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## China and Global Economic Rebalancing

The focus of the previous chapter was how China can transition to a new economic model that will allow it to sustain rapid growth. The thesis is that this transition is strongly in China's own economic and political interests because the export- and investment-driven growth strategy of the past decade is no longer viable. Given the current global environment, China's growth seems likely to slow significantly if it continues to rely on increasing exports to fuel its growth. External demand is muted and is likely to remain so for some time, given the slow pace of economic recovery from the global financial and economic crisis in the developed countries that have long been the major markets for China's exports.

The unprecedented scale of capital investment in China relative to the size of its economy in recent years also will encounter sharply diminishing returns. The heightened level of investment since 2003 reflects two factors. First, the government decided to accelerate infrastructure investment in 2009–10. Second, financial repression has contributed to a massive increase in real estate investment.

Accelerating infrastructure development to offset the softening of external demand during the global downturn was rational, but a superelevated level of infrastructure investment can't be the basis for sustained long-term economic growth. Indeed, two indicators show the pace of infrastructure investment slowed substantially in 2010 compared with 2009. First, outstanding medium- and long-term bank loans for infrastructure development grew by RMB2.5 trillion, or 43 percent, in 2009 but only by RMB1.65 trillion, or 19 percent, in 2010 (People's Bank of China 2010b, 2011b). Second, completed urban infrastructure investment soared 41 percent in 2009 to reach RMB5.5 trillion, while overall national investment rose only 30 percent. In 2010 this pattern was reversed when the growth of completed urban

infrastructure investment was a more moderate 17 percent, well below the 23 percent expansion of national investment.<sup>1</sup>

Similarly, the highly elevated level of real estate investment of recent years also is unlikely to be sustainable in the medium run. As analyzed in chapter 3, weakening of residential property investment could slow China's growth substantially for an extended period of time. Thus China's growth seems likely to slow significantly unless private consumption demand becomes a much more important source of aggregate demand over the next few years. The obvious conclusion is that rebalancing is fundamentally in China's own economic interest.

This chapter examines China's economic rebalancing from a global perspective. What are the gains to the rest of the world, if any, if China is successful in transitioning to more consumption-driven growth and a significantly smaller external surplus? Several possible gains come to mind. First, and perhaps most important, would be a reduction in global economic imbalances. There is a widespread view that the global financial crisis was in part the result of large global economic imbalances. Countries like the United States saved far too little and depended on large financial inflows to finance expenditures, particularly consumption outlays. Emerging-market countries like China saved far too much and became very large creditors to countries with external deficits, such as the United States. If these large global imbalances are eliminated or significantly reduced the risk of another global financial crisis falls.

Second, the world would also benefit from China's transition to more consumption-driven growth because it would mean reduced consumption of energy and enhanced prospects for limiting global warming. While China's energy use was only half that of the United States in 2000, its economic growth in the subsequent decade was so energy intensive that the International Energy Agency estimates that China's energy consumption surpassed that of the United States in 2009 even though its economy is only two-fifths the size of the United States. In the years between 2000 and 2008 the increase in China's energy consumption was more than four times greater than in the previous decade (IEA 2010, 5). China's energy-intensive growth path both adds to global environmental degradation and puts upward pressure on prices of a broad range of global commodities. On its current growth trajectory, China alone likely will account for as much as two-thirds of the growth of total global oil demand and 45 percent of the growth of global primary energy demand over the decade ending in 2020 (IEA 2010, 618–73). Fundamentally changing this trajectory will require China to transition to a growth model with drastically reduced subsidies for energy consumption, with less emphasis on

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1. National Bureau of Statistics of China, "Systematic Report Number Four on Economic and Social Development Accomplishments in the Eleventh Five-Year Plan," March 3, 2011, available at [www.stats.gov.cn](http://www.stats.gov.cn) (accessed on March 3, 2011); National Bureau of Statistics of China, "Systematic Report Number 16 on Economic and Social Development Accomplishments in the Eleventh Five-Year Plan," March 11, 2011, available at [www.stats.gov.cn](http://www.stats.gov.cn) (accessed on March 14, 2011).

the heavy industry closely associated with investment and urban residential construction, and with more emphasis on light industry and services that will satisfy rising consumer demand.

Third, China's export-led growth has imposed costs and risks on its trading partners. If China's growth is rebalanced and external surplus reduced, the costs and risks imposed upon its trading partners will also be smaller. The *Economist* magazine has frequently noted that in an ex post accounting sense China accounted for a large share of global growth in the previous decade.<sup>2</sup> But this does not necessarily mean that the rest of the world benefited from this outsized contribution. China's global economic surplus was expanding during most of these years, meaning that China was adding more to the supply of goods to the rest of the world than it was adding to the demand for goods from the rest of the world. Thus even as China ex post "accounted for" a large share of global growth, its rising external surplus constituted a potential drag on growth in the rest of the world, because its contribution to demand in the rest of the world was not keeping pace with its rapidly growing economy. Of course, it would be hard to argue that this drag actually slowed economic growth in other countries. The four-year period 2004–07, when China's external surplus was increasing most rapidly, was a period of unusually rapid global economic growth, indeed the most rapid since the early 1970s (IMF 2008, 21–22). But this was largely because the United States and other advanced industrial countries were pursuing expansive monetary and fiscal policies that effectively offset the drag on global growth coming from China. In retrospect, of course, it is clear that these monetary and fiscal policies were not sustainable and were among the principal factors leading to the global financial crisis and the most severe global slowdown in several decades.

In the current environment, the cost to the global economy if China's external surplus were to begin to expand again would be higher than in the last decade. There are three reasons for this. First, much of the developed world is in a "liquidity trap," meaning that monetary policy is not effective in stimulating demand because of the zero bound on the policy interest rate. Second, developed countries' internal debt rose so much during the crisis that cutting budget deficits has become an imperative and has effectively ruled out additional fiscal stimulus in virtually all cases. In short, while previously the rest of the world had some flexibility in using expansionary monetary and fiscal policy to offset China's drag on global growth, after the crisis the economic policy options of governments in the rest of the world are much more constrained. Third, China is now a larger factor in the global economy. In the middle of the

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2. "Its contribution to global GDP growth since 2000 has been almost twice as large as that of the next three biggest emerging economies, India, Brazil and Russia, combined" (July 28, 2005); "For the first time it is now contributing more to global GDP growth (measured at market exchange rates) than the United States is" (September 27, 2007); "China has become the main engine of the world economy, accounting for one-third of global GDP growth in the first half of this year" (October 9, 2008). Available at [www.economist.com](http://www.economist.com) (all accessed on May 2, 2011).

past decade it accounted for 9.5 percent of global GDP; by 2010 that share had increased to 13.6 percent (IMF 2011d). The risk of a rising Chinese surplus is that growth would stall in the United States and other advanced industrial countries that are now limited in their ability to offset China's subtraction from growth in the rest of the world. Thus the risk associated with a resurgence of China's global external surplus is an aborted global recovery, making it harder for the United States and countries in Europe to deal with their fiscal challenges.

## Global Imbalances

The supercharged global economic growth that preceded the global financial and economic crisis was accompanied by a historically unprecedented buildup of current account imbalances. On the eve of the crisis, imbalances had reached almost 6 percent of global GDP, almost triple the level of 1996 (Blanchard and Milesi-Ferretti 2009, 7).<sup>3</sup> Imbalances are not inherently bad. For example, they may be generated by an expectation of brighter growth prospects in some countries, leading to an inflow of foreign direct investment and portfolio capital seeking to gain a share of anticipated profits. In this situation the countries with relatively high growth prospects generally run current account deficits. This appears to be roughly the position of the United States in 1996–2000. Capital inflows into the United States allowed increased investment linked to the high-tech boom.

In the next period, starting in around 2001, the US current account deficit widened substantially, largely because of a substantial decline in private savings. The composition of capital inflows into the United States changed, with debt assuming a much larger role. The nature of the investors changed as well, with official investors becoming increasingly more important relative to private investors. The widening of global imbalances reflected not only the widening imbalance of the United States but also the decision in many Asian countries in the wake of the Asian financial crisis to run current account surpluses. These countries wanted to build up larger official foreign exchange reserves to serve as a buffer against future financial crises. Additionally, higher global oil prices gave oil-exporting countries larger surpluses, much of which they invested in US debt.

Global economic imbalances subsequently increased sharply after 2004. While the US contribution to global imbalances was unchanged, China's current account surplus, which earlier had averaged only 0.1 percent of global GDP, jumped to an average of 0.6 percent in 2005–08. Surpluses of oil exporters continued to rise sharply, on the back of higher oil prices. European imbalances increased as well, with a group of countries on the periphery

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3. The measure of global imbalances is the sum of the absolute value of individual country current account imbalances.

(including Ireland, Greece, Portugal, and Spain) experiencing much higher external deficits, while external surpluses rose in “core” Europe (Blanchard and Milesi-Ferretti 2009, 7).

It is relatively easy to describe the trends in global imbalances, identify where they originate, and set forth details of the associated financial flows. It is considerably more difficult, however, to demonstrate the precise linkages, if any, between these imbalances, on the one hand, and the global financial crisis that emerged strongly in 2008, on the other. Thus “controversy remains about the precise connection between global economic imbalances and the global financial meltdown” (Obstfeld and Rogoff 2010, 132). The paragraphs that follow provide a summary of three alternative views. The first is that global imbalances are mostly benign and thus efforts to reduce imbalances are misguided. A second view is that while imbalances may pose challenges, particularly in deficit countries with large capital inflows, these challenges can be overcome with appropriate adjustments in domestic monetary policy. The third view is that global economic imbalances, combined with excessive deregulation of financial markets, weak financial regulation, and distortions in financial markets, led to the global financial crisis.

The view that imbalances are benign is perhaps most strongly advocated by Richard Cooper. He views large current account deficits in the United States as the “natural consequence of the excess savings in the rest of the world, an attractive menu of financial assets from which to choose in the United States, and increasing globalization of financial markets.” Thus he argued that “it would be a mistake to try to eliminate the [US] current account deficit in the near future or even to try to reduce it to \$200 billion to \$300 billion” (Cooper 2005, 6). Cooper’s analysis focuses on China when looking at the surplus side of the equation. He argues that China’s underdeveloped domestic financial markets limit the opportunities for financial investment within the country. If China were able to liberalize its capital account, citizens likely would put a substantial portion of their savings abroad in the form of foreign currency-denominated financial assets. Given that China is not yet prepared to remove such controls on capital outflows, Cooper argues, China’s central bank is playing the positive role of a financial intermediary, in effect taking the surplus of domestic savings over domestic investment and investing it in foreign assets on behalf of China’s savers.

The second view, most closely associated with John B. Taylor, is that global imbalances per se were not the problem. Rather he argues that the US Federal Reserve maintained an accommodative monetary policy, first adopted in 2001 in the wake of the bursting of the US technology bubble, for far too long. If the Fed had tightened sooner, in 2002 rather than waiting until 2004, US domestic interest rates would have been higher, mortgage financing would have been more expensive, and the underlying bubble in property prices would have been more modest or likely avoided altogether. On Taylor’s calculation, if the Federal Reserve had followed his monetary policy rule, housing starts in the

United States would have peaked at an annual rate of a little over 1.7 million units in 2003 rather than the actual 2.1 million unit rate observed in late 2005 and early 2006 at the peak of the US housing bubble (Taylor 2009, 5).

The third view is that a complex interaction of global financial imbalances, weak financial regulation, credit market distortions, the Fed's monetary policy stance, and other factors "created the toxic mix of conditions making the U.S. the epicenter of the global financial crisis" (Obstfeld and Rogoff 2010, 145). Ouarda Merrouche and Erlend Nier (2010, 27) provide empirical support for the hypothesis that "widening global imbalances and associated capital flows were the root cause of the build-up of financial imbalances across advanced economies" and thus were the proximate cause of the global financial crisis. They find there was a strong link between widening global economic imbalances and associated capital flows, on the one hand, and the buildup of financial imbalances within Organization for Economic Cooperation and Development countries, on the other. Deficit countries with large capital inflows had higher ratios of credit to GDP (i.e., more leverage); higher ratios of financial-sector credit to deposits, reflecting a greater reliance by banks on wholesale funding (which in a crisis could and did dry up); higher ratios of household debt to GDP (i.e., more household leverage); and more appreciation of house prices ahead of the crisis. Consistent with Obstfeld and Rogoff, Merrouche and Nier also demonstrate that the supervisory and regulatory environment affected the buildup of financial imbalances ahead of the crisis.

Merrouche and Nier (2010), however, specifically reject the view that overly accommodative monetary policy fueled the buildup. They note that on a cross-country basis there is little association between measures of monetary policy and house price increases. Some countries with low real interest rates had large house price appreciation; other countries had rapid increases in housing prices with relatively high real interest rates; others had both low real interest rates and little house price appreciation. Rising house prices, however, were strongly associated with surges in capital inflows from abroad, supporting the view that the proximate cause of the global financial crisis was economic imbalances, not failures of monetary policy.

While the debate over the precise linkages between the expansion of global economic imbalances and the global financial crisis will undoubtedly continue for years, several broad if somewhat tentative conclusions can be drawn. First, the view that global economic imbalances are benign seems largely discredited. All too frequently these imbalances are the result of domestic distortions, which if eliminated would reduce imbalances. In the United States the household saving rate in the middle part of the last decade fell to a historic low because of "financial innovations," such as subprime loans and home equity lines of credit. These led to levels of household debt that ultimately proved destabilizing in the extreme. In China household savings as a share of disposable income rose sharply after 2003. This was not because domestic financial markets were undeveloped; these markets had been underdeveloped since the onset of economic reform in 1978, and household savings from disposable

income prior to 2004 were not out of line with those in other developing countries. Rather, the rise in household savings as a share of disposable income after 2003 coincides with increased financial repression that dramatically reduced the real return to savings. It appears that a primary motive for household savings is to achieve a target level of savings. Thus the income effect of lower real rates dominated the substitution effect causing savings to rise relative to disposable income. Therefore, eliminating the distortions imposed by financial repression would allow China's ultralow consumption share of GDP to rise and its external imbalance to shrink.

Second, the view that the United States would not have precipitated the global financial crisis had the Federal Reserve tightened earlier seems unpersuasive. While the Fed controls short-term interest rates, long-term rates are determined by the market. Large capital inflows into the United States, a substantial portion of which originated in China, in the middle years of the previous decade reduced longer-term rates. This reduction, in turn, reduced the spread between long and short rates. Since bank earnings are strongly correlated with the spread between long and short rates, spread compression reduced bank earnings. Lower earnings, in turn, led banks to lever up their balance sheets and to create ever riskier financial products. On the demand side, low long-term rates made mortgage borrowing cheaper and fueled the housing bubble.

Third, at this stage it is difficult if not impossible to assign precise weights to the relative roles of global imbalances and weak financial supervision as causes of the crisis. They are obviously inextricably interlinked. Thus it seems appropriate that reforms at both the national and international levels should try both to improve financial regulation and supervision and to eliminate distortions that lead to large global imbalances.

The Group of Twenty (G-20), which is now the premier forum for international economic cooperation, has embraced this dual mandate. At the G-20 meeting in Pittsburgh in September 2009, the leaders adopted the G-20 Framework for Strong, Sustainable, and Balanced Growth. This framework agreement called specifically for G-20 members with sustained, large external deficits to undertake policies to support private savings and to undertake reductions of fiscal deficits in order to reduce their external deficits. And in a symmetric fashion the framework called for G-20 members with sustained, large external surpluses to strengthen domestic sources of growth.<sup>4</sup> The G-20 enlisted the IMF to oversee a mutual assessment process to evaluate the implications of national economic policies for strong, sustainable, and balanced growth of the world economy. Among the factors identified for analysis are foreign exchange developments and the growth of foreign exchange reserves.

This process underwent a significant step forward at the meeting of G-20 finance ministers and central bank governors in Washington in April 2011.

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4. Leaders' Statement: The Pittsburgh Summit, G-20, September 24–25, 2009, available at [www.g20.org](http://www.g20.org) (accessed on May 5, 2011).

At this meeting, members “agreed on a set of indicative guidelines that complete the first step of our work to address persistently large imbalances.”<sup>5</sup> A country’s current account position is one of the key indicators. The G-20 finance ministers and central bank governors outlined a two-stage process that starts by using four separate empirical approaches to measuring whether a country has a “persistently large imbalance.” In the second, more analytical stage, a country that is judged to have a large external imbalance by two of the four methodologies will be subject to more in-depth analysis both to determine the nature and root causes of the imbalance and to identify impediments to adjustment.

Since China has been a key member of the G-20 from the outset and approved the indicative guidelines approach to reducing large external imbalances, there now appears to be a happy congruence of China’s domestic and international economic policy objectives. Reducing imbalances, including China’s still large external imbalance, is a top domestic objective embraced by China’s top leadership and enshrined in many Chinese policy documents, including the 12th Five-Year Plan. With the G-20 agreement China has also acknowledged that reducing external imbalances will contribute to strong and sustainable global economic growth. The next chapter addresses the internal political constraints that could continue to prevent China from adopting policies to achieve these national and international objectives.

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5. Communiqué: Meeting of Finance Ministers and Central Bank Governors, Washington, DC, April 14–15, 2011, G-20, available at [www.g20.org](http://www.g20.org) (accessed on May 5, 2011).