High-level Regional Policy Dialogue on "Asia-Pacific economies after the global financial crisis: Lessons learnt, challenges for building resilience, and issues for global reform"

6-8 September 2011, Manila, Philippines

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Current Regional Challenges 3: Rebalancing Growth

Presentation

Rebalancing East Asia's Growth

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Questions addressed

- Why rebalance East Asia's growth?
- What does it mean for the region? From export-led to export-substitution?
- How to address China's many interrelated imbalances?
- What role for China's exchange rate policy?
- How to address structural impediments to China's rebalancing?

Why Rebalance?

- Sino-centric "Factory East Asia" – too dependent on exports – "save, invest, produce, export, and….. the same again, and…."
- New numbers on old questions – East Asia's "export exposure" much larger than previously thought
- Half of China's growth comes from exports
- Others (Korea, Taiwan, Singapore, Malaysia) even more export-dependent; Japan almost the same as China
- Subdued domestic consumption shows up in overgrown industrial sectors and stunted service sectors
- Persistent current account surpluses and FX reserve accumulation - the paradox of poor lending to the rich

So What?
Why Fix It If Not Broken?

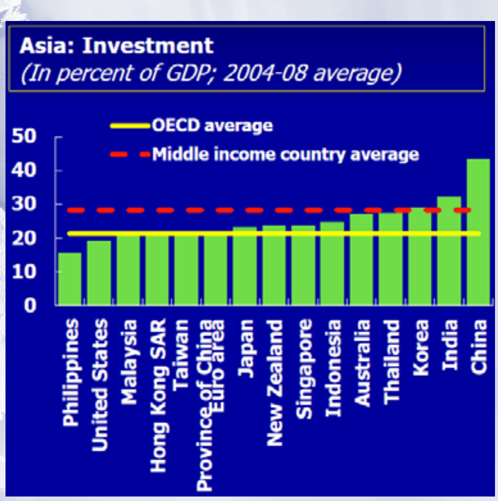
- The current global financial crisis – a wake up call for East Asia
- Business will not be as usual, as the Western countries work their way out of the lingering crisis
- Deleveraging in the US – a persistent squeeze on US growth and imports
- Impending fiscal consolidation in the US and Europe – a further lid on global demand for East Asian products
- The current East Asian "auto-finance" model of growth – sell and loan-finance the sale – will come under severe pressure
- US domestic politics too will pressure it to be less tolerant to East Asian exports - witness the pressure on Japan to rebalance in the 1980s

Overall, the global growth model of the pre-crisis years – the US, "living much above its means" and many East Asian countries "living much below their means" is neither desirable nor sustainable

Reviving Private Consumption is Key to East Asia's Rebalancing

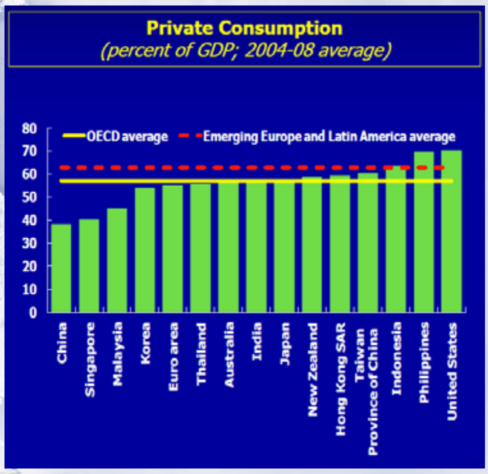
- There is scope for reviving private investment in some of the middle income ASEAN countries.
- With the exception of the Philippines, investment-GDP ratios are not too low though (slide 6).
- Also, given that China - now the largest economy in the region – has an exceptionally high investment rate – from a regional perspective, underinvestment may not be a major bottleneck to regional demand.
- The same cannot be said about consumption that ranges from 36% in China to about 70% in the Philippines (slide 7).
- China, Singapore, Malaysia have consumption-GDP ratios lower than 50%, and even Korea has a subdued consumption-GDP ratio.
- Once again, given the size of the Chinese economy, the regional consumption-ratio would be heavily tilted towards the Chinese figure
- Hence, raising private consumption in China (and reducing the external surplus) is key for rebalancing East Asia's growth away from exports to domestic-cum-regional demand

Investment Rates in Asia



Source: Pradhan, Unteroberdoerster, IMF, May 2010

Private Consumption in Asia



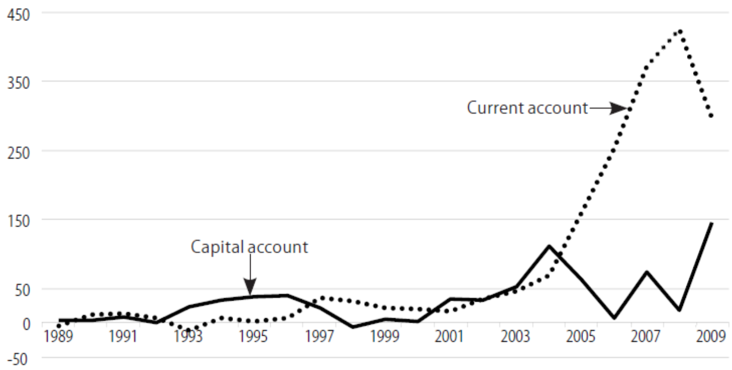
Source: Pradhan, Unteroberdoerster, IMF, May 2010

China's Many Inter-Related Imbalances – A Snapshot

- External Imbalance (twin surpluses – current account and capital account surpluses – slide 9)
- Demand Imbalance (too much investment and too little consumption)
- Production imbalance (oversized Industry, stunted service sector)
- Spacial Imbalance (rural-urban / coastal-interior divide)
- China's growth "… unstable, unbalanced, uncoordinated and ultimately unsustainable" (Chinese Prime Minister Wen Jiabao)

China's Twin BoP Surpluses

Figure 1: China's Twin Surpluses (in $ billion)



Sources: State Administration of Foreign Exchanges, the People's Bank of China.

Source: Yongding, *Rebalancing the Chinese Economy.* August 2011.

The Policy Genesis of China's Rising Current Account Surplus ...

- China devalued and unified its dual exchange rate system in 1994
- Since then and until the Asian financial crisis, China's exchange rate was set according to the production cost of exports with the aim of maintaining the competitiveness of exports - variant of a "real targeting approach"
- Tax rebates and other favorable treatment for production for exports complemented that exchange rate policy
- Since the Asian financial crisis – the Reminbi was pegged to the Dollar, with some "marginal and temporary" loosening of the peg in 2005
- As some of the tax rebates etc. were eliminated following China's accession to the WTO in 2001, exchange rate became the principal instrument to promote exports
- Since 1995, China has posted current account surpluses every year; and since 2001 the surplus rose sharply – from less than $40 billion in 2001 to a peak of about $450 billion in 2008 (slide 9).

… and the Capital Account Surplus

- China has also run capital account surpluses for almost two decades now, and it has risen sharply since the early 2000s
- A large part of the capital account surplus was due to the inflow of export-oriented FDI and in recent years foreign investors' acquisition of shares in Chinese firms.
- China's preferential policy towards export-oriented FDI, including FDI being a performance measure for local officials, is well known
- A part of the FDI to China could also be rent-seeking, round-tripping capital (the top two FDI providers are Hong Kong and Virgin Islands!)
- Coupled with current account surplus, the capital account surplus resulted in the build-up of huge FX reserves: from $400 billion in 2003 to $3.2 trillion now.
- World Bank's estimate of the return on multinationals' investment in China in 2008 was 22% (U.S Conference Boards even higher at 33%) and the return on US treasuries that China earned the same year was 3% – an inverted/loss-making financial intermediation

Options for China's Growth Rebalancing

Remove the most obvious export biases:

- Float the exchange rate
- Remove the remaining incentives for export-oriented production and investment
- Remove remaining restrictions on capital outflows
- Support consumption with accommodative macro-policies

Address the structural impediments to private consumption and consumer goods imports:

- Use the excessive retained profits of the state enterprise sector for developing mechanisms for the provision of health care, pensions, and other social safety nets
- Facilitate service sector (non-tradable) investment and development
- Speed up the process of financial sector development

The Adjustment Process could be Bumpy but Delaying it Would be Much Worse

- The adjustment process could be bumpy as it would involve significant resource reallocation across several sectors.
- The shift to a floating exchange rate regime could also involve volatility for some time, but that would be better than a one-time step revaluation of the currency
- A clear communication of the policy directions to the markets would be crucial in managing the transition
- The change in China's exchange rate regime and economic adjustment would have significant implications for the other East Asian economies and the process would benefit from regional dialogue and coordination.

East Asia's Sino-centric, export-led growth model cannot go on for ever; the region will have to move from being producer-exporters to producer-consumers and consumer-importers; and as the region's largest economy, China will have to be the prime mover in that transformation

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