China's transition to a financial market powerhouse

As China ages fast, the country will become an importer of capital and grab a greater share of international investment. Portfolios will have to adjust to reflect this

A more balanced world? For years, developing countries in Asia and oil-exporting economies in the Gulf were saving more than they were spending. This imbalance, which former US Federal Reserve chief Ben Bernanke famously described as a "global savings glut", was blamed for depressing US interest rates and encouraging speculative borrowing – a contributing factor to the 2008 financial crisis.

That glut is now fast disappearing. Global savings, as a percentage of GDP, peaked in 2014 and have been shrinking ever since. This is a phenomenon that could prove transformational for the global economy. It's because China sits at the centre of this trend.

Thanks to its export-led economic model and fixed exchange rate, China was able to build up its reserves to eye-watering levels. Now, not only are its increasingly-wealthy citizens saving less, they are also having to meet the rising costs of caring for one of the world's fastest-ageing populations.

China's current account surplus – its trade balance plus net income from foreign investment – peaked at 10 per cent of GDP in 2007. By early 2019, it had almost vanished. China may soon find itself running its first current account deficit in more than a quarter of a century.

A current account deficit means that a country consumes more than it produces. When this occurs, capital must come from abroad to make up for the shortfall. This is what the US has been doing for decades; its hugely efficient capital markets, its strong rule of law and the dollar's reserve currency status allow it to borrow money from overseas investors with relative ease.

China is about to follow a similar route. One reason is demography.

How to spend it

China is ageing fast. The proportion of the working age population – between 15 and 64 years old – peaked about a decade ago at 64 per cent and will decline to 52 per cent by 2030, according to UN projections. Over the same period, China's savings rate will have declined from about 46 per cent of GDP to below 40 per cent.[1]

As the population ages, overall spending increases, mainly on health care and pensions. But that's not the only reason for China's dissaving. Expenditure on education is also poised to increase considerably.

With millions of Chinese households no longer worrying about hunger and poverty, education becomes one of their main spending priorities. This shift – backed by government policy – should help to improve the quality of economic output and offset the loss of lower-earning rural migrant workers who were responsible for the economy's runaway growth in the past decades.

Beijing's efforts to rebalance its economy away from an export-driven model to consumption-led growth have also played a role in depleting savings. We expect the share of consumption in China's national output to rise to 45 per cent in the next five years from the current 39 per cent.

No more Great Wall

This new economic model will require China to attract foreign capital. And that necessitates embracing reform. Beijing will have to liberalise its financial market, open up its capital account and integrate more fully to the world financial system.

As China makes this transition, it is inevitable that the renminbi (RMB) will become a major international unit of exchange over the coming decades.

Currently, the share of RMB in global central bank reserves stands at just 1.9 per cent – a paltry sum compared with the US dollar's and the euro's respective figures of 60 per cent and 20 per cent. But its influence is growing as China's neighbouring trade partners increasingly settle contracts in the Chinese currency, creating what is known as the RMB bloc.

Taking that bloc into account, our economists calculate that the RMB should command a global reserve share of 13 per cent.

As China grabs a greater slice of international investment, portfolios will adjust to reflect this. One potential loser will be the US Treasuries market, where China has traditionally invested its substantial surpluses. The slow disappearance of this 'Great Wall of Money' comes at a tricky time for both Washington and US companies, which face unprecedented financing needs in the coming years. Within the world's financial markets, the redback will begin to challenge the greenback.

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[1] Source: Refinitiv.