What drives China's Current Account

Mathias Hoffmann

Discussant: Danyang Xie, HKUST
HKIMR Second Annual International Conference on the Chinese Economy
2011

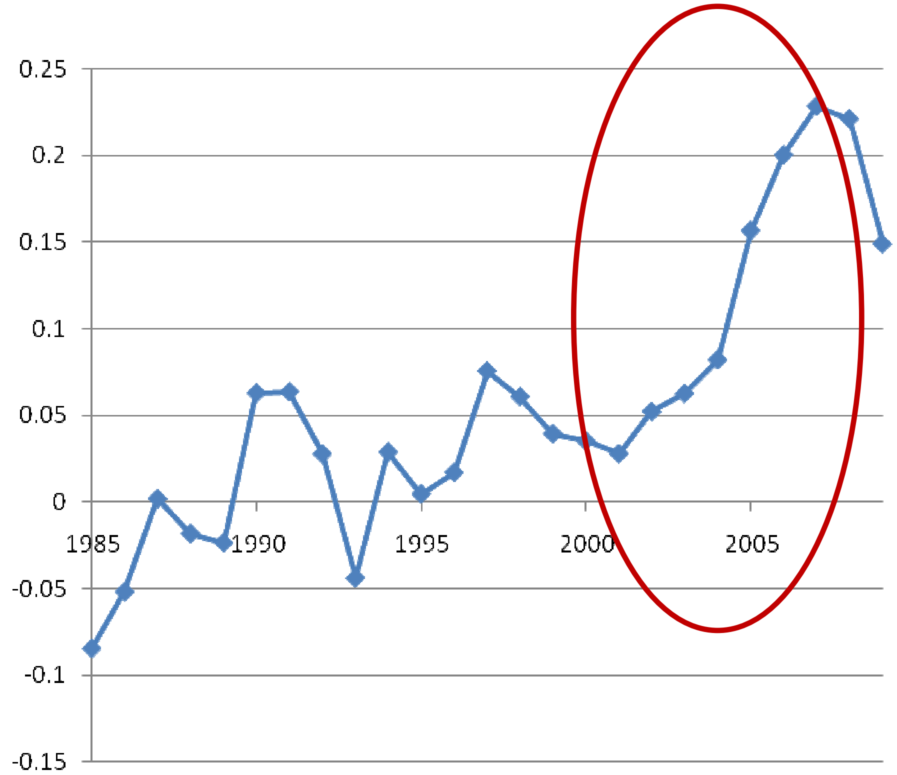
- **Summary**
  - The paper identifies factors that explain China's current account variability (1982-2007)
- **Contributions**
  - Theoretical: A simple model that nests 4 basic channels of external adjustment
    - Consumption Smoothing; NFIP; Consumption Tilting due to r_W; Consumption Tilting due to e
  - Empirical Results
    - Consumption Smoothing and Consumption Tilting due to e as the two important factors
    - 2x2 categories of shocks (global and domestic; permanent and transitory) were identified using a cointegrated structure of the simple model from the VAR

First Impression

- A serious study that applies various empirical techniques to identify the channels through which the China’s current account balance is affected
- The empirical analysis is informative, suggesting that the simple model does a good job in explaining the current account dynamics

Comments

- CA = S – I
- China's CA/NO has a clear upward trend since joining WTO
- The downturns: 92-93; 98-2001; 2008-2009



WTO Accession

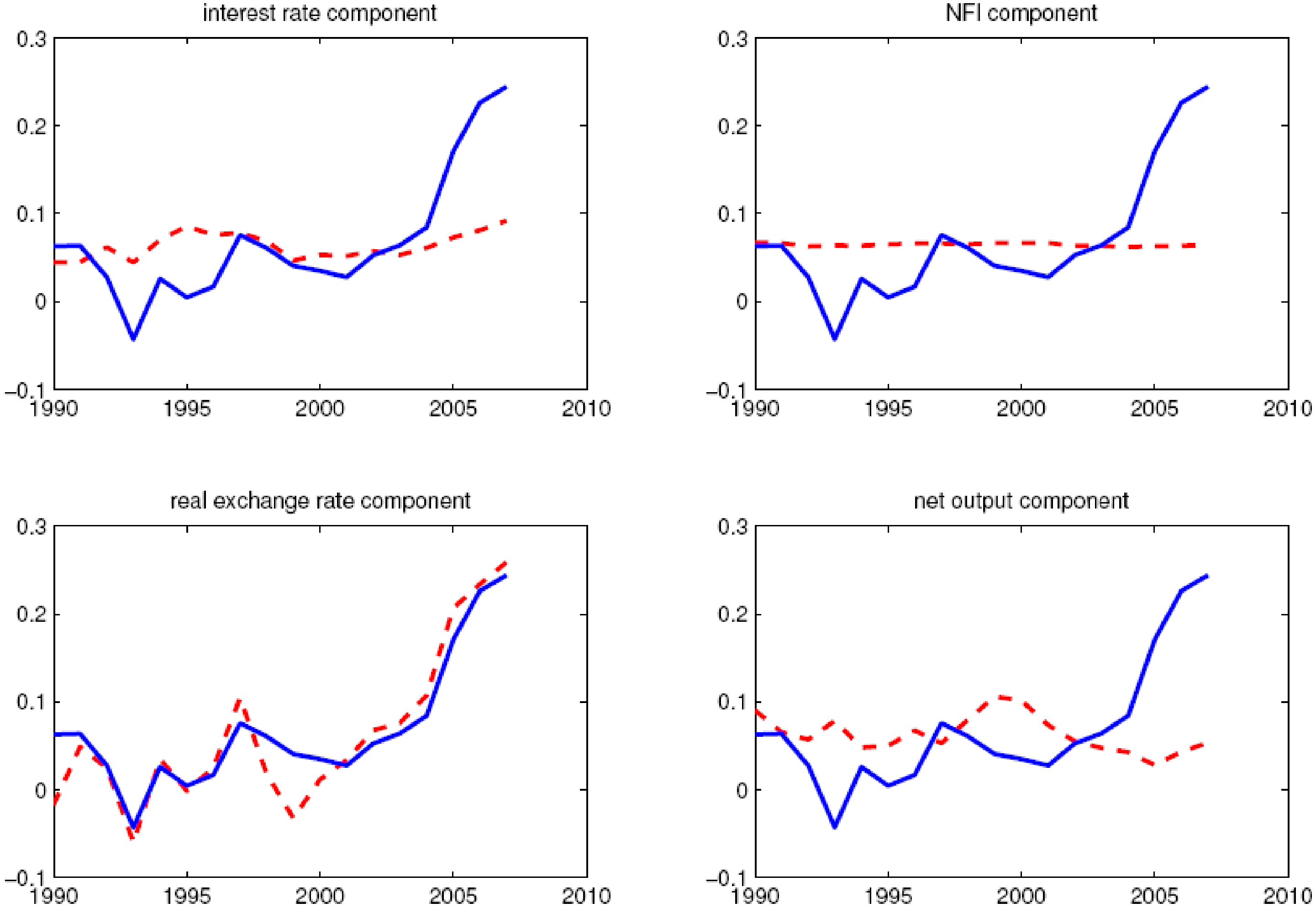
- Presumably, the successful entry to WTO in 2001 raises the prospect of higher future output growth
- The simple model presented in the paper would imply a lower saving rate (due to consumption smoothing) and hence a lower CA/NO , contrary to the actual observations
- Also, real exchange rate has appreciated since 2001, this should reduce CA/NO, again contrary to the actual observations
- Thus, the run-up of CA/NO must be due to something else (to be discussed)

Table 2: **Channels of external adjustment**

Channel	IFS data 1987-2007	IFS data 1982-2007	IFS data 2001-2007	Valuation adjusted CA 1987-2007	Valuation adjusted CA 1982-2007	Valuation adjusted CA 2001-07
Net factor income	-0.01	**-0.01**	0.00	-0.00	**-0.01**	0.00
	(-0.97)	(-2.59)	(1.41)	(-0.15)	(-2.16)	(1.36)
World interest rate	**0.11**	**-0.12**	**0.29**	-0.04	**-0.24**	**0.29**
	(2.56)	(-3.02)	(2.22)	(-0.47)	(-3.62)	(1.56)
Real exchange rate changes	**1.14**	**0.75**	**-0.30**	**0.19**	**0.60**	-0.16
	(11.02)	(6.15)	(-1.95)	(4.72)	(4.94)	(-1.05)
Net output changes	**-0.13**	0.03	**0.33**	**0.61**	**0.31**	**0.55**
	(-2.01)	(0.54)	(2.62)	(6.24)	(4.08)	(4.76)
Unexplained	-0.11	**0.34**	0.67	**0.23**	**0.32**	0.32
	(-1.35)	(3.49)	(1.63)	(2.04)	(3.07)	(0.71)

The table presents estimates of the coefficients β_x from the variance decomposition (5), where $x = b, r, \Delta q, \Delta no$ in turn. Numbers in parentheses are t-statistics. Boldface indicates significance at the five-percent level.

Figure 2A



interest rate component
NFI component
real exchange rate component
net output component
0.3
0.2
0.1
0
−0.1
1990
1995
2000
2005
2010

The Run-up of CA/NO since 2001

- The data (Zhang 2008): Table 2 Valuation-Adjusted CA
- Higher cost of inelastic demand (housing & medical),
- We may want to model the expanded access to external market (in other words, pre-WTO market was constrained)

Theoretical Limitation of the Simple Model

- The budget constraint implies that the capital account is convertible and that the stock of foreign assets is a choice variable of individual consumers. Neither is true in practice.
- The model also takes the investment and the government expenditure as exogenous, but we know that both variables respond to global demand and productivity shocks. These responses are highly relevant for CA dynamics.
- The only variable linking the rest of the world that appears in the simple model is r_w.

Suggestions on the Empirical Part

- The steady state share of foreign assets, b, was estimated using GMM (0.11). If we calibrate from the data using China's net investment position (divided by NO), we arrive at (0.6) based on the sample average between 2004-2009.
- It might be useful to plot the real exchange rate chart, including the conventional series using CPI or tradable goods prices as deflators and the one using housing and health cost as deflators, to give a visual impression of their trends.
- Possibility of a structural break at the accession of WTO in 2001

Final Comment

- An excellent start on an important question "what drives China's current account?"
- The simple model could be extended to the case with partial capital control/constrained market access.
- The model could also be extended to capture the transition of China from a small open economy to a large open economy (given the blame on China for the current global imbalance)