China: farewell to the large current account surplus

Disappearing structural current-account surplus is an inevitable trait of China's economic and social transformation

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Key points

- The steady erosion of China's current account (CA) surplus is an illustration of the ongoing structural shifts in the Chinese economy and its changing relationship with the outside world.
- The large CA surplus before the crisis was a result of the extraordinary imbalances between China's savings and investment. But as fundamentals changed, an unwinding of these imbalances has gradually closed the CA gap.
- With both savings and investment due to decline from their current levels, the future path of the CA will depend on the relative moves of the two. These moves will in turn be driven by the speed and extent of China's social and economic transformation.
- Our analysis reveals two interesting results. First, it is by no means inevitable that China will enter a CA deficit, although the era of large surplus has clearly ended. Second, the common perception of CA surplus being 'good' and deficit being 'bad' is misplaced. An entirely plausible scenario of China undergoing successful economic reforms could see its CA recording small, but persistent, deficits over the coming years.

China's new relationship with the outside world

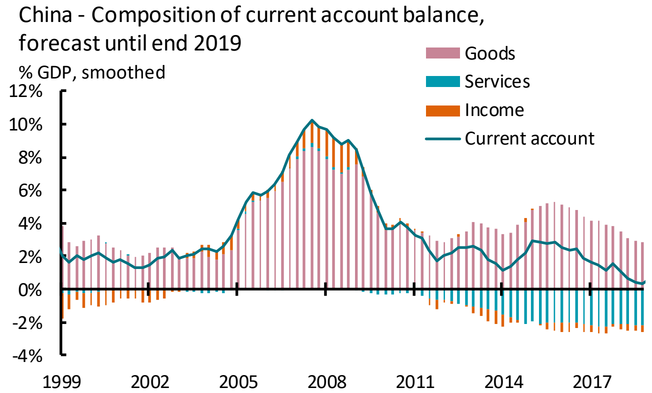
A steady, but definite, shift in China's balance of payments (BoP) suggests that a fundamental change is underway in China's relationship with the outside world (Exhibit 1). As a country of a large current account (CA) surplus – which peaked at almost 11% of GDP – China was a formidable competitor in global trade. But with its capital account (KA) closed, this surplus had to be recycled into liquid US Treasury bonds via an unprecedented build-up of official reserves. This contributed to what former US Federal Reserve Chairman Ben Bernanke called the "global saving glut"[1], which placed significant downward pressure on the US, and global, interest rates.

However, those surplus savings have now disappeared, with China's CA almost reaching a balance last year. Given the rise of trade protectionism globally – some of which targets China explicitly – it is likely that the country could record annual CA deficits in the coming year or two. However, this, as illustrated below, is not a transitory phenomenon caused by external shocks, but part of a longer-term shift driven by structural changes in the Chinese economy and society.

[1] Bernanke, B., "The Global Saving Glut and the US Current Account Deficit" Remarks by Fed Governor, 10 March 2005

This is part one of a three-part series analysing China's balance-of-payments transformation and its implications. In this note, we explain the causes of the disappearance of CA surplus and how the external balance may evolve in the future. Part two and three will focus on its implications on China's future economic development and spill-over effects onto the rest of the world.

Exhibit 1: China's CA surplus is disappearing



Source: CEIC and AXA IM Macro Research

CA reflects changes in savings and investment

There are two general ways to explain any changes in the current account. The first focuses on the composition of the CA by segregating the aggregate moves into components. Exhibit 2 shows the key contributors to the rise and fall of the CA surplus before and after its peak in 2007. The trade surplus in manufacturing goods accounted for the lion's share of the CA gains before the global financial crisis (GFC), supported by China's successful entry into the World Trade Organization. However, that contribution has declined since the crisis, with its accumulated changes accounting for about half of the CA-surplus decline over the past decade[2]. For the remaining changes, the deterioration in the services – particularly tourism – balance was a major driver[3], while income outflows – partly due to foreign companies expatriating profits – also played a role.

The second way to explain the current account is to consider its identity to the savings and investment (S-I) gap of a country. A scatter plot of CA and S-I of major economies confirms this relationship (Exhibit 3), which works nearly perfectly for China in the past 30 years (Exhibit 4). **As such, to predict the future of the CA, one has to know how China's savings and investment rates will evolve going forward.**

Exhibit 2-7

Exhibit 2: Contribution to CA changes before and after the peak

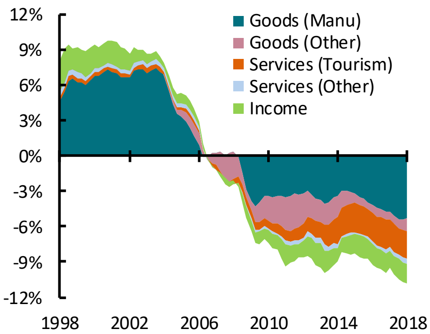


Exhibit 4: China's savings-investment gap vs. current account

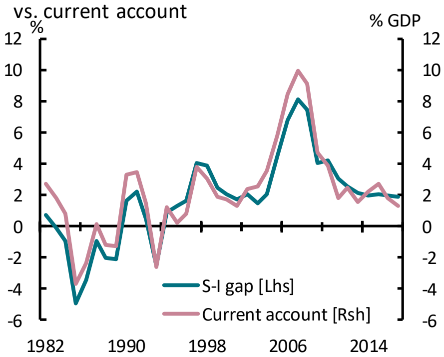


Exhibit 3: Savings-investment gap vs. current account

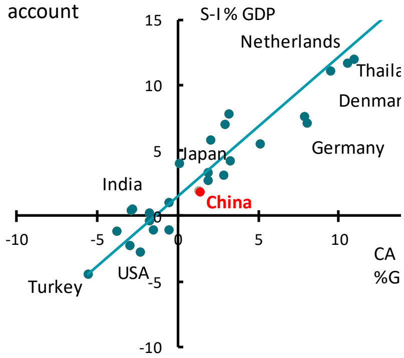


Exhibit 5: Gross domestic savings vs. gross capital formation

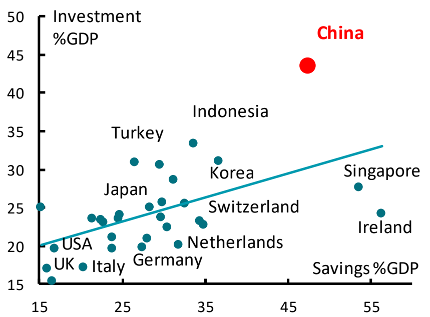


Exhibit 6: China vs. global savings breakdown

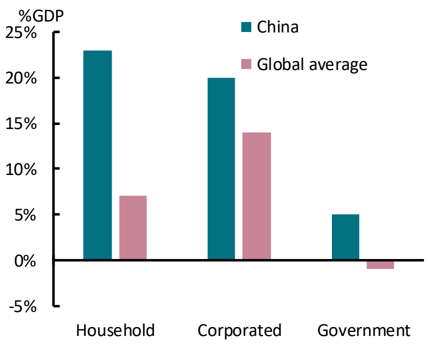
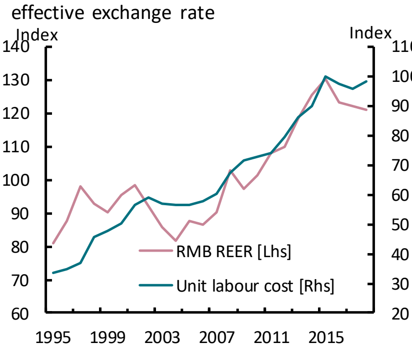


Exhibit 7: China's unit labour cost and real effective exchange rate



Source: Bloomberg, CEIC and AXA IM Macro Research

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[2] Part of this is due to relative growth differentials, with China's stronger growth rebound post the GFC spurring import growth while its export recovery was held back by lacklustre global demand. But structurally, China's overall export competitiveness has been hampered by rising unit labour costs and persistent currency appreciation (Exhibit 7).

[3] However, a recent Federal Reserve paper shows that some of the capital outflows since 2015 have been disguised as tourism outflows. See Wong, A., "China's Current Account: External Rebalancing of Capital Flight?" International Finance Discussion Paper, Board of Governors of the Federal Reserve System, No. 1208, June 2017

Savings supported by social and economic shifts

Before delving deeper, the first thing to note is that China is an outlier in both savings and investment rates globally (Exhibit 5). At 47% of GDP, China's national savings rate is almost 20 percentage points (ppt) above the global average, and this, according to the International Monetary Fund (IMF)[4], is mainly driven by extraordinarily high household savings (Exhibit 6). These savings, until recently, had been "trapped" in China – by its closed capital account – allowing the nation to self-finance its equally astonishing investment rate.

Fundamentally, high household savings are a result of structural forces that have buffeted the Chinese economy and society, including:

– **A drastic shift in population demographics,** partly due to the one-child policy. This has reduced the dependence ratio of an average Chinese family and lowered households' spending on childcare and education. According to the IMF, the rapid rise of the working-age population, who tend to save more than other demographic cohorts, explains more than half of the increase in national savings since the 1980s (Exhibit 8).

– **The lack of adequate social safety net**, which forced households to increase precautionary savings. A basic pension system in China was only established in 2009, and while the scheme has since achieved universal coverage, the level of benefits remains low, particularly for rural households.[5]

– Other factors, including **widening income equality**, where high-income households tend to save more than those of low-income, and **rising property ownership and values**, which forced buyers to save more for down-payments and mortgages.

Savings peak as tailwinds turn to headwinds

However, China's savings rate has been on a steadily decline since its peak in 2011. We believe this trend will continue as many tailwinds for savings have now turned into headwinds. For example, **China is aging at a rapid clip**, and as old-age dependency rises, national savings tend to decline (Exhibit 9). The Chinese government is also stepping up efforts to **improve the state pension and healthcare system**, reducing the need for households to maintain high precautionary savings[6]. Finally, **China is in a process of rebalancing its economy towards consumption-driven growth**, which will require households to become less thrifty. Like China, Korea experienced rapid industrialisation in the 1970s-90s supported by high domestic savings. But as its demographic and economic structure changed, the savings rate entered a prolonged decline. Once adjusted for the level of development, China appears to be following a similar path, albeit at a higher level of savings than Korea's (Exhibit 10).

Putting these factors together, our analysis, which builds on the IMF's framework[4], envisages a 4.5ppt decline in the national savings rate by 2023 in a benign case of economic transformation, and a 6.5ppt fall to 41.5% in a more aggressive case (Exhibit 11)[7].

Exhibit 8-10

Exhibit 8: China's savings vs. working-age population

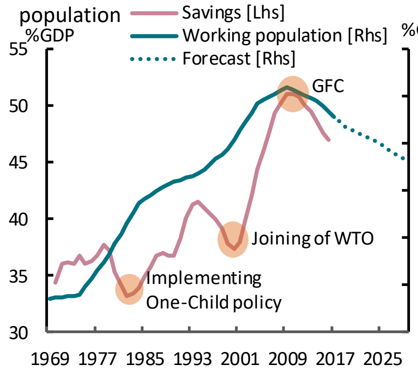


Exhibit 9: Gross savings vs. old-age dependency

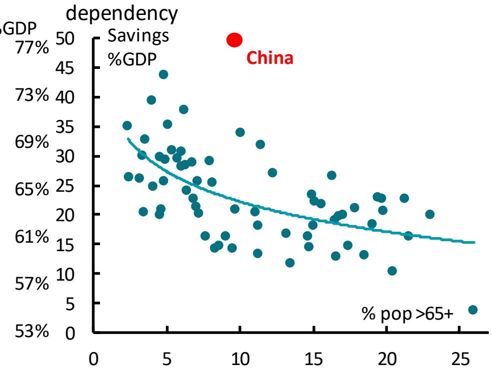
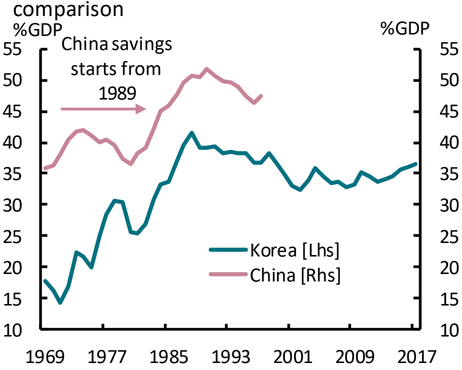


Exhibit 10: China and Korea savings comparison



Source: Bloomberg, CEIC and AXA IM Macro Research

4 Zhang, L., et al, "China's High Savings: Drivers, Prospects and Policies", IMF Working Paper, 18/277, 11 December 2018

5 Jain-Chandra, S. et al , "Inequality in China – Trends, Drivers and Policy Remedies" IMF Working Paper 18/127, 5 June 2018

6 Yao, A. and Hubert, P-E., "China: Coping with a Silver Society", Tomorrow Extended: Longevity – page 36, AXA IM Research, 9 January 2019

7 Modelling and comparative analysis against peer countries are used to access the potential changes in each of the component of national savings. Full details can be found in Zhang, L., et al (2018).

Exhibit 12-14

Exhibit 12: China's consumption and investment share of GDP

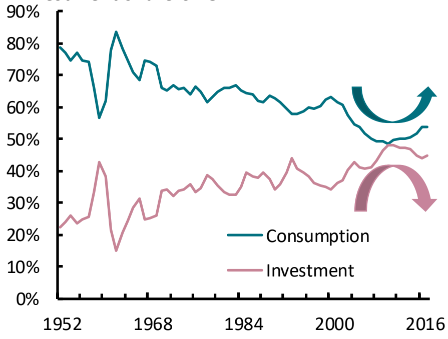


Exhibit 13:
(Emerging economies, relative to steady-state level in 2007-11)

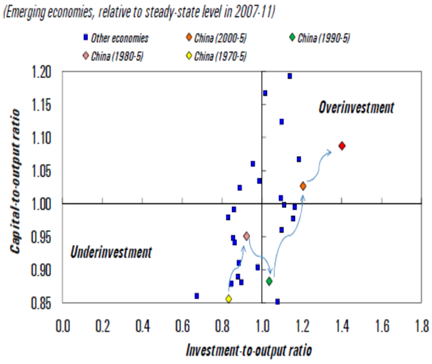
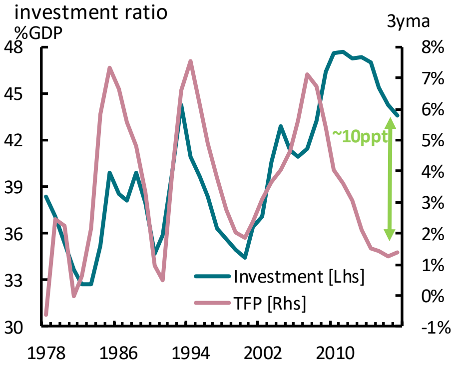


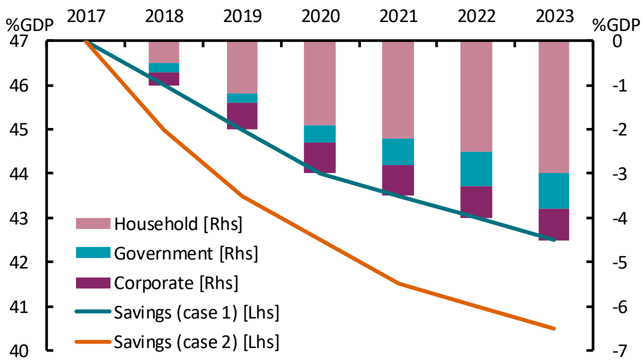
Exhibit 14: China productivity growth and investment ratio



Source: Bloomberg, CEIC and AXA IM Macro Research

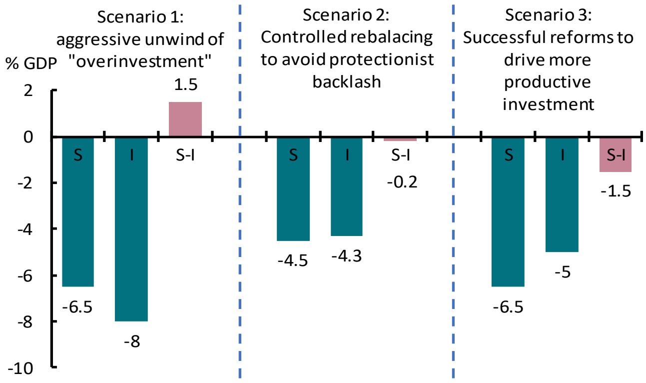
Exhibit 11: Savings rate is projected to fall

China - National savings rate projection

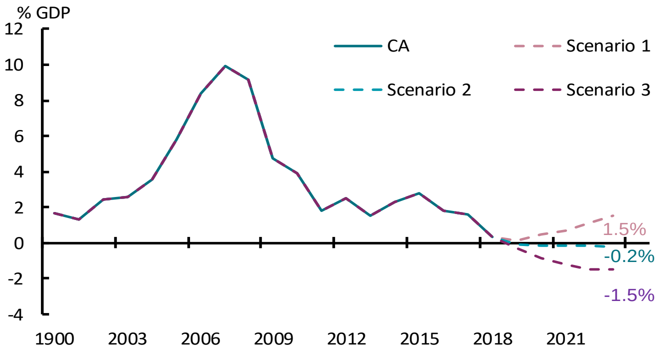


Source: CEIC and AXA IM Macro Research

Exhibit 15: Three scenarios for China's CA evolution



China's current account balance and projections



Source: CEIC and AXA IM Macro Research

Investments to decline due to growth rebalancing

At the other end of the ledger, the investment share of GDP is also expected to decline. This could be driven by a combination of growth rebalancing (Exhibit 12) and falling national savings that endogenously limit financing for investment. Echoing common beliefs, there is also evidence[8] that China has overinvested in recent years (Exhibit 13), consistent with a growing gap between its productivity growth and the investment rate. If the gap in Exhibit 14 is closed entirely by the latter, the investment share of GDP could fall by as much as 10ppt.

Three scenarios for the CA outlook

With both savings and investment due to decline from their current levels, the future trajectory of the CA will depend on the relative moves of the two. Given the numerous uncertainties, we present three scenarios to explain the possible paths.

Scenario one: a case of aggressive unwinding of "over-investment". This scenario assumes that the lion's share of China's excess investment – the gap in Exhibit 14 – will be closed by a sharp decline in the investment rate, down by 8ppt by 2023 (Exhibit 15).[9] This will lead to a rapid economic rebalancing that lifts the consumption share of GDP and reduces the savings rate by 6.5% – the aggressive scenario in Exhibit 11. The balance of S-I will therefore remain positive, leading to a rebound in the CA balance to +1.5% of GDP. This

[8] Lee, H-I., et al, "In China Over-Investing and Does it Matter?", IMF Working Paper 12/277, 27 November 2012

[9] This is an aggressive assumption, as the gap can also be closed by a recovery in China's total factor productivity growth. The latter is indeed what we expect, with productivity growth gradually recovering to around 3% in the coming years – a tame assumption compared to past experiences. See Yao, A. and Shen, S., "China: Stepping onto a new economic path", AXA IM Research, 28 February 2018

scenario implies that a sustained CA deficit, as feared by some,[10] is not inevitable. Rather, an entirely plausible combination of S-I adjustments could see China's CA stay in positive territory in the coming years.

Scenario two features a more careful management of economic rebalancing by Beijing to both maintain growth and control risks of its BoP changes[11]. In this scenario, the authorities will continue to rely on investment to keep GDP growth steady. As a consequence, the extent of growth rebalancing is slower than in Scenario 1, with a smaller decline in the savings rate (by 4.5ppt). The current account, in this case, will stay roughly balanced, oscillating around zero in the coming years. This is consistent with the latest projection from the IMF, which puts China's CA balance at -0.2% of GDP at 2023[12].

Finally, **Scenario three assumes a more successful economic rebalancing,** resulting in a faster rise in consumption that helps to lower the savings rate. At the same time, effective economic reforms will drive a rebound in productivity growth, thanks to, for example, a sustained reallocation of resources to private-sector corporates, away from unproductive state-owned enterprises (SOEs). This could in turn attract local and global capital to finance increased capex in the private sector, leading to a smaller decline in "I" than in Scenario 1. The balance of savings and investment means that China will run a CA deficit to the tune of 1.5% of GDP by 2023.

CA deficit is not a destiny, but likely path

Among the three scenarios, the last one should be the most preferred by investors and Beijing. This is a scenario of successful reforms leading to more sustainable economic development, for which a CA deficit is a just small price to pay. Scenario two is also possible given Beijing's over-protective nature of the economy, so that managing a balanced current account may become part of its overall policy operation[13]. A largely balanced CA could also arise from a more flexible RMB that helps to buffer internal and external shocks.

Scenario one appears less likely as it requires a steep drop in investment, which, without a commensurate rise in consumption (as the saving rate falls by less), would imply a fast decline in headline growth. It is true that a rebound in export growth – with the CA reverting back to surplus – could make up for some of the differences. But with the global trading environment turning more protectionist, and China's export competitiveness eroded by rising costs (at the low-end), supply-chain reshuffle (at the middle-end) and the US' tech suppression (at the high-end), it is not clear how exports could become a sustained engine of growth in the coming years[14].

Overall, the jury is still out on whether China will run a balanced or negative CA. What is more certain is that the era of a large and persistent surplus has ended. This is one of many consequences of the transformation of the Chinese economy and an ageing society. In part two of our report, we will discuss the significance of this balance-of-payments shift for China's financial liberalisation and its spill-over effects onto the rest of the world.

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[10] Takita, Y., "The vanishing illusion of China's financial might", Nikkei Asian Review, 13 May 2019

[11] One risk could be a rebound in China's CA surplus arousing further trade conflicts with trading partners

[12] IMF, "World Economic Outlook "Growth Slowdown, Precarious Recovery", April 2019

[13] Note that one of the four policy objectives of the People's Bank of China is to maintain stability of the BoP.

[14] Net exports can also increase with a reduction of imports, although China's economic rebalancing and the opening of its markets may limit the scope for import reduction.

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