Are global imbalances sustainable? Policy considerations, the case of China

Workshop on The Chinese Economy

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Outline

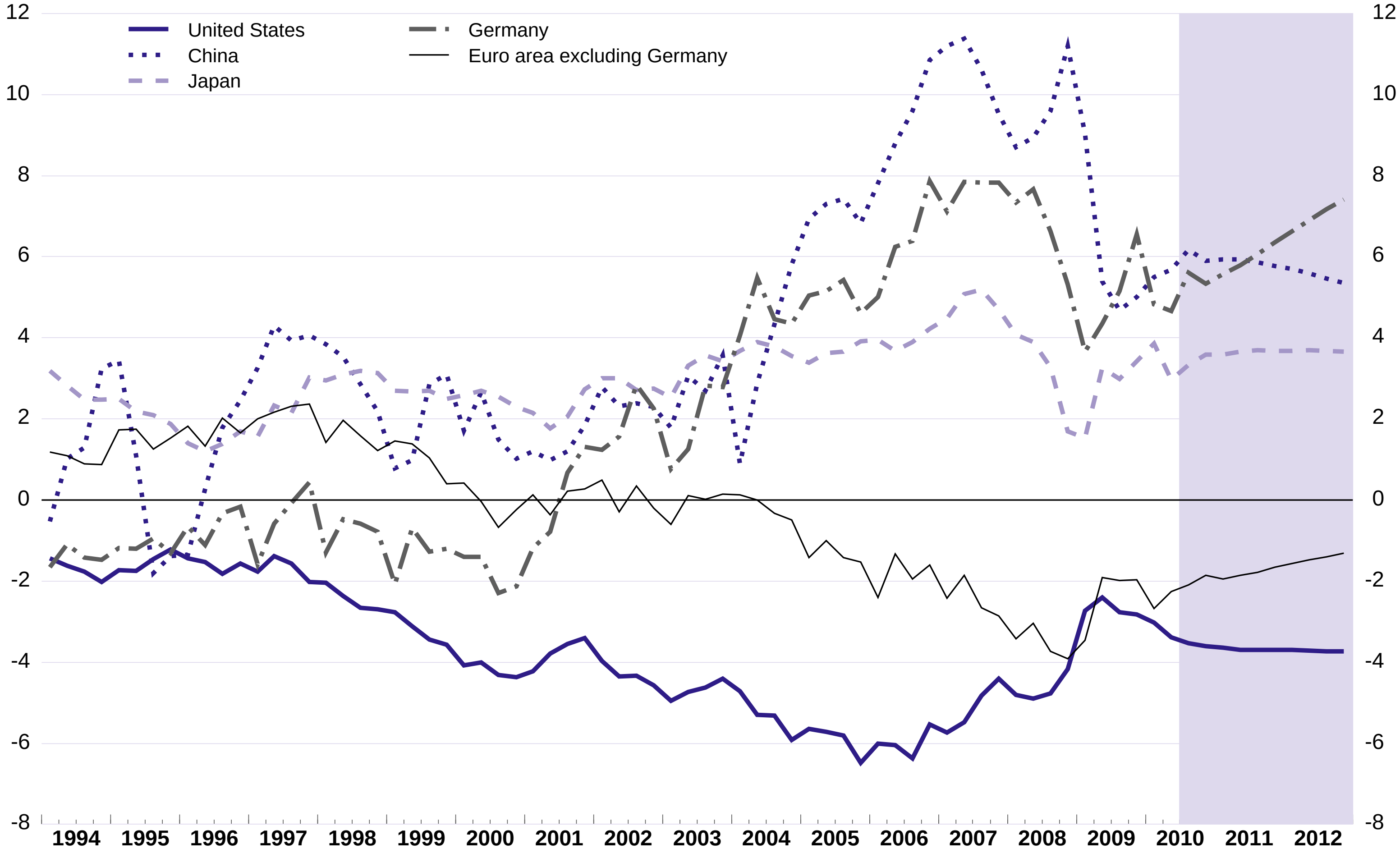
OUTLINE

- The size of global imbalances
  - ✓ Global current account imbalances nearly halved after the global crisis after reaching a post-war high of over 5% of world GDP in 2008, and remain sizeable
- The sustainability of current account positions
  - ✓ Empirical evidence (event study and regression analysis): External positions of major economic areas are not unsustainable, but structural breaks occur from time to time
  - ✓ Policy scenarios: Structural reform are needed to reduce imbalances in the coming years
- The case of China
  - ✓ What is needed to rebalance growth towards domestic sources (and contribute to global rebalancing)?

Global imbalances have narrowed but are set to remain sizeable

GLOBAL IMBALANCES

Current account balances, in % of world GDP

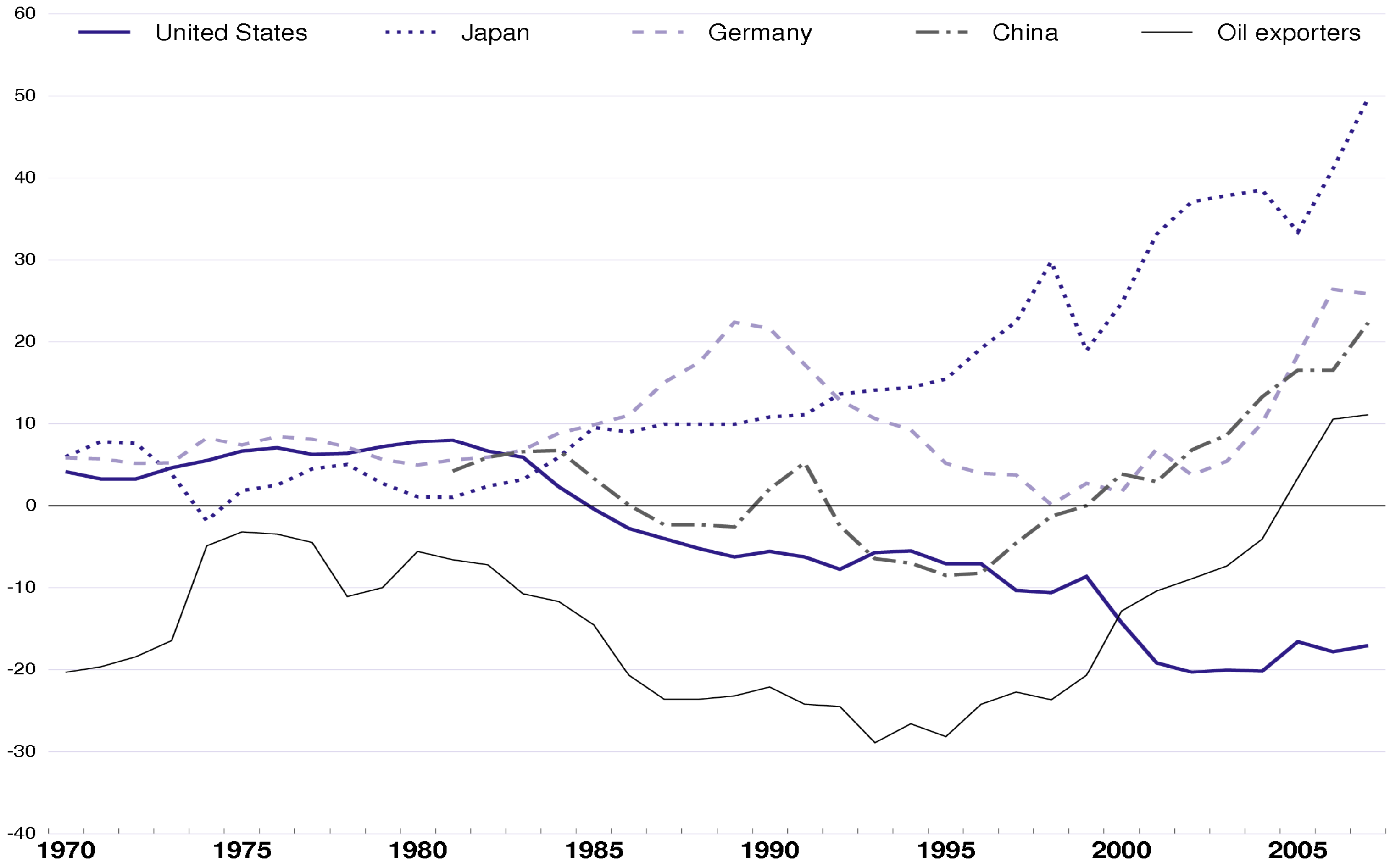


Source: OECD Economic Outlook EO88 database.

Consistent with current account trends, net foreign asset positions have widened in some countries

NET ASSET POSITIONS

In % of individual country GDP



***Source**: Updated and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti (2007).*

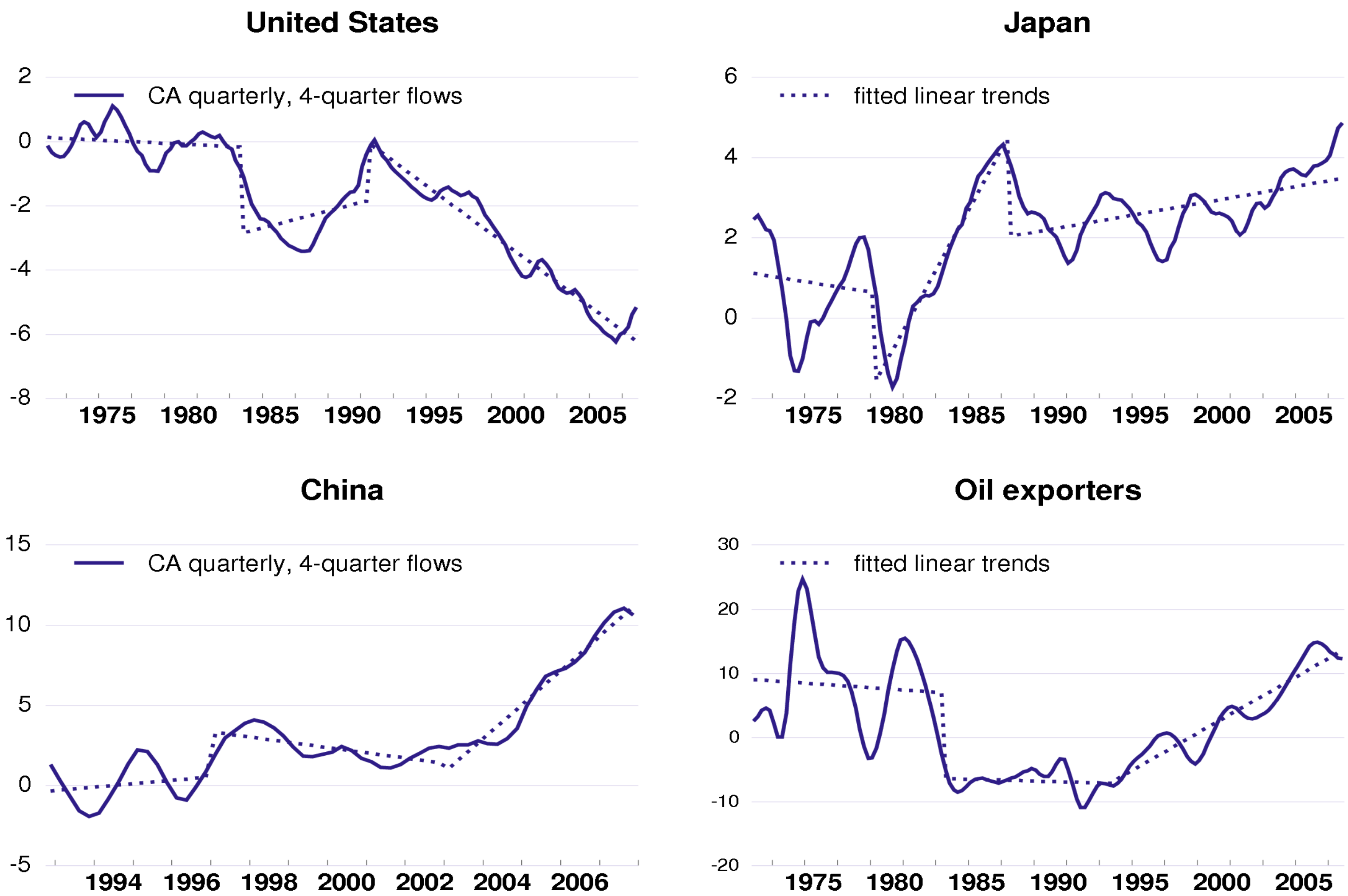
Are current account imbalances sustainable?

EXTERNAL SUSTAINABILITY

- Our empirical analysis **suggests** that current account imbalances are sustainable for periods of time but not indefinitely
  - ✓ Sooner or later structural breaks occur and current account reversals take place
- It is important to investigate features and implications of such structural breaks (event analysis)
  - ✓ Breaks are associated with changes in fiscal balances, exchange rates, potential growth (de Mello and Padoan, 2010, OECD WP No. 795)
- It is equally important to estimate jointly the driving factors of the probability of occurrence and the magnitude of reversals
  - ✓ Estimation of a selection model sheds further light on the dynamics of global imbalances (de Mello, Padoan and Rousova 2010, OECD WP No. 813)

There have been breaks in current trends

STRUCTURAL BREAKS



Note: Structural breaks identified on the basis of the Lee-Strazicich unit root tests.
Source: de Mello, Padoan and Rousova (2010), OECD WP No. 813.

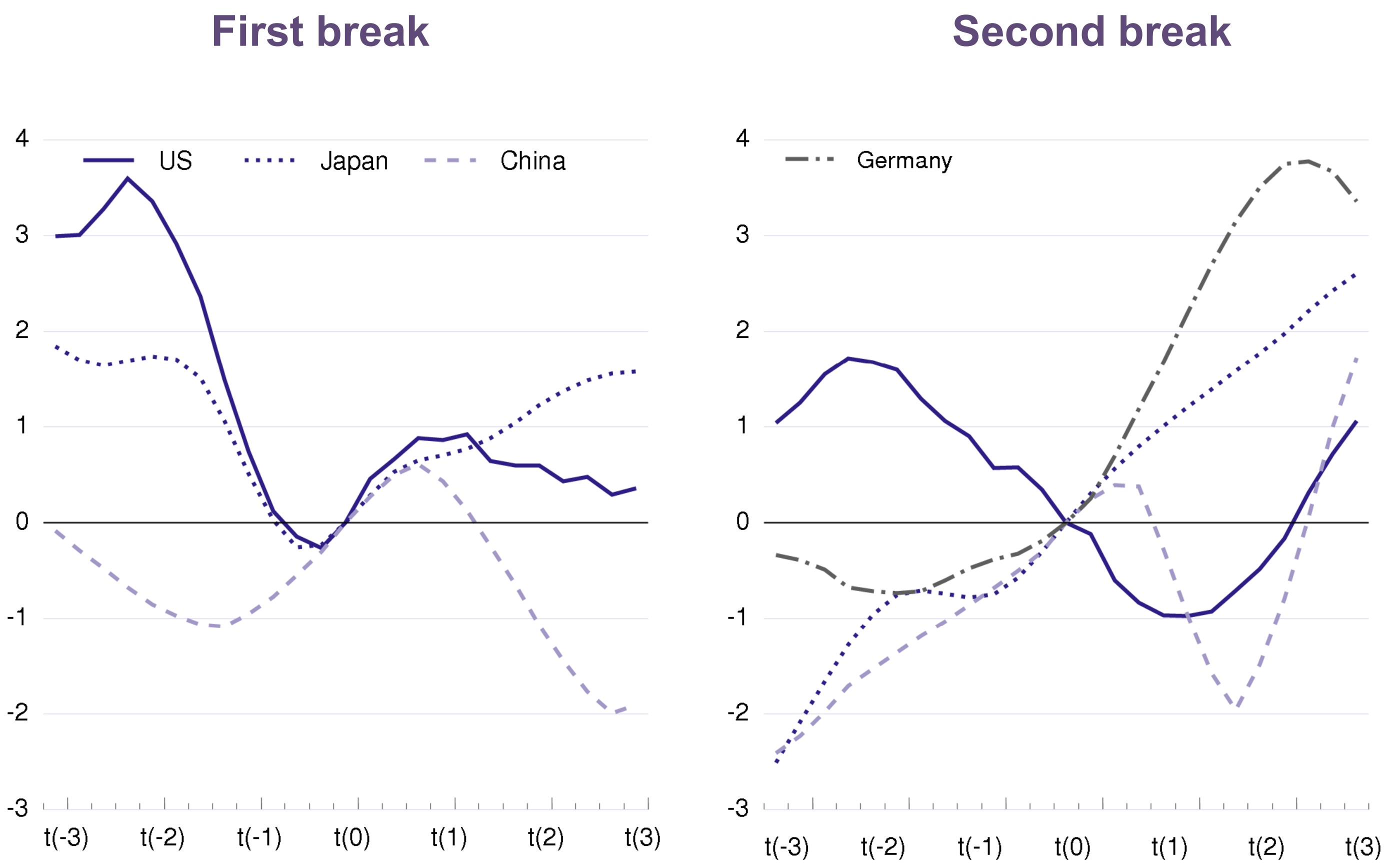
EVENT ANALYSIS

Budget balances tend to improve after current account reversals

Budget balance, rescaled to 0 at t_0

First break: t_0 = 1983q4 for the United States, 1979q2 for Japan and 1997q1 for China

Second break: t_0 = 1991q3 for the United States, 1987q3 for Japan, 2003q1 for China and 2005q4 for Germany



Source: de Mello and Padoan (2010), OECD WP No. 795.

Exchange rates sometimes appreciate after current account reversals

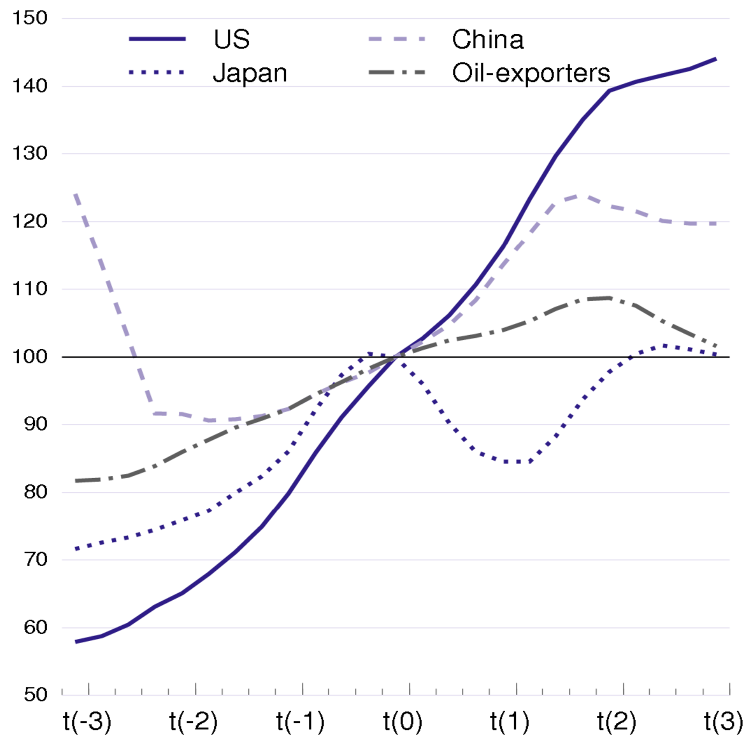
EVENT ANALYSIS

Nominal effective exchange rate, rescaled to 100 at t_0

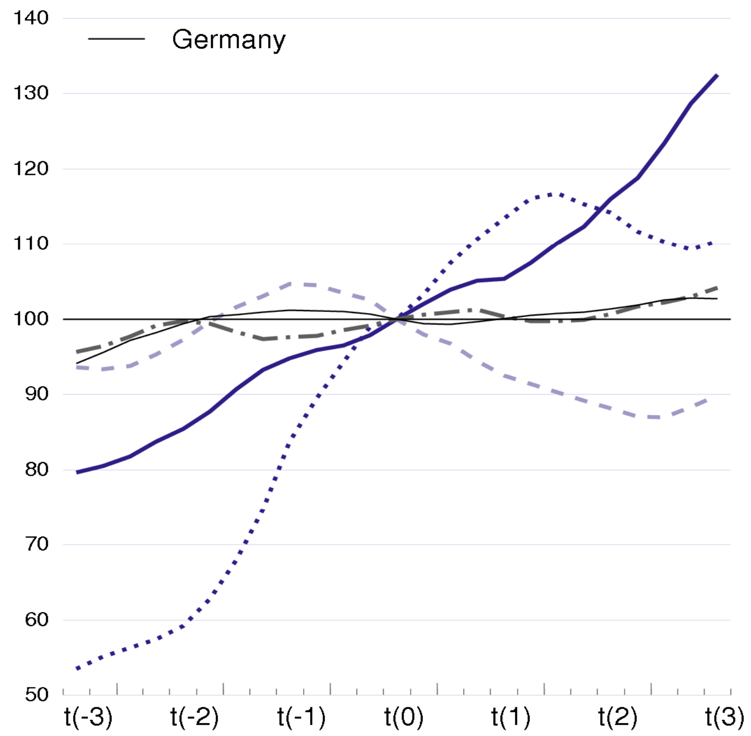
First break: t_0 = 1983q4 for the United States, 1979q2 for Japan, 1997q1 for China, and 1983q3 for the oil-exporting countries

Second break: t_0 = 1991q3 for the United States, 1987q3 for Japan, 2003q1 for China, 2005q4 for Germany and 1994q1 for the oil-exporting countries

First break



Second break



Source: de Mello and Padoan (2010), OECD WP No. 795.

Potential output growth rises for a while after current account reversals

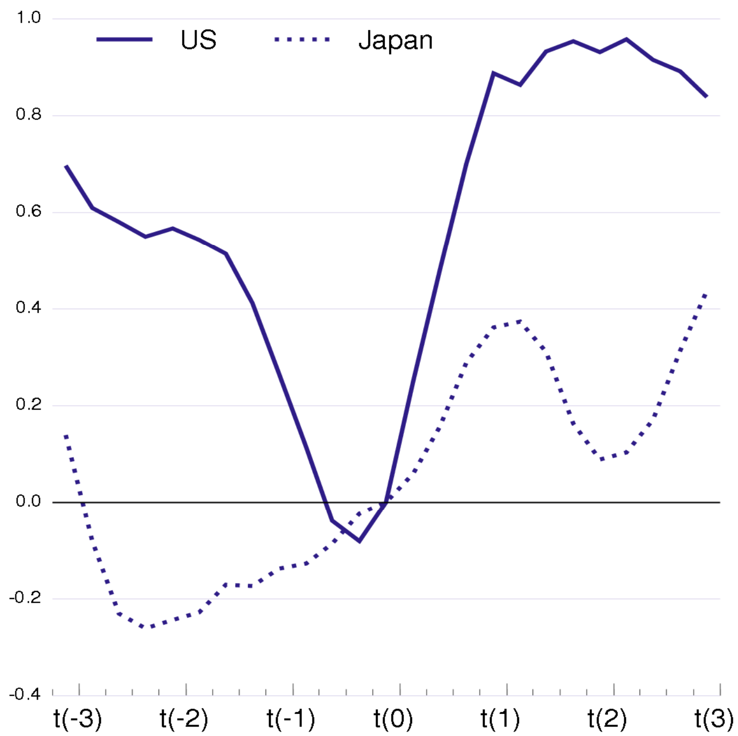
EVENT ANALYSIS

Potential output growth, rescaled to 0 at t_0

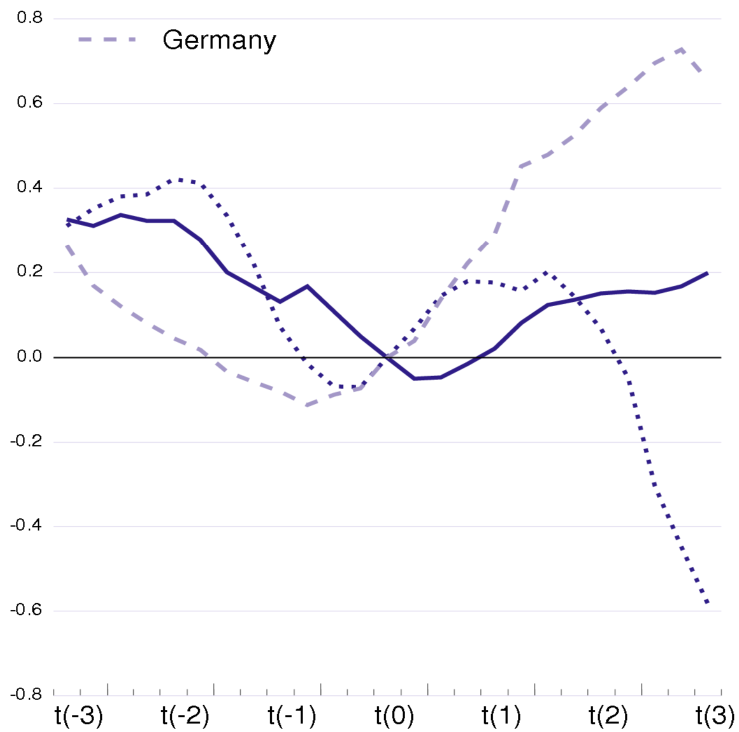
First break: t_0 = 1983q4 for the United States and 1979q2 for Japan

Second break: t_0 = 1991q3 for the United States, 1987q3 for Japan and 2005q4 for Germany

First break



Second break



Source: de Mello and Padoan (2010), OECD WP No. 795.

Going beyond the stylised facts

ANALYSIS

- The event analysis highlights regularities in the data and provides a general description of the economic processes at play

- But one can go beyond these regularities and use regression analysis to uncover causal relationships and highlight the role of macroeconomic policy and capital flows as determinants of current account reversals

The role of capital flows

CAPITAL FLOWS

- Capital flows are important determinants of current account reversals: Portfolio investment and FDI inflows have different effects
  - ✓ Rising portfolio inflows increase the probability of improvements in external positions and are associated with larger reversals when they occur
  - ✓ Rising FDI inflows reduce the probability and magnitude of improvements, possibly because of an increase in factor payments abroad once FDI operations have started
- Recent debate on whether, due to a savings glut, demand for foreign financial assets by East Asia has been a main driver of the current-account deficit in the United States
  - ✓ Contributions by Bernanke (2005); Caballero, Farhi and Gourinchas (2008); Obstfeld and Rogoff (2009)

MACROECONOMIC POLICY

The role of macroeconomic policy

- By reducing absorption over the period leading up to a reversal, a monetary tightening increases the likelihood of an improvement in external positions
  - ✓ When an improvement occurs, a monetary tightening is associated with smaller subsequent swings in external positions
- As for fiscal policy, a fiscal tightening prior to a reversal increases the probability and magnitude of an improvement in external positions, when it takes place

Policy simulations

- Dealing with global imbalances in the years ahead must be put in a broader perspective as most countries will have to undergo fiscal consolidation and adopt measures to sustain medium-term growth

- Policy scenarios look at the implications on growth, fiscal consolidation, and imbalances

Looking ahead: What do we learn from policy simulations?

POLICY SIMULATIONS

- 3 different scenarios are considered:
  - ✓ Baseline (business as usual): limited fiscal consolidation and no structural reform
  - ✓ Fiscal consolidation: Debt-to-GDP ratios are reduced to pre-crisis levels (except for Japan) by 2025 and exchange rate effects are taken into account
  - ✓ Structural reform: measures are phased in to reduce (raise) savings in surplus (deficit) countries and to reduce structural unemployment in the euro area
- Simulations carried out **using the OECD Global Model**
  - ✓ OECD Economic Outlook, No. 87 (May 2010)

Structural reforms could prevent large global imbalances from re-emerging

POLICY SIMULATIONS

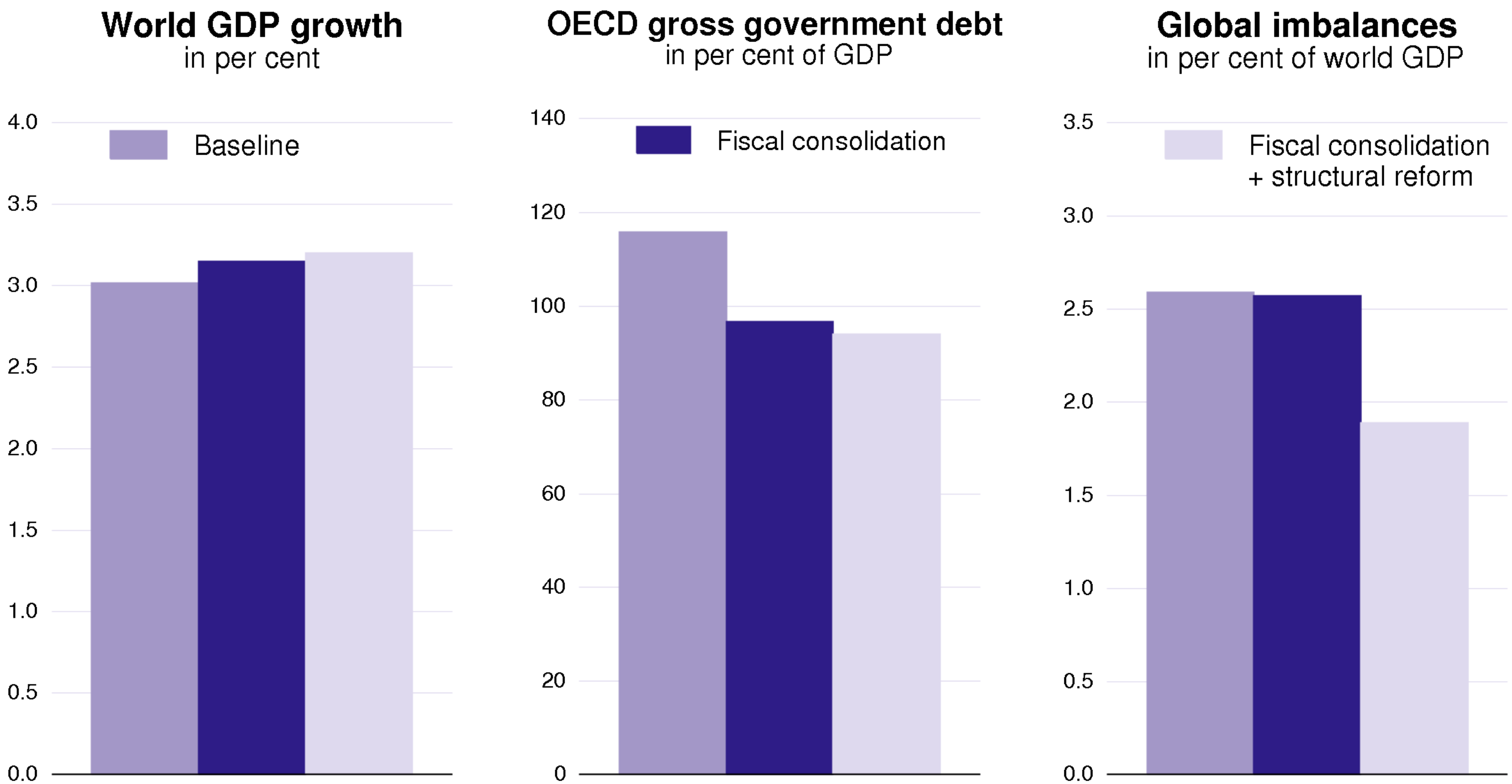
	Current account balance				Difference from baseline scenario		
	2008	2011	2015	2025	2011	2015	2025
United States							
Baseline	-4.9	-4.0	-4.1	-4.2	...	...	...
Plus fiscal consolidation	-4.9	-3.7	-4.0	-4.2	0.3	0.1	0.0
Plus exchange rate response	-4.9	-3.6	-3.6	-3.5	0.4	0.5	0.7
Plus structural reform	-4.9	-3.5	-2.8	-1.0	0.5	1.3	3.2
Japan							
Baseline	3.3	3.5	3.1	2.0	...	...	...
Plus fiscal consolidation	3.3	3.8	4.3	2.7	0.3	1.2	0.7
Plus exchange rate response	3.3	4.0	4.6	3.5	0.5	1.5	1.5
Plus structural reform	3.3	3.9	4.8	2.9	0.4	1.7	0.9
Euro area							
Baseline	-0.8	0.8	1.1	1.3	...	...	...
Plus fiscal consolidation	-0.8	1.1	0.4	1.4	0.3	-0.7	0.1
Plus exchange rate response	-0.8	1.1	0.7	1.7	0.3	-0.4	0.4
Plus structural reform	-0.8	1.2	0.7	1.8	0.4	-0.4	0.5
China							
Baseline	9.4	3.4	4.0	5.5	...	...	...
Plus fiscal consolidation	9.4	3.2	3.9	5.3	-0.2	-0.1	-0.2
Plus exchange rate response	9.4	2.8	3.3	4.7	-0.6	-0.7	-0.8
Plus structural reform	9.4	2.3	2.2	3.1	-1.1	-1.8	-2.4
Other non-OECD Asia							
Baseline	2.7	1.9	1.7	1.5	...	...	...
Plus fiscal consolidation	2.7	1.3	1.6	1.2	-0.6	-0.1	-0.3
Plus exchange rate response	2.7	1.5	1.3	0.7	-0.4	-0.4	-0.8
Plus structural reform	2.7	1.5	0.7	-0.7	-0.4	-1.0	-2.2

Source: OECD Economic Outlook EO87.

POLICY SIMULATIONS

Structural reform can do much to sustain growth and reduce global imbalances while pursuing fiscal consolidation

Policy simulations, 2016-25 average



Source: OECD calculations.

Bottom-line of policy simulations

POLICY SIMULATIONS

- Global imbalances would continue to widen in the baseline scenario
- Fiscal consolidation could narrow global imbalances but not by a large amount, in part because of the synchronicity of adjustment in many countries
- Structural reform would yield the largest payoff in terms of lower global imbalances
  - ✓ Essential for achieving the G20’s shared objective of strong, sustainable and balanced growth

Implications of a reconfiguration of current account imbalances for capital flows

CAPITAL FLOWS

- Fiscal consolidation
  - ✓ A reduction in the supply of government bonds in (mostly advanced) countries that currently have high debt and/or budget deficits could lead to a rebalancing of capital flows towards corporate bonds, equity and/or foreign direct investment, which could be growth-enhancing
- Exchange rate flexibility
  - ✓ Alongside greater exchange-rate flexibility, surplus countries whose currencies are pegged to the U.S. Dollar (China, oil-exporters) could decrease accumulation of international reserves in the form of U.S. government bonds
- Structural reforms (see below)

China's current account trends: 3 different phases

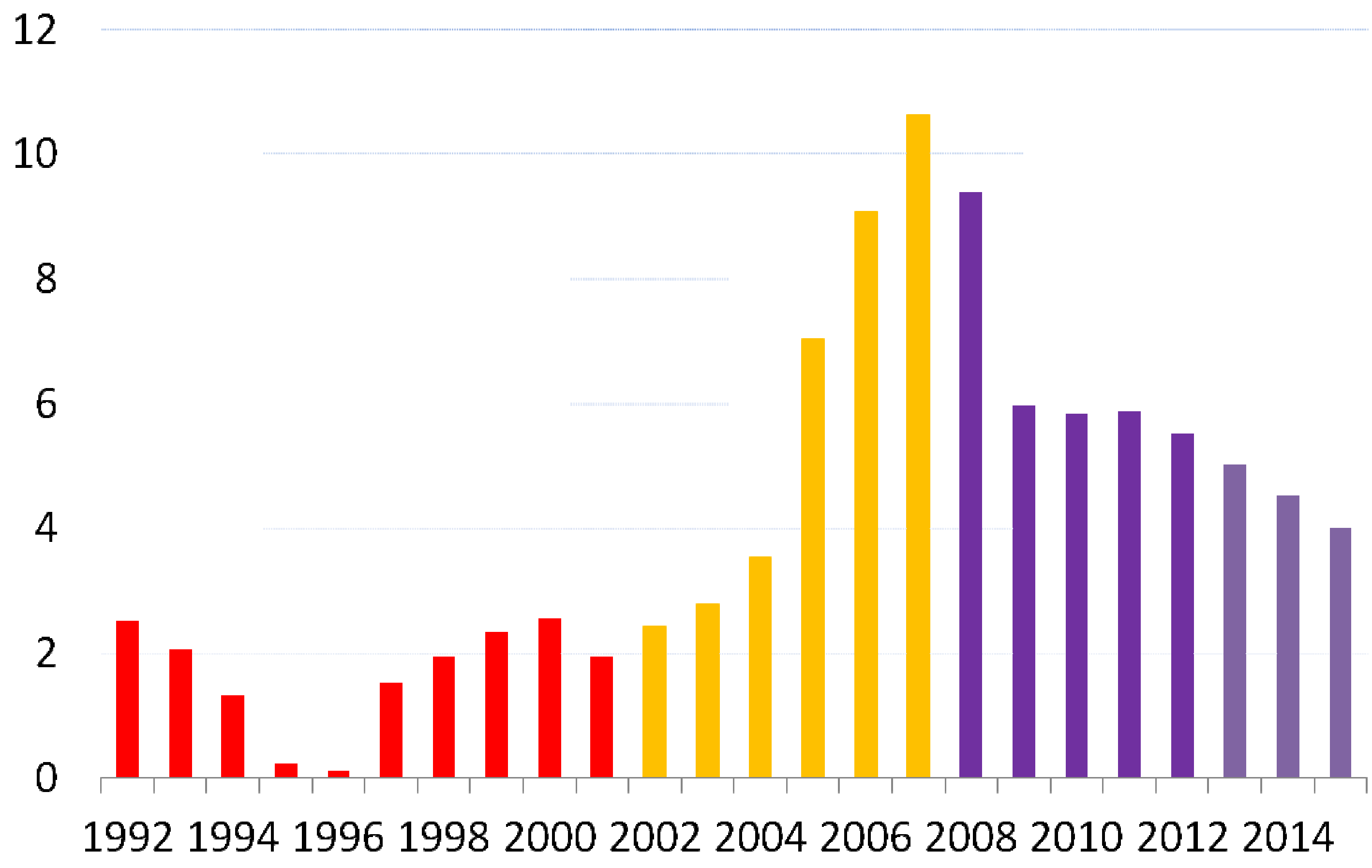
CHINA

- Modest imbalances (1992-2001)
  - ✓ Opening up, enterprise restructuring, FX rate unification
  - ✓ Growth in foreign investment and exports, SOEs cut investment and raise productivity
- Surging CA surpluses (2002-07)
  - ✓ WTO entry, FX appreciation, fall in US saving rate
  - ✓ China joins world supply chain, rising household and government savings
- Adjustment phase: falling CA surpluses (from 2008)
  - ✓ Re-emergence of government deficits, surge in public infrastructure, drop in world trade
  - ✓ Pick-up in domestic demand, worsening of ToT, surge in imports and government borrowing

Large external surpluses are associated with high domestic savings

CHINA

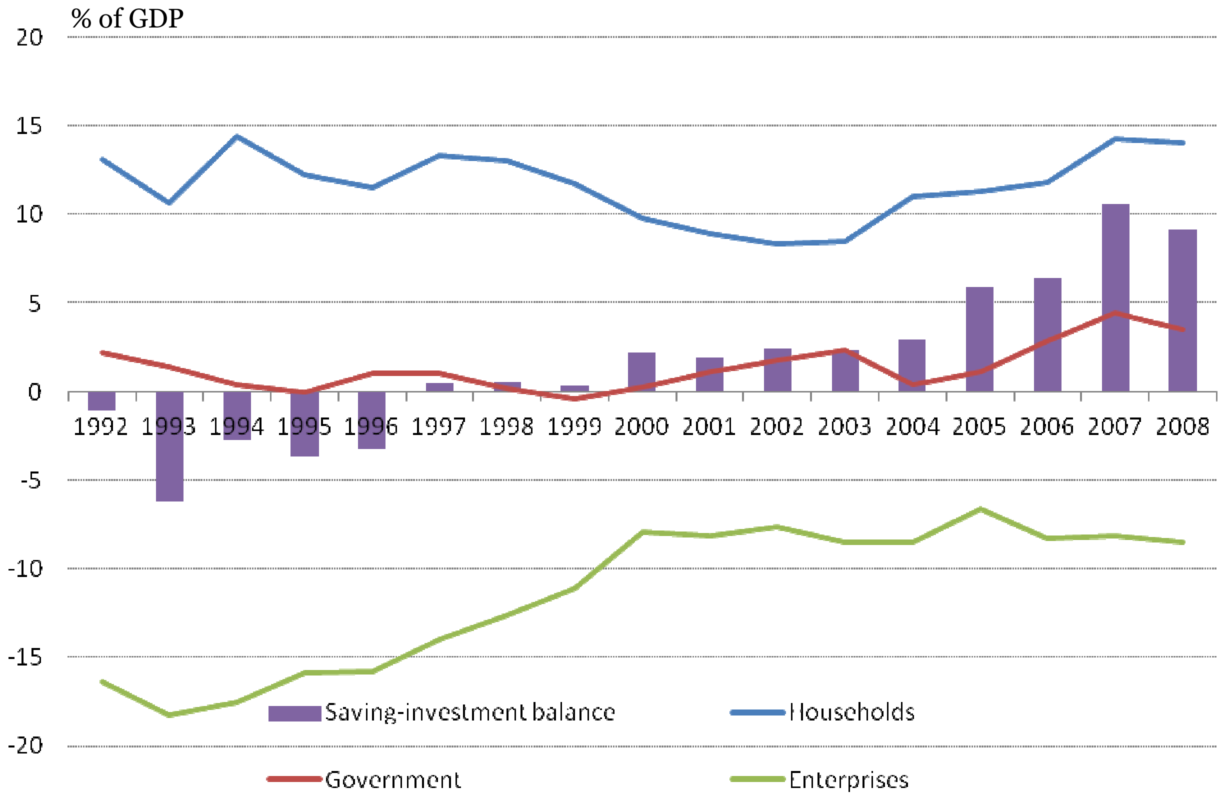
China's current account balance, in % of GDP



Source: CEIC China database.

Rising household and government saving-investment balances pushed up the current account surplus after 2003

CHINA



Source: CEIC China database.

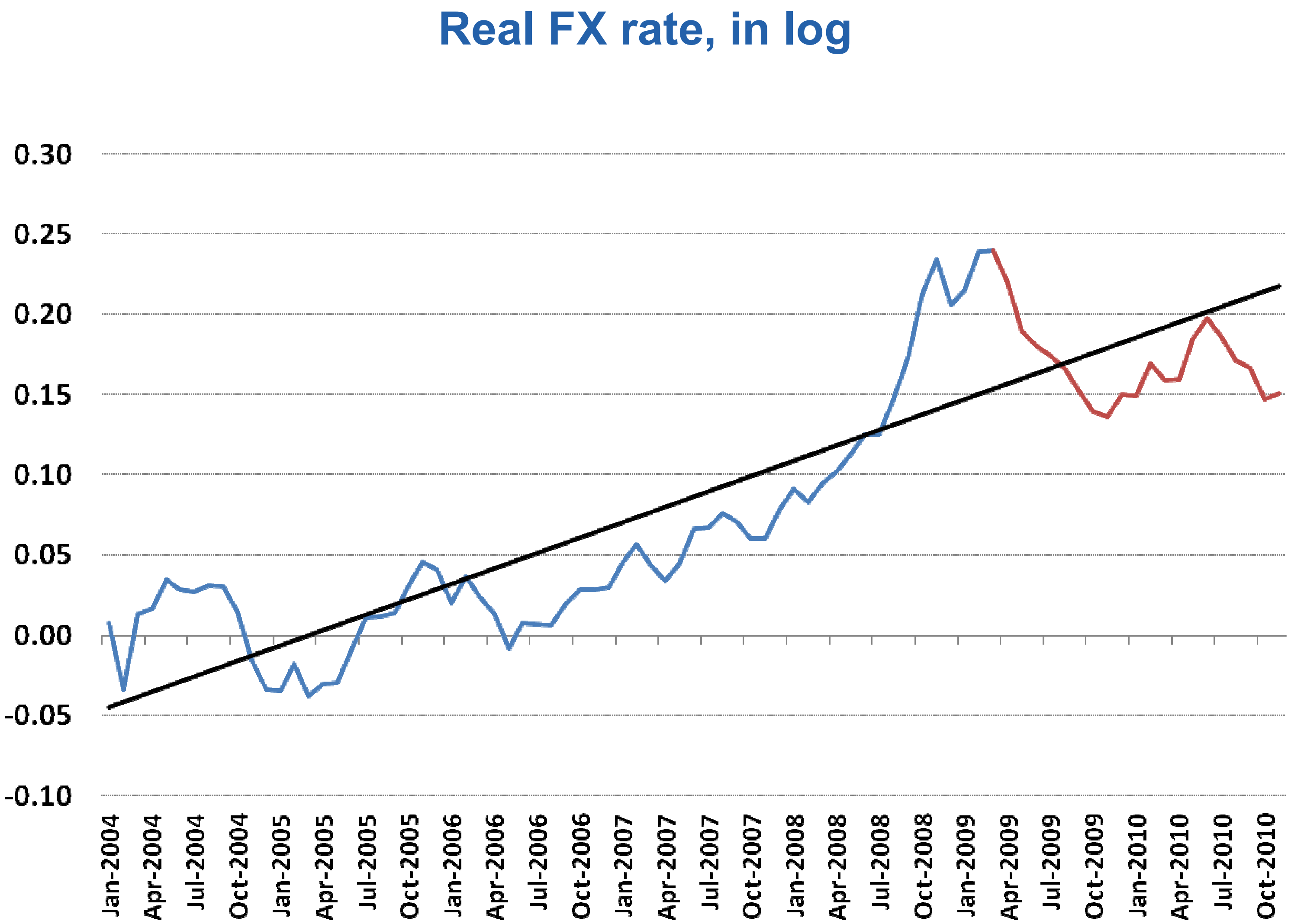
What is needed to rebalance Chinese growth?

GROWTH REBALANCING

- No one sector has consistently raised the CA balance, levels of indebtedness are not high
  - ✓ Off-budget borrowing is not excessive, households have large assets, investment income surplus has risen
- Can the government reach its target for the CA balance in the 12th Plan?
  - ✓ Policy moves are welcome (urbanisation drive, completion of social security system by 2020, better income distribution, reduction in number of SOEs)
  - ✓ Expected policy impact: rise in domestic demand and government borrowing, buoyant exports
- FX appreciation is the missing link
  - ✓ Real (CPI) FX rate has appreciated until recently and China has moved up the Harrod-Balassa-Samuelson curve
  - ✓ OECD has argued for nominal appreciation against a basket of currencies; the alternative is higher inflation

Real FX rate has appreciated but is now falling

FX RATE



Source: OECD.

Which structural reforms for China?

REFORM OPTIONS

- Several initiatives to rebalance growth in China towards domestic demand are in line with OECD policy advice (OECD Economic Survey of China, 2010)

- Strengthening of formal safety nets

  - ✓ Empirical evidence: A 1% increase in social spending could reduce the saving-to-GDP ratio by about ½ percentage point in the OECD area on average, and by as much as 1 percentage point in China (Baldacci *et al.,* 2010; Furceri and Mourougane, 2010)

- Pension and health care reforms

  - ✓ Overcome fragmentation in the welfare assistance, pension and health systems

  - ✓ Progress towards universal, affordable basic health care (greater role for primary care, more efficient hospital management, changes in some relative prices, merger of the different insurance systems)

Which structural reforms for China?

CHINA

- ❑ Financial deepening can reduce precautionary saving by facilitating access to credit for households

- ❑ Structural reforms can unleash opportunity for investment and, all else equal, reduce high corporate savings

  - ✓ Continued product market reforms to loosen traditional ties between state-owned enterprises and central authorities, reduce administrative burdens, allow greater private-sector involvement in network sectors and lower barriers to foreign direct investment in services

  - ✓ Further financial sector reform, including raising the ceilings on foreign investment in the financial sector, expanding the corporate bond market, creating a formal deposit insurance system for commercial banks and strengthening supervisory capacity. Continued vigilance is called for to avoid a build-up of loans that may underperform

Structural reforms for rebalancing global growth

REFORM OPTIONS

- Structural reforms affect the current account through their effects on saving and investment

- Reform needs and priorities vary across countries
  - ✓ OECD Report to G20 Leaders on the role of structural policies

- In the United States, large current account deficits reflect low savings, especially among households
  - ✓ Scrapping income tax deductibility for mortgage payments
  - ✓ Shifting the personal income tax further to a consumption base

- External imbalances are also large within the euro zone; sizeable surpluses in Germany reflect low investment
  - ✓ Policy action to boost investment in new sources of growth (OECD Economic Survey of Germany, 2010)

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