EUROPEAN POLICYBRIEF

FINANCIALISATION ECONOMY SOCIETY AND SUSTAINABLE DEVELOPMENT

Policies for Rebalancing China's Economy and Their Global Impact

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INTRODUCTION

This Policy Brief draws on FESSUD Working Paper 144, "Assessing China's Economic and Financial Prospects within the Context of Global Imbalances" in order to highlight how the country could rebalance its economy over the next 10 years and thereby help to improve global economic and financial imbalances.

Global economic growth has been slowing in recent years and this trend is likely to continue. For example, in its October *World Economic Outlook* the IMF downgraded its estimate of the global rate of GDP growth for 2016 to 3.1% (IMF 2016). Exactly a year ago it had projected a 3.6% growth rate.

Substantial current-account imbalances at the global level are also projected to persist over the next ten years. 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 generate large current-account surpluses.

Importantly, financial imbalances have also become an increasingly severe 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 have flowed into and out of countries at a rapid pace in a frantic effort to maximize short-term financial rates of return.

This Policy Brief begins by outlining a Baseline Scenario that depicts the projected trends in GDP growth and current-account balances across major countries and blocs of countries for the 10-year period between 2017 and 2026. Such a scenario assumes no major policy changes.

The Policy Brief then compares these projected trends to those generated by assuming that China would move more aggressively to rein in its current-account surpluses and increasingly rely on increases in domestic consumption to drive its economic growth. We label this second projection an Alternative Policy Scenario. Both Scenarios are generated by the global stock-flow consistent Cambridge-Alphametrics Model (the CAM).

Evidence and Analysis

Baseline Scenario

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 over two-thirds of global GDP. The bloc of "East Asian High Income" countries includes Japan and the Republic of Korea. 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 2012-2016.

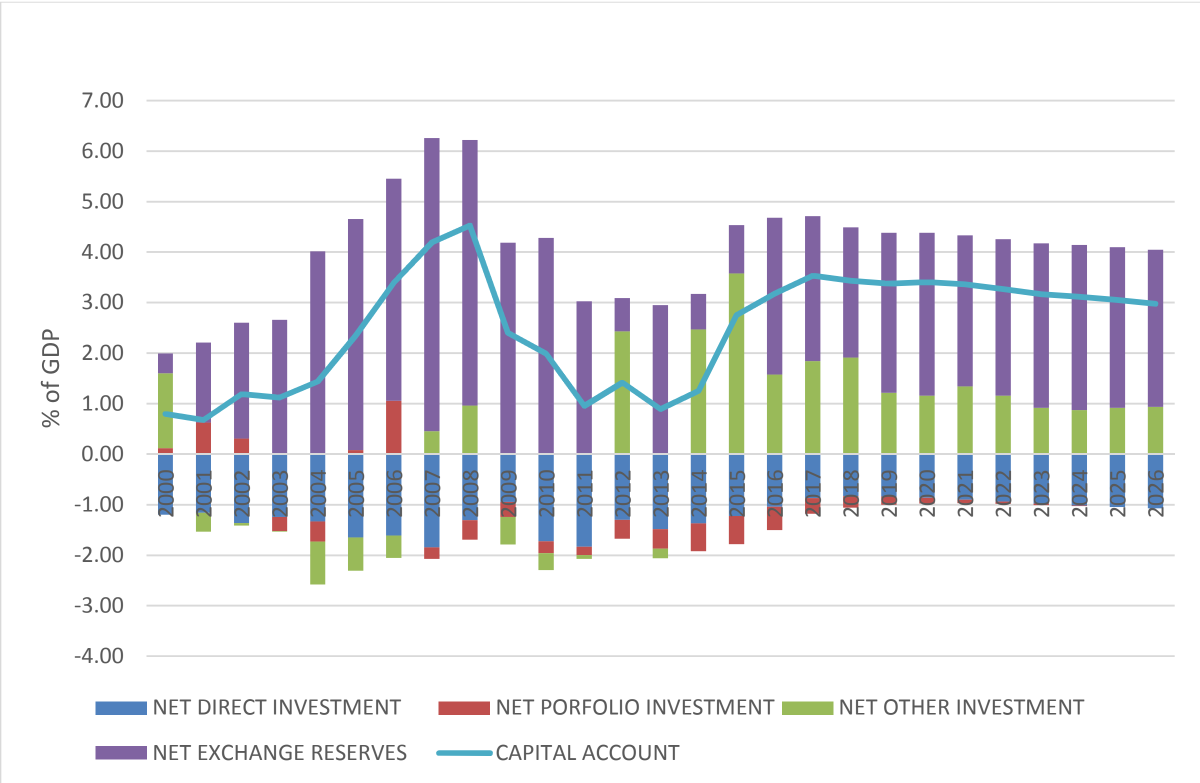
Table 1. Average GDP Growth (%), Baseline Scenario

	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
East Asian High Income	2.3	1.0	1.2	2.4	2.3
Global	3.4	2.2	2.2	2.3	2.5

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
East Asian High Income	3.3	3.9	2.8	5.2	2.7	2.4

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



The historic and projected trends of the *combined* current-account balances of the European Union tend to be positive but relatively small. However, when the results for the EU are disaggregated, Germany would still have a large current-account surplus of almost 5% of GDP by 2026 and France would have a sizeable deficit of -2% of GDP. The United Kingdom would also suffer from a large current-account deficit of almost -6% of GDP. However, the recent significant drop in the value of the Pound in late 2016 because of the Brexit vote will likely moderate this deficit.

In the era of financialisation capital flows have become increasingly destabilizing—independently of trends in a country's current account. **Graph 1** depicts 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) by a positive value and inward investment in China by foreigners being denoted by a negative value.

Between 2000 and 2008, China's large and rising holdings of foreign exchange reserves (the purple bars) dominated its capital outflows (as well as its overall capital account). The smaller inward flows into China were dominated by Net Direct Investment (blue bars), which reached a peak of -1.8% of GDP in 2007 and continued to flow inward between 2008 and 2015.

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

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 be due primarily to its 'investment' in foreign exchange reserves. But, unfortunately, such reserves generate a fairly low rate of financial return—especially compared to foreign direct investment. But China does appear to have remained relatively protected against the instabilities of inward short-term capital flows, such as portfolio investment and 'other investment'.

Policy Implications and Recommendations

Alternative Policy Scenario

In order to improve the global economic outcomes over the next ten years, an Alternative Policy Scenario was devised that focused on altering economic growth rates and reining in current-account imbalances. The focus in this Policy Brief is on China. Hence, this Scenario emphasizes a policy-induced reduction in China's savings rate, which would increase consumption and thereby also increase imports.

Such a change would, in turn, reduce China's current-account surplus. This strategy would be in line with China's long-term strategy of shifting to more consumption-led economic growth. In fact, the Baseline Scenario had already projected a drop in China's savings rate and an accompanying decline in its current-account surplus. The Alternative Policy Scenario would accentuate such changes by projecting a greater drop in savings along with a modest appreciation of China's real exchange rate.

Since most other countries face economic problems quite different from China's, the Alternative Policy Scenario programmed some combination of changes in their government income and expenditures in order to provide greater stimulus to their economies, especially since continued austerity policies after 2008 have dampened their economic growth. These changes also prioritised boosts to private and public investment, particularly for the USA and countries in Europe. But this was not the case for China, where the investment rate has remained relatively high.

For Germany and the bloc of East Asian High Income Countries—which, like China, run globally sizeable current-account surpluses—there were also programmed increases in their consumption. By contrast, for the USA and the UK, which have run large current-account deficits, there were programmed modest *decreases* in their real exchange rates along with decreases in their consumption. Recent Brexit-related drops in the value of pound sterling have been more pronounced.

Table 3 depicts the projected results for GDP growth among the four global blocs and countries as well as the world as a whole. It contrasts the results for the 'Baseline Scenario' (which assumes minimal changes in policy) to those for the 'Alternative Policy Scenario', which introduces the alternative set of economic policies outlined above.

Based on the Alternative Policy Scenario's programmed reductions in savings and appreciation of its real exchange rate, China's GDP growth rate would decline to an average of 5.6% during 2022-2026. In contrast, it would have remained 6.5% under the Baseline Scenario.

The programmed improvements in economic growth in the other blocs and countries would lead to a global GDP growth rate of 2.9% in 2022-2026. This would be an improvement over the 2.5% growth rate projected by the Baseline Scenario for the same period.

For the USA the contrast in GDP growth rates between the two scenarios would be notable. During 2022-2026, for example, the USA would grow at only 1.3% under the Baseline Scenario whereas it would achieve a 2.0% growth rate under the Alternative Policy Scenario.

Table 3. Average GDP Growth (%), Alternative Policy Scenario

	Projections		Scenario
	2017-2021	2022-2026	
China	6.5	6.5	Baseline Scenario
	5.3	5.6	Alternative Policy Scenario
United States	1.2	1.3	Baseline Scenario
	1.8	2.0	Alternative Policy Scenario
European Union	1.2	1.2	Baseline Scenario
	2.3	1.5	Alternative Policy Scenario
East Asia High Income	2.4	2.3	Baseline Scenario
	3.5	3.1	Alternative Policy Scenario
Global	2.3	2.5	Baseline Scenario
	2.8	2.9	Alternative Policy Scenario

Table 4 shows that the Alternative Policy Scenario projects a sharp fall in China's current-account surplus to 1.8% by 2026. This would contrast sharply with the 3.9% surplus projected by the Baseline Scenario in the same year—as well as China's surplus of 4.4% of GDP in 2016. Hence, the programmed declines in savings and the corresponding increases in consumption would have their intended effects.

East Asian High Income countries are also projected to experience a fall in their combined current-account surplus. By 2026 their combined surplus would be 1.8%. This outcome contrasts with this bloc's 2.4% surplus projected by the Baseline Scenario for the same year, and contrasts even more sharply with the 5.2% surplus recorded for 2016.

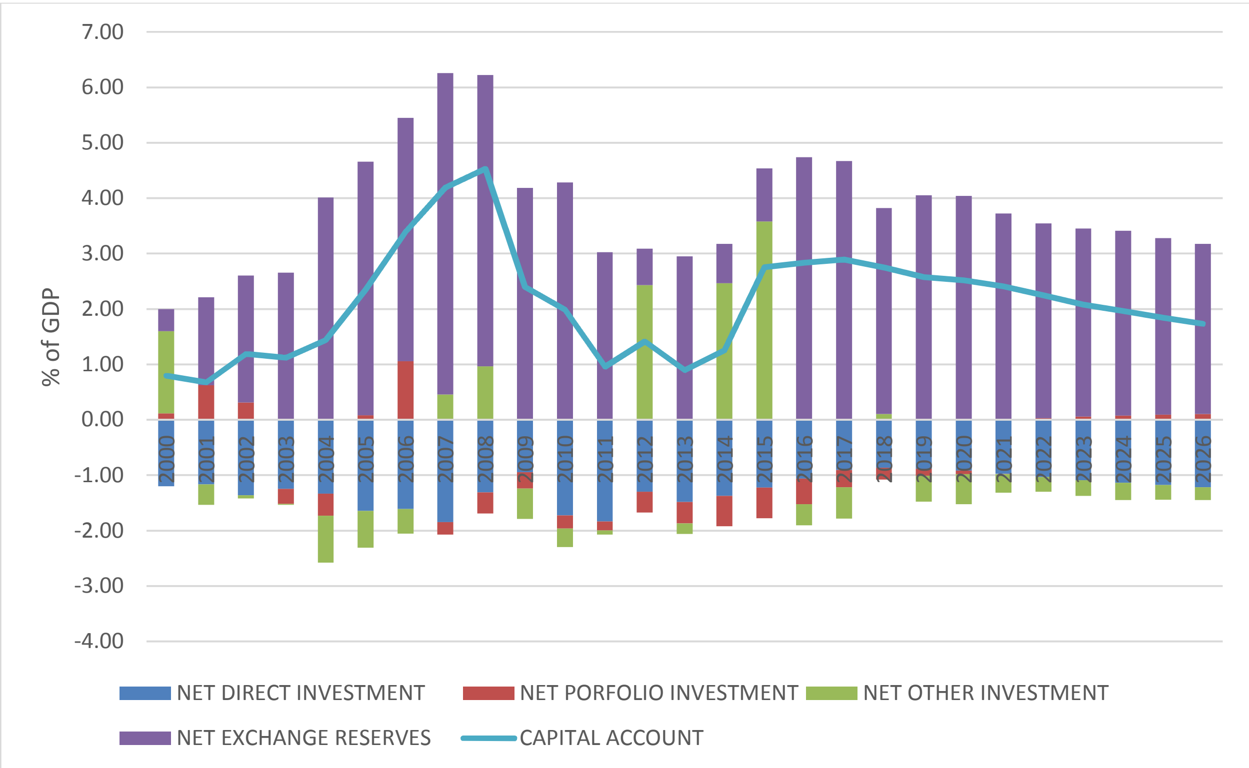
It is striking, however, that under the Alternative Policy Scenario the current-account deficit of the USA would still be -4% of GDP in 2026. For the Baseline Scenario it was projected to be slightly worse, i.e., -4.8%. Yet it is worth noting that in 2016 the US deficit is estimated to be much smaller, at -3.2% of GDP.

Table 4. The Current Account as % of GDP, Alternative Policy Scenario

	Projections		Scenario
	2021	2026	
China	4.6	3.9	Baseline Scenario
	2.7	1.8	Alternative Policy Scenario
United States	-3.9	-4.8	Baseline Scenario
	-3.0	-4.0	Alternative Policy Scenario
European Union	1.1	0.8	Baseline Scenario
	0.6	0.4	Alternative Policy Scenario
East Asia High Income	2.7	2.4	Baseline Scenario
	2.3	1.8	Alternative Policy Scenario

This Policy Brief ends with the depiction of the trends in China's capital account generated by the Alternative Policy Scenario. For this projection, the Net Capital Account would remain below 3% of GDP and would progressively decline, dropping below 2% by 2024.

Graph 2. Capital Account (% of GDP) in China, Alternative Policy Scenario



Graph 2 depicts the results for the capital account that are generated by this scenario. For this projection, the Net Capital Account would remain below 3% of GDP and would progressively decline, dropping below 2% by 2024.

Foreign Exchange Reserves, which represented 4.7% of GDP in 2016, would completely dominate the outflow of capital from China (see the purple bar). However, the relative size of these reserves would progressively decline over time, reaching about 3.1% of GDP by 2026.

Over the same period, the net inflow of capital into China would remain above -1.5% of GDP, with Net Direct Investment (the blue bar) continuing to dominate since it would account for -1% to -1.2% of GDP. But unstable Net Other Investment (the green bar) would not amount to more than -0.5% of GDP over this projected period.

Hence, compared to many other major Emerging Economies, China is projected, under our Alternative Policy Scenario, to have a fairly stable and positive capital account, denoting (in this particular configuration) that its capital outflows (especially Foreign Exchange Reserves) would far outweigh its capital inflows. Moreover, its capital inflows would continue to be dominated by FDI, which tends to be more stable than either Portfolio Investment or Net Other Investment.

RESEARCH PARAMETERS

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

PROJECT IDENTITY

PROJECT NAME	Financialisation Economy Society and Sustainable Development (FESSUD)
COORDINATOR	Professor Malcolm Sawyer. University of Leeds, UK: email fessud@leeds.ac.uk
CONSORTIUM	University of Siena, Italy School of Oriental and African Studies, UK Fondation Nationale des Sciences Politiques,France Pour la Solidarite, Brussels, Belgium Poznan University of Economics, Poland Tallin University of Technology, Estonia Berlin School of Economics and Law, Germany Centre for Social Studies, University of Coimbra, Portugal University of Pannonia, Veszprem, Hungary National and Kapodistrian University of Athens, Greece Middle East Technical University, Ankara, Turkey Lund University,Sweden University of Witwatersrand, South Africa University of the Basque Country, Bilbao,Spain
FUNDING SCHEME	FP7 Socio-economic Sciences and the Humanities, topic for SSH.2010.1.2-1, 'Changing the role of the financial system to better serve economic, social and environmental objectives'
DURATION	1st December 2011 to 30th November 2016
BUDGET	EU contribution: 7,923,728.02 euros
WEBSITE	fessud.eu
FOR MORE INFORMATION	Helen Evans: fessud@leeds.ac.uk

FURTHER READING

Terry McKinley, *Assessing China's Economic and Financial Prospects within the Context of Global Imbalances, Working Paper Series No. 144, September 2016*