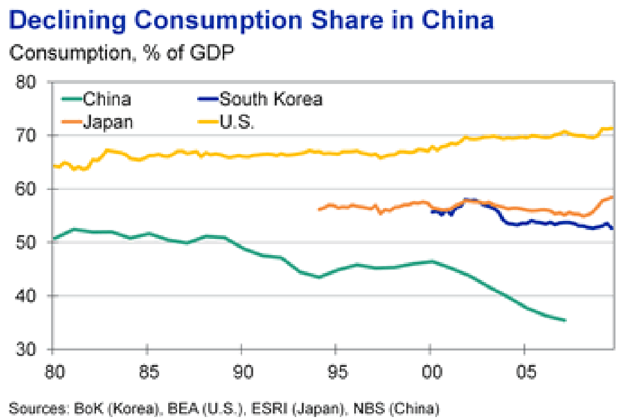
What to do with Reserves?

- Slower accumulation of foreign reserves would be a positive development for the world economy.
  - A sustainable global recovery is likely to require stronger Asian currencies and weaker currencies in the developed world, which would raise net exports in the U.S. and Europe and cool inflation pressures in Asia. (Refer to the open macro-economy framework in the previous lecture.)

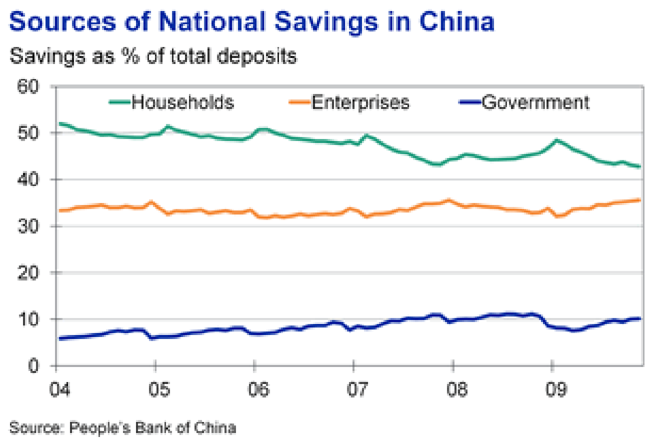
Second rationale for accumulating foreign reserves

- Clearly, countries have a second reason for the buildup: keeping their currencies stable to promote exports.

- China's Ministry of Commerce has been resisting pressure to let the yuan appreciate, citing studies that many exporters would become unprofitable if the yuan were to rise just 1% against the dollar.
- Yet, this claim is at odds with the rising share of overall corporate profits in the economy, which has risen at the expense of household incomes.
- Weaker household income growth has hurt consumption. China's savings have been driven by corporates, not households. This is a key issue that needs to be addressed if China is to switch its growth driver from exports to domestic demand.



Declining consumption share in China reflects weaker household income.



China's savings have been driven mainly by corporates, not by households.

Possible policy options for China

- One solution would be to first slow the gains in reserves and invest domestically. This would mean tolerating currency appreciation, which would dampen net exports but need not mean a slowdown in economic growth if accompanied by increased investment and measures to boost consumption.

- Despite the existing investment, China is still a developing economy, with GDP per capita around US$4,000. Therefore, increased capital investment will make the labour force much more productive.

- Much of the past investment has been wasted (due to inefficiency in capital investment determined by the nonmarket-based methods). Hence, moving the banking system towards a market-based lending and investment regime would reduce the number of non-performing loans (NPLs) and allow a greater level of investment.

Possible policy options for China

- On the other side of the coin, boosting consumption would lower savings and provide room for the currency to appreciate.

- In China's case, many structural factors favour investment over consumption, essentially subsidizing corporations at the expense of households.
  - For instance, low deposit and lending rates penalize households and reward borrowers, typically state enterprises.
  - The cheap currency makes exports competitive but raises the cost of imports, lowering real wages.
  - The government helps favoured companies and industries and keeps the price of energy low, but spends little on social services.

- Reversing these policies would lower corporate savings and help shift the economy towards a consumption-driven model.
  - For instance, if profitable state enterprises were compelled to pay dividends rather than save their income, the government could use the funds for welfare payments.

Sources of Foreign Reserves

Aside from the impacts of exports and imports, capital account also imposes an impact on the country's foreign exchange market.

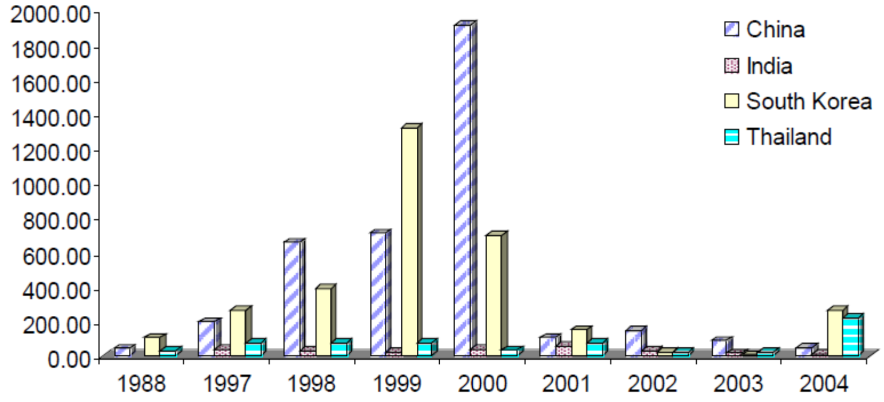
The two major components of the capital (financial) flows are:
- Equity investment (FDI & portfolio) – The trends have been increasing, particularly for the case of China and India in recent years. On the other hand, the trend show that S. Korea, Malaysia had declined.
- Commercial banks flows.

Net Equity Investment (FDI and Portfolio Investment) (Million $US)

Country	Cumulative Flows (1993-1996)	Share of Total Flows (%)	Cumulative Flows (2000-2003)	Share of Total Flows (%)
China	132,753	47	187,600	71
India	19,707	7	30,779	12
South Korea	58,745	21	13,546	5
Thailand	10,186	4	10,473	4
Malaysia	29,243	10	4,358	2
Total[1]	281,173	100	265,530	100

- Aside from current account surplus, these countries experience net capital inflows.

Net FDI Contribution to Financial Capital Account (%)



Sources of Foreign Reserves

By the early 2000s, there had been an increase in FDI flows to Thailand and S. Korea, which contributes to the overall foreign exchange market.

However, the sharp rise in net portfolio into countries like China, India and S. Korea had greater effect on the foreign exchange market.

Portfolio capital inflows had been persuaded by the equity market boom in the region (see the growth rate of share price index) as well as expected exchange rate appreciation in some countries – see graphs on exchange rates.

The portfolio flows in India had been 1.7% of GDP, exceeding the flow of FDI (about 0.8% of GDP) in 2003.

The same trend is observed in China that FDI about 3.5% plays major part in equity investment.

Sources of Foreign Reserves

The other component of capital account, the commercial bank flows also needs consideration.

This has different nature from equity investment.

We learn from crisis that contagious withdrawal of capital from the region caused immediate break of capital inflows – liquidity constraint. – see graph on net commercial bank flows.

Sources of Foreign Reserves

From figure, S. Korea, one of the countries badly hit by the crisis still experience net total commercial bank outflow in recent years, whereas China and India experience net inflows.

By decomposing the components of capital account, it can be observed that the degree of volatility of capital account would depend on the types of flows each country is experiencing. FDI tends to be least volatile; portfolio and bank flows are more fragile.

The volatility and actual magnitude are affected by <u>capital controls</u> that each country adopts. We will examine the case of China.

Adding up to a crisis

- Inflation targeting regimes in developed economies: not focused on asset bubbles.
- Fixed exchange rate regimes prevented automatic re-balancing as purchasing of US Treasuries continued regardless of the yields.

The 2008 global financial crisis

- 1980s financial deregulation; 1990s globalization; 2000s global imbalances
- Dot.com bubble -> sub-prime mortgages -> Credit crunch.
- Housing has much wider coverage than tech stocks & securitization spread the debt instruments throughout global markets.

Effect of global financial crisis on China

- Financial effects: contagion
- Real economy effect: de-coupling

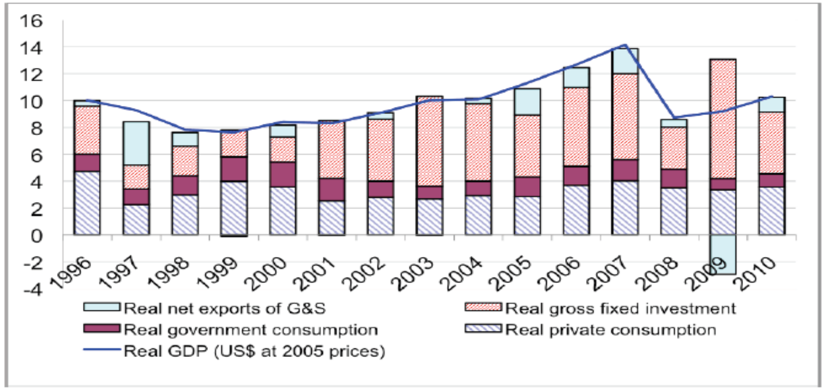
Financial sector effects: contagion

- Some state-owned commercial banks have write-downs, but of limited magnitude.
- No comparable trade in securitized assets, so limited exposure to the financial crisis.
- Despite limited global integration, China's stock markets have fallen dramatically since October 2007 but 2009 risen over 80% since January, followed by a 20% drop in August.
- Reflects concerns/optimism about the real economy.

Real economy effects: de-coupling

- Exports have collapsed, resulting in 20 million unemployed migrant workers.
- Unemployment, as a result, is rising, though not captured by official figures which is expected to rise to 4.5%.
- Annual growth was 9% in 2008 and 7.1% in the first half of 2009, with fears of continued fall in exports dragging down growth but it will be offset by increased government spending?

Figure 3. Composition of GDP growth
(in percent)



Source: EIU CountryData.
Note: Shaded regions in each bar show the contributions (in percentage points) of each component to total GDP growth. 2010 data are EIU estimates.

Fiscal stimulus & public spending

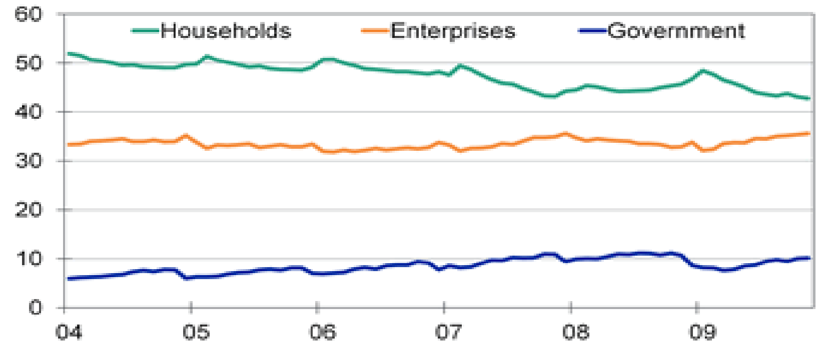
- 4 trillion RMB (US$586 billion) to be spent as a stimulus measure, plus another US$125 billion on health (to achieve universal coverage by 2020) and around US$400 million on rural pensions.
- 1.7 trillion in lending in first half of 2009 has led to growth of 7.1% but asset bubbles building in stock markets and real estate.
- Infrastructure is needed, but few measures to address corporate savings and little on other social welfare coverage, eg., pensions, unemployment.

Savings, jobs & institutional reform

- Opportunity to focus on reducing motives for precautionary savings and address social insecurities to increase consumption.
- Reforming capital markets to reduce corporate savings so that productive investments can take place and increase domestic demand. (refer to previous lecture)
- Public works (infrastructure) create jobs to absorb job losses and provide future benefits.
- Must do more to shore up institutional foundations of the market.

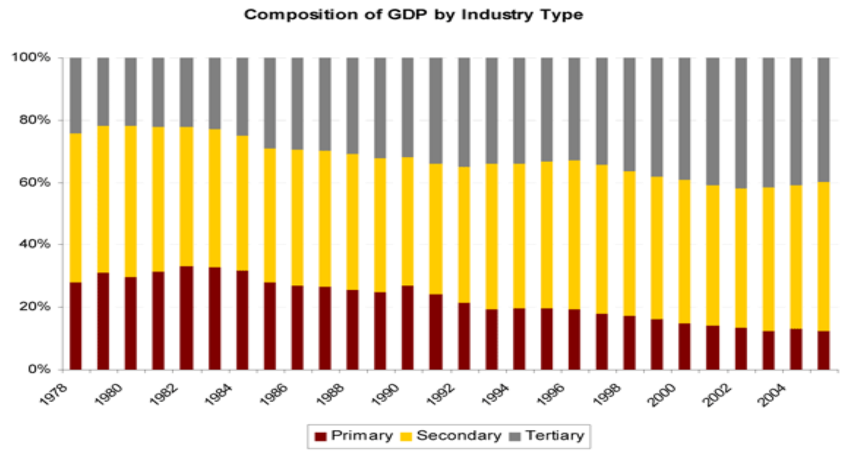
Sources of National Savings in China

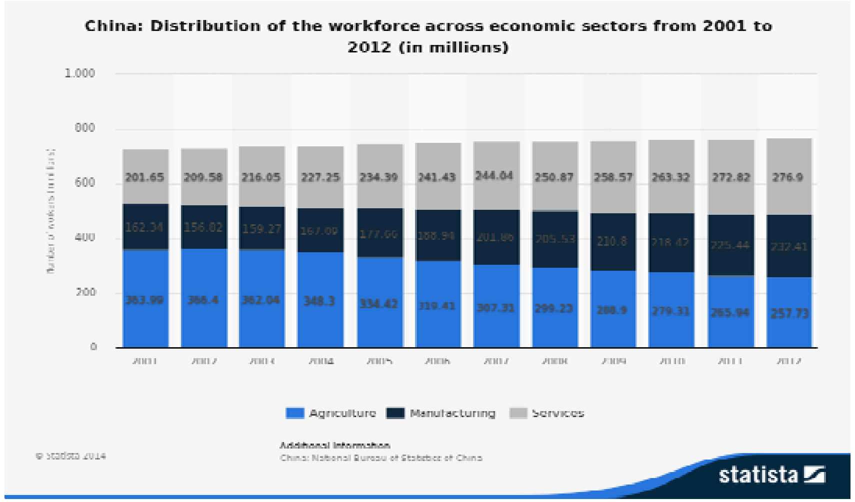
Savings as % of total deposits



Source: People's Bank of China

Re-industrialization & services





Internal reasons for global re-balancing

- Volatility in its own assets pint to the need for reform, eg., stock markets and housing.
- Participate in global regulatory reforms, including 'early warning' system against build up of macro imbalances.
- Allow global re-balancing to occur, but gradually whilst changing future of capital outflows ("going global" policy)

Implications for global imbalances

- Already some global imbalances:
  - China's exports (and imports) are down and the US trade position has improved.
  - US savings rate is up some four-fold and Chinese consumption is steady.
- Gradual re-balancing is preferable as Western economies issue record levels of debts and China may well continue its surplus.
- G20 agreement portends 'new world order'