CHINA'S ECONOMIC REBALANCING: WHAT ARE THE IMPLICATIONS FOR ITS EXTERNAL SECTOR?

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Abstract
This paper examines the core aspects of China's economic rebalancing process (from industry to services and innovations, from investment to consumption, and from exports to domestic demand), presents the main economic policy measures adopted to that end by China's government, paying special attention to the impact of this process on the external sector of the Chinese economy, relevant for the rest of the world. We use China's balance of payments and international investment position statistics to identify several major trends in China's external sector in the context of economic rebalancing, among which the gradual abandoning by China of its role as assembler of goods after processing and shifting from "double surplus" (in the current account and in the financial account) to "current account surplus and net capital outflow", in connection with China's entering into the next phase of economic development.

Keywords: *balance of payments; China; current account; economic rebalancing; international capital flows*

JEL classification: *F02, F32, F42, O11, O53*

I. INTRODUCTION

Today the People's Republic of China (PRC) ranks the second (after the USA) largest economy in the world, with a GDP of approximately US$ 11 trillion in 2016. Since the start of economic reforms in 1978 and until 2010 China's economy grew, on average, by 10% yearly. In the following period however, economic growth rates took a descending trajectory, reaching 6.7% in 2016 (the lowest rate during the last 25 years), which gave rise to concerns about the potential implications of this deceleration for the rest of the world.

While some researchers find that this slowdown is cyclical, related to the decline in global demand, and that China will be able to achieve a double-digit growth rate again (for instance, Lin and Zhang, 2015), other argue that China's extensive development is still sustainable over medium-term but not in the long-run (Silagadze et al, 2016), it is increasingly accepted that China's economic growth model is becoming exhausted and that the economic slowdown is a structural phenomenon (for example, Perkins, 2015). Among the main structural causes of deceleration mentioned is (1) the overaccumulation of capital, which has led to excessive capacity buildup, particularly in heavy industry, and caused a decrease in capital productivity, as well as (2) the shrinking flow of cheap labor force from rural areas and the decrease in the number of working-age population as a result of the "one family, one child" policy, which has pushed up labor costs and thus deteriorated the competitiveness of labor-intensive goods manufactured in China. This means that profound reforms are needed to rebalance China's economy. In the following we will describe the main points of these reforms, paying special attention to the impact of rebalancing process on the external sector of China's economy, relevant for the rest of the world.

II. CHINA'S ECONOMIC REBALANCING

Because China can no longer rely on the traditional engines of its economy – a large supply of labor force and massive investment in infrastructure, housing and industry, as well as because of other recent issues (such as high risks in the banking sector driven by the accumulation of nonperforming loans, high volatility in the domestic securities market, and the recent devaluation of domestic currency), China's government has adopted a set of policies aimed at rebalancing the country's economy towards a more sustainable path.

In May 2014 president Xi Jinping used the term "new normal" to describe a slower, but more equilibrated trajectory of economic growth (Xinhua, 2014). The slowdown of economic growth was expected by the Chinese government and, in its view, is a healthy development reflecting the effects of policies aimed at reducing excessive capacity in industry and at tempering fast credit growth, implemented after the 2008 financial crisis (IMF, 2016).

Today the efforts of China's government are channeled towards "rebalancing" the economy, that is, changing the development model so that the main engine of economic growth would be the development of the domestic market and the "new economy" sectors (including technological innovations and services), rather than exports of goods. The idea of shifting focus *from industry to services and innovations, from investment to consumption, and from exports to domestic demand* is not new. The former prime-minister of the PRC Wen Jiabao and other Chinese leaders have repeatedly mentioned that economic growth in China relies excessively on exports and domestic investment in housing and infrastructure, and have emphasized the government's intention to stimulate domestic consumption (BBC, 2007). Later on, Li Keqiang's government as well, making notice of slow post-crisis recovery in developed economies and of the gradual eroding of China's external competitive advantages based on low costs, reiterated the government's preoccupation with economic rebalancing by abandoning the model based on exports of goods and directing the economy towards satisfying domestic households' demand and growth in services sector (China.org.cn, 2015).

Economic policies implemented by China in view of achieving the above-mentioned objectives can be grouped as: (1) supply-side policies; (2) policies aimed at domestic demand; (3) policies aimed at external demand.

Supply-side policies provide the following:

a. Reducing excessive industrial capacity and corporate debt (as announced by Chinese authorities in the Plan for 2016, the first year of the 13th 5-year plan) (Li, 2016);
b. Increasing the role of services sector in the country's economy. To that end, a set of fiscal measures has been proposed, such as replacing the "business tax" in services with the VAT. Currently, the VAT is applied on goods, while the levy on services is „business tax", which is imposed on the value of a firm's sales. This results in a tax on tax: it is charged on the taxes already included in the prices of supplies. It is assumed that the reduction of fiscal burden on services companies will encourage the development of this sector (Xinhua, 2016);
c. Increasing the quality in consumption goods manufacturing to a medium-high level. For this purpose, a greater exposure of manufacturers to external competition is proposed: since the beginning of 2014, custom duties on approximately 700 categories of imported goods have been lowered. Additionally, the number of free-trade agreements between China and other countries and regions is growing (Hewitt, 2015);
a. Shifting from the „assembled in China" model to the „created in China" model by encouraging technological innovations aimed at increasing the domestic value added, so that the industry based on mere processing of goods be replaced by domestic companies with their own brands (Chistruga and Soloviova, 2014).

Following the economic policies applied, China's GDP structure has indeed improved: in 2013 the share of the tertiary sector in GDP surpassed for the first time that of the secondary sector. In 2015, the share of the tertiary sector in GDP reached 50% (from 25% in 1978 and 40% in 2000).

Domestic demand stimulation policies are based on the fact that nowadays China's population is about 1.37 billion people and is growing, representing a big potential as consumers. However, the current ratio of households' final consumption to GDP in China is considerably lower than in many other countries: in 2015 it amounted to 37% while the world average was 58% (Chart 1).

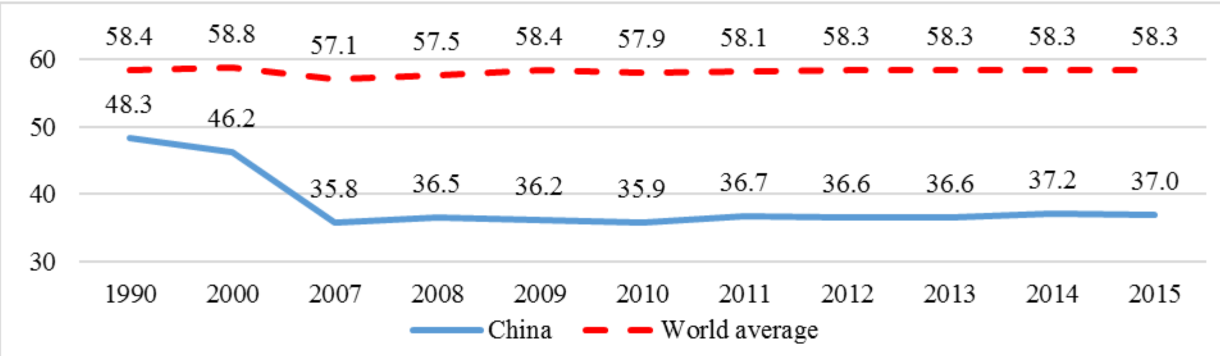


Chart 1. Dynamics of households' final consumption in PRC, % to GDP
Source: Elaborated by author based on World Bank data (World Development Indicators)

Thus, the government's goal is to boost domestic consumption demand so that it become the main engine of economic growth instead of stagnating exports. The core measures aimed at achieving this goal include:

a) Further development of the social security system (in order to encourage households to spend their excessive savings): creating a centralized national-level pension system, expanding the number of people covered by the system (particularly among rural residents), encouraging additional voluntary social contributions from businesses etc.;
b) Lowering taxes and decreasing customs duties on imports. At the beginning of 2016 the Chinese government announced the upcoming personal income tax reform. It will comprise measures such as:

increasing nontaxable income, deducting expenditures on education, childcare and mortgage from the taxable income. Additionally, lowering customs duties on imported goods mentioned earlier in this article, besides exposing Chinese manufacturers to external competition, will also contribute to the growth in consumption (Xinhua, 2016);

c) Flattening income inequalities between urban and rural population, Eastern and Western regions of the country. It is assumed that increasing the income of low-income groups with a higher propensity to consume will lead to an increase in overall propensity to consume;

d) The reform of household registration („hukou"): granting rural workers the right to register in cities so that they can legally buy or rent homes, which will boost demand in real estate and home appliances markets (Xinhua, 2015);

e) Improving the consumption environment, more specifically, raising safety standards for goods and services;

f) Introducing the system of paid annual leave, which will drive travel and recreational services consumption (currently, Chinese employees go on vacation simultaneously during national holidays, while the practice of voluntary annual leave isn't widespread).

Although the rebalancing of China's economy implies its orientation towards satisfying domestic consumption demand, exports of goods are still an important component of the economy. Thus, recent **policies aimed at external demand** pursue at least the stabilization of China's exports and include, in broad lines, the following:

1) The „New Silk Road" („One belt, one road") initiative launched in 2013 by president Xi Jinping in view of increasing international connectivity and supporting external trade. This plan to revive the ancient Silk Road which connected the Orient to the Occident implies the building of roads, railways, ports and other infrastructure elements to create transport corridors (land and maritime) between China and the rest of Asia, Europe, and Africa, comprising approximately 60 countries. Financing will be provided by: Asian Infrastructure Investment Bank, BRICS New Development Bank, Silk Road Fund, China-ASEAN Banking Consortium etc. (Huang, 2016);
2) Concluding free trade agreements (FTA) with an increasing number of countries and regions (related to the first objective). Currently, China has 14 FTAs signed with 22 countries and regions: ASEAN, South Korea, Australia, Singapore, Pakistan, Iceland, Switzerland, Chile, Peru, Costa Rica, New Zealand, including economic cooperation agreements with Hong Kong, Macao and Taiwan. Under negotiation currently are the FTAs with: Norway, Japan, Sri Lanka, Maldives, Israel, Georgia and the countries of Gulf Cooperation Council. At the stage of consideration are FTAs with India, Columbia, Fiji, Nepal, Mauritius and Moldova (Ministry of Commerce, PRC, 2017);
3) Granting official loans to other countries, contingent on purchasing goods and services from China (export seller's credits, export buyer's credits and governmental concessional loans). The PRC started providing official export credits in the 1990s, and in the last decade the Chinese government export crediting activity has expanded remarkably (Soloviova, 2016). Thus, according to some estimates, China is today the world's largest provider of official medium and long-term export credits, with US$ 58 billion lent in 2014 alone. Jin and co-authors (2016) estimate that the total outstanding stock of external loans offered by China Development Bank and China Eximbank amounts to circa US$ 350 billion, almost equal to that of the World Bank;
4) Intensifying international economic cooperation both in bilateral and multilateral format, by means of: BRICS, Shanghai Cooperation Organization, Asia-Pacific Economic Cooperation, ASEAN plus China (10+1), Forum on China–Africa Cooperation, cooperation platform between Central and Eastern Europe and China (16+1) etc.

III. THE IMPACT OF ECONOMIC REBALANCING PROCESS ON CHINA'S EXTERNAL SECTOR

Issues related to the exhaustion of China's economic growth model and to the economic rebalancing (from investment to consumption, on the demand-side, and from manufacturing to services and innovations, on the supply-side) are also reflected in the evolution of its external sector.

China's traditional current account surplus results from national saving being superior to investment: in China, consumption is well below the world average, which leads to a very high saving rate and, respectively, to a very high positive current account balance (CAB).

The chart below presents China's ***current account*** dynamics, which shows persistent surpluses starting from the mid-nineties of the last century and gaining momentum after China' joining the WTO in 2001. In 2015, China's CAB reached US$ 331 billion (3% to GDP), up by 19% as against 2014.

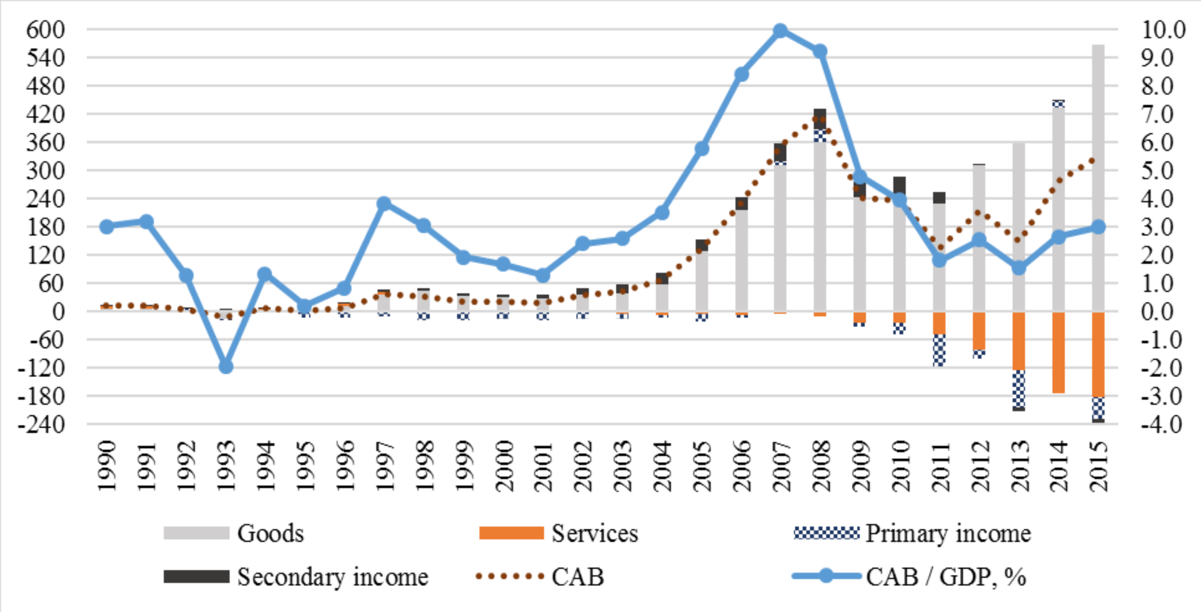


Chart 2. China's balance of payments current account (BPM6), US$ billion

Source: Elaborated by author based on the data of State Administration of Foreign Exchange of the PRC (SAFE)

The structure of the current account shows that the source of China's surplus is the **foreign trade in goods**: in 2015, China's trade in goods balance amounted to US$ 567 billion. Although exports were lower than in 2014 (-5%), the trade surplus increased because imports fell (-13%) (Chart 3). The negative dynamics of China's imports of goods reflects both the impact of global processes (weak global demand leads to the decrease in exports from China and, respectively, to lower imports of raw materials, parts and assemblies in China) and the influence of the above-mentioned rebalancing of China's economy process. First, from the point of view of supply, the decrease in imports was caused by China's shifting from manufacturing (more import-intensive) to services. Second, from the point of view of demand, shifting from investment to consumption has as well contributed to the contraction of imports of goods (according to the IMF's estimations, consumption in China is less import-intensive than investment (IMF, 2016, p. 66)). Finally, due to technological innovations supported by the government, the process of imports substitution by locally-made goods is picking up steam in China.

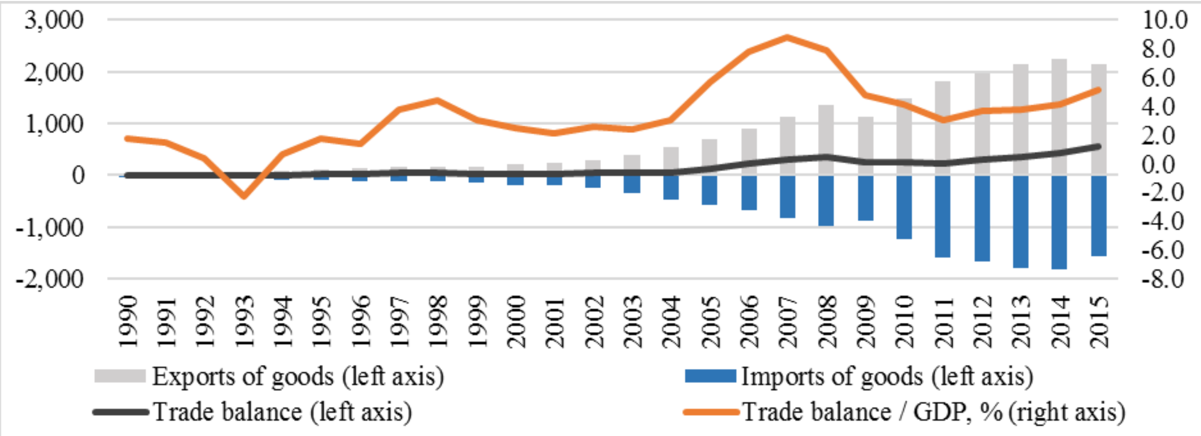


Chart 3. China's foreign trade in goods (FOB-FOB, BPM6), US$ billion

Source: Elaborated by author based on the data of State Administration of Foreign Exchange of the PRC (SAFE)

Services account for 12% of China's exports of goods and services and for 23% of imports (2015). The services balance is traditionally negative (- US$ 182 billion in 2015), particularly because of massive imports of travel services (especially personal travel – related to education, tourism and shopping abroad – which has increased as a result of households' growing income (SAFE, 2016, pp. 18, 32)), accounting for 62% of total services imports in 2015. Besides travel, there are large imports of transport (16%) and business (8%) services. The downturn in exports of *manufacturing services on physical inputs owned by others* shows China's tendency to gradually abandon its role as assembler of made-to-order goods and its upward movement within the global value chain. Chart 4 shows the decline, starting from 2012, of processing services exports, both in absolute terms and as a share of total exports of goods and services from China.

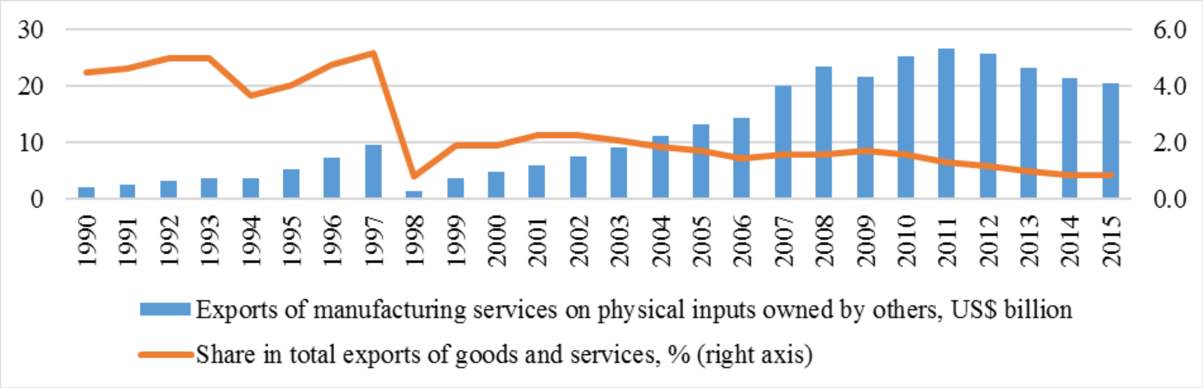


Chart 4. China's exports of manufacturing services on physical inputs owned by others
Source: Elaborated by author based on the data of State Administration of Foreign Exchange of the PRC (SAFE)

China's **primary income** balance is negative (- US$ 45 billion), showing net payments of investment income (dividends, interest) to foreign investors, while the compensation of employees records net receipts.

The sign of **secondary income** balance has become negative in recent years (- US$ 9 billion in 2015) because of current transfers to the rest of the world recorded by the nonfinancial corporations and households sectors.

China's balance of payments ***financial account*** (including changes in reserve assets), just as in previous years, showed a net capital outflow (US$ 143 billion) in 2015 (Chart 5). However, there are several notable changes in the financial account structure as compared to previous periods.

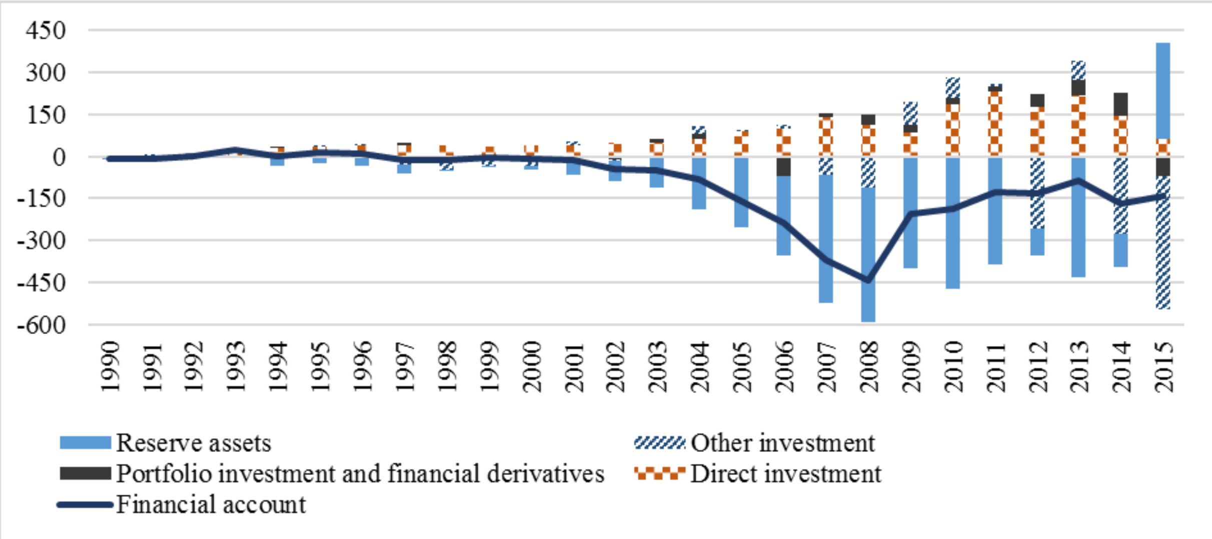


Chart 5. China's balance of payments financial account (BPM5[3]), US$ billion
Source: Elaborated by author based on the data of State Administration of Foreign Exchange of the PRC (SAFE)

Prior to 2014, China's financial account in the narrow sense (excluding reserve assets) showed net capital inflows, resulting primarily from FDI. The Chinese government called this situation "double surplus" (referring to the current account surplus recorded simultaneously with net capital inflows in the financial account). Starting from 2014, however, the "double surplus" trend has changed, shifting to "current account surplus + net capital outflow" (Chart 6).

The change in financial account trend does not result from massive withdrawals of foreign investment from China, but is, in our view, the outcome of two phenomena, one temporary, and the other one structural:

1) The first reason for net capital outflows, the temporary one, are the hedging activities undertaken by businesses after the recent devaluations of Renminbi yuan (the first one – in August 2015), resulting from the commitment by the Chinese government to gradually liberalize the exchange rate of the domestic currency (particularly in connection with the IMF's decision to include the yuan in the SDR currencies basket taken in 2015), thus letting the market play a more significant role in determining the

[3] According to the BPM5 statistical standard, a net increase in assets is presented with a minus sign, and a net decrease in assets – with a plus sign. A net increase in liabilities is presented with a plus sign, and a net decrease in liabilities – with a minus sign.

value of the yuan. Although some commenters have noted the existence of motivation for Chinese authorities to manipulate the yuan's exchange rate in order to support falling exports, nonetheless, considering China's economic growth slowdown in recent years and the general strengthening of the US dollar, one can say that the depreciation of the yuan was in line with market developments. Anticipating a further appreciation of the US dollar, businesses in China hastened to repay their dollar-denominated debt: according to balance of payments data, in 2015 the net repayments of external loans by Chinese residents amounted to US$ 167 billion (as compared to US$ 34 billion in 2014) (SAFE, 2016, p. 34). Likewise, Chinese importers hurried to settle their trade debt (liabilities in the form of trade credits decreased by US$ 63 billion as compared to US$ 2 billion in 2014). Other factors that generated capital outflow were: net decrease in nonresidents' deposits (US$ 123 billion in 2015), increase in the assets of resident banks and corporations in the form of foreign currency and deposits (US$ 100 billion in 2015).

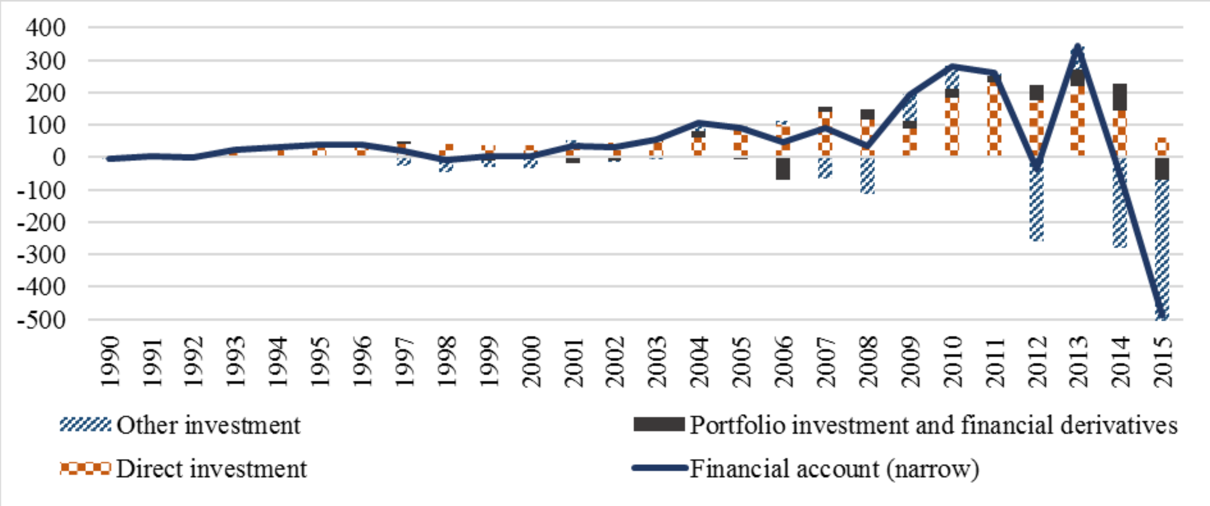


Chart 6. China's financial account excluding reserve assets (BPM5), US$ billion

Source: Elaborated by author based on the data of State Administration of Foreign Exchange of the PRC (SAFE)

2) The second reason for trend reversal in China's financial account, the structural one, is the change in economic paradigm: China is entering into the following stage of development, from export of goods and import of capital to the phase when China itself becomes an investor in other countries. Indeed, the statistics of China's residents' assets in the form of direct and portfolio investment abroad shows a firm growing trend (Chart 7). In 2015, Chinese assets in the form of direct investment abroad increased by US$ 188 billion and reached a total stock of US$ 1,129 billion, while those in the form of portfolio investment grew by US$ 73 billion and amounted to a total stock of US$ 261 billion as of the end of 2015.

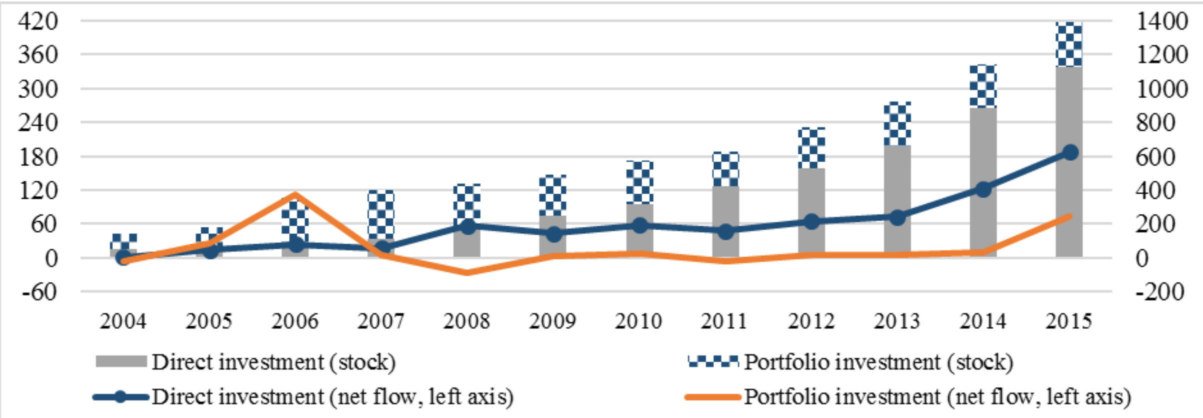
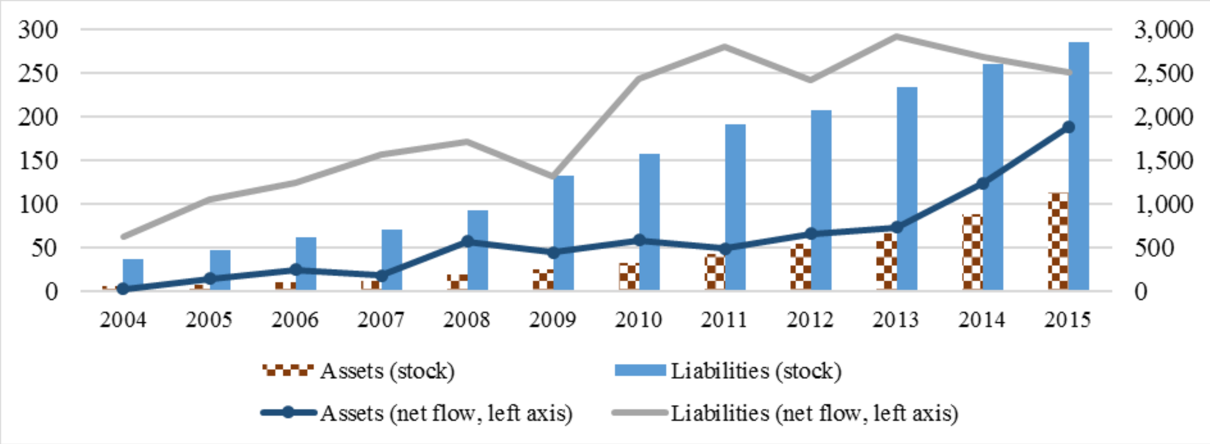


Chart 7. China's residents' assets in the form of direct and portfolio investment abroad, flows and stocks, US$ billion

Source: Elaborated by author based on China's balance of payments and international investment position data published by the State Administration of Foreign Exchange of the PRC (SAFE)

Even though the flows of Chinese direct investment abroad are still below foreign direct investment flows in China, resulting in net capital inflows, one can note a convergent trend (Chart 8).



flows and stocks, US$ billion

Source: Elaborated by author based on China's balance of payments and international investment position data published by the State Administration of Foreign Exchange of the PRC (SAFE)

As a result of above-mentioned developments in the financial account, the demand for foreign currency in China's domestic market increased and, for the first time in the last 20 years, China's official reserve assets went down (by US$ 343 billion in 2015), despite the current account surplus and net FDI inflow. However, the total stock of China's official reserve assets remains the world's largest (US$ 3.3 trillion at the end of 2015).

IV. CONCLUSIONS

This paper examines the core aspects of China's economic rebalancing process and its impact on the external sector of the Chinese economy.

According to numerous studies, there are signs that China's current economic growth model is becoming exhausted, which is manifested in its shift from an accelerated growth rate to a moderate one.

Because China can no longer rely on the traditional engines of its economy, China's government has adopted a set of policies aimed at rebalancing the country's economy towards a more sustainable path, so that the main engine of economic growth would be the development of the domestic market and the "new economy" sectors (including technological innovations and services), rather than manufacturing and exports of goods. In outline, the rebalancing process implies shifting focus from industry to services and innovations, from investment to consumption, and from exports to domestic demand. In the article we have presented the main economic policy measures adopted to that end by China's government, grouping them as: supply-side policies, policies aimed at domestic demand and policies aimed at external demand.

Relative to existent papers, the main value added of our study is that, by analyzing China's balance of payments and international investment position statistics, we have identified how developments related to the exhaustion of the current economic growth model and the rebalancing of China's economy are reflected in the evolution of its external sector. We find several major trends in China's external sector in the context of economic rebalancing: (1) China's persistent current account surpluses show that, despite the government's efforts, the gross saving rate is still high in this country and the consumption is low, so that further consumption support action is needed; (2) Imports of goods in China fall faster than exports. The negative dynamics of China's imports reflects both the impact of global processes (weak global demand leads to the decrease in exports from China and, respectively, to lower imports of raw materials, parts and assemblies in China) and the influence of economic rebalancing: China's shifting from manufacturing (more import-intensive) to services, and from investment (more import-intensive) to consumption, as well as the development of the import substitution process; (3) China's services balance is traditionally negative, particularly because of massive and growing imports of travel services. The downturn in exports of manufacturing services on physical inputs owned by others shows China's tendency to gradually abandon its role as assembler of goods after processing and its upward movement within the global value chain; (4) The "double surplus" recorded in China's current and financial accounts (excluding reserve assets) prior to 2014 has now become "current account surplus + net capital outflow". After a detailed analysis of China's balance of payments we find that this change does not result from massive withdrawals of foreign investment from China. Besides short-term reasons (such as hedging activities undertaken by Chinese businesses following the recent devaluations of the yuan), the structural reason for this change is China's movement to the following stage of economic development, from export of goods and import of capital to the phase when China itself becomes an investor in other countries.

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