

# **FESSUD**

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE  
DEVELOPMENT

## **Working Paper Series**

**No 144**

Assessing China's Economic and Financial  
Prospects within the context of Global Imbalances

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## **Assessing China's Economic and Financial Prospects within the Context of Global Imbalances**

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**Abstract:** This deliverable develops two medium-term projections for China's economic and financial development over the next ten years based on utilizing the CAM global macro-econometric model. The first projection is a Baseline Scenario that assumes continuing global imbalances in economic growth and current accounts among major countries and blocs (i.e., China, USA, the EU and Other East Asian High-Income Countries). The second projection is an Alternative Policy Scenario that programs improvements in such global imbalances. In addition, the deliverable discusses, in more detail, China's international financial position and its domestic financial conditions, especially the degree of different forms of indebtedness.

**Key words:** Economic Growth, Current Account Imbalances, Capital Account, Indebtedness.

Journal of Economic Literature classification ###, ###

Date of publication as FESSUD Working Paper: 144, 2016

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**Acknowledgments:**

The research leading to these results has received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800.

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## I. Introduction

This FESSUD Working Paper #144 first 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 current-account imbalances. It then projects China's prospects within an alternative scenario in which global imbalances in economic growth and current-account balances are modified.

As is now widely recognized, global economic trends have worsened appreciably since mid-2015. 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). This estimate was a downgrading from its estimate of 3.4% published in January 2016; and the January estimate was, in turn, a downgrading from its estimate of 3.6% in its October 2015 *World Economic Outlook*. And in late July, in the wake of the UK's Brexit vote, the IMF has downgraded its estimate of 2016 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 that suffer from large current-account deficits, and those countries such as China, Germany, Japan and other key East Asian economies that enjoy large current-account surpluses.

Financial imbalances have also become an increasingly serious problem at the global level. Some countries, such as the USA, have a large positive net external asset position while others, such as Brazil, suffer from a large negative net external asset position. Simply put, US citizens own many more foreign financial assets than foreigners own US financial assets. And Brazil suffers from the opposite problem, namely, foreigners own many more Brazilian domestic financial assets than Brazilians own foreign financial assets.

This imbalance tends to put Brazil at a disadvantage because if it experiences economic problems, such as slow or declining economic growth, foreigners are likely to quickly disown its financial assets and move their funds out of the country. However, such a rapid trend depends crucially on the proportion of *short-term* Brazilian financial assets that foreigners own. Such assets are represented mostly by portfolio investment or 'other investment' e.g., bank lending.

This Working Paper starts its analysis by first describing the historical trends in GDP growth and current-account balances across major countries and blocs of countries between 2002 and 2016. Thereafter it uses a global macro-econometric model, the CAM, to project the trends in these two variables through 2026. This is considered a medium-term projection.

The CAM model is distinctive in being a demand-led and stock-flow consistent model that also does not assume general equilibrium (see Cripps, Izurieta and McKinley 2007 and Cripps and Godley 1976). The CAM relies on using a huge databank of UN statistics stretching back to 1970 to depict historical trends. However, usually for the two latest years—in this case 2015 and 2016—it is deliberately aligned with IMF estimates (published in either its October or April *World Economic Outlooks*).

Thereafter the model's real strengths lie in projecting medium-term trends, such as over the next 10-15 years. For this Working Paper we carry out projections over 10 years, namely, to 2026.

At the global level, this Working Paper focuses its analysis on China but compares its trends to those in the United States of America, the European Union, and a major bloc of countries is labelled 'Other East Asian High-Income Countries'. This latter grouping is dominated by Japan and the Republic of Korea. Together these four blocs have accounted recently for at least 70% of global GDP.

## II. Baseline Global Trends in Economic Growth

Our first objective is to utilize the CAM to produce projections for what we customarily call a 'Baseline' Scenario. Such a scenario projects forward, over the medium term, established historical trends, such as of economic growth. Such a Baseline Scenario would assume, at most, only minimal well-established changes in policies. An example would be the €315 billion Juncker investment plan being implemented in the European Union.

Later in this Working Paper, we will construct an 'Alternative Policy Scenario'. Such a scenario will incorporate major policy changes into its programming and test the results. For recent concrete examples of such scenario-building read the Policy Briefs by Cozzi and McKinley 2015 and Cozzi, McKinley and Michell 2014.

We report first on the projected global trends in GDP growth that are generated by the '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. Note that GDP is calculated by the CAM at market rates.

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

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

<b>Global</b>	3.4	2.2	2.2	2.3	2.5
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First we report on results for the global economy. **Table 1** shows that 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.

The CAM model projects that global economic growth would increase over the next ten years though 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 economic stagnation 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 is still impressive.

Moreover, the CAM projects that this average rate would decline only modestly over the next ten years, i.e., between 2017 and 2026. It would still average 6.5%. Hence, China's economic growth would still contrast sharply with the global context of secular stagnation.

In contrast, 'Other East Asia High-Income' countries (e.g., Japan and the Republic of Korea) are projected to roughly mirror the modest rate of global economic growth over the next ten years: the CAM projects that this bloc's average rate would remain at about 2.3% to 2.4%.

However, such a rate of growth would represent an improvement. During the most recent period of 2012-2016, this bloc had average GDP growth of only 1.2% (primarily because of persistent stagnation in Japan, where economic growth has been below 1%).

Both the European Union and the USA are projected to grow even more slowly than the bloc of East Asian High-Income countries. During 2012-2016 the average economic growth of the EU is reported to be only 0.9%. And over the next ten years, this rate is projected to rise to only about 1.2%. Hence, such a low rate would contribute to pulling down global economic growth.

Moreover, the vote for Brexit in the United Kingdom on June 23, 2016 is very likely to lead to significantly lower economic growth in this country for the rest of this year and beyond, and could well have knock-on effects on the rest of Europe.

The growth of GDP in the USA is projected to worsen over the next ten years. While this country's economic growth achieved a credible average of 2.1% during 2012-2016 (namely, a rate comparable to that of the global economy), this would drop to only 1.2% to 1.3% during 2017-2026. This is an alarming prospect since the USA has

been one of the few Developed Economies that has been helping to drive global economic growth.

In other words, the USA would no longer be expected to function as an engine of economic growth for the global economy. Instead, it would join the EU, as well as Japan, in dragging down the rate of global growth. Only China represents the one clear exception in our table (despite a modest projected slowdown): it is expected to continue boosting global economic growth.

### III. Baseline Global Trends in Current Accounts

In this section we focus our attention on current-account balances for China as well as the USA, the European Union and East Asian High-Income countries. **Table 2** reports on the historical yearly averages and the yearly averages for our four global blocs of countries projected by our baseline scenario. 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.

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

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

The historical results for East Asian High-Income countries suggest that they have rapidly expanded their current-account surplus in recent years. Between 2011 and 2016 this bloc-level surplus has risen back up from 2.8% of GDP to 5.2%, the latter being even higher than the surplus achieved by China (i.e., 4.4%).

However, this bloc's combined surplus is projected to markedly decline through 2026, reaching 2.4% of GDP. Still, along with China, this sizeable bloc would still contribute significantly to global imbalances.

The results for the USA suggest that 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 again to -4.8% of GDP.

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. In 2016 the EU current-account balance is indeed expected to rise to a positive 2% of its combined GDP. But the CAM projects that this balance would progressively decline back 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, the United Kingdom would suffer from a current-account deficit of almost -6% of GDP. In addition, France would see its current-account deficit worsen by 2026 to -2% of GDP. Since such countries have large economies, their current-account imbalances would contribute significantly to global imbalances.

In the wake of the British vote for Brexit on June 23, 2016, the British pound has plummeted in value. Though some recovery might be possible, this currency is likely to have a significantly lower value for the foreseeable future.

In theory, such depreciation should help to correct the country's current-account deficit since its imports should become more expensive and its exports cheaper. However, the UK's rate of growth of investment would also likely slow and foreign investors are much more likely to abstain from financing the country's deficit.

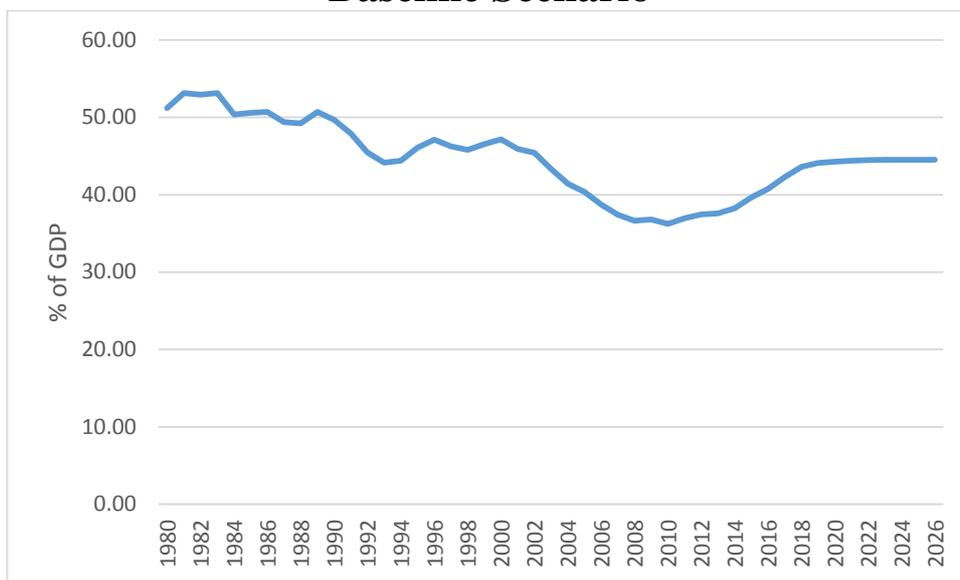
## **IV. China's Baseline Trends in Consumption, Savings and Investment**

In this section, we focus in more detail on historical and Baseline-projected results for China. Of particular concern are its trends in consumption, savings and investment. **Graphs 1, 2 and 3** present the historical results and the future results projected by the Baseline Scenario.

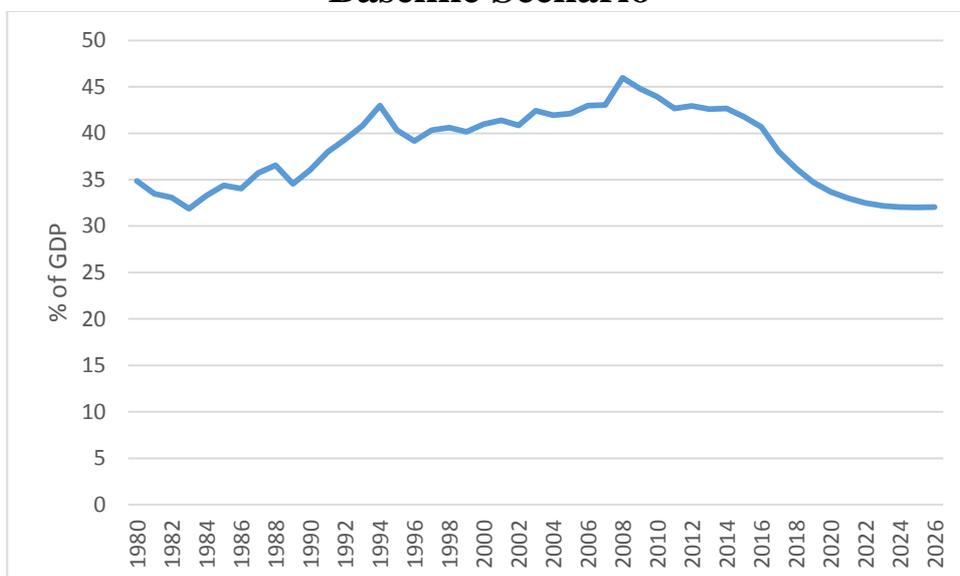
**Graph 1** depicts the historical trend and the Baseline Projection for China's consumption as a ratio to GDP. Consumption had already fallen substantially between 2000 and 2010, from 47.1% of GDP to 36.2%. Thereafter it began to recover, reaching 40.8% by 2016.

The Baseline Scenario projects that this percentage would continue rising sharply until 2018 and then begin to flatten out thereafter. By 2026, the last year of our projection, consumption would reach 44.5% of GDP. This trend in consumption is consistent with the projected decline in the current account as a % of GDP.

**Graph 1. Consumption (% of GDP) in China  
 Baseline Scenario**

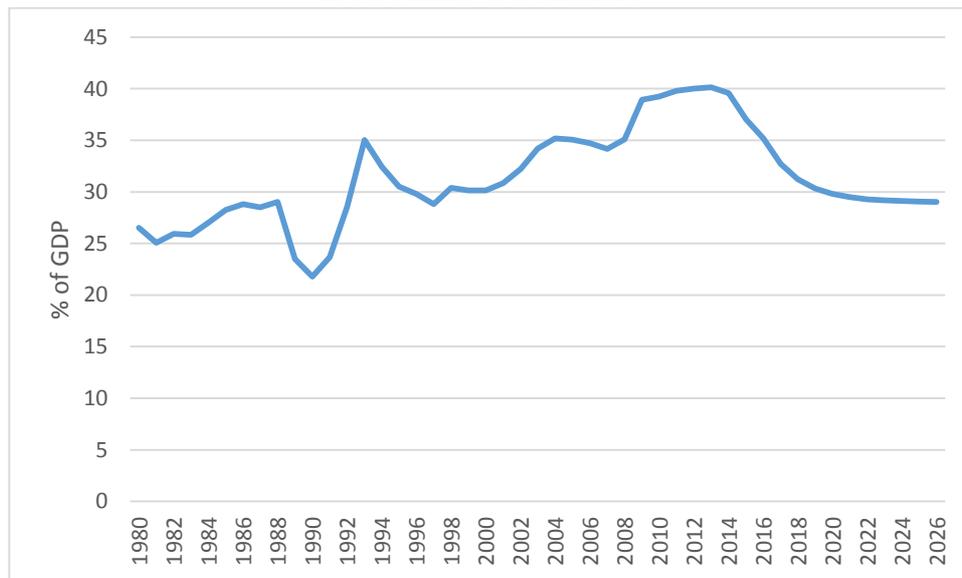


**Graph 2. Savings (% of GDP) in China  
 Baseline Scenario**



**Graph 2** depicts how savings (as a % of GDP) has been falling markedly since 2008 (the onset of the global financial crisis). In 2008 this ratio was 46% but by 2016 it had already fallen to 40.7%. Furthermore, the Baseline Scenario projects that savings would decline further, namely to 32%, by 2026. This sharp downward trend is not entirely consistent with the more restrained increase in consumption.

**Graph 3. Investment (% of GDP) in China  
Baseline Scenario**



**Graph 3** illustrates the trend in investment (as a % of GDP) in China. While in 2013 it had been a little over 40%, it started falling significantly thereafter. The Baseline Scenario projects that it would fall to 29.8% by 2020. Then it would start to level off, dropping only to 29% by 2026. But this is still a relatively high level.

The three trends depicted above are consistent with an economy that is already undergoing a structural transformation. Consumption would become a more important factor in driving economic growth while investment would decline.

## V. Framing an Alternative Policy Scenario

In order to improve the global economic outcomes over the next ten years, we have programmed a set of policy changes that are focused on altering economic growth rates and reining in current-account imbalances. We call this programming the **Alternative Policy Scenario**.

Our focus in this Working Paper is on China. The results from our Baseline Scenario suggest that the projected pace of its economic growth and the large size of its current-

account surpluses over the next ten years are likely to be unsustainable and contribute to global economic instability.

In order to forestall such problems, our programming for China concentrated on altering the relationship between savings and consumption. We explicitly programmed a reduction in savings.

It was assumed that such an approach would increase consumption and thereby increase imports. This increase in turn would reduce China's current-account surplus. Such a strategy would be in line, for example, with China's long-term strategy of shifting to more consumption-led economic growth.

A reduction in China's savings rate was already projected, in fact, by the Baseline Scenario. As indicated in **Graph 2**, savings as a ratio to GDP dropped from about 41% in 2016 to about 32% in 2026. This trend was responsible, in part, for the projected decline in China's current-account surplus to less than 4% of GDP.

As a complementary measure, we also programmed in our Alternative Scenario a modest increase in China's real exchange rate as a further basis to narrow its current-account surplus.

Most other countries face economic problems that are quite different from those for China. For such countries, especially those in Europe, we programmed some increases in both government income and expenditures. The primary intent of these changes was to provide greater stimulus to their economies since continued austerity has dampened their economic growth, especially through retarding investment.

The programming for the Alternative Policy Scenario also prioritised boosts to private and public investment for countries in Europe and the USA. Generally, the targets for investment as a ratio to GDP were 20-21% for the countries in Europe. But there was a lower target for the USA and the United Kingdom, where investment has languished well below 20%.

The principal objective of such programming was to have investment play the leading role in reviving economic growth. This approach could be called an 'Investment-Led' recovery strategy. For its rationale see, for example, the paper by Griffith-Jones and Cozzi, 'Investment-Led Growth: A Solution to the European Crisis' (Griffith-Jones and Cozzi 2016).

However, there was no investment target for China since it has historically maintained a relatively high rate, as illustrated previously in **Graph 3**. Moreover, since 2013, China's investment has already been falling from its high plateau of about 40% of GDP. By 2016 this ratio had declined to 36%. According to the projections of the Baseline Scenario, this ratio would drop further to 29% of GDP by 2026.

For Germany and the bloc of Other East Asian High Income Countries, which, like China, run globally sizeable current-account surpluses, we also programmed increases in their consumption.

By contrast, for the USA and the UK, which have run large current-account deficits, we programmed modest *decreases* in their real exchange rates along with decreases in their rate of consumption. However, their persistently large current-account deficits proved to be particularly difficult to contain.

## VI. The Policy Alternative: Trends in Economic Growth

**Table 3** presents the results for GDP growth among our four global blocs and countries as well as the world as a whole. It contrasts the results for what is called the ‘Baseline Scenario’ (which assumes minimal changes in policy) to the results for the scenario that is called the ‘Alternative Policy Scenario’. The latter 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 growth rate would decline to an average of 5.6% during 2022-2026 while it would have remained 6.5% under the Baseline Scenario (see **Graph 4**).

For the European Union as a whole, the Alternative Policy Scenario does provide a greater initial boost to GDP growth. But the greatest contrast between the Baseline Scenario and the Alternative Policy Scenario would occur during 2017-2021, when the European Union would grow at only 1.2% for the first scenario but 2.3% for the second. Thereafter, however, its growth rate would decline, reaching the average of 1.5% during 2022-2026. In the wake of the recent Brexit vote by the United Kingdom, this slow rate of economic growth is likely to drop even further.

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

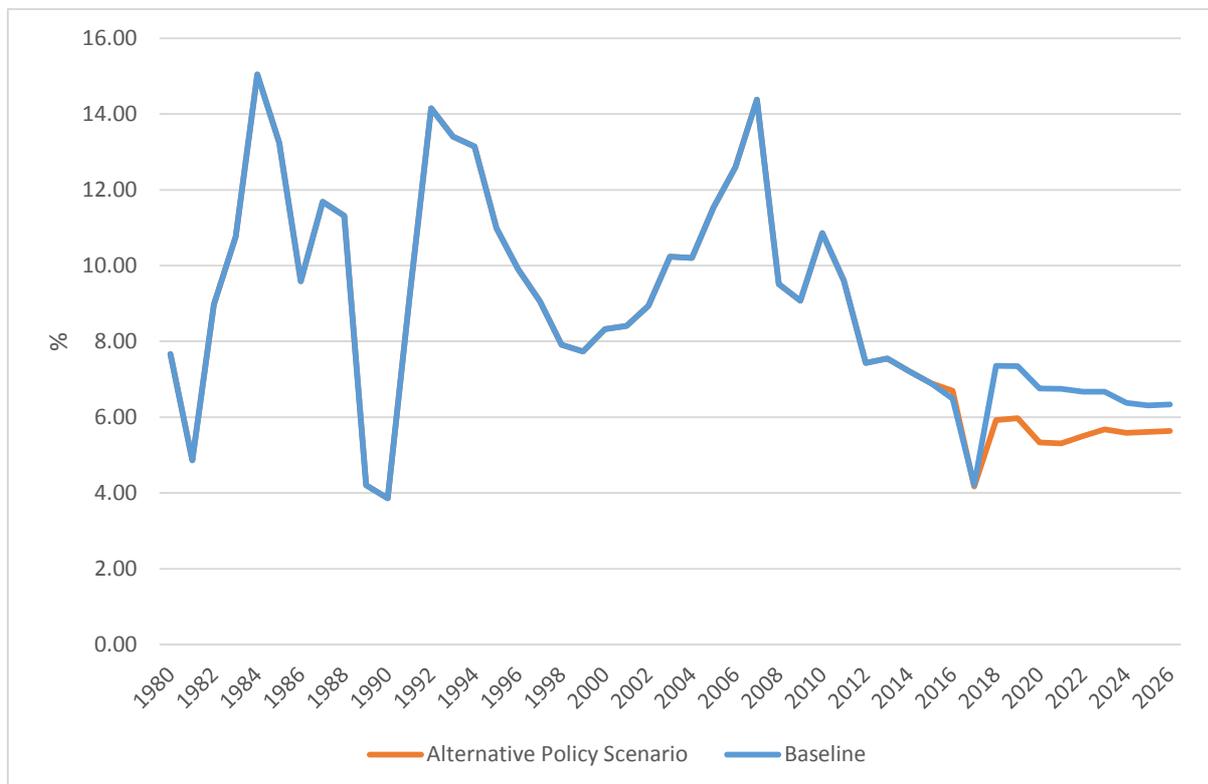
	Projections		Scenario
	2017-2021	2022-2026	
China	6.5	6.5	Baseline Scenario
	5.3	5.6	Alternative Policy Scenario
United States	1.2	1.3	Baseline Scenario
	1.8	2.0	Alternative Policy Scenario
European Union	1.2	1.2	Baseline Scenario
	2.3	1.5	Alternative Policy Scenario
Other East Asia High Income	2.4	2.3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

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

Under the Alternative Policy Scenario, the growth of GDP would improve in the bloc of East Asian High-Income Countries (e.g., Japan and Republic of Korea), even though there were only minimal policy changes, such as boosting consumption. While this bloc's growth rate for 2022-2026 is projected to be 3.1% under the Alternative Policy Scenario, it was only 2.3% under the Baseline Scenario.

Under the Alternative Policy Scenario, the programmed improvements in economic growth in most of the blocs led to a global growth rate of GDP of 2.9% in 2022-2026. This was only a moderate improvement over a 2.5% growth rate projected by the Baseline Scenario for the same period. During 2012-2016, global economic growth had been only 2.2%

**Graph 4. Average GDP Growth of China  
Baseline and Alternative Scenarios**



Part of the reason for the restrained increase in global economic growth stimulated by the Alternative Policy Scenario is that economic growth in China has been programmed to slow down over the projected period. As already reported, during

2022-2026 China’s growth would decline to 5.6% under the Alternative Policy Scenario. But it would have been maintained at a rate of 6.5% under the Baseline Scenario.

## VII. The Policy Alternative: Trends in Current Accounts

The Alternative Policy Scenario projects a sharp fall in China’s current-account surplus to 1.8% by 2026 (see **Table 4**). This contrasts 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 had their intended effects.

Other East Asian High Income countries are also projected to experience a fall in their combined current-account surplus. By 2026 their combined surplus would also be 1.8%. This contrasts with the 2.4% surplus projected by the Baseline Scenario for the same year, and contrasts even more sharply with its 5.2% surplus in 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 much smaller, at -3.2% of GDP.

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

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

So under either scenario the imbalance imparted to the global economy by the USA would clearly worsen. It appears that while the USA remains the dominant reserve-currency economy in the world, there would be great difficulty in fashioning a progressive policy alternative that could substantially reduce its persistent structural deficit.

The same logic applies to the United Kingdom within the European Union. Under the Alternative Policy Scenario, for example, its deficit would still be -4.7% of GDP in

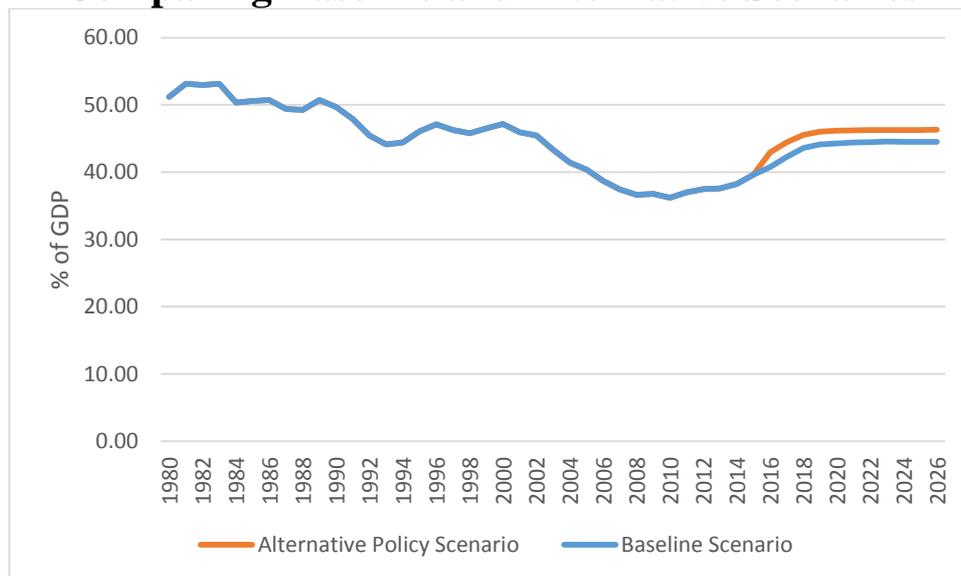
2026. Given the Referendum result in late June 2016 and the consequent decline in the value of the Pound, these projections would need to be modified.

As a bloc, however, the European Union would not contribute significantly to global current-account imbalances. The Alternative Policy Scenario would reduce its small overall surplus to only 0.4% of global GDP by 2026. This result would not be significantly different from the 0.8% surplus expected under the Baseline Scenario.

## VIII. China's Alternative Trends in Consumption, Savings and Investment

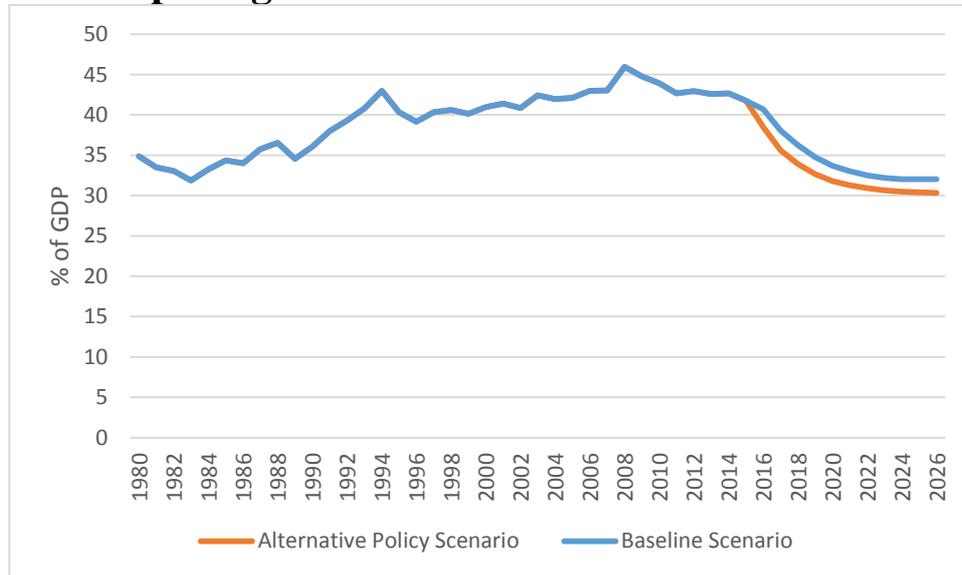
In this section we report the changes in Consumption, Savings and Investment in China projected by our Alternative Policy Scenario through 2026. For these variables **Graphs 5, 6 and 7** present both the trends for the Baseline Scenario and those for the Alternative Policy Scenario.

**Graph 5. Consumption (% of GDP) in China Comparing Baseline and Alternative Scenarios**



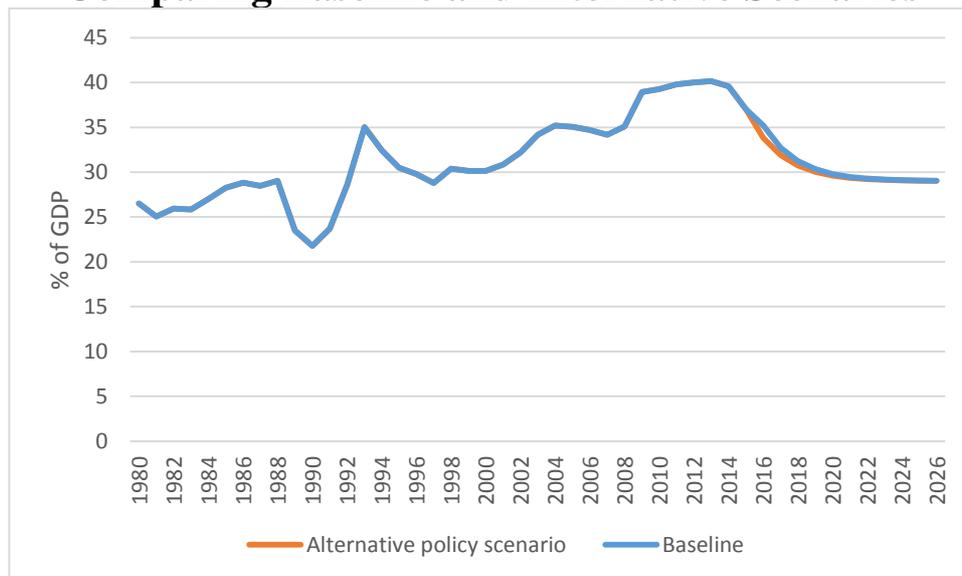
**Graph 5** illustrates that by 2026 our Alternative Policy Scenario would generate only a modest rise in consumption in China relative to the level projected by the Baseline Scenario. While consumption as a ratio to GDP would level off and stay at 44.5% by 2026 according to the Baseline Scenario, it would reach a plateau of 46.3% according to the Alternative Policy Scenario.

**Graph 6. Savings (% of GDP) in China  
Comparing Baseline and Alternative Scenarios**



Correspondingly **Graph 6** shows that there would be a modest reduction in savings (as % of GDP) in China between 2017 and 2026 under the Alternative Policy Scenario. By 2026, the savings under the Baseline Scenario would drop to 32% of GDP while under the Alternative Policy Scenario this variable would be somewhat lower, namely, about 30%.

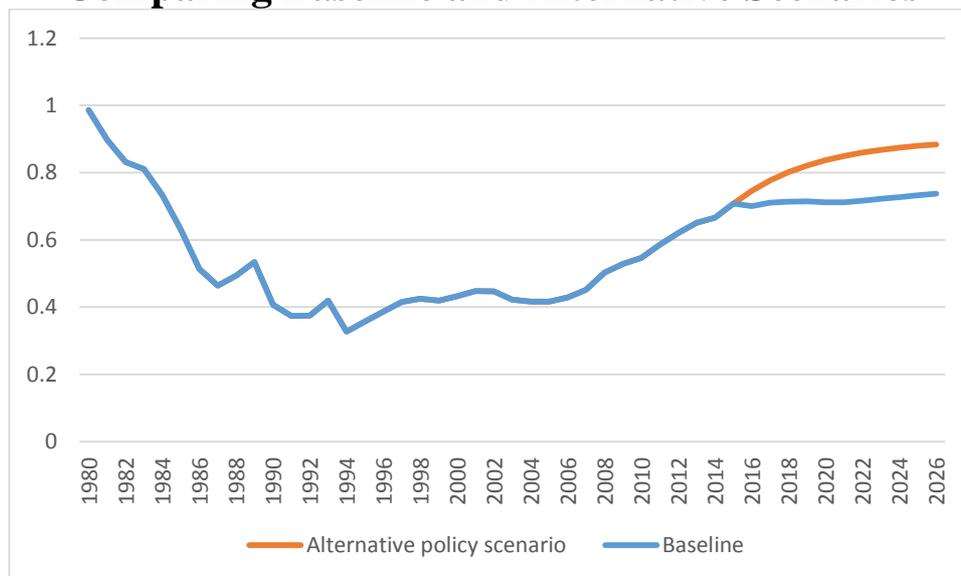
**Graph 7. Investment (% of GDP) in China  
Comparing Baseline and Alternative Scenarios**



**Graph 7** shows that there would be virtually no difference between the Baseline Scenario and the Alternative Policy Scenario with regard to investment. Both of them project that investment would reach 29% of GDP by 2026. This is not surprising since we did not program any boost to investment for this Scenario.

But we did program an appreciation of the renminbi under the Alternative Policy Scenario. The effect is captured in **Graph 8**. This Graph shows that the unit index for the renminbi (i.e., denoting the real exchange rate) appreciated only marginally between 2017 and 2026, i.e., from 0.70 to 0.74, under the Baseline Scenario. In contrast, it rose dramatically, from 0.70 to 0.88 (or about 25%), under the Alternative Policy Scenario. This notable appreciation exerted the decisive influence in reducing China's current-account surplus to only 1.8% in 2026.

**Graph 8. The Real Exchange Rate (Unit Index) Comparing Baseline and Alternative Scenarios**



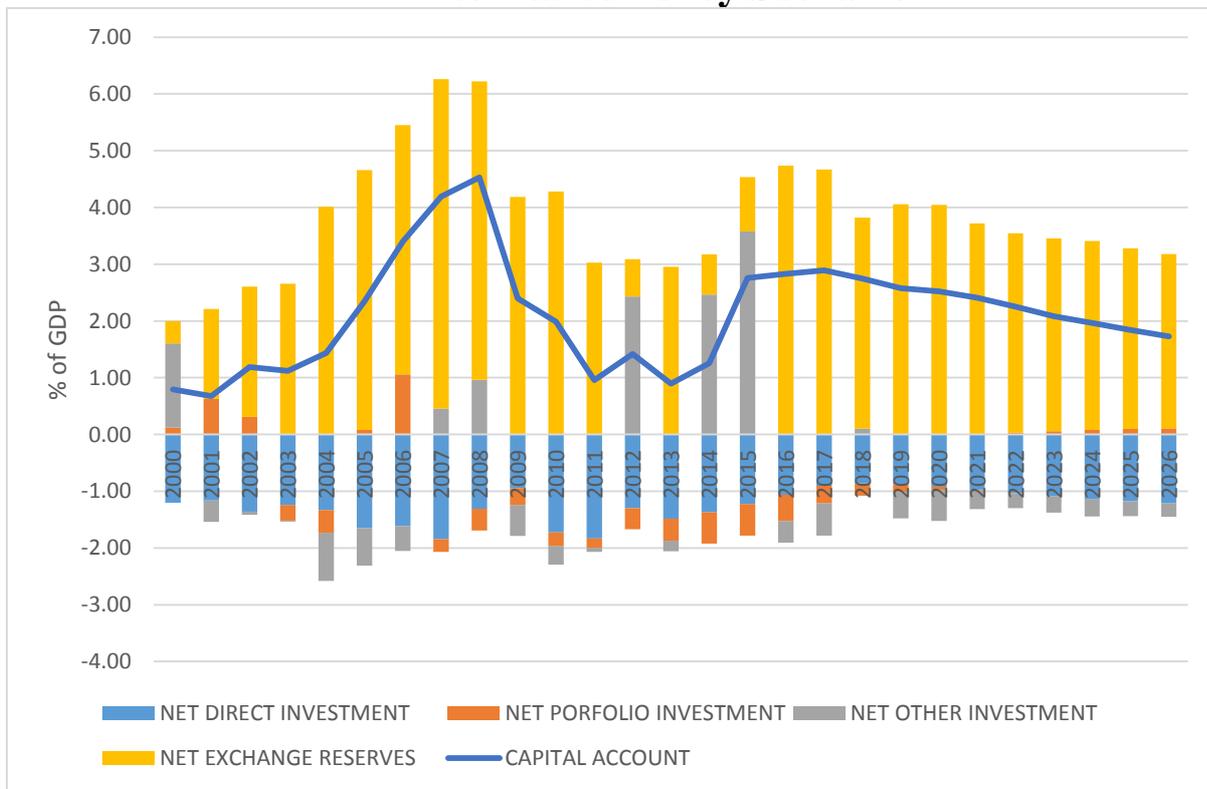
## IX. The Impact of External Financial Flows on China

In this 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 with a positive value and inward investment in China by foreigners being denoted with a negative value.

**Graph 9** 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%.



**Graph 10. Capital Account (% of GDP) in China.  
Alternative Policy Scenario**



**Graph 10** depicts the results for the capital account that are generated by our 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.

Even in 2016 Foreign Exchange Reserves would completely dominate the outflow of capital from China. In that year they would represent 4.7% of GDP. However, the relative size of these reserves would progressively decline over time, reaching about 3.1% of GDP by 2026.

The net inflow of capital into China would tend to remain below 1.5% of GDP. Net Direct Investment would continue to dominate these inflows, accounting for 1% to 1.2% of GDP. Net Other Investment would supplement Net Direct Investment but the former would not amount to more than about 0.5% of GDP over this 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 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.

The decline in the positive value of the capital account would mirror, in our framework, the relative fall in China's current account. This would be reflected, in particular, in the relative but slow decline in China's holdings of Foreign Exchange Reserves.

## **X. Is China's Rising Indebtedness Sustainable?**

The projections produced by the CAM macro-econometric model for Working Paper #141 provide useful scenarios for analysing the likely future external financial trajectory of China. But data limitations do not allow this Working Paper to assess historical trends in China's financial sector and to generate useful medium-term projections of its trajectory.

Since the summer of 2015, there have been world-wide concerns about the financial stability of the Chinese economy. On June 15, 2015, the value of China's stock market suddenly tumbled and two major aftershocks followed soon afterwards, the first in late July and the second in late August. During the second aftershock, China's Shanghai Stock Exchange fell by about 8.5%, the largest drop since 2007. In response on August 24th, major stock markets across the globe fell sharply, with the U.S. Dow Jones index initially plummeting, for example, by 1000 points, its largest drop ever.

By December 2015 China's stock market appeared to have substantially recovered from the sharp summer declines. But then in early January 2016 the stock market plummeted again, this time by about 18%, and trading had to be halted. This apparent meltdown triggered global financial instability. In response, the People's Bank of China devalued the renminbi to its lowest level since 2011.

Given such China-induced financial instability between mid-2015 and mid-2016 (which has also been exacerbated recently by the United Kingdom's vote for Brexit), this Working Paper devotes its last section to a more explicit examination of financial trends in China. But in this endeavour it focuses its attention on China's debt dynamics, which have emerged most recently as an overriding area of concern.

Data on the public debt of China's central government is certainly available to international researchers but corresponding data on the various forms of private debt (both for households and corporations) and even reliable data on local government debt are not readily available. Various western institutions, including Moody's and McKinsey, have attempted to produce estimates of such debt, especially since China was shaken so badly by financial instability in late 2015 and early 2016 and this instability threatened to have dire global repercussions.

For example, the McKinsey Global Institute has reported that China's total debt stood at about 217% of GDP in 2014. By May 2016 Moody's raised this total to 280% of GDP (McKinsey Global Institute 2015, Moody's 2016, Li 2016). Although dwarfed by the debt levels of some Developed Economies, such as Japan and Singapore,

China's level of total debt has been higher than that of almost all other emerging or developing countries. Hence, the rapid rise in China's debt has alarmed many analysts.

However, within this total, China's external debt has remained fairly small. Moody's has estimated that such debt represented no more than 9% of GDP in 2014 (Moody's 2016). Moreover, China does not appear to have any problems in servicing its external obligations. Its net foreign asset position has remained solidly positive over recent years.

At the end of 2015 China's public debt stood at about 40% of GDP, which represented a fairly manageable level. Within this category, the share owed by China's central government has remained fairly small, i.e., about 17% of GDP (Moody's 2016). However, when all types of local government debt are also included, the estimate of total public debt rises to about 60% (Prasad 2016).

Household debt is estimated to be relatively low—namely, less than 40% of GDP. Most of this debt has taken the form of house mortgages. But, as is well known, Chinese households have a fairly high savings rate so the probability of defaulting on such mortgages is not high.

But the most troublesome form of debt in China appears to be corporate debt. Informal estimates by the IMF suggest that this form of debt stood at about 160% of GDP (Daniel, Garrido and Moretti 2016). But most of this corporate debt is owed by state-owned enterprises and has taken the form of utilising domestic bank loans or bonds.

Moreover, since 2014 the Chinese government has been encouraging enterprises to repay any foreign debt that they have incurred. The Bank of International Settlements claims, for example, that this development partially explains the noticeable outflow of capital from China in recent years (BIS 2016).

Although much of China's debt, both public and private, appears to be manageable, it is still true that its total debt, as a ratio to GDP, has risen rapidly since the onset of the global financial crisis in 2008. Some recent rough estimates claim, for example, that just between 2008 and 2016 this ratio shot up from about 170% of GDP to even 280%.

In addition, there appears to be a significant share of non-performing loans in China's corporate sector and local governments. For example, the IMF has warned recently that about 15% of bank loans to Chinese corporations are at risk of not being repaid (IMF 2016a). Also, many local governments probably do not have the revenue sources that would enable them to repay their substantial public debts. Apparently, some of them have already resorted, for example, to land sales in order to generate revenue for this purpose.

However, by contrast, both governments and households appear to have sufficient assets to enable them to effectively service their relatively manageable levels of debt. Moreover, as the projections of Working Paper #141 suggest, China is likely to

continue having a very large stockpile of foreign exchange reserves that it could readily mobilize in order to meet any external debt obligations.

China's government also continues to have significant influence over the financial activities of state-owned enterprises as well as state-owned banks. Also, the country's banks appear to be fairly liquid and are financed mainly by deposits, which are estimated to represent about 200% of GDP.

Moreover, China's capital account has not been completely liberalised. In fact, capital controls were tightened in 2015 as private capital outflows began to increase. Apparently in recent years many newly rich Chinese households have begun to buy properties abroad, particularly in developed economies (Yang 2016).

In summary, China's total indebtedness—public and private as well as domestic and foreign—appears to remain manageable. Both its high savings rate and the fiscal space that its central government continues to command are potential shields against financial instability.

In addition, its positive net external asset position, buttressed mainly by its sizeable holdings of foreign exchange reserves as well as its rising trend of foreign investment, could be mobilized in the event that its financial indebtedness (mainly by its 'private' corporations and local governments) reached unsustainable levels.

## XI. Concluding Remarks

This FESSUD Working Paper #144 has focused its attention on historical trends and projections for the People's Republic of China. However, it has placed its focus on China within a global historical and projected context within which differential growth rates of GDP and current-account imbalances between major countries and blocs would remain a major stumbling block to achieving global economic and financial stability.

For example, under this Working Paper's **Baseline Scenario** for 2017-2026 that is projected by the CAM global macroeconomic model, there would be sharp differences in both rates of economic growth and current-account balances among four dominant economic blocs or countries, i.e., China, the USA, the European Union and Other East-Asian High Income countries.

For example, China is projected to grow at an average rate of 6.5% over 2017-2026. However, both the United States and the European Union would experience much slower average growth rates of GDP of only 1.2% to 1.3%.

Over this same projected period, China would achieve an average current-account surplus of 3.9% to 4.6% while the USA would suffer from an average current-account deficit of -3.9% to -4.8%. Other East Asia High Income countries (such as Japan and the Republic of Korea) would also have average current-account surpluses of 2.4% to 2.7% of GDP over the projected period.

While the European Union as a whole would not average current-account surpluses of over 1.1% of GDP, the same could not be claimed for some of its large constituent countries. For example, Germany would enjoy a current-account surplus of 5% of GDP by 2026 while the United Kingdom would suffer from a deficit of -6%.

Hence, we have utilized the CAM global macroeconomic model in order to program an Alternative Policy Scenario for 2017-2026 that is designed to narrow the sharp global differences in rates of economic growth and current-account balances.

As a result, China's rate of economic growth would slow to an average of 5.3% to 5.6% over 2017-2026 while economic growth in the USA would rise from 1.8% to 2.0%. Over the same 10-year period economic growth would increase noticeably in both the European Union and Other East Asian High Income.

As a result, global economic growth would be boosted—for example, to an average of 2.9% during 2022-2026, in contrast to only 2.5% under the Baseline Scenario.

The changes in China's rate of economic growth and its current-account balances would stem from programmed changes in its savings and consumption and in its real exchange rate. For example, its rate of savings is programmed to fall modestly and its rate of consumption is programmed correspondingly to increase.

Combined with a pronounced drop in China's real exchange rate, this shift to a more-consumption driven economy would lead to both a narrowing of its current-account surplus and a relative slowdown in its economic growth—trends that are also likely to be more sustainable and less detrimental, especially in terms of exacerbating global imbalances.

The impact on the relative importance of different types of financial flows into and out of China would also be noticeable under our Alternative Policy Scenario. China's capital account would remain dominated by the outflow of its capital into holdings of foreign exchange reserves. Additionally, the inflows of capital into China would continue to be dominated by Direct Investment.

This kind of foreign investment is more stable and predictable than the erratic inflows and outflows of both Portfolio Investment and Other Investment, which have bedeviled many other major Emerging Economies. Both of these latter two forms of financial inflows would remain fairly small in China over the ten-year period (2027-2026) projected by our Alternative Policy Scenario.

Because of the periodic financial instabilities that China has experienced since mid-2015, this Working Paper has also devoted a section to a review of trends in the country's indebtedness, both domestic and external. While it is true that China has confronted an alarming rise in instability in its stock markets, both in the summer of 2015 and early 2016, underlying financial trends in the country appear to more stable than these events would suggest.

The central Chinese government and the country's household sector appear to have relatively manageable levels of debt. Moreover, despite experiencing a recent secular rise in consumption and a corresponding decline in savings, China still has a remarkably high rate of national savings, and this pool of savings is readily available to the country's banking sector for the purposes of lending.

Where indebtedness remains a problem that still needs to be monitored and carefully managed is in the corporate sector and in local government. But most of China's corporate debt is held by state-owned enterprises and is domestically financed.

It is true that local government needs to be accorded greater latitude in raising its own revenue so that it can contain the secular rise in its indebtedness. But since the indebtedness of the central government has not reached serious proportions, public debt as a whole should remain manageable.

What is crucial is that China's external debt, both public and private, is not large. In addition, as discussed above, the CAM projections have indicated that the financial flows on the country's capital account are very favourable, especially compared to those of other major emerging economies, such as Brazil and Indonesia. China has ample foreign exchange reserves on which it could call in order to stabilize its exchange rate and capital inflows remain dominated by foreign direct investment, which is much more stable and predictable than the erratic speculative flows associated with the vagaries of short-term portfolio investment and 'other' investment.

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Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

## THE ABSTRACT OF THE PROJECT IS:

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?

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Published in Leeds, U.K. on behalf of the FESSUD project.