



# China and global rebalancing: A two-country approach<sup>☆</sup>



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## ABSTRACT

Based on simulations of an original DGE model of the US and the Chinese economies under various monetary regimes, we show that an overhaul of China's social safety net is capable of reducing global imbalances whatever the exchange-rate regime, provided international capital flows are allowed to react to expected return differentials, which requires some relaxation of capital controls. Exchange-rate flexibility would accelerate the rebalancing, but not make it larger. A monetary reform would fail to rebalance the economy unless the government simultaneously acts to curb NFA accumulation through consumption-enhancing reform or reducing its objective in terms of reserve accumulation.

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## 1. Introduction

Since the early 2000s, China has been the center of repeated criticism by the international community concerning its contribution to global imbalances, with two main recriminations: (i) excess savings prompted by a number of market and social distortions, and (ii) a quasi-fixed exchange-rate regime backed by capital controls and official reserve accumulation. Global imbalances temporarily retreated during the 2007–2009 global crisis, as a consequence of the trade collapse and financial de-globalization. When the global economy started to pick up in mid-2009, it however became clear that the crisis had not wiped up the problem which was deemed to soon re-emerge (see Blanchard & Milesi-Ferretti, 2010). However China continued to resist international pressures to reform its exchange-rate regime. Instead, it committed to stimulate domestic demand through a number of structural reforms, especially the reconstruction and extension of the social safety net, while slowly moving in the direction of financial opening up and currency internationalization.

This paper aims at comparing the effectiveness of structural and monetary reforms, and the complementarity between the two, in reducing global imbalances, within a two-country, dynamic general equilibrium (DGE) model. Specifically, we compare how a more generous social safety net in China would be capable of curbing the current-account surplus in this country and the mirror deficit in the United States with or without a change in the monetary regime. Symmetrically, we analyze whether a monetary reform in itself could curb global imbalances without the help of structural reforms in China.

Two groups of explanations to global imbalances have been suggested in the literature (Bernanke, 2005; Caballero, Farhi, & Gourinchas, 2008; Dooley, Folkerts-Landau, & Garber, 2003; Mendoza, Quadrini, & Rios-Rull, 2007): (i) macroeconomic and

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structural factors, such as high saving rates in emerging countries triggered by energy windfalls, deficient social safety nets, or financial under-development; low investment rates in some emerging countries following the Asian crisis; and lax monetary policy in the United States; and (ii) the international monetary system (IMS hereafter) itself, through the key role of the United States as a supplier of international reserve assets, the lack of trust in multilateral financial safety nets which has led emerging countries, especially in East Asia, to self-insure through reserve accumulation, and the success of export-oriented growth strategies that have encouraged fixed or quasi-fixed exchange-rate regimes. Contrasting with this two-pillar understanding of global imbalances, researches on rebalancing scenarios have tended to focus on real exchange-rate adjustment, especially for the United States, abstracting from the IMS (Blanchard, Giavazzi, & Sa, 2005; Obstfeld & Rogoff, 2005). Few studies have been devoted to the interconnection between real adjustments and monetary regimes. One exception is Blanchard and Giavazzi (2006) mentioning the needs to combine a nominal appreciation of the renminbi with a fall in China's saving rate, in order to secure internal balance while reducing the current-account surplus. Another one is Faruqee, Laxton, Muir, and Pesenti (2007) who contrast the impact of a fiscal adjustment in the US depending on China's monetary regime, within a four-region DGE model.

The present paper is interested in the intertwined contribution of structural and monetary reforms to global rebalancing. While acknowledging that China has in no way been the only contributor to global imbalances, we focus on this country which represents a unique example of very high gross saving rate (50% of GDP on average over the 2005–2008 period according to Ma & Yi, 2010) combined with a quasi fixed exchange-rate regime that feeds fast reserve accumulation. These features would be benign if China was still a small country. But China has become the first official reserve holder in the world, and it accounted for 62% of gross national savings in Asia excluding Japan in 2008 (see Prasad, 2011).

We successively cover the two lines of explanation of global imbalances, hence the two possible channels of global rebalancing. First, we study the contribution of China's aggregate saving rate. Although, as argued by Ma and Yi (2010), the unique feature of China's rising saving rate during the 2000s is that the three sectors of the economy (households, firms and the government) have simultaneously contributed to the very high saving rate, here we concentrate on the social safety net for three reasons: (i) Chamon, Liu, and Prasad (2010) estimate that “rising income uncertainty and pension reforms can account for over half of the increase in the urban saving rate in China since the mid-1990s” (p.1). Hence, any improvement of the social safety net could be instrumental in curbing households' saving rates; (ii) consistent with the goal of “universal social security coverage for urban and rural residents by 2020” (Chinese Government, 2006), the Chinese have taken decisive actions especially concerning health insurance (see Li, 2011) and the pension system (see Herd, Hu, & Koen, 2010). In particular, it was decided in 2005 to reduce the share of the “individual account” in the calculation of pension benefits, thereby raising the replacement rate for urban households, and in 2009 a new rural pension program was launched with the aim to progressively extend the coverage from 10% of the counties at end-2009 to 50% in 2012 and complete coverage by 2020. The twelfth 5-year plan approved in 2011 has confirmed the extension of social security coverage as a top policy priority; (iii) reforms aiming at reducing corporate or government saving rates can be shown to have similar effects on global imbalances as social security ones, although the impact for the Chinese economy may differ (see Bénassy-Quéré, Carton, & Gauvin, 2011). After simulating rebalancing scenarios based on a reduction in Chinese households' saving rate, we turn to the second interpretation of global imbalances, based on the functioning of the international monetary system, in particular the willingness of the People's Bank of China to accumulate reserves.

We build a DGE model of two countries (China and the United States) with overlapping generations and nominal rigidities, and simulate a more generous pay-as-you go pension system in China that results in a decline of the aggregate saving rate,<sup>1</sup> under different monetary regimes: the status quo (a fixed exchange rate backed by capital controls and foreign-exchange interventions), a relaxation of capital controls, and a flexible exchange-rate regime. We then study the impact of a monetary regime change in itself, in a context of global imbalances. As in Bagnai (2009), we simulate the effect of a rebalancing shock, but unlike this author, we rely on a model where consumption, pricing and portfolio choices derive from utility maximization and account for expectations.

We find that a fall in China's saving rate would contribute to global rebalancing whatever the exchange rate regime, provided international capital flows do react to interest-rate differentials (which implies less-than-complete capital controls in China). The reason for this result is the following: with lower savings, the autarkic interest rate of China is higher, which attracts foreign investments. With low capital mobility, this effect is muted, hence there is less capital accumulation in China and the current account stays unaffected. In contrast, with high capital mobility, the higher autarkic interest rate attracts large capital inflows. The People's Bank of China (PBoC, hereafter) cannot simultaneously prevent a nominal exchange-rate appreciation and a rise in domestic prices: to prevent the former, the PBoC needs to follow the US monetary policy, which feeds domestic inflation; conversely, the PBoC can successfully avoid inflation if the currency is allowed to appreciate. In both cases, the real exchange rate appreciates and the current-account surplus is reduced.

The difference between the two exchange-rate regimes is the speed rather than the extent of the adjustment: it is quicker in a flexible regime than in a fixed one. The two regimes also differ for China, since only in a flexible regime is China able to control inflation stemming from more dynamic domestic demand (consistent with the intuition of Blanchard & Giavazzi, 2006). This feature provides strong incentive for China to move away from its fixed peg, although the advantage for the United States of such move is only transitory.

Additionally, we show that, should the United States refrain from hiking its interest rate when global savings are reduced, the need for China to float its currency would become more acute, and the extent of the rebalancing would depend more directly on the exchange-rate regime. Finally, we find that a monetary reform in itself is unable to rebalance the Chinese economy unless it is accompanied by a shift in government policy concerning net foreign asset (NFA) accumulation, either through consumption-enhancing reforms, or through a halt to active reserve accumulation by the central bank.

<sup>1</sup> By extension, the simulation of a pension reform covers any overhaul of the social safety net that would reduce uncertainty about the ability of households to cover “big ticket” expenses (such as health care).

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