

# **China's macroeconomic imbalances: causes and consequences**

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# 1. Introduction

This paper is different from the specialist papers at this conference

It is more general, and is more concerned with China's underlying political economy

It written for my book *China's Remarkable Economic Growth* (due with OUP next month)

It is part of a chapter on China's growth prospects

The book's theme: however much technical economics the book contains, it is the underlying political economy that explains China's remarkable growth

The Chinese economy has huge macroeconomic imbalances

High investment, low consumption, huge current account surplus

If these are not corrected, can China's rapid growth be sustained?

Will the imbalances unwind of their own accord , and with what consequences?

Among the most important questions facing the Chinese, and the global, macro-economy

## 2. The imbalances

Over the period 2004-8, China's consumption averaged close to 50%, investment over 40%, and net exports about 6% of GDP

In other countries we compare China with, consumption usually comprises two-thirds or more of GDP, and investment one third or less of GDP

Only Russia had a higher export ratio

China is indeed an international outlier!

China's imbalances grew over the decade 1999-2008

Consumption fell, investment rose and net exports rose, all as a proportion of GDP

Since  $S - I = X - M$ , saving exceeds investment

Complicated interactions among these variables, involving output, prices and exchange rate

But it is clear: China's export boom more than offset its investment boom

## **Investment**

Good research evidence that investment is an important causal, although proximate, determinant of China's economic growth

Two reasons: high level of investment, and high coefficient in the growth equations

Enterprise investment is the international outlier

Rate of profit has remained high despite the very rapid increase in the capital/labour ratio

Reasons:

Technological progress, structural change raising average productivity, improved incentives for efficiency (SOE reform), the expanding, profitable export sector....

Underlying factor is investor confidence – entrepreneurial expectations of rapid growth

# Saving

Saving rate 50% of GDP in 2008:

remarkable for such a poor country

Household saving was also remarkable:

27% of household income

Literature provides various explanations:

High target wealth due to high expected growth

Fall in dependency ratio

Credit constraints together with increased need to have funds for house purchase, education, health insurance, old age

Increased economic insecurity

Government willingness to take a long view and to save rather than spend more on services

Redistribution of income from households to non-households

High enterprise saving out of profits

The repressed financial system: need for private sector to save in order to invest

The share of profits in GDP has risen in recent years

Reasons for rising profits:

- SOE reform and corporatization
- Expansion of profitable export sectors

## **Net exports**

Research indicates that exports have a positive causal effect on China's growth rate

But we are interested in the relationship between *net* exports and growth

China's export surplus exploded 2004 -2008.  
Why?

Many of China's exports are processing exports – only half of export value represents domestic value added – so imports rise when exports do

Entry to WTO in 2001: China could now move towards trade equilibrium

Why the delay? Need to build up export capacity?

Reasons for basic competitive advantage:

- low labour cost, important for low value added processing; and rising labour productivity has offset wage increases
- high excess capacity in heavy industries in mid-2000s
- exchange rate: holding the real trade-weighted exchange rate fairly stable despite the rising trade surplus

# 4. External surplus and the foreign exchange reserves

Reasons for holding down the RMB?

- To promote exports (output, employment) and to avoid unemployment and social instability
- Any expected continuing appreciation would induce speculative capital inflow
- The effect of appreciation on domestic value of foreign exchange reserves?
- Substitute for 'industrial policy' – not permitted by WTO

Accusations of 'currency manipulation' are simply rhetoric

The serious issue: does China on balance benefit from its policy of holding down the RMB?

## Problems of doing so:

1. The need to sterilise the export surpluses
  - Otherwise, a danger of asset bubbles
3. Huge accumulation of foreign assets:
  - the risks involved, e.g. of dollar depreciation
  - the irony of one of the poor countries of the world lending to one of the rich countries

#### 4. Worsening trade relations

- Introduction of trade sanctions against China, exacerbated by world economic recession
- These pressures are likely to grow if the export surplus continues

# 5. Policies to correct the macroeconomic imbalances

Policies to correct external and internal imbalances can't be separated, but:

## **Policies for external balance**

With WTO entry, China has gradually withdrawn its policies to encourage or subsidise exports and to discourage imports

But the exchange rate is the key variable

During the world economic recession  
China's export surplus has naturally fallen  
as a proportion of GDP

But this is a cyclical issue: China's  
underlying competitiveness hasn't  
deteriorated significantly

The likely prospect is for the net export  
surplus to rise again as the world economy  
recovers

Would rapid appreciation of the RMB restore external balance?

The small appreciation of 2005-8 failed to do so

Disagreement among researchers on the sensitivity of China's trade balance to its exchange rate

Most economists agree that the RMB is undervalued

But no agreement on the extent of misalignment:

- Estimates vary from 40% to 10% undervaluation
- The importance of processing intermediate products reduces sensitivity
- But relative rates of growth of exports to the US and Europe do appear sensitive to movements in the dollar/euro exchange rate

- Indirect effects via adjustment of output and prices, e.g.
- How would S-I change if X-M fell?
  - loss of competitiveness could reduce I
  - but redistribution from profits to households could also reduce S
  - and additional public consumption expenditure can offset any fall in I

Evidence that short term capital controls are not very effective

Currency floating could give rise to speculative expectations of future appreciation

Probably the least bad exchange rate policy would be:

- a significant one-off appreciation (to avoid expectations of further appreciation)
- followed by a pegging of the RMB to a trade-weighted basket of currencies

This would help to avoid trade sanctions and permit more effective domestic monetary and stabilization policies

## **Policies for internal balance**

The huge monetary expansion of 2008 and 2009 did nothing to help rebalance the economy

This investment boom has increased the dangers of NPLs and of asset bubbles

The main policy tools for raising consumption are additional public consumption (education, health care, etc) and policies to reduce households' insecurities and their incentives to save

# 6. Conclusion

The underlying issue for both the internal and external imbalance is the inter-temporal distribution of consumption:

- more investment relative to consumption in the present raises consumption in the future
- More exports relative to imports increases foreign assets, so making resources available for consumption in the future

How can the low rate of time preference be explained?

Since 1978, highest policy priority has been given to economic growth

To restore CCP's political legitimacy and curb social discontent, China became a 'developmental state'

The rapid growth of GDP produced slower, but still rapid, growth of household real income

This meant that the rising consumption matched expectations and kept down social and political discontent - even though the share of consumption in GDP has been low and falling

The concern for economic growth also helps to explain the exchange rate policy and thus the rising net export ratio

Given these objectives, are the macroeconomic imbalances sustainable?

**Internal imbalance:**

The rate of profit on capital has risen despite the rapid accumulation of capital

China is in a virtuous circle: high confidence, high investment, high growth, high confidence, high investment, high growth....

No persuasive evidence that the virtuous circle is likely to be broken

But there are dangers of an adverse shock which could break the circle:

e.g. a financial crisis, asset bubbles that burst, or social and political instability

The experience of Japan in the late 1980s is the spectre to avoid.

### **External imbalance:**

Three dangers of a large continuing export surplus

1. Inability to curb the growth in liquidity could generate asset bubbles, which could collapse confidence when they burst
2. Growing foreign exchange reserves, on which the real rate of return could prove to be negative. The bind: any attempt to diversify away from dollars could reduce the value of the remaining dollar-denominated assets
3. One must ask: is this accumulation in the interests of the Chinese people?

4. If China's export surplus as a proportion of GDP rises again, China's main trading partners may take more drastic action against China's exports.

These risks, and their political repercussions, may be the worst way of reducing the export surplus.