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

Bhanupong

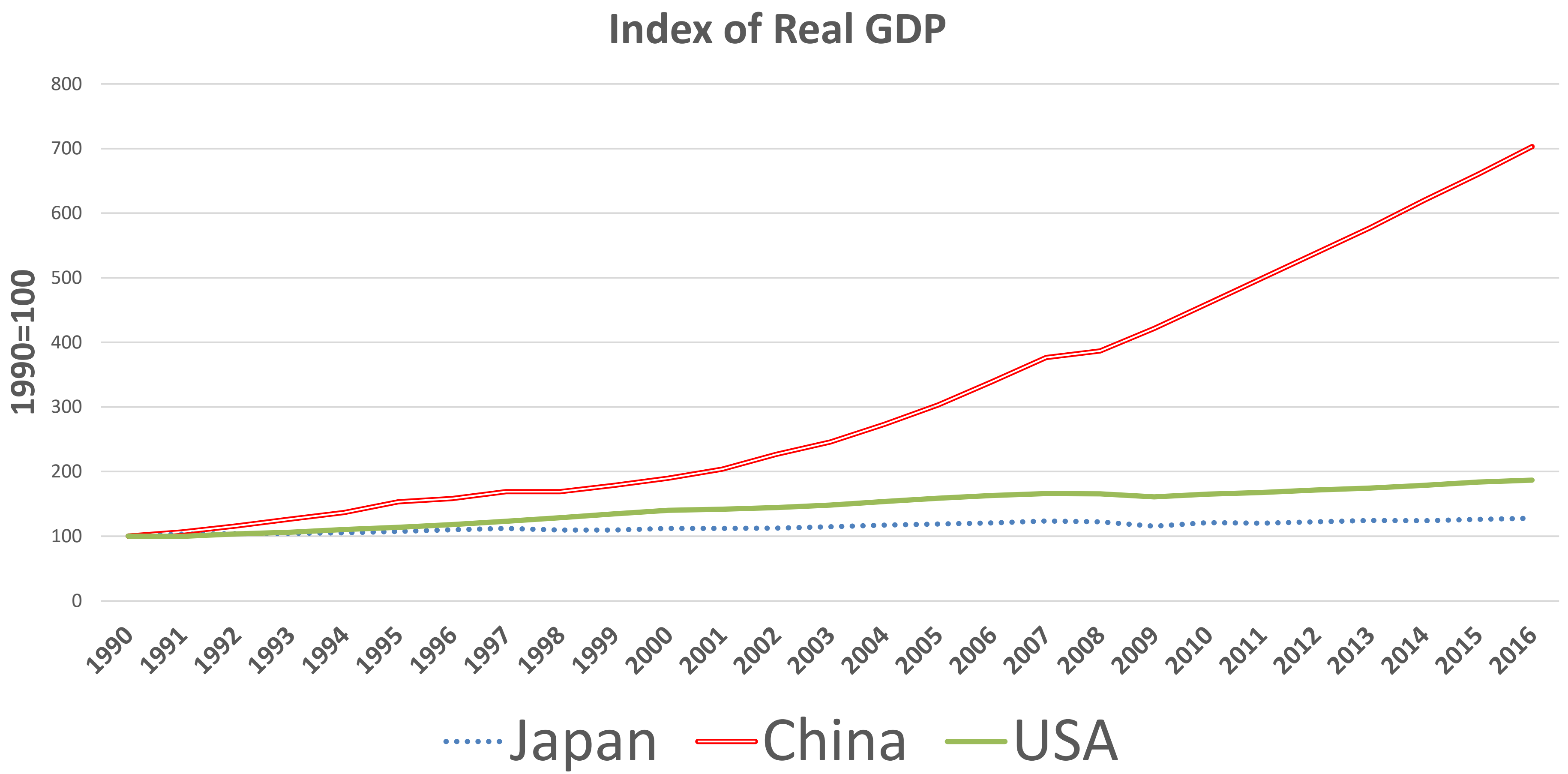
Lecture 21

How important is the China factor to the Thai economy?
What are adjustment mechanisms for external disequilibrium?
Are capital flows fickle?

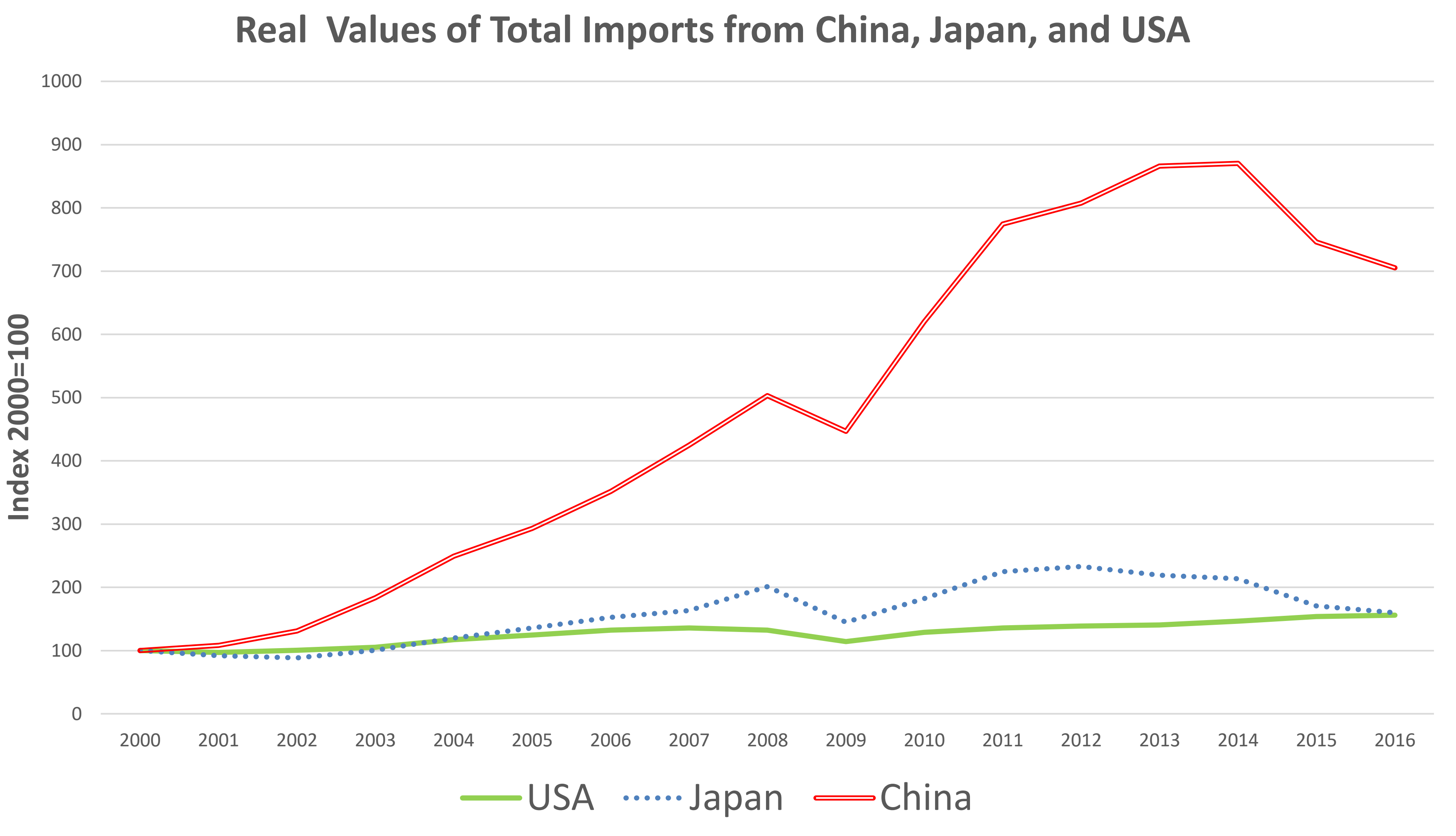
Main themes

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. Fickle capital flows

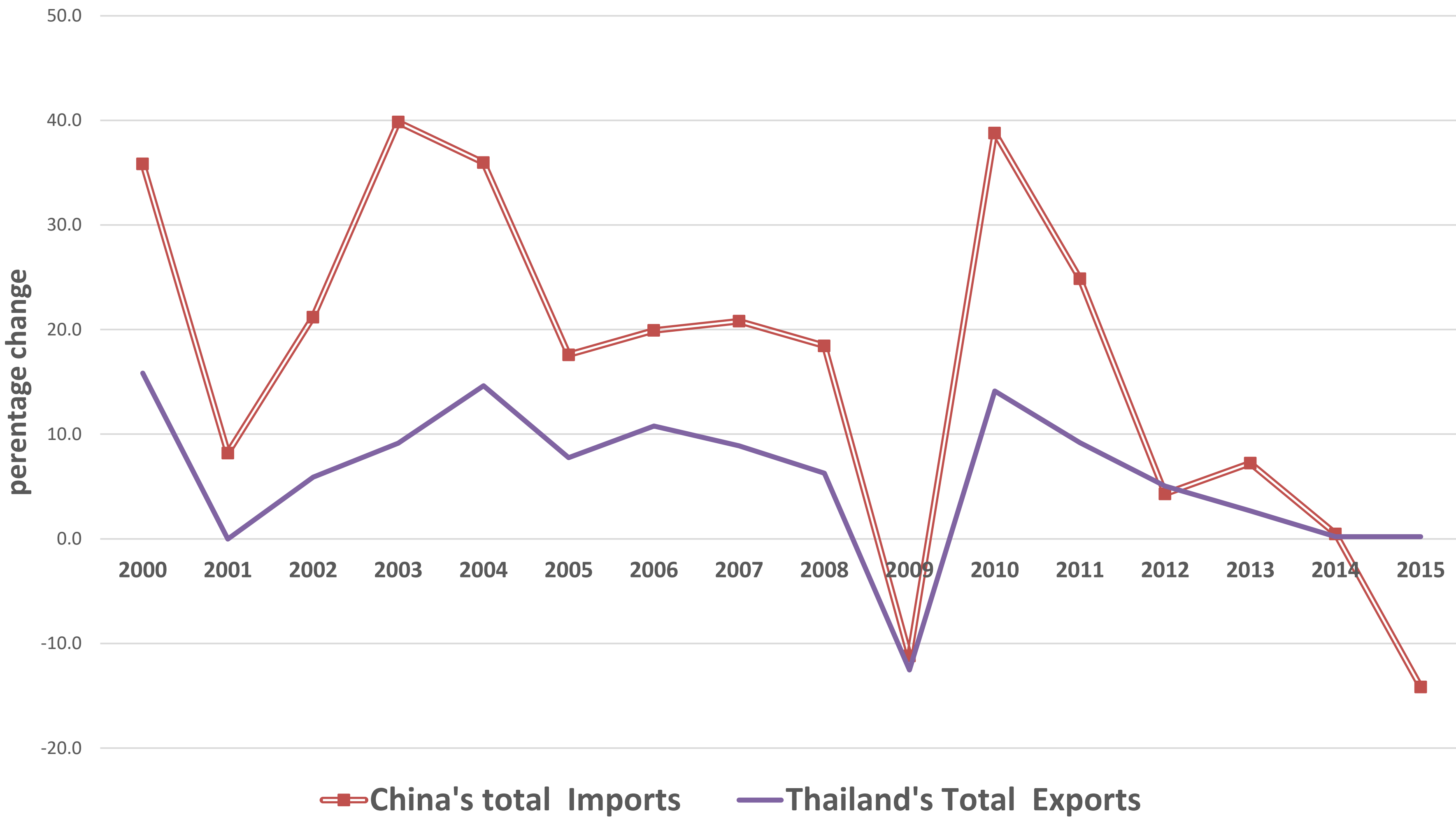
1. China Rising



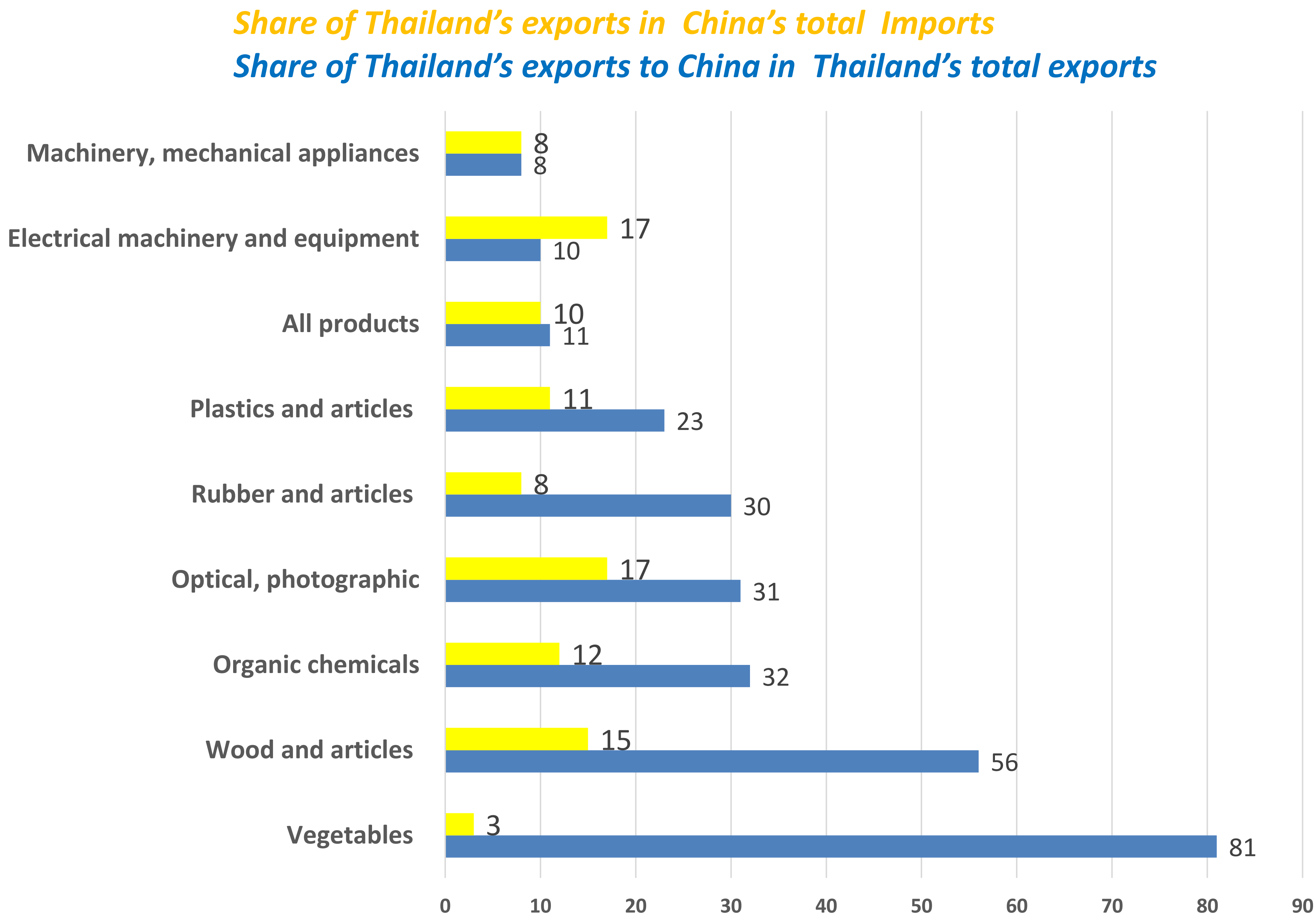
Imports from the three largest economies



China's influence on Thailand's exports

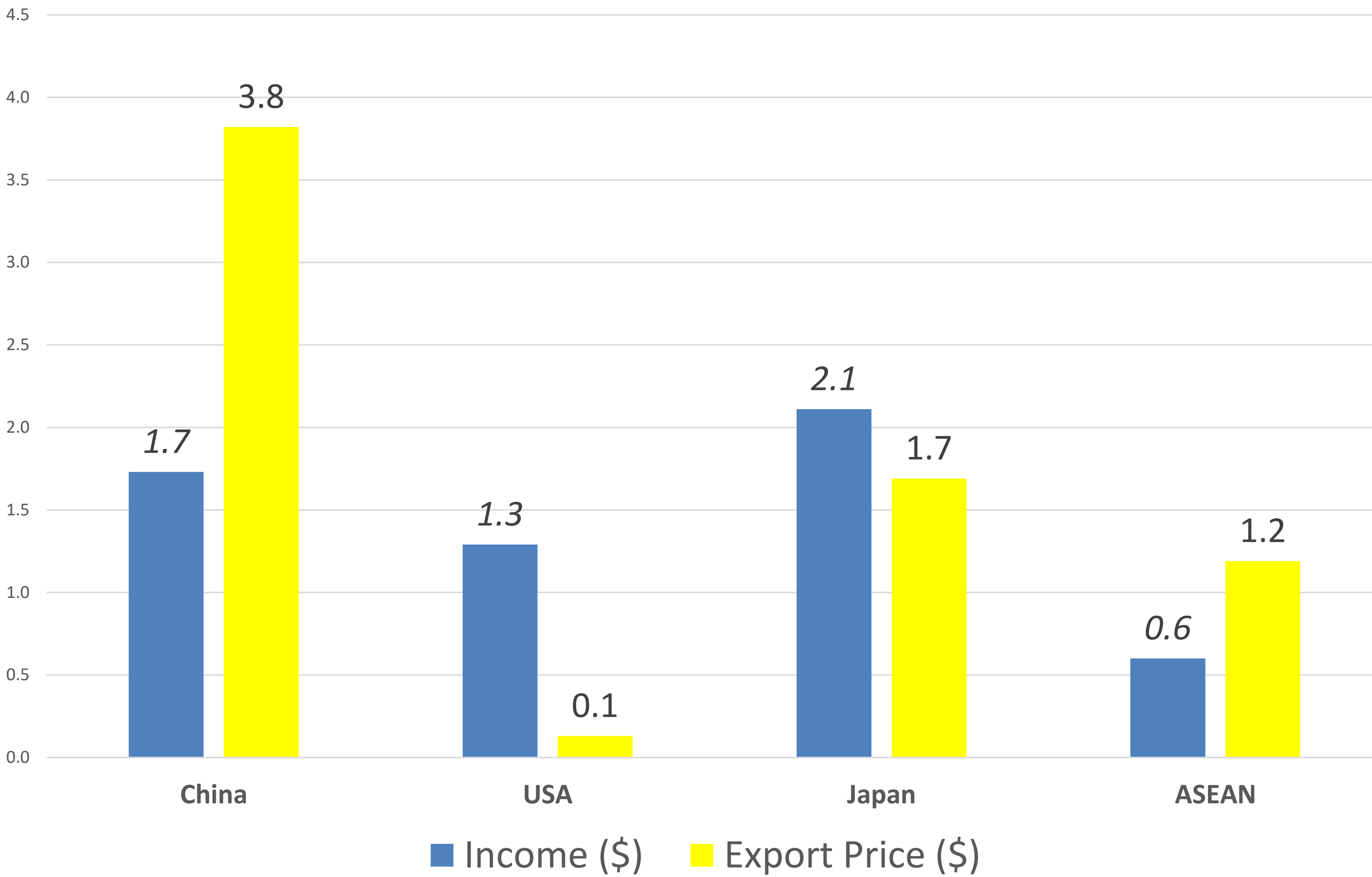


China's influence on Thailand's exports: 2016

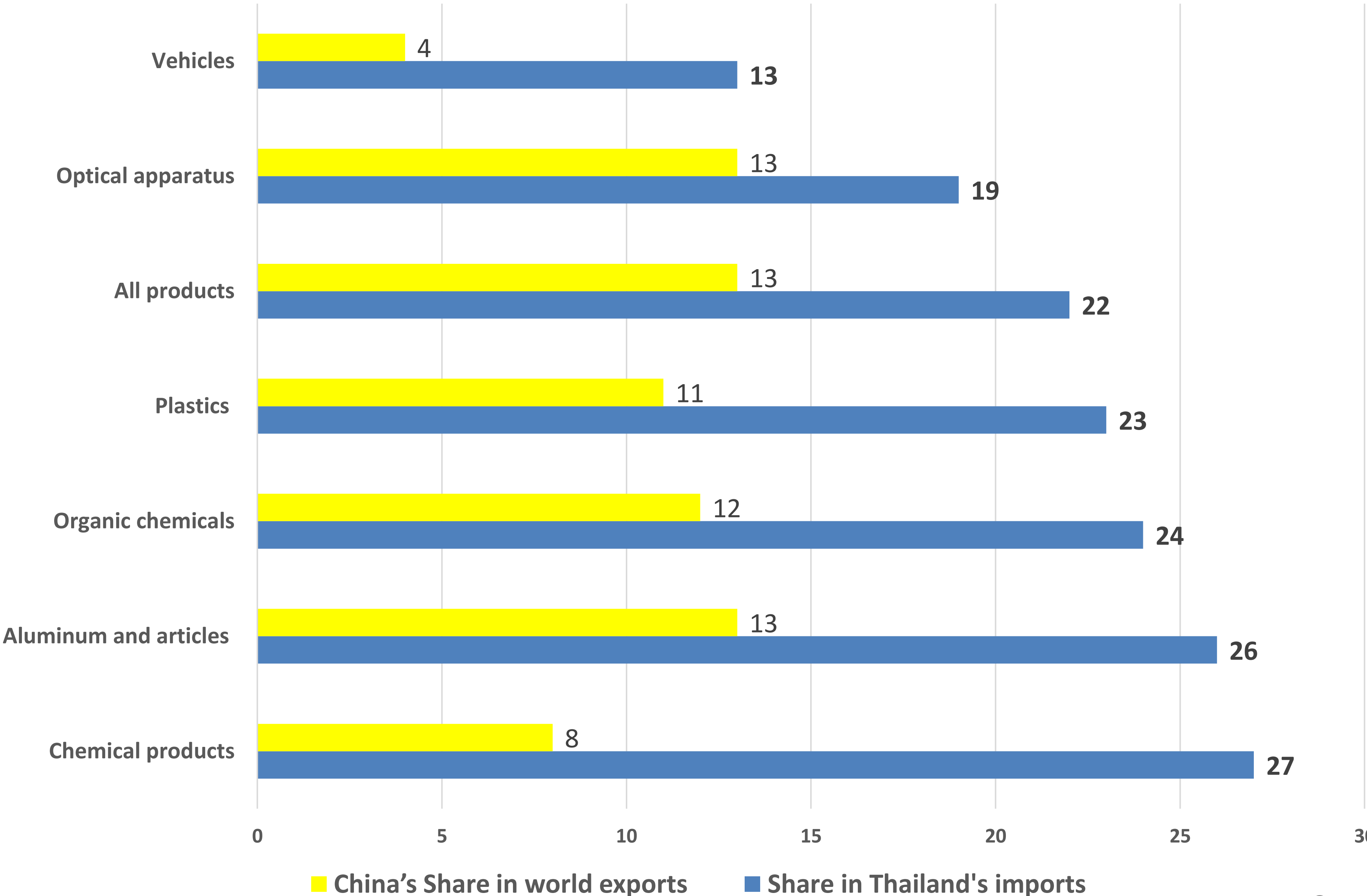


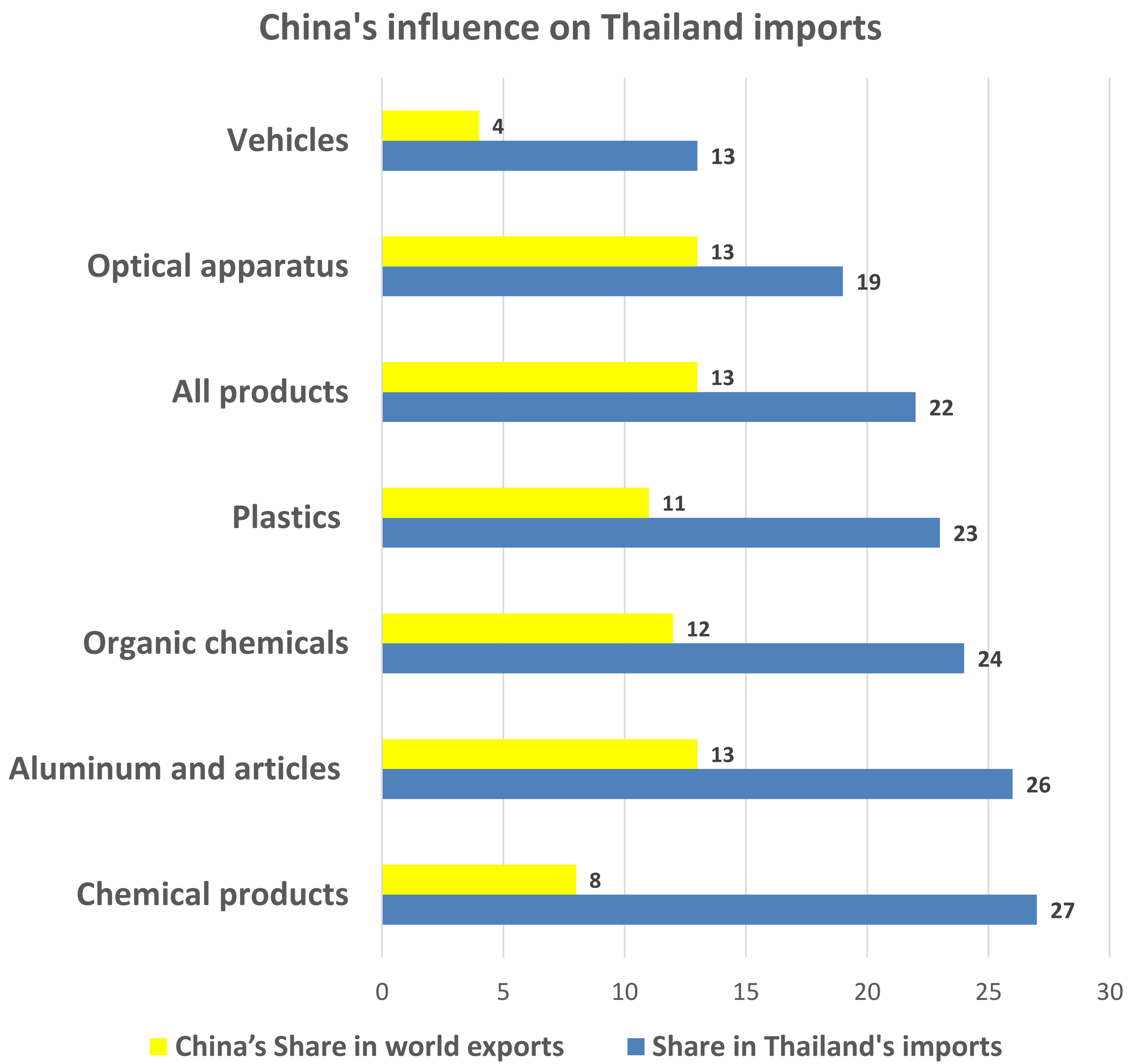
Thailand's ***exports value*** elasticities

Source: FMOLS (2003-2016)

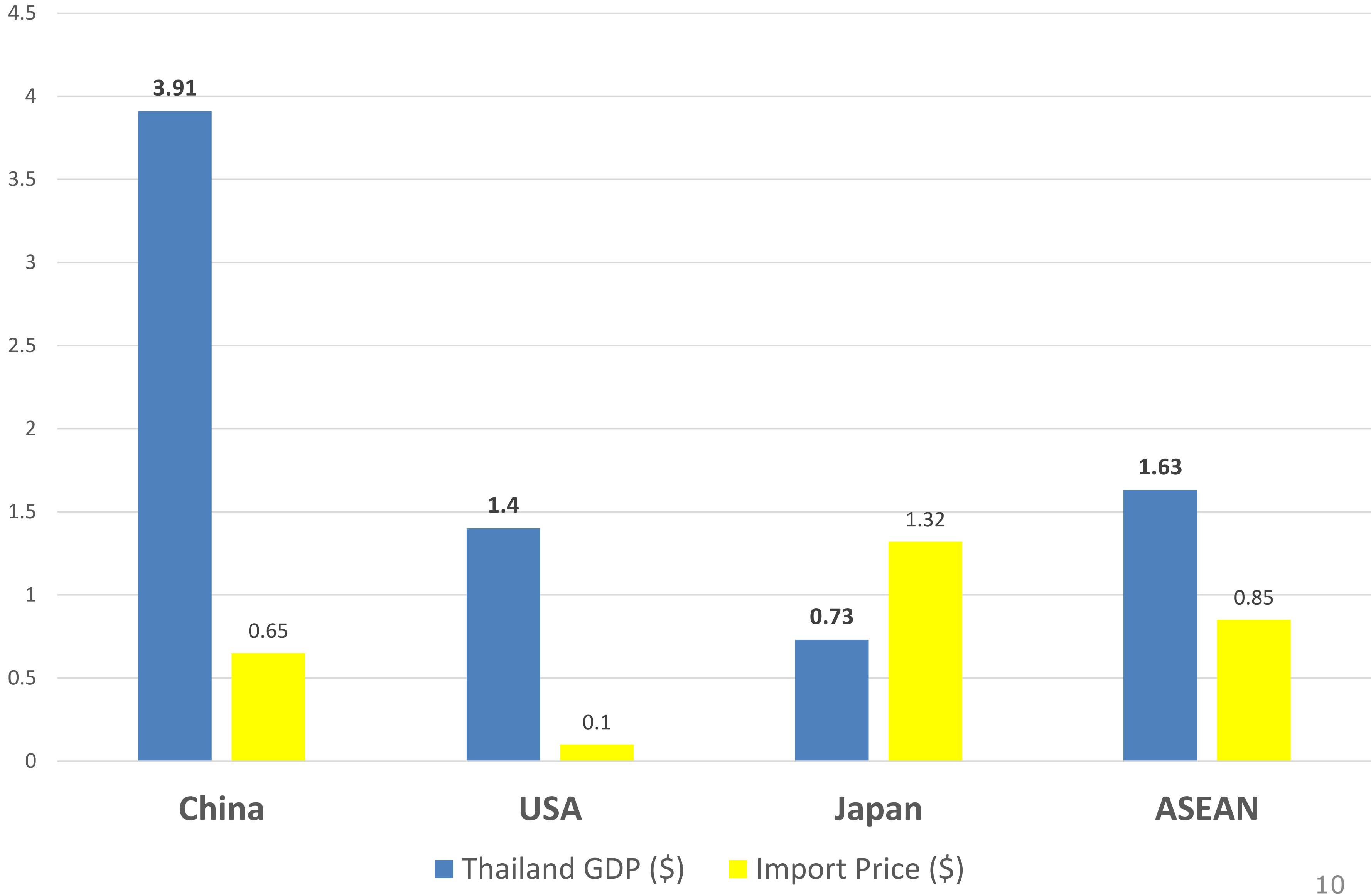


China's influence on Thailand's imports: 2016

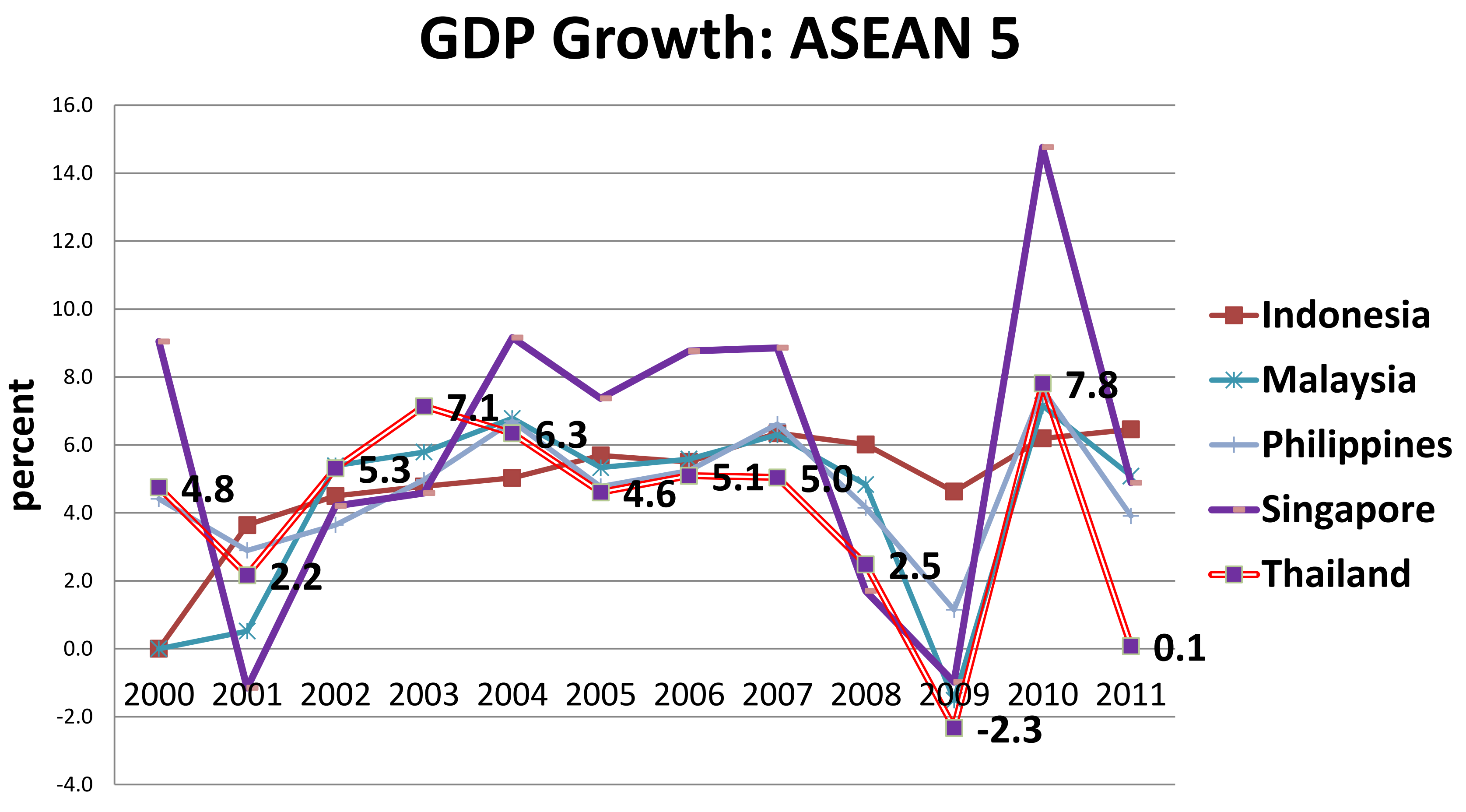



China's influence on Thailand imports
Vehicles
Optical apparatus
All products
Plastics
Organic chemicals
Aluminum and articles
Chemical products
4
13
13
19
13
22
11
23
12
24
13
26
8
27
0
5
10
15
20
25
30
China's Share in world exports
Share in Thailand's imports

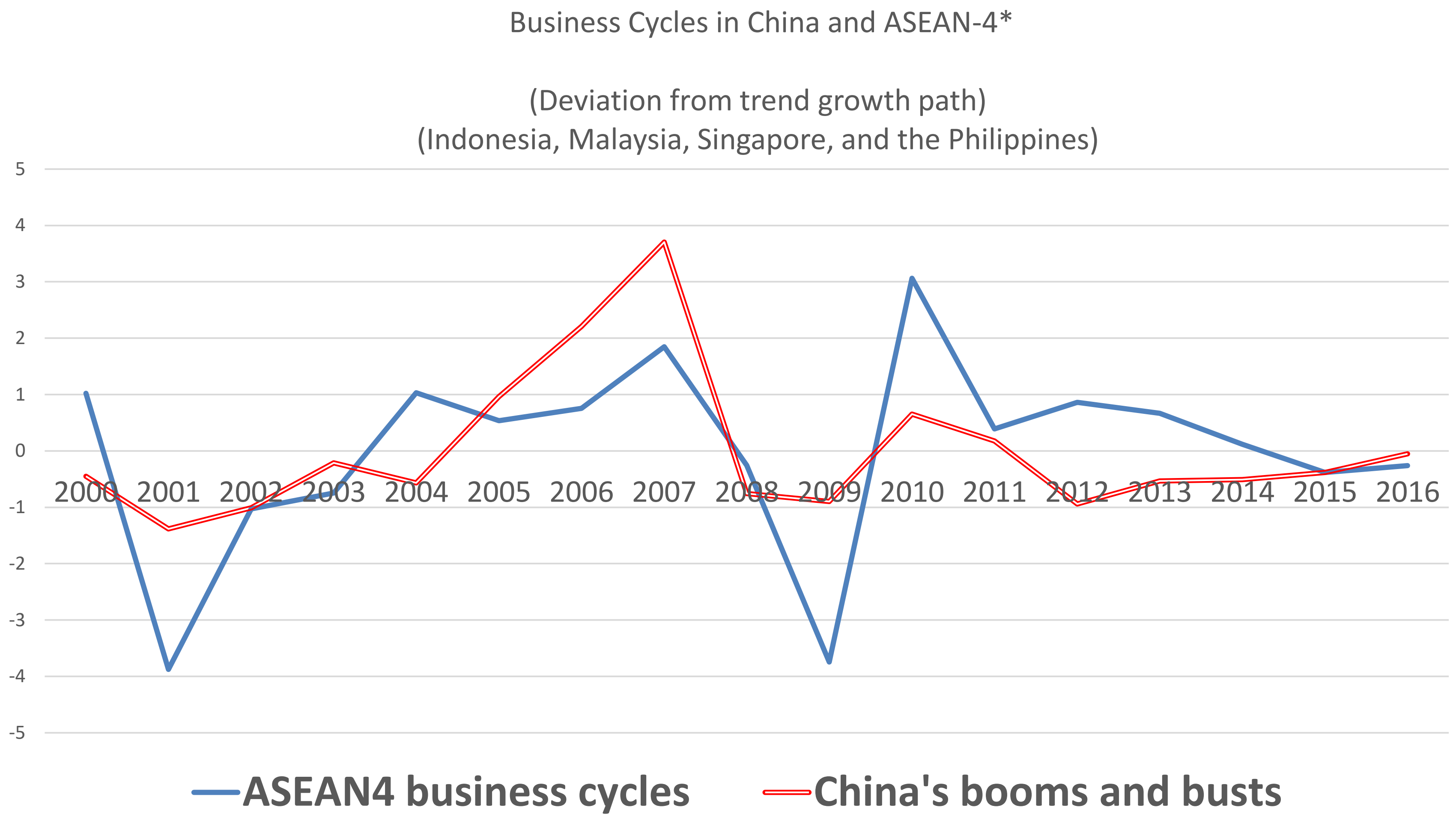
Thailand's ***import value elasticities***: 2002-2016
Source: FMOLS estimates



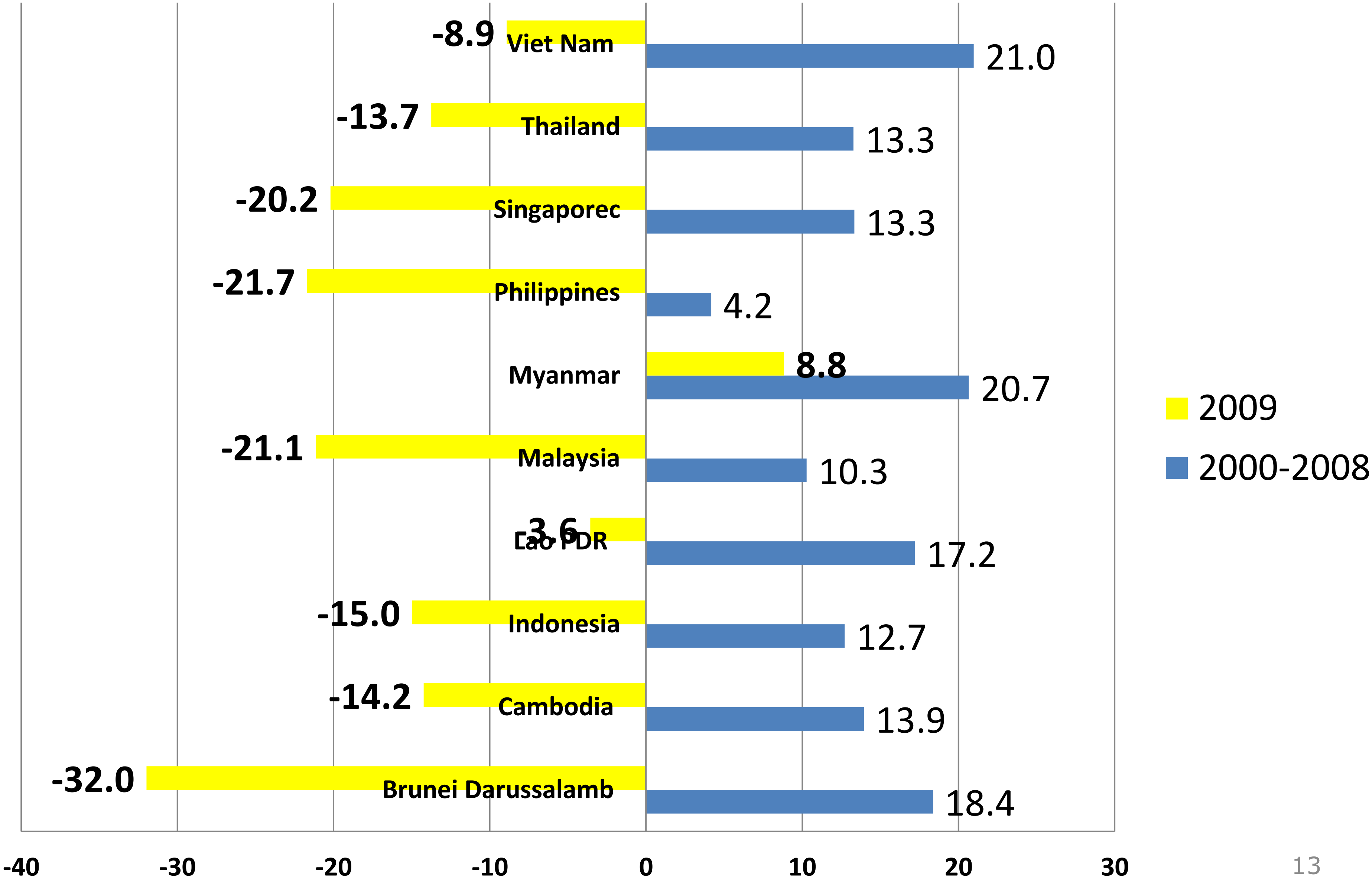
2. ASEAN Business Synchronization



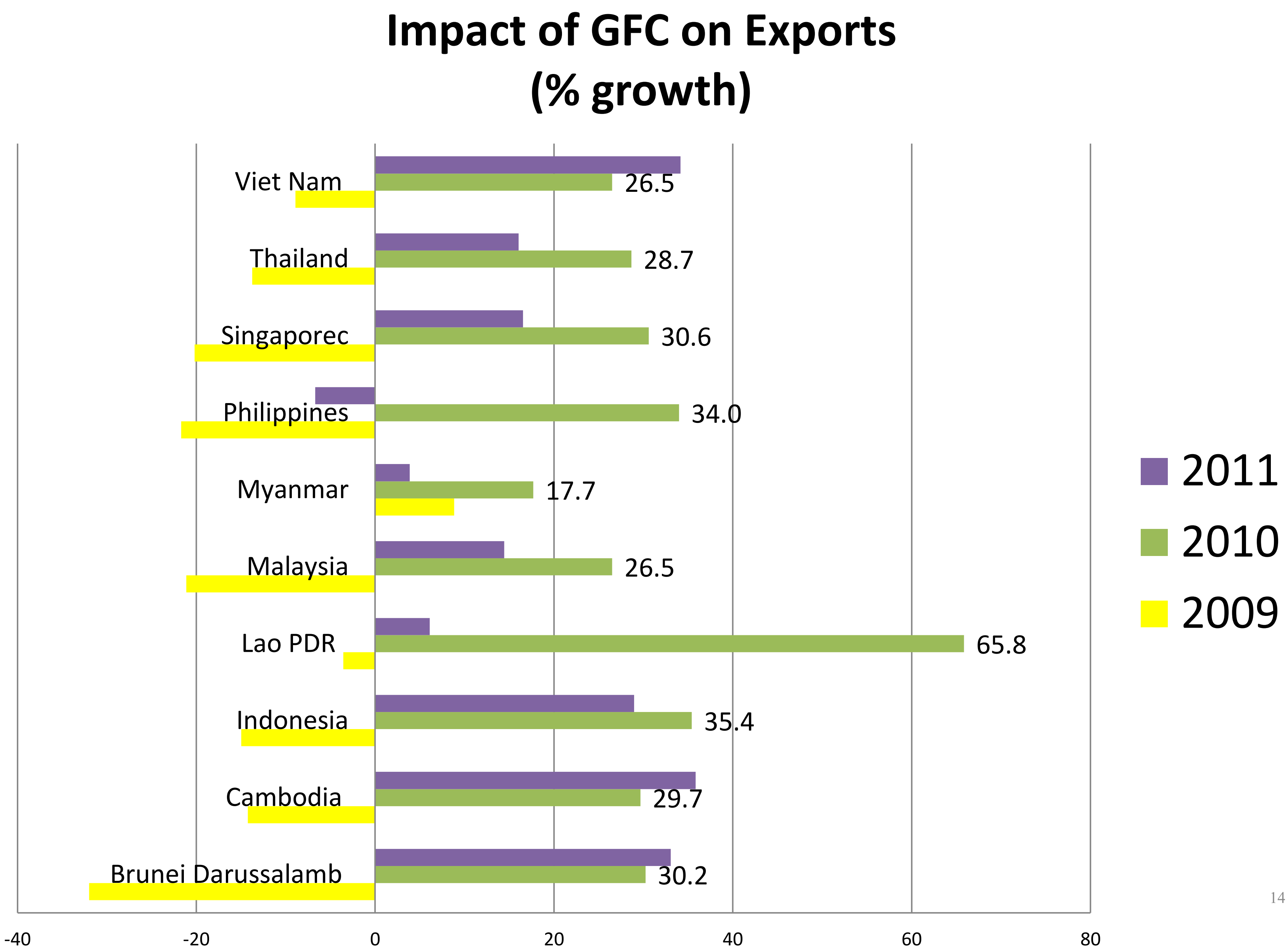
China and ASEAN-4 Business Cycle



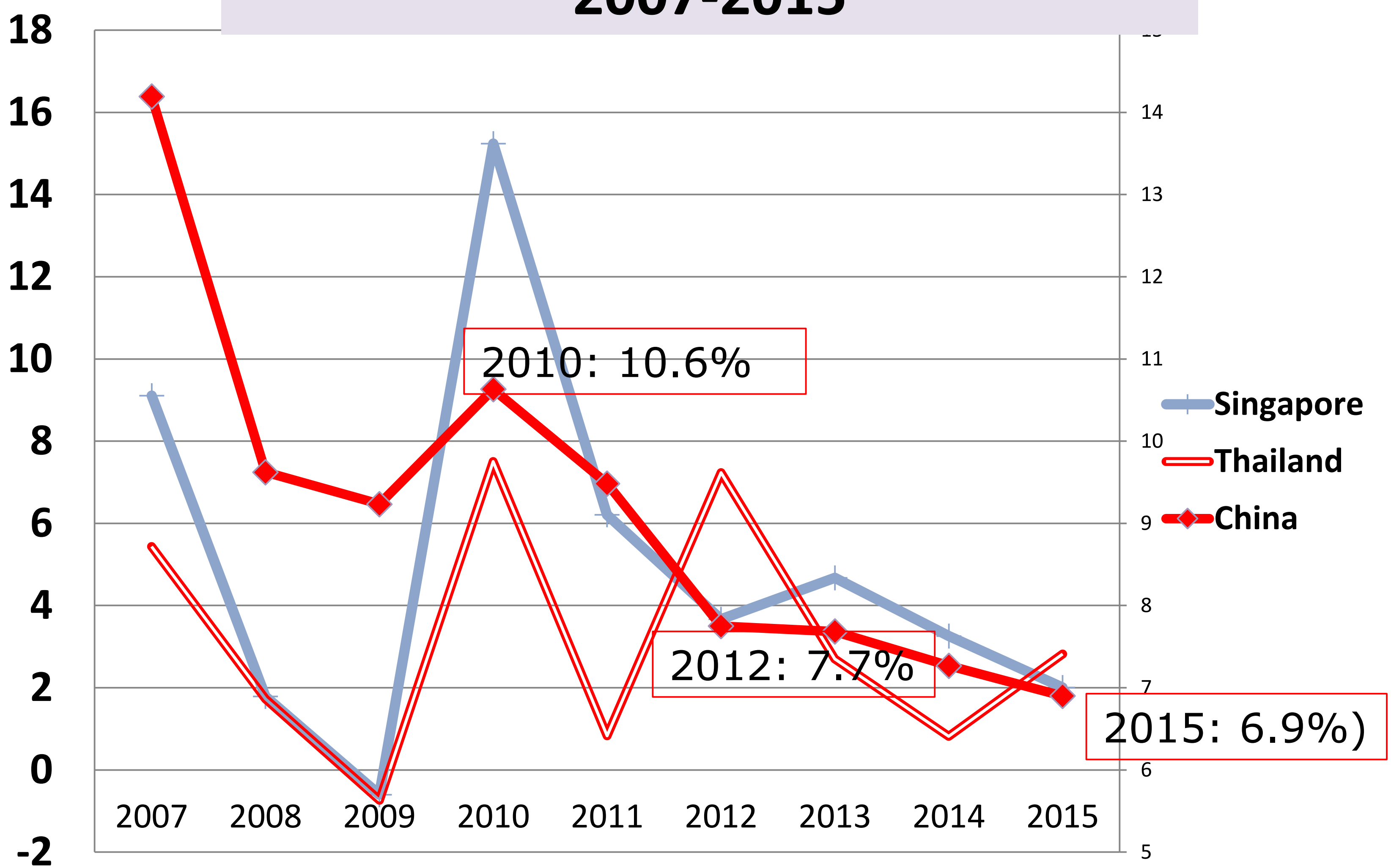
The 2009 GFC's impacts on ASEAN Exports (% change)



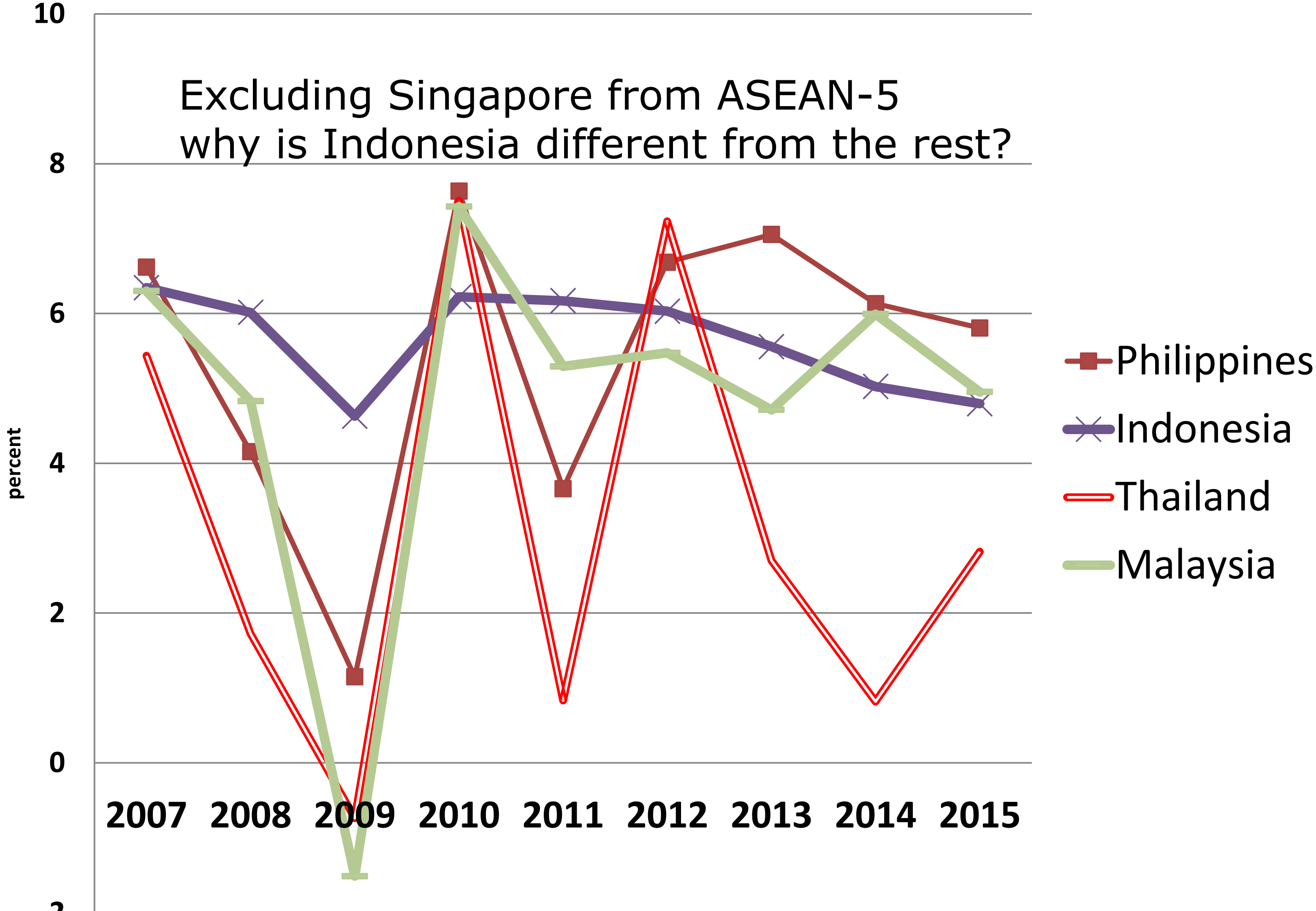
What did ASEAN Exports have in common after the GFC?



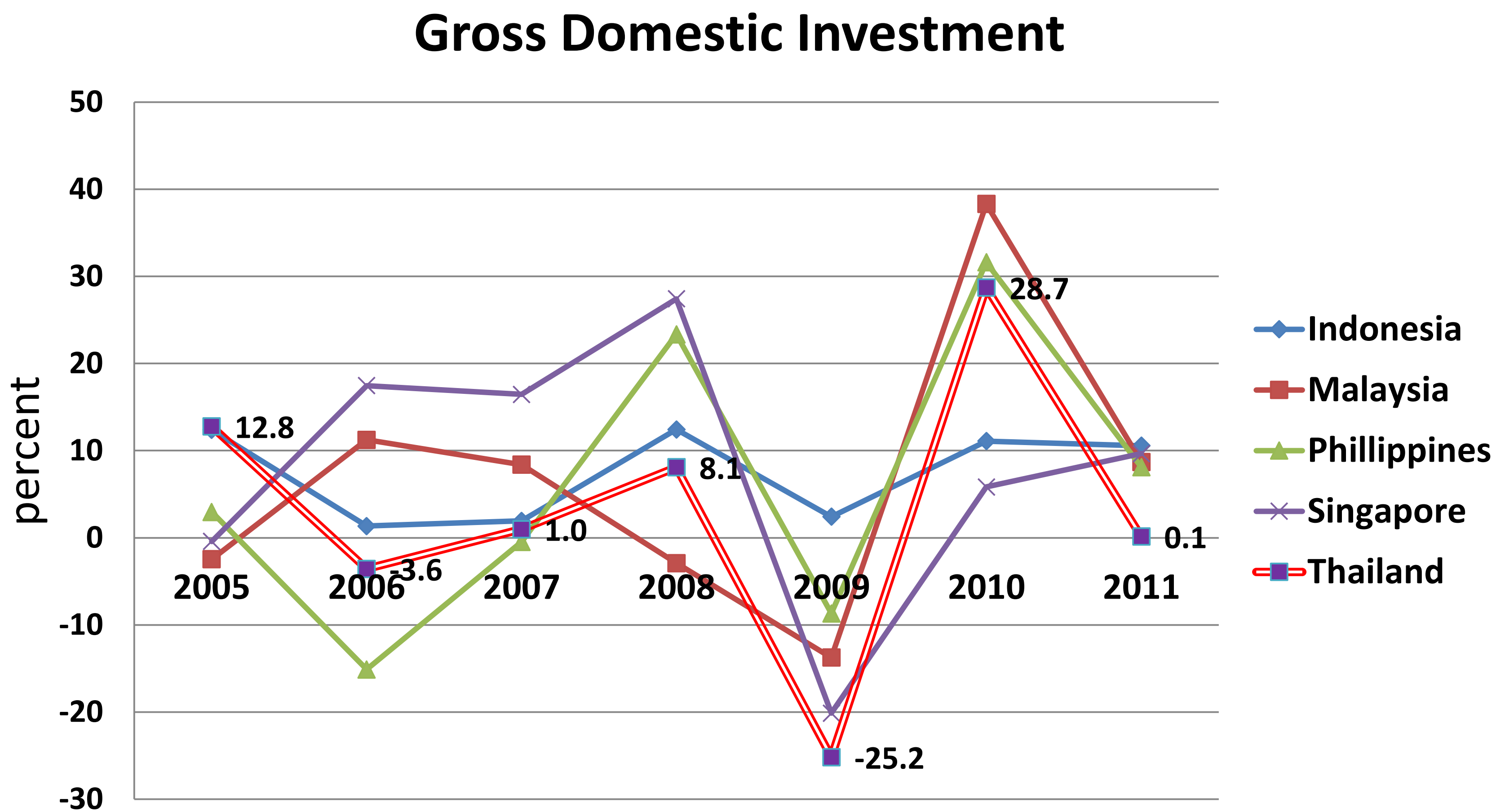
GDP growth in China, Singapore, and Thailand 2007-2015



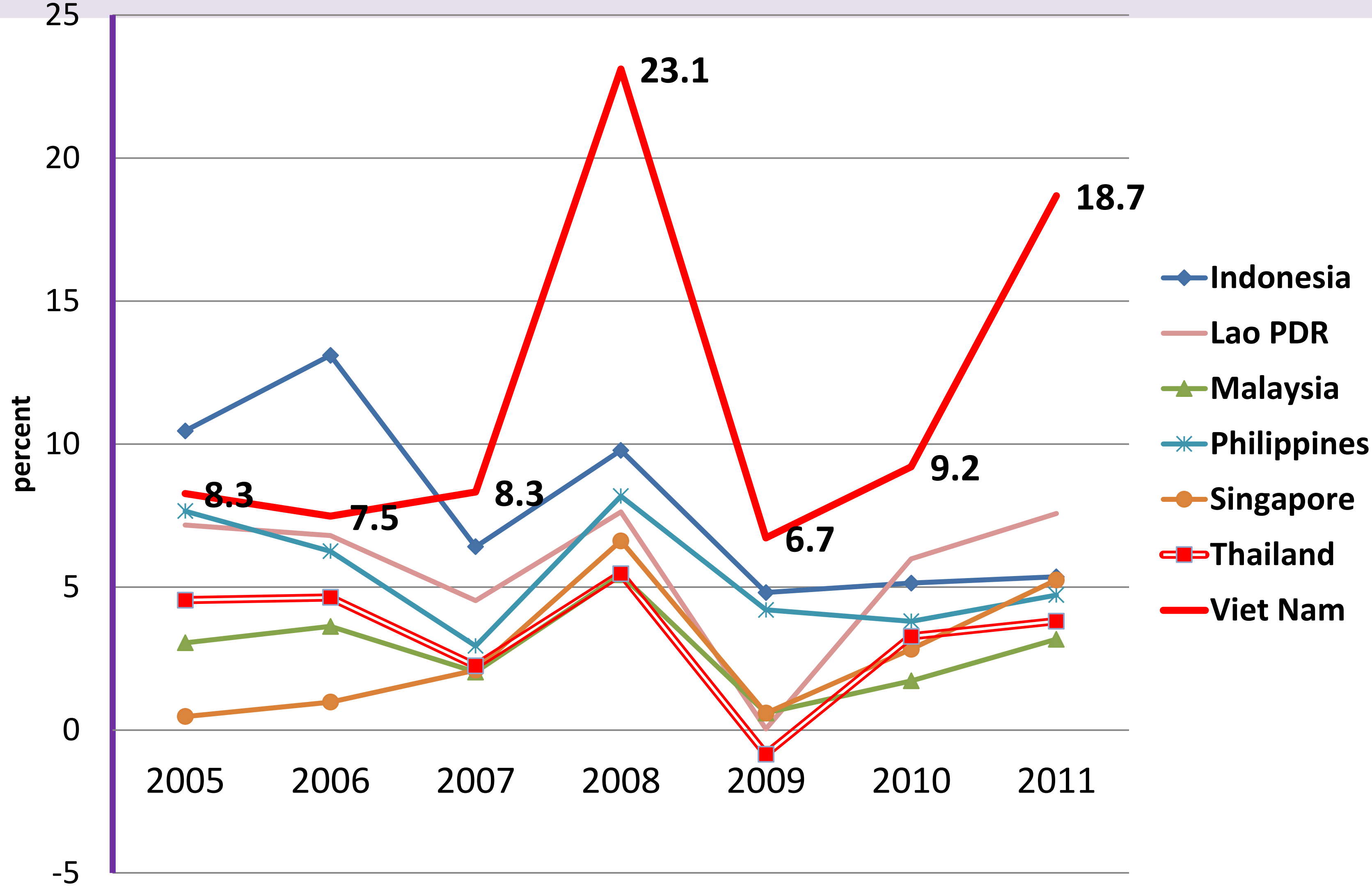
ASEAN-4 GDP Growth Rates: High Volatility with synchronization



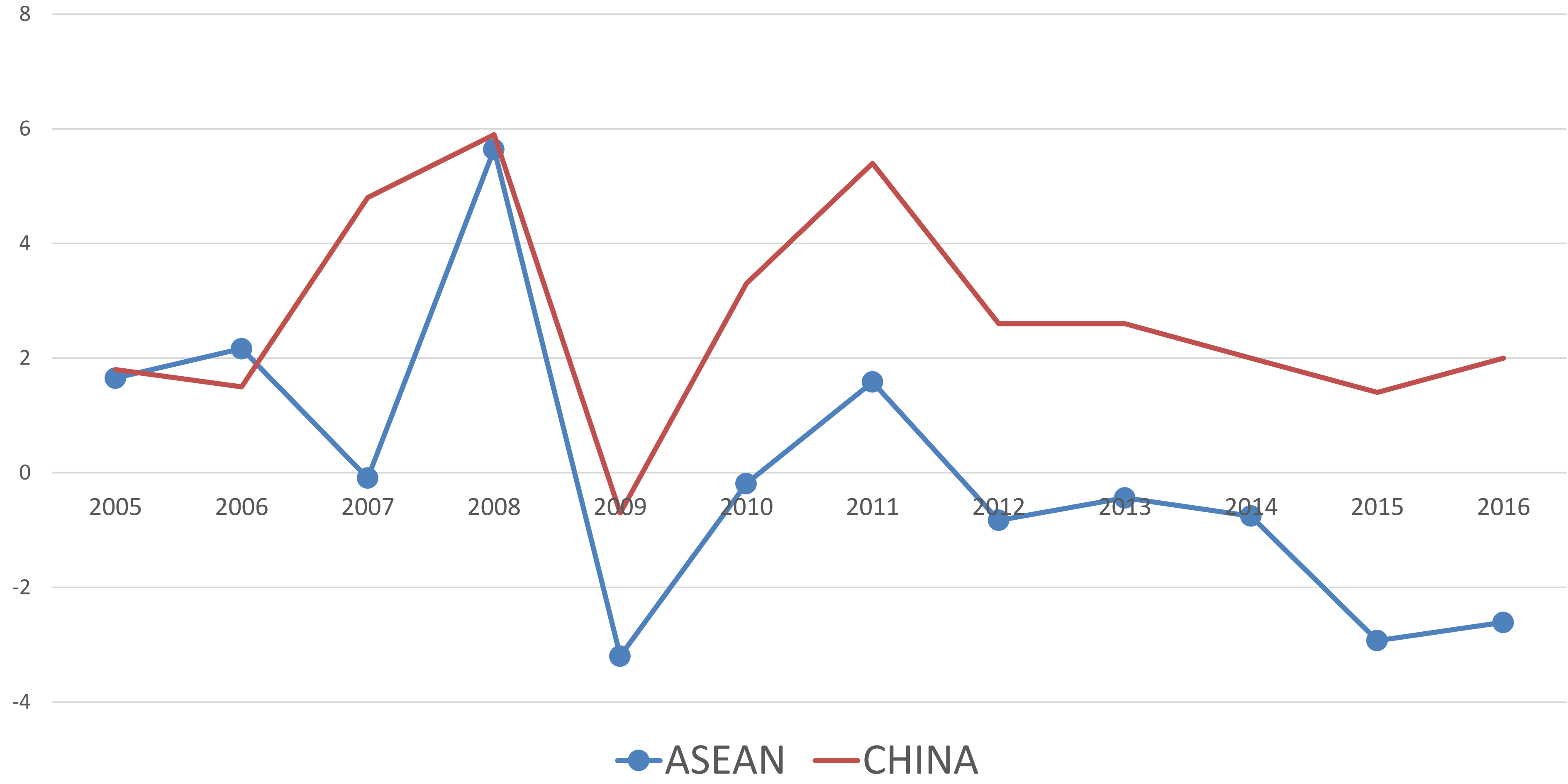
ASEAN Investment synchronization



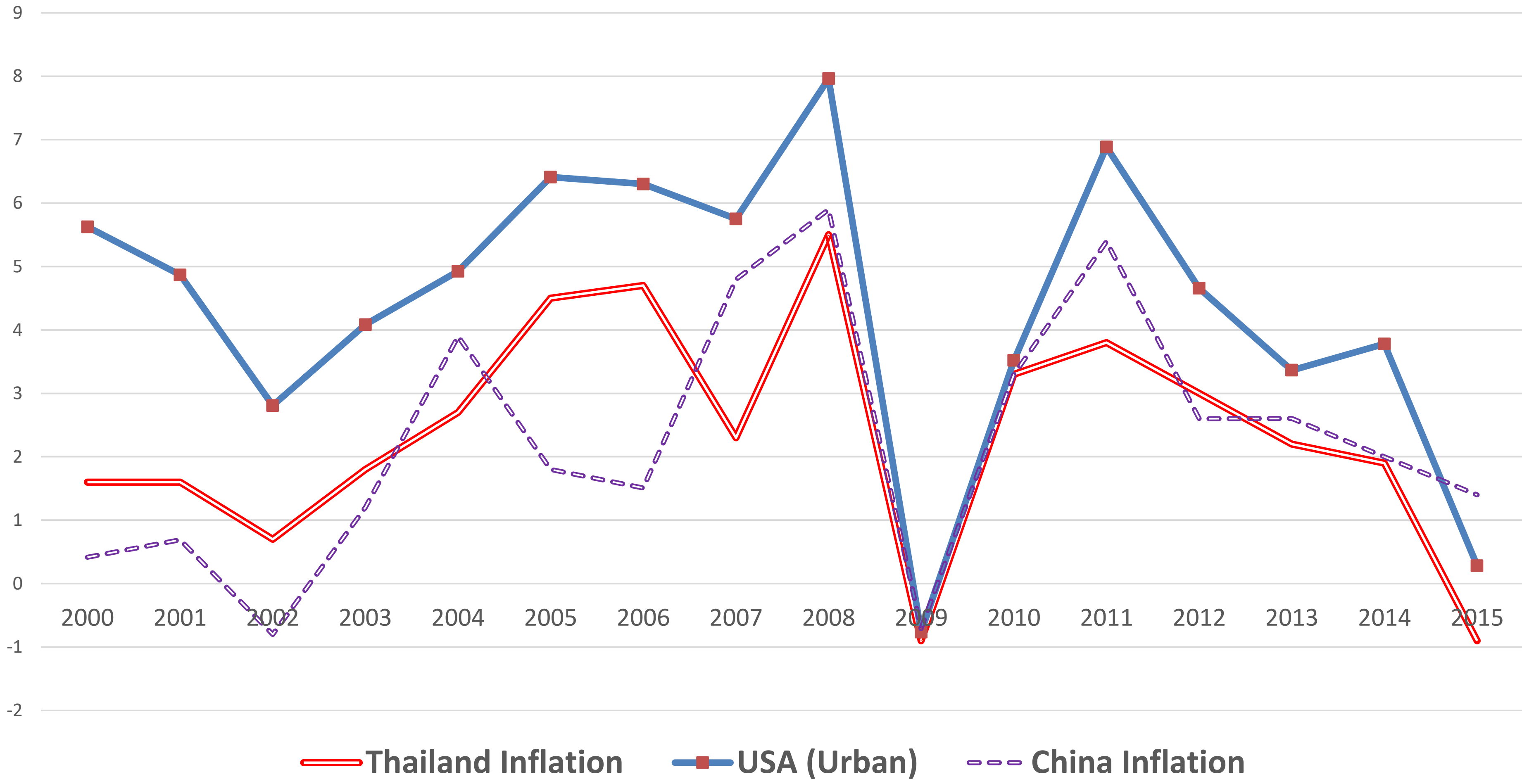
Inflation synchronization in South East Asia



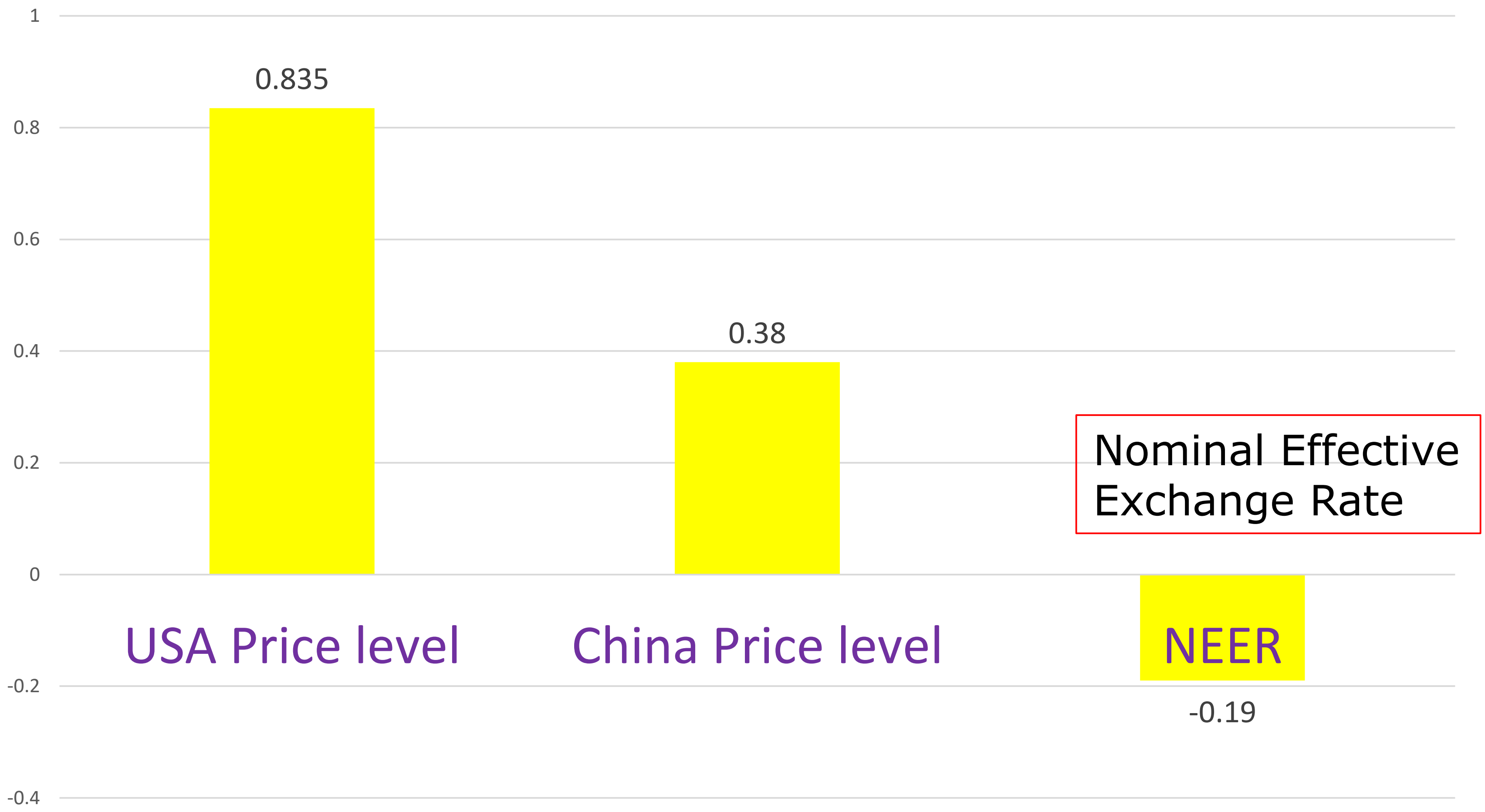
China and ASEAN *Inflation Synchronization* (Principal Component of CPI inflation)
Source: ADB Key Indicators



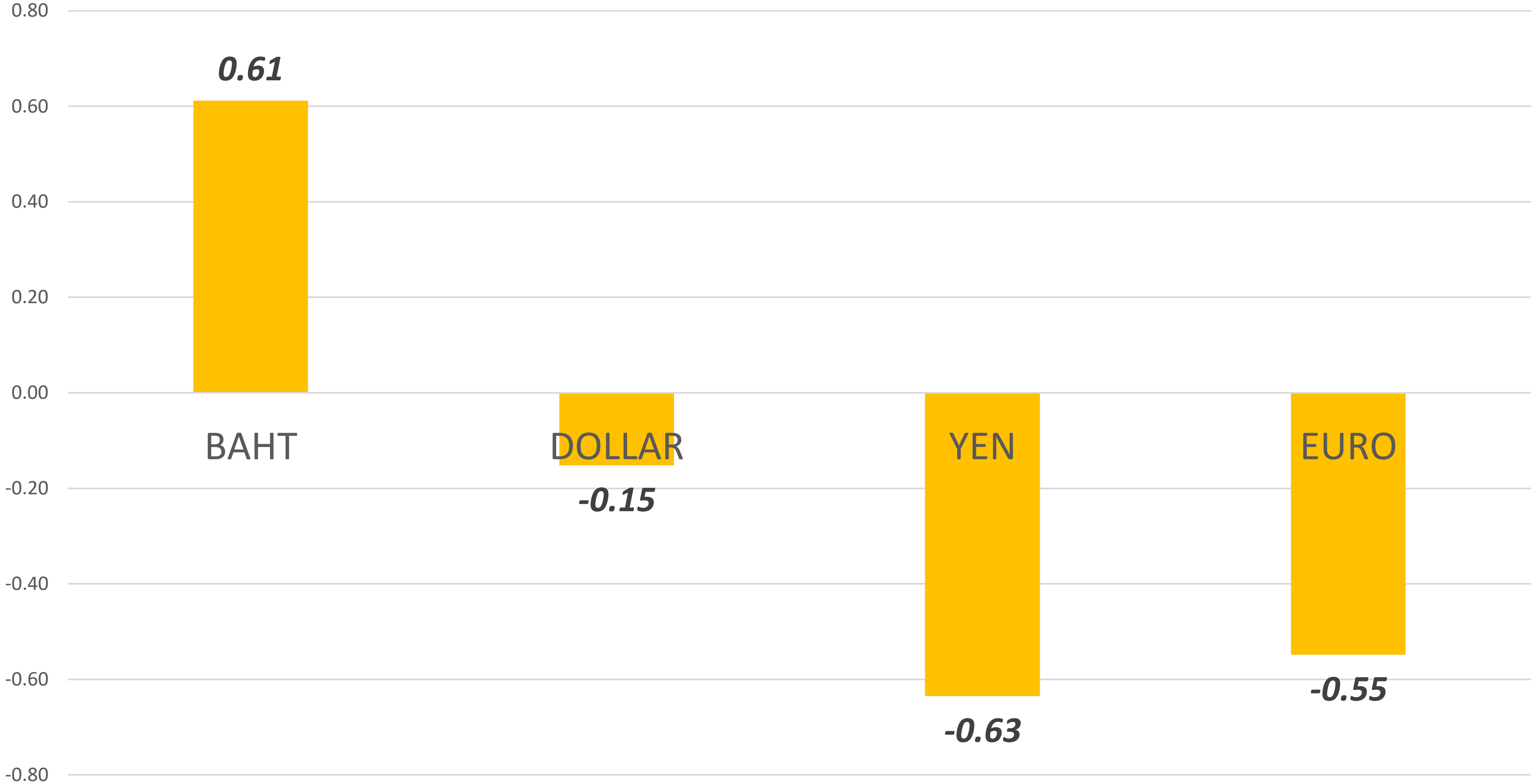
Influences of the Two Major Trading Partners on Thailand's inflation

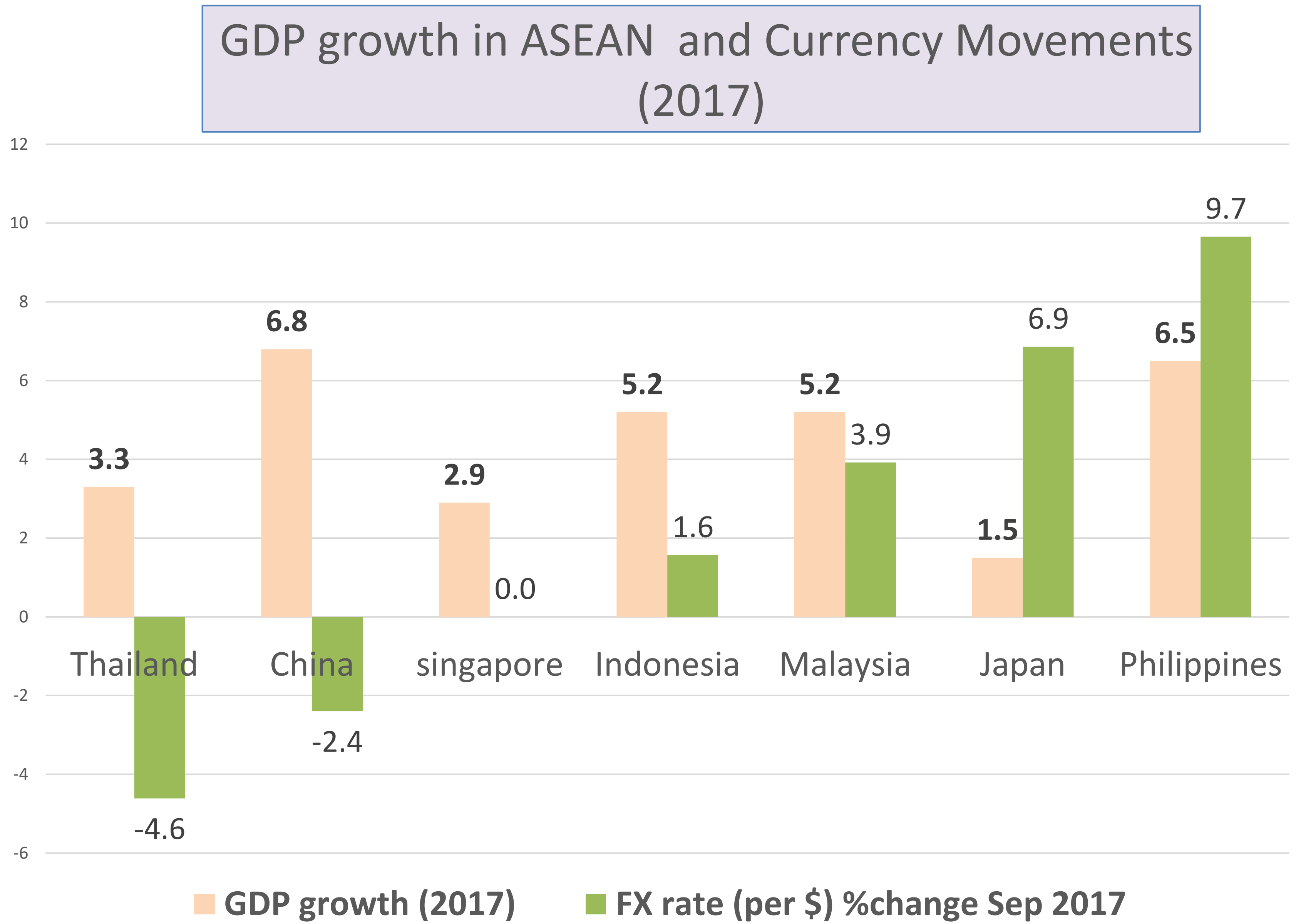


Thailand's Consumer Price Elasticities
Source: Estimated coefficients obtained from Canonical Cointegrating Regression
(Jan 1994 -May 2017)



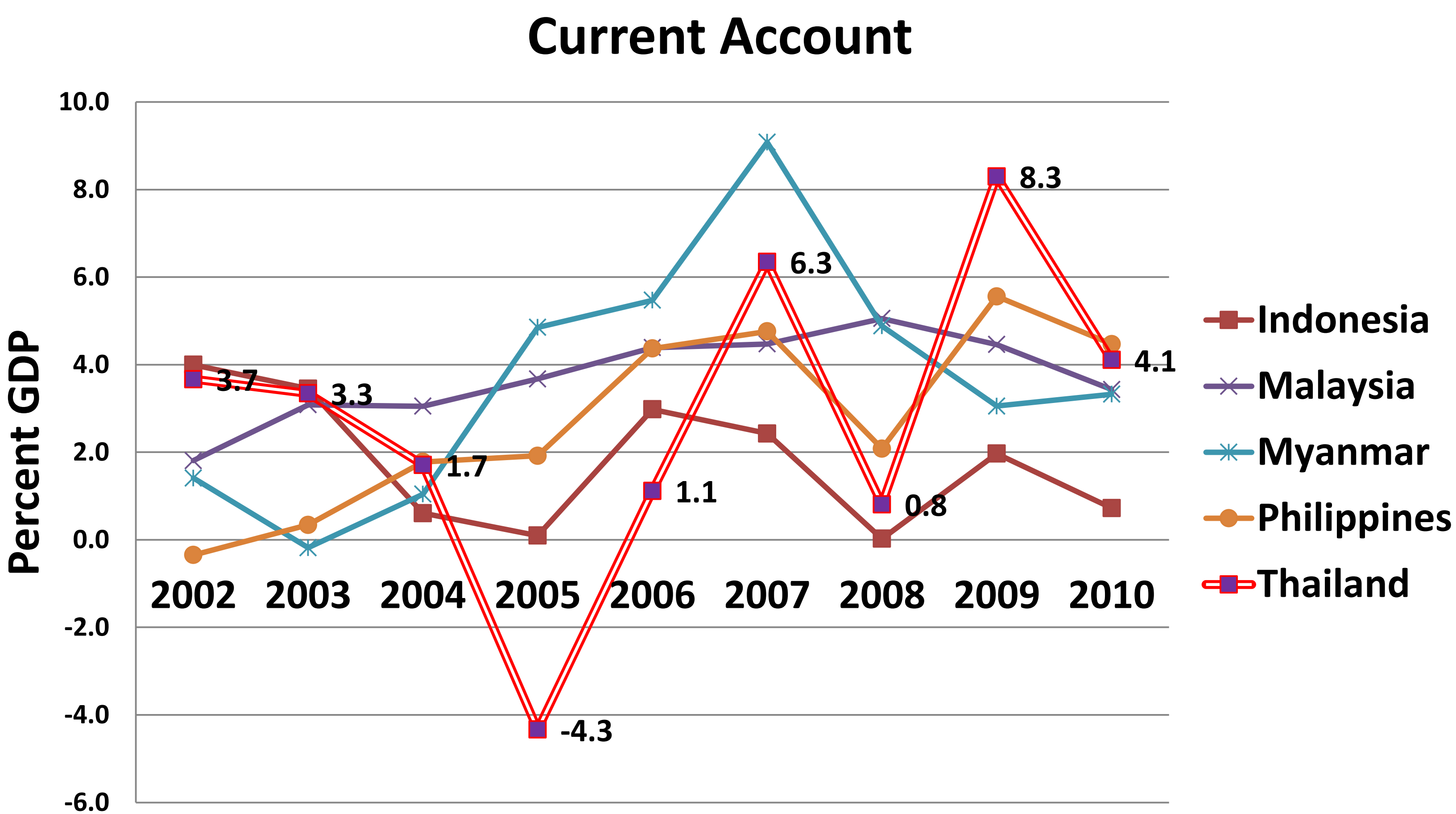
Correlates of the renminbi Real Broad Effective Exchange Rates (Jan 2000-July 2017)





GDP growth in ASEAN and Currency Movements (2017)
12
10
8
6
4
2
0
-2
-4
-6
3.3
-4.6
6.8
-2.4
2.9
0.0
5.2
1.6
5.2
3.9
1.5
6.9
6.5
9.7
Thailand
China
singapore
Indonesia
Malaysia
Japan
Philippines
GDP growth (2017)
FX rate (per $) %change Sep 2017

What are other common macro variables among ASEAN countries?



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)

$s = \alpha/[(1+\mathbf{g})Y_{t-1}] + \beta$ (g=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 (higher savings generate more 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

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

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

$$e = Baht/\$$$

$$P_f = Foreign\ price$$

$$Y_f = Foreign\ income$$

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

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

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

What are other determinants of CF?
Output growth, capital account openness, financial sector depth
Business environment (ICRG rating on investment risk) VIX,

International Country Risk Guide Index

Determinants of current account balances

- Growth (affecting savings and investment)
- Real interest rates
- Capital inflows (FDI, portfolio investment)
- Inflation
- Exchange rates
- Fiscal imbalance (Twin Deficits Hypothesis)
- *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.
- Engineer competitive (though unrealistic) exchange rates to drive exports.

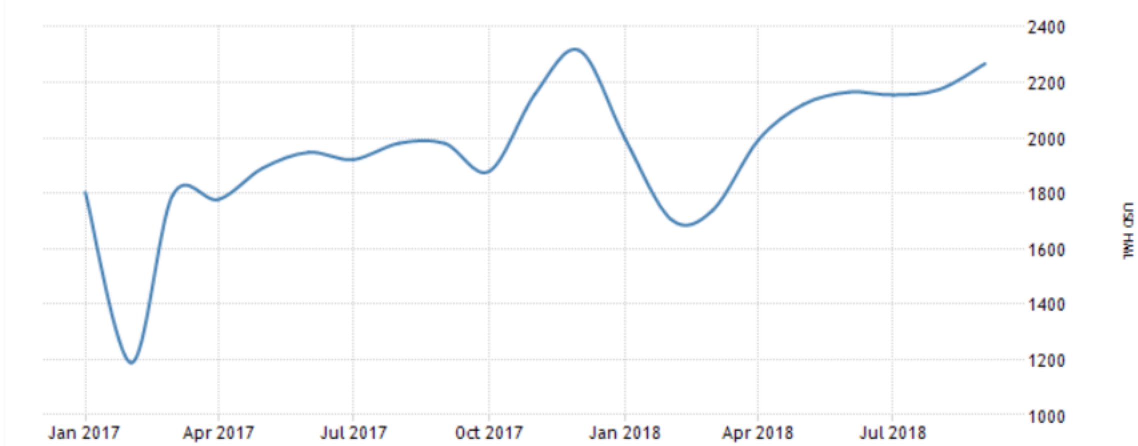
Growth engines downed

- 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
- Unlike the recovery of exports after 2010, the revival of exports did not happen, thanks to China’s slowdown after 2015.
- The short rebound of Thailand’s exports in 2018 can be attributed to Chinar’s trade volume growth, which might slow down as the impact of the trade war has come into full force started from the last quarter of 2018.

China Exports: Jan 2017-Sep 2018



Exports from China increased by 14.5 percent year-on-year to USD 226.69 billion in September 2018, after a 9.8% rise in July, beating market consensus of 8.9%.

It was the fastest growth in outbound shipments since February, due to strengthening global demand and despite intense trade tensions with the US.

China exports and trade tensions with the US.

- Unwrought aluminum and aluminum product exports surged 37 percent year-on-year to 507,000 tonnes, but were down 0.6 percent month-on-month from a downwardly revised 510,000 tonnes in August, which was the second-highest on record.
- The US has imposed tariffs of 25 percent on Chinese steel imports and 10 percent on aluminum imports since March 23rd.
- However, a lower yuan has helped metal exports. China's steel product exports went up 15.8 percent year-on-year to 5.95 million tonnes in September and was up 1.4 percent from a revised figure of 5.87 million tonnes in August.

4. China's Slowdown

The ASEAN business cycle and China's slowdown

Bhanupong Nidhiprabha

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.

Global rebalancing: It started with the huge trade deficit between the US and China

- When the issue of global rebalancing first emerged, it was focused squarely on the trade imbalance between **China and the Unites 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.
- Nevertheless, the consumption share of GDP in China is still low (and even declined according to recent statistics).

Global rebalancing

- 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.

For global rebalancing between the two countries

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

For the U.S. to cutdown trade deficit with China, private and public saving must rise: lower domestic consumption,
the US government must tax more and spend less
(Lower absorption)

For China to cut down trade surplus with the U.S., private and public saving must fall: higher domestic consumption (Higher absorption)

Three fundamental changes are happening in China:

1. The Chinese government's actions

- 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.

2. Maturing Chinese Economy

- 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.
- 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.

3. 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.

3. Robust growth in America and Europe

- 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.

The Chinese Yuan reached an all time low of 8.73 in January of 1994 and a record high of 1.53 in January of 1981

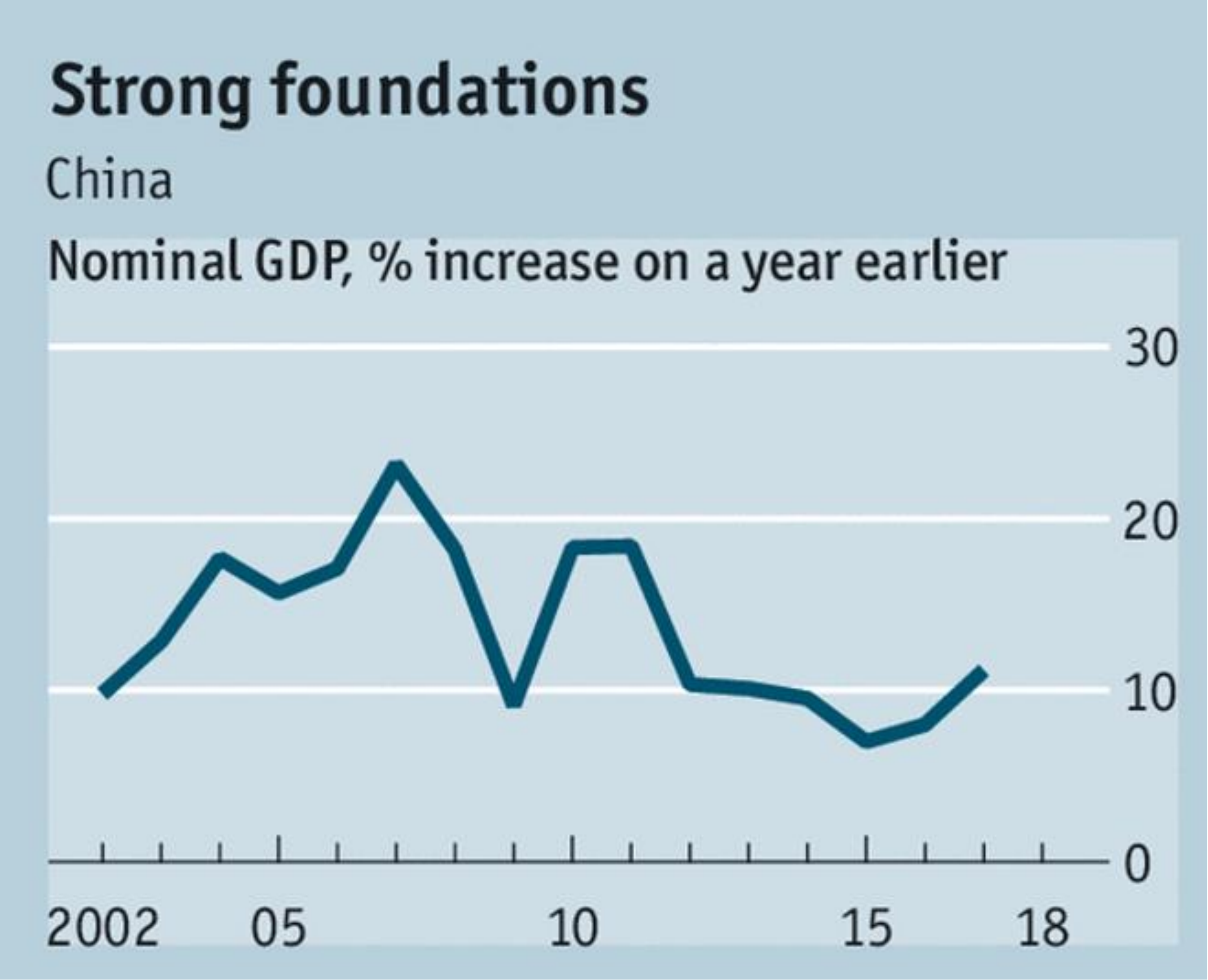
In 2015, the country was reeling from a stock market crash, suffering from capital outflows and accumulating debt at an alarming rate.

"Downward pressure has increased"

- The impact of Trump's penalty tariffs of up to 25 percent on Chinese goods in a dispute over Beijing's technology policy has been limited. But with the rest of their $12 trillion-a-year economy slowing, the communist leaderships has reversed course and ordered banks to lend.
- Vice Premier Liu He, reassured investors about a stock market that has sagged 30 percent since January. The decline is "creating good investment opportunities.
- "China's current economic fundamentals are good," the central bank's governor, Yi Gang, said on its website.

In this Friday, Oct. 12, 2018, photo, a worker walks by the container ship docked at a port in Qingdao in east China's Shandong province. China's economic growth slowed further in the latest quarter, adding to challenges for communist leaders who are fighting a mounting tariff battle with Washington. (Chinatopix via AP)

In nominal time, growth was above 10%



A new normal growth

- Growth in the quarter that ended in September 2018 slipped to 6.5 percent over a year earlier from the previous quarter's 6.7 percent, official data showed. It was the slowest rate since early 2009.
- The world's second-largest economy already was cooling ***before*** a tariff war between Beijing and President Donald Trump erupted.
- Beijing **tightened controls on lending** last year to rein in a debt boom.
- That has weighed on housing sales and consumer spending. Car buyers are steering clear of dealerships.

To avoid liquidity risk

- The government also said insurers will be allowed to create products to help stabilize the market by reducing "liquidity risk."
- That refers to *fears* lenders that accepted stock as collateral for loans might sell, flooding the market and driving a new price collapse.
- Retail sales, factory output and investment in factories and equipment — bigger drivers of growth than exports — all weakened in the latest quarter.

The Trade Conflict and China’s strategy

- The conflict with Washington has prompted Chinese leaders to step up a marathon effort to encourage ***self-sustaining growth driven by domestic consumption and reduce reliance on exports and investment***.
- Beijing has cut tariffs, promised to lift curbs on foreign ownership of auto producers and taken other steps to rev up growth.
- But leaders have refused to scrap plans such as "Made in China 2025," which calls for state-led creation of Chinese champions in robotics and other technologies.

4. Are Capital flows Fickle?

Eichengreen's Three Research Questions
Asian Economic Papers 2017

- 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

Pull factors
GDP growth
Business environment

FDI

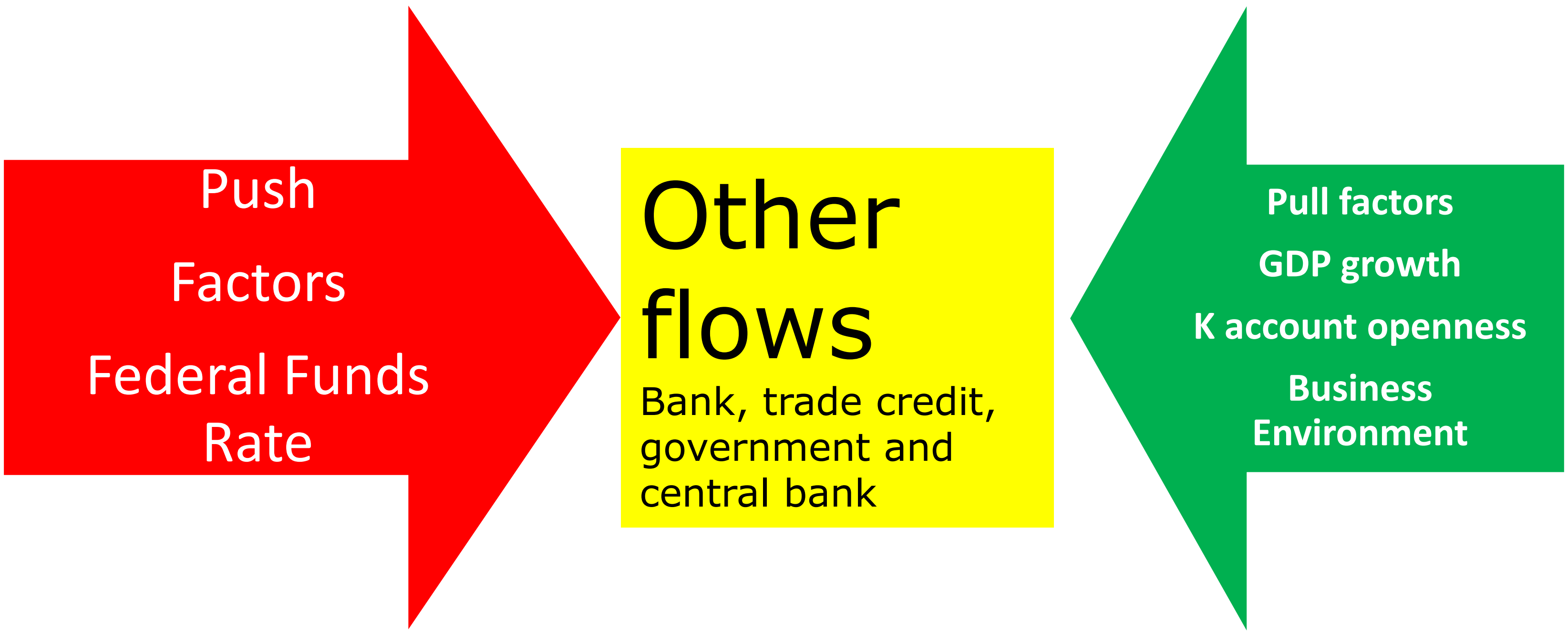
Most stable component of capital flows

Push

Factors

(Federal Funds Rate)

Portfolio
(Debt & Equity)
Most volatile component


Push
Factors
Federal Funds Rate
Other flows
Bank, trade credit, government and central bank
Pull factors
GDP growth
K account openness
Business Environment

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: Thailand in 1995)

2. Sudden stops: when the reversal in financial flows is more than 5 % of GDP

3. Global stops are deepening and more persistent than sudden stops. Global FDI declined by 13 % in 2016

4. Retrenchments: Reduction of capital inflows

5. Capital flights: capital outflows, no more charming economies (Thailand in 1997)

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 and the trade war with the U.S.