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FESSUD

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Research Brief #10

Projecting China's Economic and Financial Prospects: Confronting the Challenge of Global Imbalances

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I. Introduction

This Research Brief #10 assesses the future economic and financial prospects of the People's Republic of China within the current and projected global context of slow economic growth and wide imbalances in current accounts among major economies. In doing so, it draws on FESSUD Working Paper #144, "Assessing China's Economic and Financial Prospects within the Context of Global Imbalances".

Global economic growth has been slowing in recent years and this trend is likely to continue. For example, in its April *World Economic Outlook* the IMF downgraded its estimate of the global rate of economic growth for 2016 to 3.2% (IMF 2016). And in late July, in the wake of the UK's Brexit vote, it downgraded its 2016 estimate further, to just 3.1%.

Substantial current-account imbalances at the global level are also projected to persist. The most prominent are between those countries, such as the USA and the United Kingdom, which suffer from large and persistent current-account deficits, and those countries, such as China, Germany and Japan, which continue to enjoy large current-account surpluses.

Financial imbalances have also become an increasingly serious problem at the global level. Short-term financial flows, such as portfolio investment and the residual category of 'other investment', have been particularly unstable. They flow into and out of countries at a rapid pace since they are continuously seeking to maximize short-term financial rates of return. Such capital flows are also determined by the need to finance imbalances in current accounts.

This Research Brief describes the historical trends in GDP growth and current-account balances across major countries and blocs of countries between 2002 and 2016 as the context for its focus on the trends for the People's Republic of China. It then uses a global macro-econometric model, the CAM, to project the 10-year trends of these two variables through 2026.

This exercise is considered a medium-term projection. This Research Brief considers only a 'Baseline Scenario', which projects future trends on the basis of well-established historical trends and assumes only minimal well-established changes in policies.

II. Trends in Economic Growth

Table 1 reports on the historical trends (for 2002-2016) and the projected trends (for 2017-2021 and 2022-2026) for average GDP growth of major countries and blocs of countries. Together, these countries account for about two-thirds of global GDP. The table shows global growth of GDP (at market rates) has slowed from an average of 3.4% during 2002-2006 (before the global crisis) to 2.2% during the most recent period of 2012-2016.

Table 1. Average GDP Growth (%)
Baseline Scenario

	Historical			Projections	
	2002-2006	2007-2011	2012-2016	2017-2021	2022-2026
China	10.7	10.7	7.1	6.5	6.5
United States	2.9	0.6	2.1	1.2	1.3
European Union	2.2	0.7	0.9	1.2	1.2
Other East Asia High Income	2.3	1.0	1.2	2.4	2.3
Global	3.4	2.2	2.2	2.3	2.5

The CAM model projects that although global economic growth would increase over the next ten years, this increase would be very modest. The average GDP growth for the period 2017-2021 would be 2.3% and for the period 2022-2026 still only 2.5%. Hence, continuing slow growth (since the global financial crisis) appears to be the likeliest medium-term outcome for the global economy.

What does such a prospect imply for China? China's growth has declined noticeably over the last 15 years, from an average of 10.7% during 2002-2006 to 7.1% during 2012-2016. But a 7% average rate of economic growth has still been impressive. The CAM projects that China's average rate would decline only modestly over the next ten years, namely, to 6.5%. Hence, China's economic growth would still contrast sharply with the global context of relative stagnation.

III. Trends in Current Accounts

Table 2 reports on the trends in current-account balances for China as well as the USA, the European Union and East Asian High-Income countries. The table provides information on the historical yearly averages as well as the projected yearly averages for the four major countries or blocs of countries. The historical data are provided for 2002, 2006, 2011 and 2016 (i.e., every five years). The projected data for the Baseline Scenario are provided for 2021 and 2026.

The historical results suggest that while China's current-account surplus dipped from the very high level of 7.9% of GDP in 2006 to only 1.6% in 2011 (in the aftermath of the global financial crisis), it improved significantly thereafter, rising back up to 4.4% of GDP in 2016.

The Baseline Scenario suggests that China would maintain a comparable current-account surplus through 2021, and by 2026 this surplus would decline only marginally to 3.9% of GDP.

Hence, China would continue to play a major role in contributing to global imbalances. The same would be the case for Other East Asian High-Income Countries (such as Japan and the Republic of Korea), which are projected to maintain a surplus of 2.4% by 2026.

The results for the USA contrast sharply with those for China and Other East Asian High-Income countries. At the global level the USA has been the most prominent current-account *deficit* country. In 2006, for example, its current-account deficit was an alarmingly high -6.3% of GDP. Thereafter, in the wake of the global crisis of 2008, its deficit moderated as a result of declining aggregate demand, dropping to a negative 3.2-3.4% of GDP. However, the CAM projects that by 2021 the US current-account deficit would expand again to -3.9% and by 2026 it would rise further to -4.8% of GDP.

Table 2. The Current Account as % of GDP
Baseline Scenario

	Historical				Projections	
	2002	**2006**	**2011**	**2016**	**2021**	**2026**
China	2.7	7.9	1.6	4.4	4.6	3.9
United States	-3.7	-6.3	-3.4	-3.2	-3.9	-4.8
European Union	0.9	0.2	0.5	2.0	1.1	0.8
Other East Asia High Income	3.3	3.9	2.8	5.2	2.7	2.4

The historic and projected trends of the *combined* current-account balances of the European Union tend to be positive but in comparative terms they are relatively small at the global level. The CAM projects that this balance would progressively decline down to only 0.8% by 2026.

However, when the EU is disaggregated into some of its major constituents, it is apparent that its combined modest current-account balance disguises serious imbalances within the union. For example, the Baseline Scenario projects that by 2026 Germany would still have a current-account surplus of almost 5% of GDP. Meanwhile, in contrast, France would see its current-account deficit worsen by 2026 to -2% of GDP.

The United Kingdom would also suffer from a current-account deficit of almost -6% of GDP—though the recent drop in the value of the Pound because of the Brexit vote would likely moderate this deficit.

IV. The Impact of External Financial Flows on China

In this final section we examine historical and projected trends in external financial flows into and out of China. These are depicted through delineating trends in the capital account, but with financial investment abroad being denoted (unconventionally) with a positive value and inward investment in China by foreigners being denoted with a negative value.

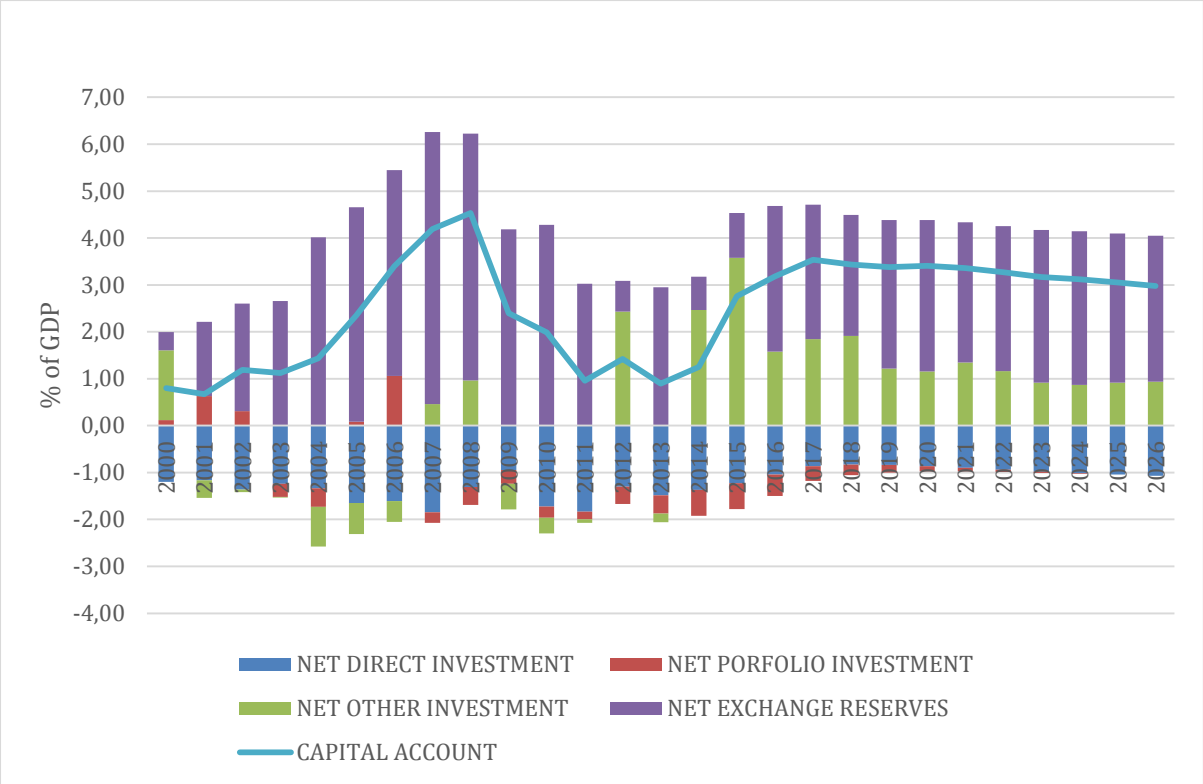
Graph 1 depicts the historical trends and the future trends generated by the Baseline Scenario. Between 2000 and 2008, China's large and rising holdings of foreign exchange

reserves dominated its capital account. Whereas in 2000 these reserves accounted for only 0.4% of China's GDP, by 2008 they had risen to 5.3%.

Inward flows into China were dominated by Net Direct Investment (FDI), which reached a peak of -1.8% of GDP in 2007. FDI continued to flow into China at a fairly steady rate between 2008 and 2015. But net 'other investment' (e.g., bank lending) began to flow out of the country to a significant degree.

As a result, the capital account began to increase (move in a positive direction) beginning in 2013. This result denoted that China was investing more abroad than foreigners were investing in China. However, the projections by our Baseline Scenario suggest that China's capital account would stabilize around 3% to 3.5% of GDP throughout the period 2017-2026.

Graph 1. Capital Account (% of GDP) in China. Baseline Scenario



The dominant outflow of capital from China would still be represented by the acquisition of foreign exchange reserves (equivalent to about 3% of GDP). At the same time, the outflow of 'other investment' would continue to be important (at around 1% of GDP), although it would exhibit a generally declining trend.

At the same time, capital inflows into China over this projected period would be dominated by Net Direct Investment though they would amount to only about 1% of GDP per year. Under this scenario projected inward portfolio investment would still be negligible.

These projected results suggest that China would remain in a fairly stable position over the next ten years with regard to international financial flows. This outcome would primarily be due to its reliance on 'investing' in foreign exchange reserves.

Unfortunately, such reserves generate a fairly low rate of financial return—especially compared to foreign direct investment. Relying on more stable and remunerative forms of foreign investment would probably be preferable.

But China does appear to have the advantage that it would remain relatively protected against the instabilities of inward short-term capital flows, such as portfolio investment. However, the outflow of 'other investment' (such as bank lending and other miscellaneous short-term flows) might pose problems. An additional problem is that the recording of such *net* financial flows might disguise greater underlying instabilities in *gross* financial flows. Future work on the CAM model is prioritizing the recording of such gross flows in order to generate a more comprehensive depiction of the movement of international capital flows.

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