BARCLAYS

Macro Research
25 January 2019

#tradepolicy

Thinking Macro

Can China become a deficit economy?

- **Although China's record 2018 bilateral trade surplus with the US captured headlines and many policymakers' attention, the country's broader current account balance continued its multi-year decline and recorded a slight deficit in the first half of the year. As recently as 2015, China ran the largest current account surplus in the world (in absolute terms, though not relative to the size of its economy). We now project modest deficits in 2019 and 2020, transforming China from the world's largest exporter of capital to a modest capital importer.**

- **Against this backdrop, China's recent offer to eliminate its USD400bn trade surplus with the US by going on a massive 'shopping spree' should raise eyebrows. Unless the improvement in the bilateral trade balance comes mainly at the expense of China's other trading partners, it would imply a substantial and sustained current account deficit. Is China able and willing to run large current account deficits for the foreseeable future?**

- **Such ability is not likely to be constrained by the simple arithmetic of international debt dynamics. But we believe other market constraints and policy priorities would prevent a sustained widening of the Chinese current account deficit. China is unlikely to become one of the worlds' deficit economies.**

  - Sustained current account deficits would transform China from a net international creditor to a net debtor. China possesses financial assets that international investors would, under a reasonably liberal policy regime, be willing to hold. But at the existing state of market development, they fall short of what would be required to finance external deficits comparable in magnitude, for example, to the US. Moreover, Chinese authorities are likely to remain less comfortable with the liberal approach to international capital that global investors may require.

  - Alternatively, China might decide to finance current account deficits by running down its still considerable stock of international reserve assets. However, while its reserve coverage of international trade flows is now adequate, rapid growth in liquid liabilities of the financial system creates potential financial vulnerabilities that would be aggravated by such use of international reserves.

  - Substantial external imbalances may also complicate the government's signature Belt and Road Initiative, in which China exercises influence over global infrastructure projects by exporting capital to finance them.

- **With China's ability to run large, sustained current account deficits constrained by market forces and likely policy orientation, we think there is very limited scope for China to resolve its bilateral trade imbalance with the United States by running a current account imbalance.**

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Completed: 25-Jan-19, 16:17 GMT Released: 25-Jan-19, 16:21 GMT

A tale of two imbalances

Late last week, US equity markets soared on reports that China had offered to go on a six-year buying spree.[1] The goal was to ramp up imports from the US as a way to reduce China's trade surplus to zero by 2024. If true, this is an ambitious goal; one of the ironies of the US-China trade war is that 2018 is likely to have the largest ever Chinese trade surplus with the US, significantly higher in dollar terms than in either 2016 or 2017.

A number of factors contributed to the surge in the trade balance, including strong growth in US demand, front-loading by US importers in anticipation of tariffs, and a weaker renminbi. But it was also part of a decades-long rise in the bilateral imbalance that has become a focus of US economic policymakers. China's purported offer is presumably a way to correct this.

But is it a realistic goal? After all, China's overall current account surplus has dwindled to negligible levels in recent quarters, despite its record balances with the US. In fact, in the first half of 2018, the Chinese current account was in (small) deficit for the first time in at least two decades, even as the bilateral trade surplus with the US was marching toward new records. A move to eliminate its US trade surplus would almost certainly push China into a sustained current account deficit position. This begs the question – can the world's second-largest economy run a sustained current account deficit?

Anatomy of an external adjustment

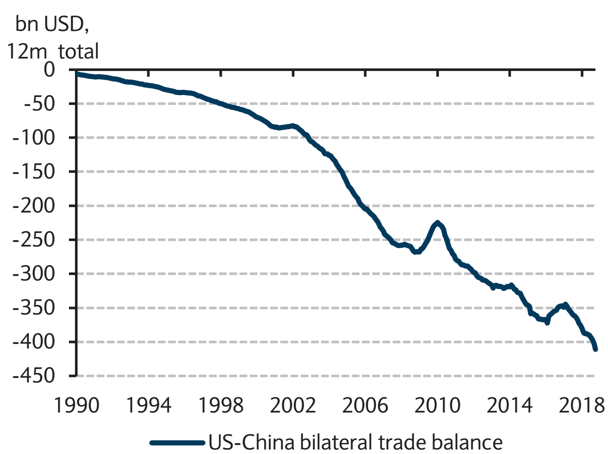
The Chinese current account adjustment reflects economic rebalancing

From a broad macroeconomic perspective, the fading of the Chinese current account deficit reflects a gradual and still incomplete normalization of the domestic saving rate, which surged to an extraordinarily high level between 2000 and 2008 (Figure 3). This pushed China's current account surplus to a peak of roughly 10% of its GDP in 2007. As China's saving has normalized since then, the very high rate of domestic investment has also fallen. But its saving has fallen more than investment, with the result that current account balance has declined from its extraordinarily high level in 2007 to rough balance in 2018.

This perspective suggests to us that the erosion of the Chinese current account surplus reflects a desirable rebalancing of the economy that is likely to continue for some time to come, rather than transitory shocks or cyclical fluctuations.

FIGURE 1

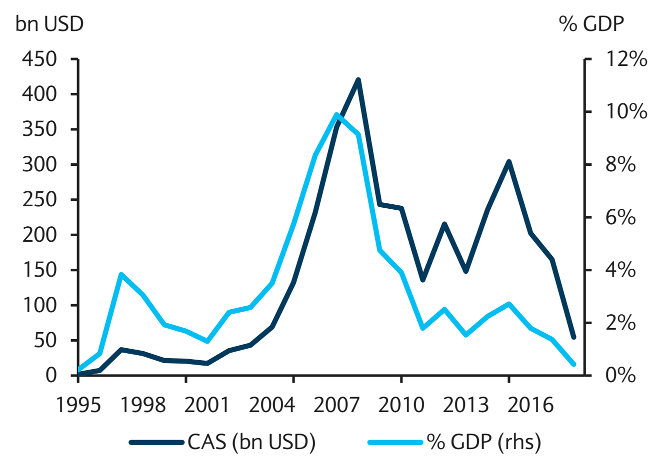
The US-China bilateral trade balance continues to grow…



Source: Haver Analytics

FIGURE 2

…even as China's overall current account surplus has fallen



Source: Haver Analytics

[1] https://www.bloomberg.com/news/articles/2019-01-18/china-is-said-to-offer-path-to-eliminate-u-s-trade-imbalance?srnd=premium

International travel spending and investment income have driven current account adjustment, while the trade balance has remained robust

It is also useful to adopt a more bottom-up approach to the evolution of China's international accounts, especially in light of the intense policy emphasis on the trade balance. From this perspective, and oversimplifying a little, the disappearance of the Chinese current account has been driven by a few major trends.

Since early 2015, a modest decline in the country's still-substantial trade surplus has contributed. However, from a longer-term perspective, the trade balance has played a smaller role, since in absolute terms it remains even larger now than in 2006-08.

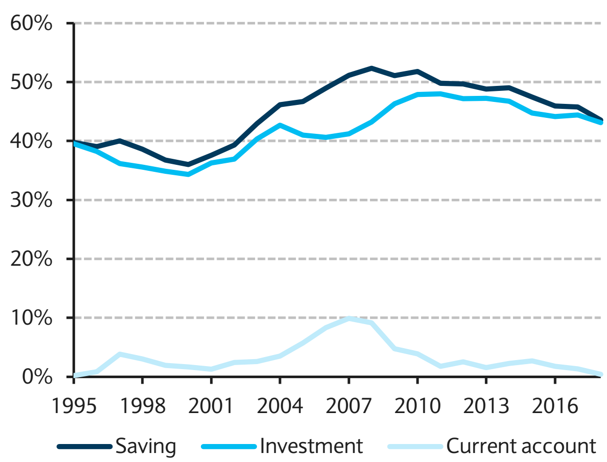
Instead, the longer-term decline in China's current account surplus is mainly reflected in two other categories of spending. Quantitatively, the more important is international travel expenses, which in the past decade have grown from almost nothing to about USD235bn (about 1.75% of GDP). This net expense reflects Chinese travel expenditures of about USD275bn (2% of GDP), offset by international travel income of about USD40bn.

The rapid growth in travel spending brings it to levels that are not without precedent in other middle-income economies (for example, international travel spending is also about 2% of GDP in Korea, and it is about 1.6% in Poland). However, it is substantially lower in other middle income countries such as Brazil, Mexico and South Africa, where international travel expenses are slightly less than 1% of GDP. This provides some reason to believe that the very rapid growth in Chinese travel spending peaked around 2015, and its growth will subside to more normal levels in the years to come, as seems to have happened since that year.

The second major trend is in international investment income, which has fallen by roughly USD80bn since 2008, taking an equivalent bite out of the current account balance. This is despite the fact that persistent surpluses over the past decade have increased China's already-substantial international creditor position. The anomaly is due, of course, to the composition of China's international assets and liabilities. Since it needs to be factored into forward-looking assessments of external sustainability, we offer some background here.

FIGURE 3

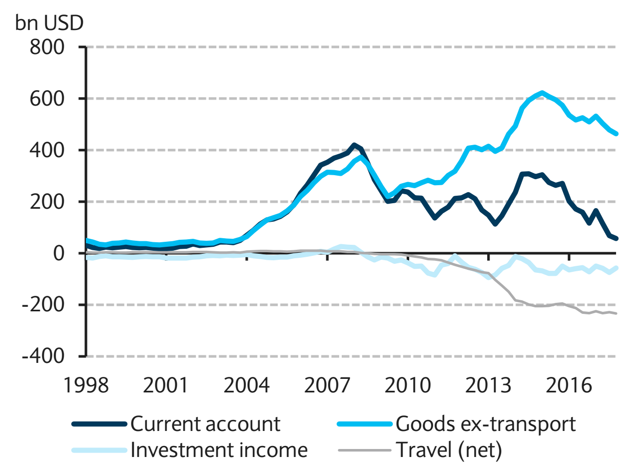
China's falling current account reflects economic rebalancing



Note: Saving is computed as the sum of investment and the current account balance. Source: Haver Analytics

FIGURE 4

Travel spending and investment income have been key drivers of the current account adjustment



Note: To simplify the presentation, we have subtracted net transport expenditure from the merchandise trade balance, on the view that transport of goods is appropriately viewed as a cost of carrying out merchandise trade. Source: Haver Analytics

Notwithstanding the recent rapid growth in Chinese direct and portfolio equity investments abroad, China's international assets remain heavily tilted toward low-return, safe reserve assets (which still comprise nearly half of total foreign assets). Only about 25% of its external assets consist of riskier ones such as direct and equity portfolio investment, while the vast majority comprise much safer and lower-yielding investments such as international reserve assets, trade credit, and foreign currency and deposits. Chinese foreign liabilities, on the other hand, are heavily concentrated in riskier and therefore higher (expected) return instruments such as direct and portfolio equity investments, which together comprise nearly 70% of China's external liabilities.

FIGURE 5

Chinese foreign assets are predominantly safe and its liabilities risky

	USD bn	%		USD bn	%
International assets	**7,047.3**		**International liabilities**	**5,354.5**	
Reserve assets	3,177.1	45.1%	Direct investment in China	2,960.3	55.3%
			Equity portfolio investment	715.5	13.4%
Debt portfolio investment	222.4	3.2%			
Trade credit	669.9	9.5%	Debt portfolio investment	417.7	7.8%
Currency and deposits	374.6	5.3%	Trade credit	321.1	6.0%
Loans	698.7	9.9%	Currency and deposits	464.9	8.7%
			Loans	417.0	7.8%
Direct investment	1,542.0	21.9%			
Equity portfolio investment	306.4	4.3%	Other	58.0	1.1%
Other	56.2	0.8%			
Net international assets	**1,692.8**				

Source: Haver Analytics

The result of this international portfolio composition is that Chinese earnings from external assets (about USD232bn in the four quarters through Q3 18) fall short of payments to foreign investors in China (about USD290bn in the same period). The low return on a high share of China's foreign assets bears importantly on the external sustainability calculus.

Debt dynamics are not a limitation, but they highlight other constraints

It is hard to make a case that China's capacity to sustain a current account deficit would be constrained by the simple arithmetic of international debt dynamics. The Chinese economy is not, as a matter of economic principle, incapable of supporting the external liabilities that persistent current account deficits would imply. The potentially more relevant constraint is whether, under plausible institutional and policy settings, the Chinese financial system would be able and willing to supply the world with the requisite financial assets, under policies toward foreign investment that would offer the comfort to international investors required to induce them to hold the substantial positions implied.

Comparatively under-developed asset markets may constrain market financing of external deficits

To pose the problem more concretely, we trace some implications of a sustained current account deficit equal to 3% of GDP, a little smaller than the average for the US during the past two decades. This is not intended as a realistic scenario, but rather to highlight the implications of such deficits that, in our view, render them unlikely to be financed by markets or tolerated by policy authorities.

Under economic and financial assumptions that we consider a plausible base case, a sustained current account deficit of this magnitude would eventually push the country's international investment position from a substantial surplus at present to net foreign liabilities equal to a bit under 45% of GDP – very similar to the US at present (see the appendix for a more detailed discussion of our framework and assumptions).

China's gross external liabilities would have to be substantially higher than this, because China would be likely to maintain substantial foreign assets, even as its net investment position deteriorated. To be concrete, let us assume that China would for the foreseeable future maintain safe, international reserve assets worth about 20% of GDP (down from roughly 25% at present) and that it would hold direct and equity portfolio investments abroad of about 15% of GDP (roughly the same as in 2018). These latter investments reflect official investment priorities such as the Belt and Road initiative and international investments by China's globally engaged businesses (given recent, rapid growth in outward FDI by Chinese investors, we view 15% of GDP as a conservative projection of outward investment).

Taking these external assets into account, for China to finance a persistent 3% current account deficit would require gross foreign liabilities of nearly 80% of Chinese GDP. This sounds high, but it is not inconceivable. For example, the US now maintains gross foreign liabilities equal to 175% of GDP. To a large extent, these comprise safe assets that the US financial system specializes in producing, but they also include foreign direct and equity portfolio investments of about 85% of GDP.

However, China is not the US, and not only because the US has an advantage in producing safe-haven assets such as US Treasuries. The US financial system is a prolific producer of financial assets across the risk spectrum:

- The market capitalization of the S&P 500 is nearly 110% of US GDP, and the broader Russell 3000 is worth nearly 140% of GDP. The Shanghai composite, on the other hand, is valued at a bit over 30% and the Shenzen stock exchange at just below 20% of Chinese GDP. Even if foreign investors owned 100% of both markets, it would fall well short of the liabilities required in the long run to cover the hypothesized 3% deficit.
- The US also possesses a deep bond market that is accessible to foreign and domestic investors alike, which provides securities across a broad risk spectrum that finance all levels of government, corporations, household investments in residential housing, school loans and auto purchases, among other things. The Chinese bond market is developing rapidly, but is likely for some considerable time to remain secondary in importance to the banking system as a source of finance for businesses and households. We expect this to constrain the bond market's potential as a producer of assets available, in principle, for international and domestic investors to hold. In theory, if the regulatory environment permitted, international investors could help finance businesses and banks by holding deposits in the domestic banking system. But under the existing regulatory framework, the return on bank deposits compares poorly with returns available to globally active investors.

Institutions also influence potential inflows

It is not just a matter of numbers. International investors are comfortable entering US and other advanced economies' asset markets because full convertibility of current and capital account transactions allows them to exit reasonably quickly if their circumstances or their assessment of the investment outlook changes, and investment disputes are generally handled by a reasonably efficient, predictable and even-handed system.

China continues to reduce barriers to foreign participation in domestic financial markets, but the policy framework remains less liberal than would likely be required to induce global investors to increase their exposure to the levels required to finance large external deficits. Replicating anything like the US history of persistent and substantial current account deficits would seem to require financial market development and institutional reforms that do not seem imminent, if only because deep liberalization of the financial markets could weaken the authorities' capacity to manage business and financial developments and could leave the country more vulnerable to episodic capital inflows and flight.

Of course, the United States's relatively problem-free experience with sustained current account deficits is not the only possible scenario. Brazil, a country at the other end of the economic and political risk spectrum, has also sustained substantial current account deficits during most of the past three decades and, as a result, maintains net foreign liabilities of about 25% of GDP and gross liabilities of nearly 70% of GDP. This reflects, in part, more substantial foreign direct and equity portfolios investment than in China (nearly 50% of GDP, compared with China's 27%) and much higher external debt finance by public and private borrowers.

However, Brazil's mode of integration into international capital markets has not been an unmitigated blessing, as it has made the country highly vulnerable to shifts in global market sentiment and arguably contributed to economic and financial volatility in recent decades. We doubt that the Chinese authorities would feel comfortable allowing the country to slide into a Brazilian-style 'high-yield' approach to integration in world financial markets.

International reserves also pose a potential constraint

With sufficiently mobile international capital, current account imbalances have no necessary implications for international reserves. However, when countries are financing external deficits and managing the associated external liabilities, the temptation may arise to run down reserves, rather than issue higher-cost forms of financing.

In the Chinese case, reserves would provide only a marginal form of financing liabilities that would eventually result from persistent current account deficits, because at less than 25% of GDP, they fall far short of the liabilities in question. Moreover, any use of international reserves would further aggravate the imbalance between liquid CNY assets that could, in principle, 'run' into foreign assets and the stock of foreign reserves available to accommodate such a run. This is not a hypothetical concern. China memorably had a sharp rise in capital outflows in the second half of 2015 and early 2016. The good news is that there seem to have been no signs of any such run in 2018 even as the RMB weakened 6-7% against the USD.

But China's FX reserves are now significantly lower (about $3 trillion) than they were in early 2015 (about $4 trillion) even as the country's stock of broad money, as well as the aggregate local banking system, is considerably larger. In other words, the percentage of domestic liquidity that would need to run to the point where investors worried if their existing FX reserves were adequate is substantially lower. And if those FX reserves showed signs of persistently shrinking because of a sustained current account deficit, it would leave China more vulnerable to any new round of capital flight.

We do not mean to imply that current account surpluses provide ironclad protection against a country suffering a rush of capital outflows. After all, China's previous bout of capital flight in 2015 occurred even as the country ran a healthy current account surplus. But we strongly suspect that the 2015 panic could have been even more disruptive for China's financial system if the country had been holding significantly fewer foreign reserves or had maintained a less comfortable current account position.

Geopolitics and imbalances

We have so far suggested that sizable, persistent current account imbalances are unlikely to be sustainable because under existing institutional arrangements, international investors would be unable to find enough assets to finance the external liabilities that would eventually be generated and, further, that developing markets and establishing a reasonably liberal policy framework that would attract the requisite capital flows is not likely to be a priority for Chinese authorities. Substantial current account deficits would also complicate a signature policy priority of the Chinese authorities, the Belt and Road Initiative, which leverages China's ability and willingness to finance infrastructure projects in the priority regions.

It would be possible, in theory, for China to export capital for investment in specific infrastructure projects in these strategically significant regions while simultaneously importing capital to finance its own external deficits. But it would be a much less natural application of its financial comparative advantage than to export its own external surpluses.

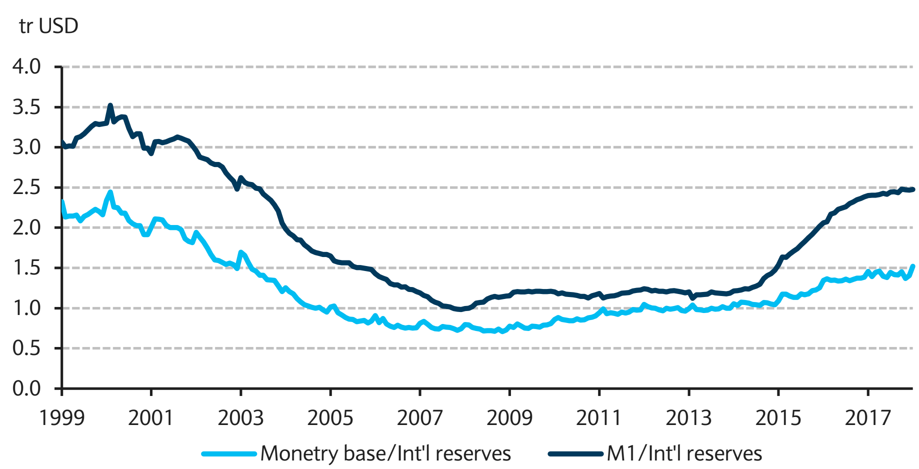
Conclusion

For all of these reasons, we are very skeptical that China can run a sustained current account deficit for the next several years. It is in this context that investors need to evaluate the promise to eliminate the trade surplus with the US. Of course, one way that China might try to reduce its US surplus while not worsening its aggregate current account balance is through a zero sum game: buy from the US what it currently imports from other countries. But the limits of this approach are obvious; in many cases, imports are not substitutable (including, but not limited to, China's massive commodities imports) and presumably other countries would retaliate if China were suddenly to throw up barriers to their exports.

In the near term, the country has some other levers to pull, not least because of the recent drop in oil prices (one of China's biggest imports). The authorities could also increase restrictions on international tourism if the external balance showed signs of worsening further. But in sum, it is very difficult to believe that China's current account balance would not worsen significantly if its US trade surplus approached zero, increasing the risks mentioned earlier. Maintaining a current account deficit also runs directly opposite to China's One Belt One Road ambitions, which are basically about exporting excess domestic savings abroad. For all of these reasons, investors should treat any announcement about a sharp reduction in China's US trade surplus with caution.

FIGURE 6

International reserves are not keeping up with CNY monetary liabilities



Source: Haver Analytics

Appendix

Here, we provide background on the dynamics of net foreign liabilities to which we refer in the report. The framework is a simple and standard version of external debt-dynamic arithmetic, adapted to the Chinese case in which a large share of net foreign assets consist of safe, and therefore low-yielding, reserve-quality assets.

Framework:

Define:

F = Net foreign assets, measured in USD.

Y = Nominal GDP, also measured in USD

f = Ratio of net foreign assets to GDP: f = F/Y

c = Current account surplus as a share of GDP

We use conventional 'dot' notation to denote a rate of change in some variable over time:

$$\dot{X} \equiv \frac{dX}{dt}$$

Because current account imbalances need to be financed, we have:

$$\frac{\dot{F}}{Y} = c$$

This is an identity, except that it neglects capital gains and losses on external assets and liabilities that affect the net external position, without being recorded in the current account of the balance of payments. These can be important in the short run, but we will assume that they are negligible for the long-run analysis that concerns us here.

From the definition of f, we compute:

$$\dot{f} = \frac{\dot{F}}{Y} - \frac{\dot{Y}}{Y}\frac{F}{Y} = c - gf$$

If the current account balance is constant, then net foreign assets will eventually converge to a steady-state share of GDP:

$$\bar{f} = {}^{c}/_{g}$$

When we assume a constant current account balance, we are implicitly assuming adjustments over time in the trade balance (and non-interest service accounts) as required to maintain a constant current account as net interest receipts or payments change over time in response to changes in the level of foreign assets. This is not a particularly realistic scenario, but it allows us to discuss the implications of different levels of the current account balance. We view it as a reasonable way to analyze different average current accounts over long periods.

We are interested in the composition of the current account, specifically net interest income (or payments) and the non-interest component. Here is where the distinction between safe assets (such as international reserve assets) and risky assets is important. We define:

i_s = return on safe assets

i_r = return on risky assets

s = net ownership of safe external assets as a share of GDP

As with everything else, we measure the interest rate on safe and risky assets in terms of USD. With these definitions, investment income from net foreign assets (as a share of GDP) is:

$$e = i_s s + i_r(f - s) = i_r f - (i_r - i_s)s$$

We are interested in gross foreign liabilities, as well as the net position, because the gross position determines the quantity of assets that needs to be created by the domestic economy to be held by foreign investors. This follows naturally from the definition of net foreign assets:

$$f = s + a_r - l$$

where, as before, s refers to safe foreign assets (mainly international reserve assets), a_r denotes risky foreign assets such as outward direct foreign investment, and l denotes gross foreign liabilities. In the illustrative examples below, we assume that the country owns safe foreign assets of 20% of GDP and risky foreign assets of 15% of GDP. Gross foreign liabilities are therefore equal to the 35% of GDP required to finance these assets, minus the net asset position.

Example

We adopt the following assumptions:

$i_s = 3\%$ The safe rate of interest, measured in USD. This is consistent with 2% inflation and a real interest rate of 1%.

$i_r = 9\%$ The return to risky investments such as direct or portfolio equity investment, which equals 7% after adjustment for 2% inflation. The implied equity risk premium is 600 bp.

$g = 7\%$ The nominal growth rate of the economy measured in USD. This is consistent with 5% real growth, 2% inflation, and no trend in the USD/CNY real exchange rate.

$s = 20\%$ Safe international assets as a share of GDP. These are mainly official international reserves, which are equal to just under 25% of GDP at present. We therefore assume a modest decline in holdings of safe international assets, as a share of GDP.

$a_r = 15\%$ Foreign assets other than the safe assets, such as outward FDI and equity portfolio investments abroad. This is now just under 15% of GDP and has been growing rapidly in recent years. The assumption of 15% is therefore conservative.

Figure 7 summarizes the implications of these assumptions for various levels of the current account imbalance.

FIGURE 6

Results of model simulation for various current-account deficits

	2018	Simulations		
Current account balance	0.4%	-1%	-2%	-3%
Net foreign assets	12.5%	-14.3%	-28.6%	-42.9%
Net investment income	-0.4%	-2.5%	-3.8%	-5.1%
Non-interest current account	0.8%	1.5%	1.8%	2.1%
Non-interest service income (net)	-2.1%	-2.0%	-2.0%	-2.0%
Trade balance	2.9%	3.5%	3.8%	4.1%
Gross foreign liabilities	39.7%	49.3%	63.6%	77.9%

Note: All data are expressed as a share of GDP. Data for 2018 refer to the four quarters through Q3 18.
Source: Barclays Research

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