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The Drivers, Implications and Outlook for China's Shrinking Current Account Surplus

by Pragyant Deb, Albe Gjonbalaj, and Swarnali Ahmed Hannan

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I N T E R N A T I O N A L M O N E T A R Y F U N D

IMF Working Paper

Asia and Pacific Department

The Drivers, Implications and Outlook for China's Shrinking Current Account Surplus¹

Prepared by Pragyan Deb, Albe Gjonbalaj, and Swarnali Ahmed Hannan

Authorized for distribution by James Daniel

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Abstract

China's current account surplus has declined significantly from its peak in 2008 and the external position in 2018 was in line with medium-term fundamentals and desirable policies. While cyclical factors and expansionary credit and fiscal policies contributed, the trend decline has been largely structural, driven by economic rebalancing from investment to consumption, appreciation of the real effective exchange rate (REER) towards equilibrium, increase in outbound tourism, and moderation in goods surplus reflecting market saturation and China's faster growth compared with trading partners. Policies should focus on continued rebalancing and opening up to ensure excessive surpluses do not return, and to prepare the economy and the financial system to handle more volatile capital flows. From a global perspective, the decline in China's surplus has lowered global imbalances, but with different impact across countries. The analysis is based on data as of July 2019.

JEL Classification Numbers: F1, F3.

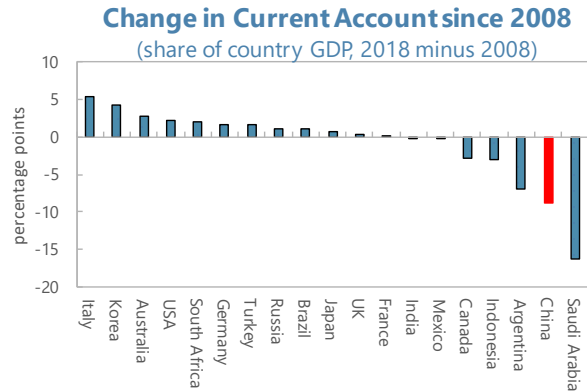
Keywords: current account, global value chains, global imbalances.

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I. INTRODUCTION

In the past decade, China’s current account balance has declined remarkably—one of the most amongst G-20 countries. As the second largest economy of the world, this development has implications for not only China but also the global economy. The 2018 decrease in current account surplus—one of the highest declines in recent years—has only added further interest in understanding the drivers behind the decline in China’s current account surplus.



Source: IMF World Economic Outlook

Against this background, this paper takes a holistic look at China’s current account, discussing the key trends, drivers, and domestic/global implications. The sharp decline in China’s current account surplus from its pre-global financial crisis peak has been associated with significant compositional shifts: (i) the services trade balance swung from a small surplus to a deficit of 2.2 percent of GDP in 2018, mainly due to increase in outbound tourism; (ii) the income balance has turned negative, despite China’s net creditor position, reflecting a combination of falling global interest rates and rising returns on equity liabilities; and (iii) the goods surplus has fallen, responding to changes in commodity prices as well as macroeconomic policy support. While imports of raw materials have risen, the manufacturing balance (though still sizeable) has plateaued, consistent with the pace of trade integration.

In terms of drivers of the surplus decline, the key finding is that, while cyclical factors helped in 2018 (price impact of oil and semiconductor prices), the trend decline has been largely structural, driven by rebalancing, appreciation of the REER towards equilibrium, increase in outbound tourism, and moderation in goods surplus reflecting market saturation and China’s faster growth compared to trading partners. Domestic policies – expansionary credit and fiscal policies – have supported the surplus decline, but at the expense of internal imbalances. Achieving a lasting external balance would thus require that the gradual reining in of expansionary macroeconomic policies be accompanied by structural reforms (for example,

improving the social safety net, undertaking state-owned-enterprise reforms, and opening markets) that place China on a sustainable path, with higher consumption and lower overall saving.

As a share of global GDP, China's current account balance has declined and is expected to continue to shrink over the medium-term, though this will depend critically on policies, both in China and globally, and volatility around this trend is likely to increase. The impact has been different across countries, with the trade balances of economies like Korea, Germany, Brazil improving vis-à-vis China, while that of economies like Japan, India, and Indonesia deteriorating. Going forward, advanced economies (e.g. USA, New Zealand, Japan) could increase exports to China, as they have comparative advantage in some of her growing import sectors.

This paper is based on the analysis conducted as part of China's 2019 Article IV consultations. Key insights from the analysis in this working paper was included in the China 2019 Article IV Staff Report and a summary prepared as part of the 2019 China Selected Issues Paper. The analysis in this paper is based on data up to July 2019 and the forecasts are based on the July 2019 WEO vintage.

The rest of the paper is organized as follows. Section II looks at the trends in China's current account, Section III discusses the key structural, cyclical, and macroeconomic policy drivers, Section IV offers forward looking implications, Section V discusses the global implications, and Section VI concludes.

II. TRENDS IN CHINA'S CURRENT ACCOUNT

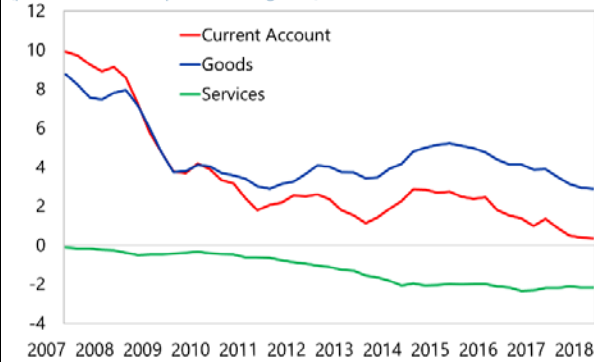
China's current account surplus has declined significantly from its peak in 2008. While part of the sharp decline in 2018 is cyclical, the trend over the past decade is largely structural, driven by a widening of the services deficit and a moderation of the surplus in goods trade (Figure 1). Even at the bilateral level, the trend has been towards a greater balance, with declining goods trade surpluses with the US and the EU; and declining deficits with Japan, Korea and Taiwan, Province of China. With China's growth model moving from exports towards consumption, the trend toward broad balance, with a smaller surplus or even a small deficit, is likely to stay with far reaching implications for China and the rest of the world.

Figure 1. China's Current Account

China's CA surplus has declined significantly from its peak...

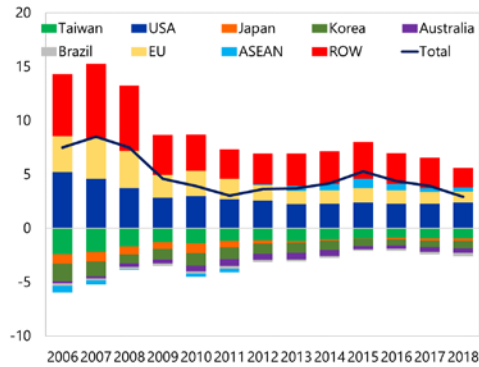
.... with a fall in both bilateral surplus and deficits.

China's Current Account Balance
(percent of GDP, 4 quarter trailing sum)



Sources: CEIC; and IMF staff calculations.

China Goods Trade Balance Contributions
(In percent of China's GDP)



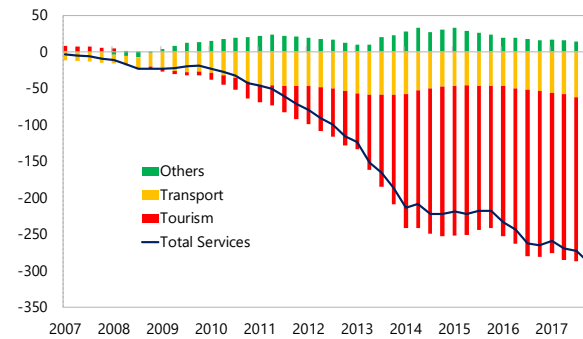
Source: Haver Analytics; and IMF staff calculations.

A massive increase in outbound tourism and associated overseas spending has led to a surge in the services deficit. China's

tourism balance, mostly on account of outbound tourism, has swung from a small surplus of around 5bn USD in 2008 to a deficit of nearly 250bn USD in 2018, driven by the increasing purchasing power of the middle class and an appreciating currency. While there is some controversy regarding the measurement of the tourism balance (see Wong, 2017), with some

observers opining that Chinese tourist spending is overestimated (and indeed, foreign tourist spending in China is underestimated) and reflects disguised capital outflows, the trend is undeniable. It is also borne out by an almost fourfold increase in the number of Chinese outbound visitors – from 46mn in 2008 to 162mn in 2018. While other items such as transport services and royalty payments for intellectual property use have also increased, their contribution and size has been much smaller.

Components of Service Account
(In USD billion, 4 quarter rolling sum)



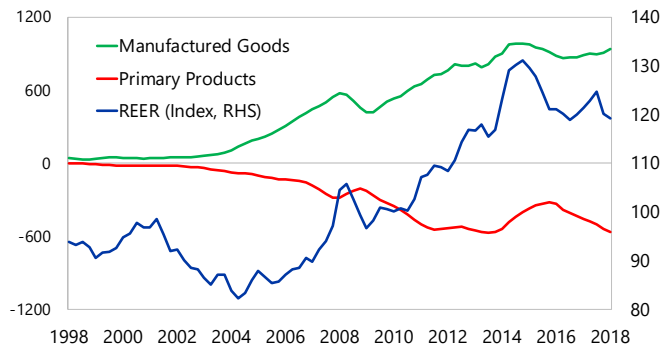
Sources: CEIC; and IMF staff calculations.

Import of raw materials and commodities have increased, but the surplus in manufacturing remains strong. The trend in the goods balance is more volatile, affected by changes in commodity prices, government policy and stimulus measures – particularly through infrastructure investments – and broader Chinese and global growth prospects.

While China has boosted imports of raw materials such as oil and iron ore to feed its domestic economy, its surplus in manufacturing, although sizeable, has plateaued as dividends from joining the World Trade Organization in 2001 have diminished and China already occupies a dominant position in many markets. After significantly appreciating for much of this period, the REER has stabilized since 2016, though the relationship between REER and the goods balance is difficult to establish, with other factors such as domestic and external demand playing a more dominant role. The importance of processing trade (see below) and exporters’ adjustment of costs and profit margins to offset the impact of changes in REER further diminishes its effect.

Trade Balance

(In USD billions, 4 quarter rolling sum)



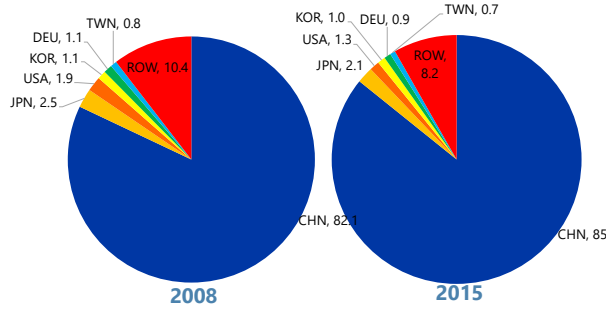
Sources: China Customs; Haver Analytics; and IMF staff calculations.

Technological upgrade in China and a small share of consumer imports have kept import growth below overall growth. China’s domestic share in final demand (as a share of total value added) has increased through a combination of increased domestic capabilities in manufacturing, particularly in high-tech sectors, and greater import substitution (Figure 2, top panel). In addition to its impact on final demand, it has also resulted in a decline in the share of re-exports as Chinese firms have increasingly been able to move up the value chain and replace imported intermediate goods. While ongoing rebalancing and higher demand for more-expensive consumer goods by the country’s growing middle classes is expected to increase demand for consumer imports, household consumption remains a small part of the overall import basket (Figure 2, bottom panel).

Figure 2. Structure of Imports

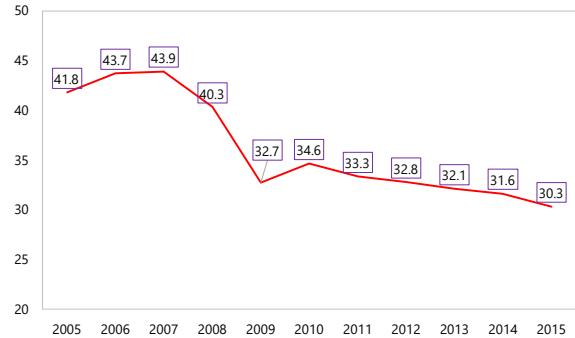
Domestic share in China's final demand has increased...

Value Added Share in Final Demand



... while the share of re-exports has fallen.

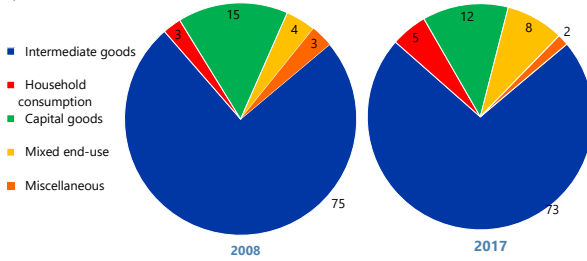
Re-exported Intermediate Imports to Gross Imports of Intermediate Products
(In percent)



Source: OECD, TiVA; and IMF staff calculations.

Imports are dominated by intermediate and capital goods...

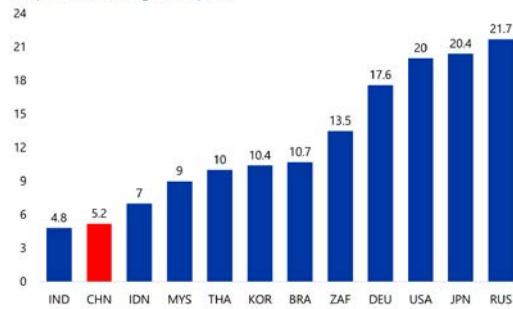
China Imports by end use
(In percent)



Source: OECD TiVA.

... with the share of consumer goods relatively small.

Good Imports for Household End-Use, 2017
(In percent of total good imports)

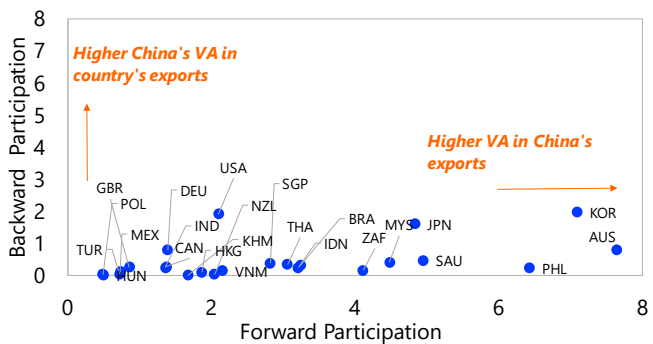


Source: OECD TiVA.

Although China's export embody value-added by several countries, the domestic share is increasing as China moves up the value chain. OECD data from 2015 shows that countries tend to have forward participation with China. Over 80 percent of value-added (VA) in total gross exports is due to China, with Korea and United States accounting for around 2 percent of VA in Chinese exports (Figure 3). In addition, China's share in VA has been increasing over time as it moves up the value chain, with the increase being particularly rapid for high-tech sectors. The gaps in VA shares differ by countries, with the gap

GVC Integration with China in 2015

(In percent)



Sources: OECD TiVA.

between gross and VA exports relatively wider for EU28 compared to that of the United States. In addition, the contribution of foreign funded enterprises to China's exports has declined over time.

Focusing on the United States-China bilateral trade balance, the VA trade balance in 2015, at USD219 billion, was 13 percent lower than the trade balance in gross terms (USD 251 billion). Taking the average of the available years (2005-2015), the value added trade balance is 19 percent lower than the corresponding gross numbers.

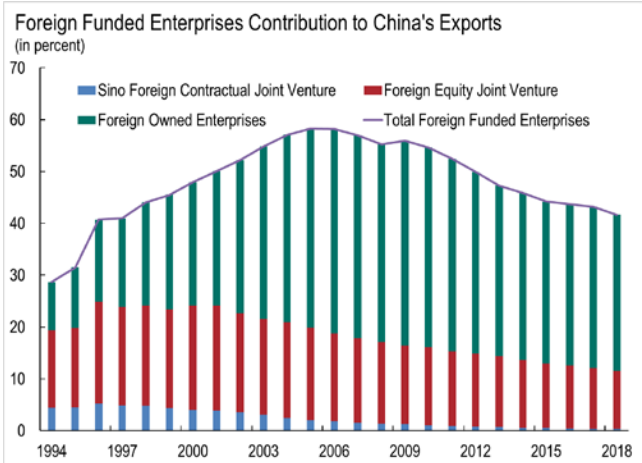
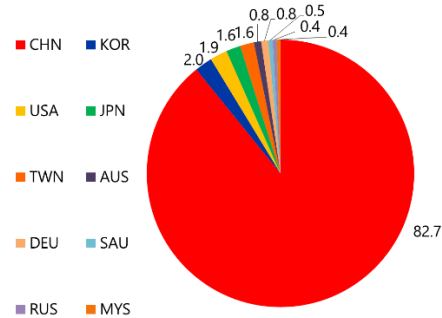


Figure 3. Trade in Value Added Terms

China's exports embody VA by several economies,

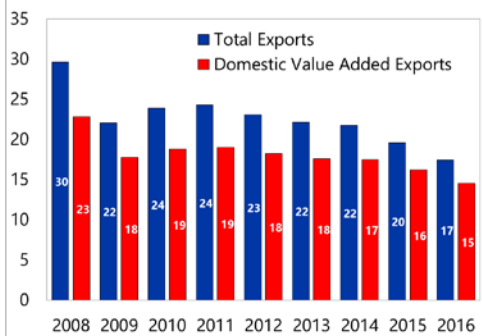
... though China's share has been going up...

Distribution of China's Value Added Exports by Economies, 2015
(In percent of China's total gross exports)



Sources: OECD TiVa; and IMF staff calculations.

China's Gross Exports vs Value Added Exports
(In percent of China's GDP)

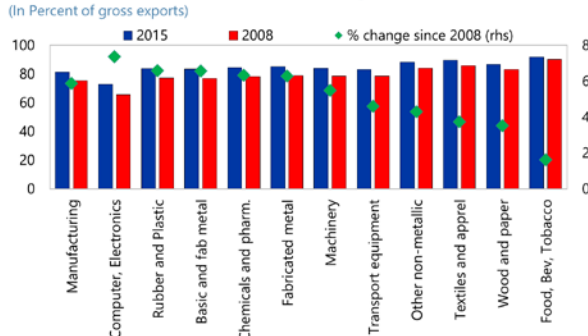


Sources: OECD TiVa; IMF, World Economic Outlook; and

... as it moves up the value chain and witnesses a rapid expansion in VA shares in high-tech sectors.

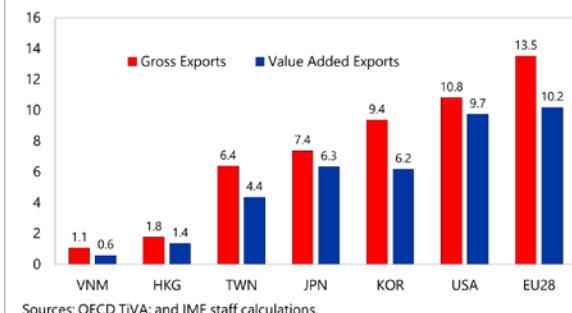
VA shares differ by economies...

China's Domestic Value Added in Gross Exports



Sources: OECD, TiVa; and IMF staff calculations.

China's Gross Exports vs Value Added Exports to Key Markets, 2015
(In percent of China's total gross exports)

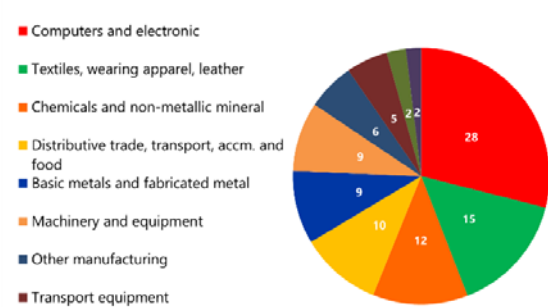


Sources: OECD TiVa; and IMF staff calculations.

... and sectors.

Bilateral trade balance with US is 13 percent lower in VA, compared to gross terms.

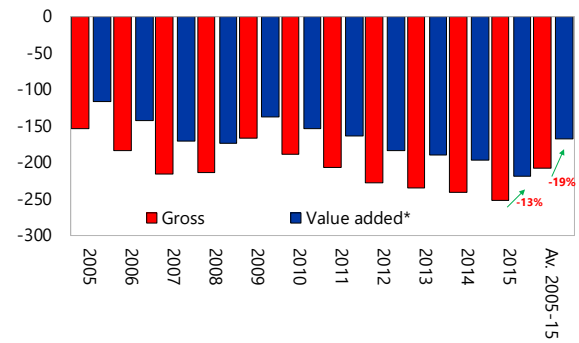
Distribution of China's Exports, Value Added by Industry, 2015
(In percent of total gross exports)



Sources: OECD TiVa; and IMF staff calculations.

U.S. Bilateral Trade Balance with China

(In billions of US dollars)



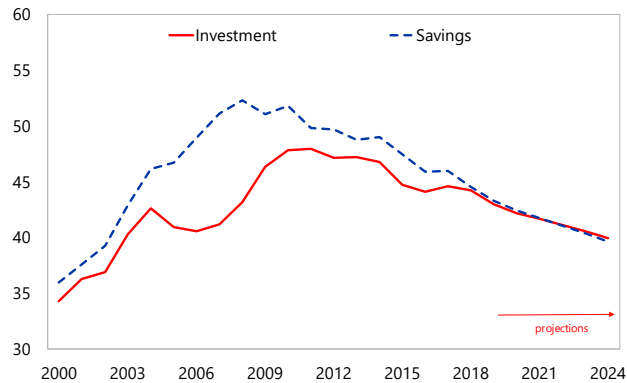
III. DRIVERS BEHIND THE DECLINE IN THE CURRENT ACCOUNT SURPLUS

A. Structural Factors

The fall in China’s current account surplus primarily reflects normalization of the domestic saving rate. From a broad macroeconomic perspective, the decline in the Chinese current account surplus reflects a gradual and still ongoing normalization of the domestic saving rate, which surged to an extraordinarily high level between 2000 and 2008.

Since the peak, a weaker national saving rate, in part due to an ageing population, has decreased the savings-investment gap. While both savings and investment have declined, savings declined at a faster pace than investment, resulting in a fall in the current account surplus from its peak in 2008 to near balance in 2018.

China's Gross Saving and Investment
(In percent of GDP)

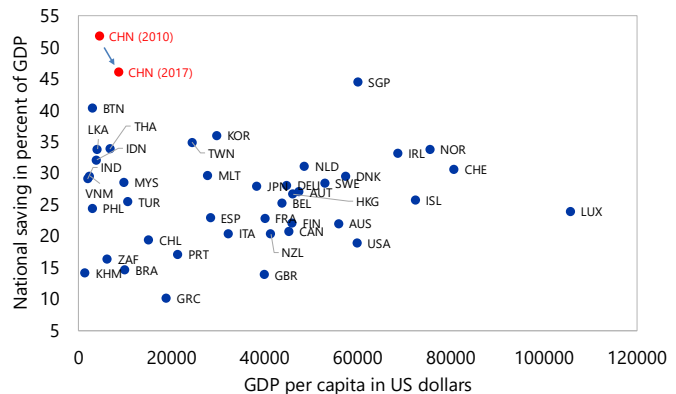


Sources: National authorities; and IMF World Economic Outlook.

China’s saving rate is expected to continue its downward trajectory as it remains an outlier in terms of the household savings ratio. Despite the decline from its peak in 2008, China’s national saving rate remains much higher than the global average and other countries with similar income levels, creating room for further declines.

Much of this is due to very high levels of household savings, resulting from demographic changes induced by the one-child policy; the transformation of the social safety net and job security that occurred during the transition from planned to market

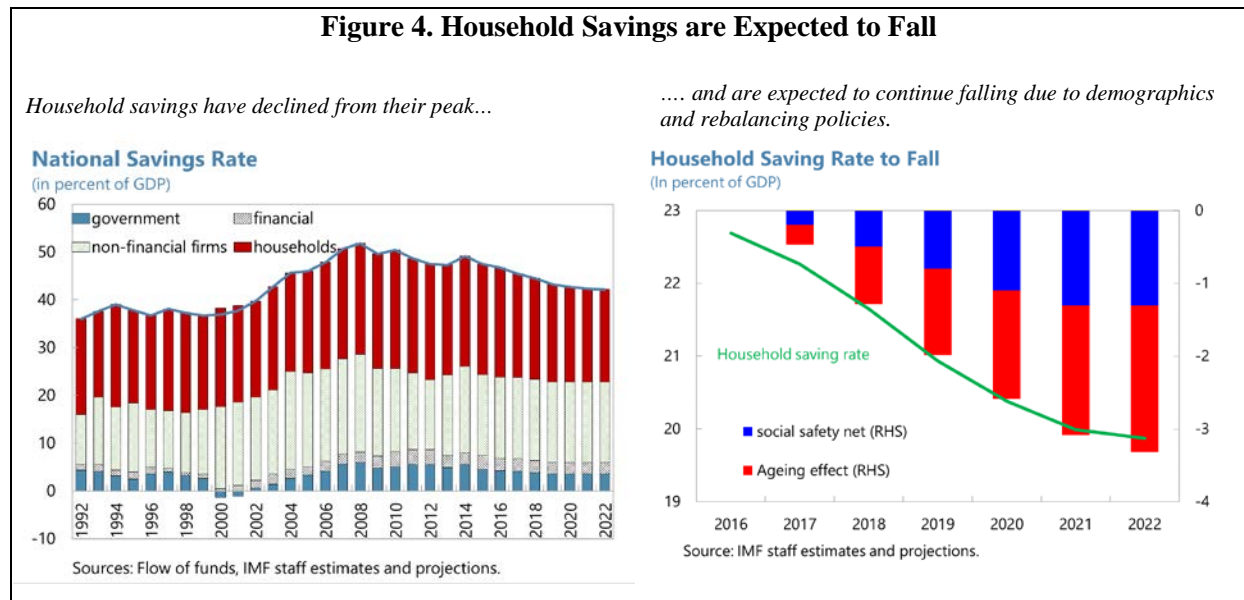
National Saving Rate



Sources: World Economic Outlook; and IMF staff calculations.

economy; and housing reforms and rising income inequality. Corporate and government savings are largely in line with global norms, despite the significant widening of the augmented deficit since the global financial crisis (see Zhang et al, 2018). While adverse demographics and ageing will play a role in bringing household savings down, savings behavior is a slow-moving event

and normalization will take time and would depend on the pace and success of rebalancing towards a consumption driven economy. In addition, improving the social safety net and reducing income inequality will be critical to continued decline in saving rate (Figure 4 and see IMF 2018a).



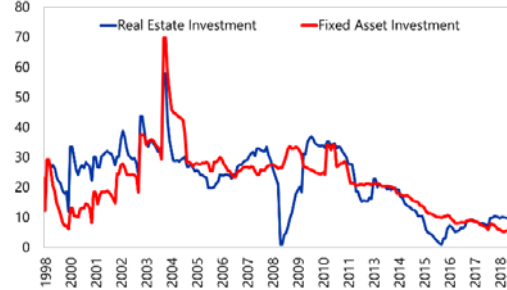
While policies will play a key role, investment has likely peaked and is expected to decline, albeit at a slower pace than savings. Fixed assets investment in China has been falling as rebalancing continues and the economy slowly switches from investment to consumption (Figure 5). Real estate investment, in particular, has declined from its nearly two decades of above 20 percent growth. It is expected to continue moderating given high vacancy ratios, declining working age population, and slowing migration to cities. As investment growth moderates, Chinese imports for commodities should also decline. However, this decline is expected to be offset by the decline in household savings ratio and the associated demand for consumption imports. Furthermore, continuing reforms and liberalization measures, in particular the lowering of tariffs on imports – according to government estimates, the average tariff ratio has fallen from 9.8 percent in 2017 to 7.5 percent after cuts in November 2018 – will encourage imports and is expected to keep the current account surplus in check.

Figure 5. Investment Has Likely Peaked

FAI is falling as rebalancing continues...

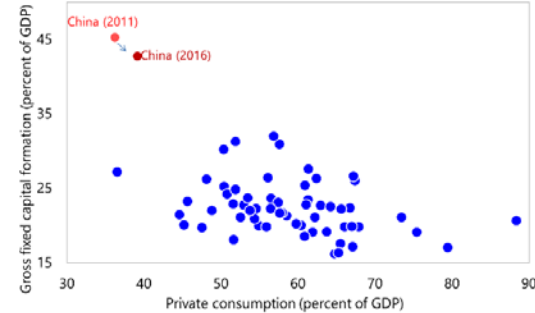
.... with a slow shift from investment to consumption.

China's Real Estate and Fixed Asset Investment
(Year-on-year percent change)



Sources: CEIC; and IMF staff calculations.

Slowly Switching from Investment to Consumption
(Industrial Countries and Emerging Markets; average, 2008-17)



Source: World Economic Outlook and IMF staff calculations.

China's export market share is already large, making it difficult to continue increasing market share. Historically, Chinese exports have grown faster than trading partner GDP as China has gained market share globally. In 2001, when China joined the WTO, the share of Chinese exports to total world exports was around 4 percent. This more than tripled to 13 percent in 2017. In the case of manufacturing, the corresponding figures are 5 and 17 percent respectively (Figure 6). China is now the largest goods exporter in the world and its share of world exports declined in 2016 and 2017. Exports are therefore likely to grow at the same pace as trading pattern growth, with a slowdown in global trade providing additional headwinds.

Figure 6. China Exports Have Slowed and are Likely to be Outpaced by Imports

China's export market share may have peaked...

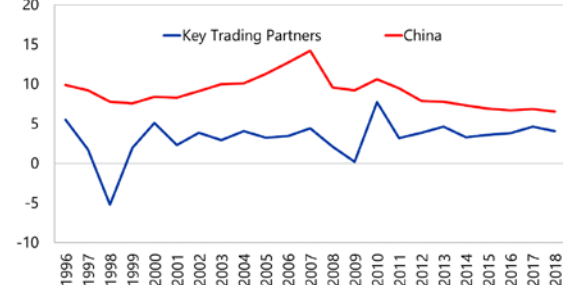
.... suggesting exports may grow at the same pace as trading partners and hence lag import growth.

China Export Market Share
(China merchandise exports in percent of world exports)



Sources: WDI, IMF Staff Calculations.

Real GDP Growth
(Year-on-year percent change)



Sources: National authorities; World Economic Outlook; and IMF staff calculations.
Note: Real gdp growth of key trading partners is PPP GDP weighted.

Given China's faster growth compared to its trading partners, imports are expected to outpace exports. As the economy rebalances towards greater consumption, as opposed to being

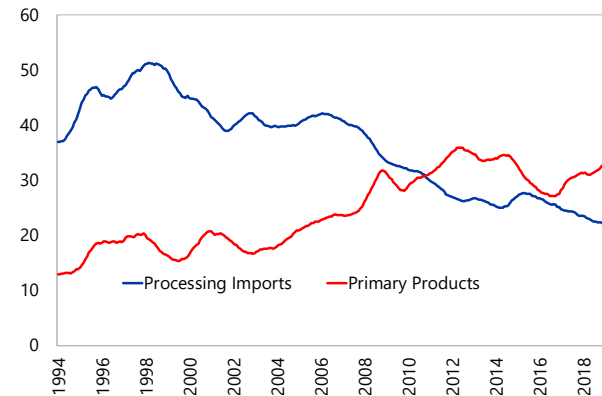
export driven, demand for consumer imports and intermediate goods are expected to increase. A part of this can already be seen in the decline in the share of China's exports and imports as a share of GDP. Although this partly reflects the global trade slowdown, the trend is more pronounced in China relative to other large economies. Taken together, these trends would result in a smaller current account surplus and an overall shift towards a more balanced external position.

With the declining importance of processing trade and the increasing share of commodities and tourism, China's current account is likely to be more volatile.

Processing trade is a customs arrangement that exempts from tariffs raw and auxiliary materials, parts and components, accessories, and packaging materials imported from abroad with the express intention of re-exporting the finished products after processing or assembly. The share of processing trade has declined significantly as manufactures have shifted towards more local components and flexible trading arrangements, raising the volatility of the current account. For processing trade, exports automatically determine imports as a decline in exports would result in a corresponding decline in imports, leaving the current account largely unaffected. In contrast, the share of primary products, around half of it fuel and petroleum, has increased, which tend to be more volatile and driven by global commodity price cycles.

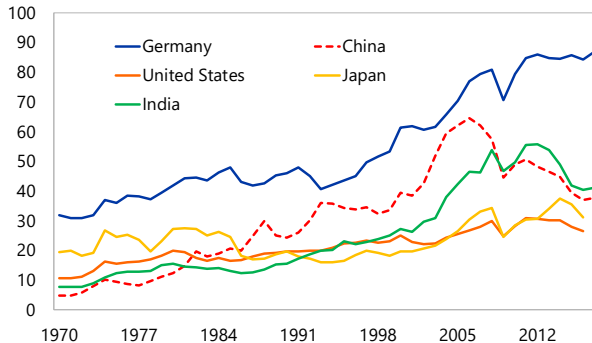
Furthermore, the increase in share of outbound tourism is likely to make the current account more sensitive to currency fluctuations.

China's Goods Imports
(Share of China's imports, 12-month moving average)



Sources: CEIC; and IMF staff calculations.

Trade Openness
(Sum of export and imports of goods and services as percent of GDP)

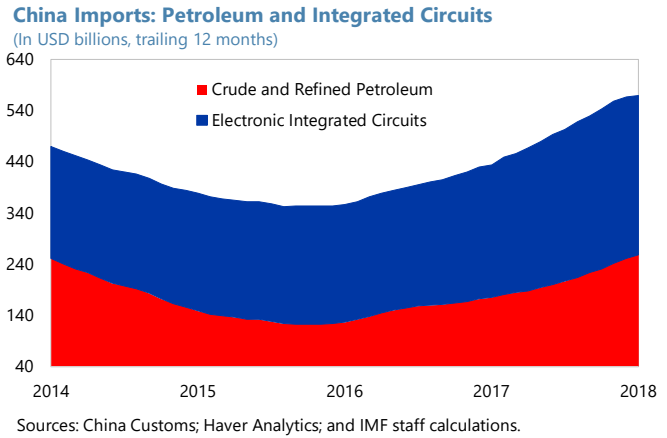


Sources: World Bank, WDI.

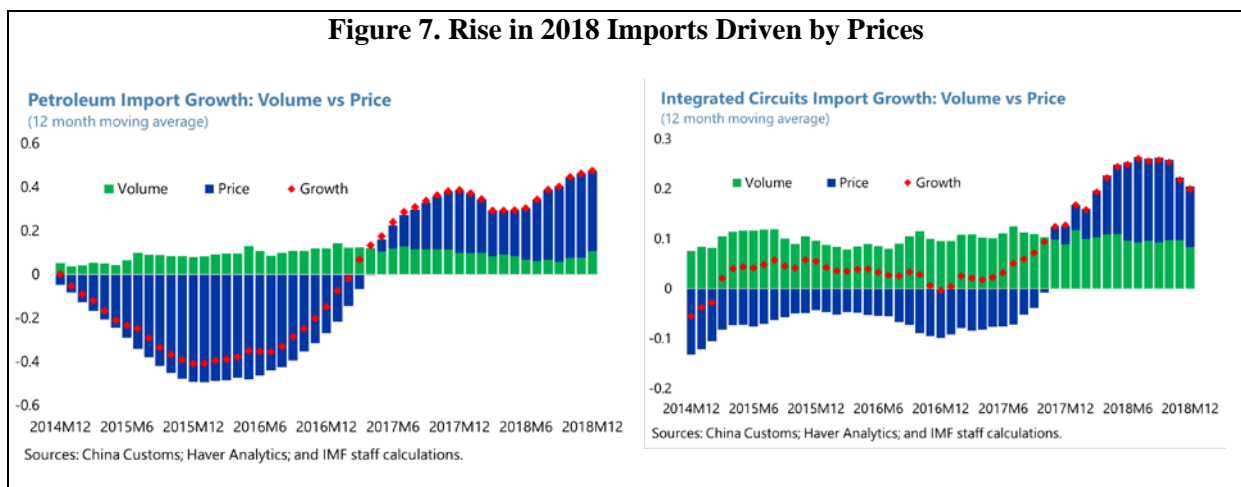
B. Cyclical Factors

The sharp decline in the current account surplus in 2018 was in part driven by cyclical factors.

After recording a deficit in the first half of the year, China's current account surplus came in at 0.4 percent of GDP in 2018 (down from 1.6 percent of GDP in 2017). The 1.2 percentage drop in current account surplus was mostly due to a decline in the goods trade balance. In particular, the rise in imports of crude and refined petroleum and integrated circuits can explain close to half of the increase in 2018 imports, which increased by around 0.7 percent of GDP. The rest is mostly explained by lower exports due to trade tensions and weak global demand.



The rise in imports was driven by an increase in oil and integrated circuit prices. Oil prices spent much of 2018 in the range of US\$70-85/bbl, up from US\$55-65 range in 2017. The price increase accounted for close to 80 percent of the increase in petroleum imports, which increased by \$80bn or around 50 percent from 2017. Similarly, after years of price declines, the prices of semiconductors surged, pushing up imports by around \$50bn compared with 2017, with increase in prices accounting for around 60 percent of the increase in integrated circuit imports in 2018 (Figure 7).

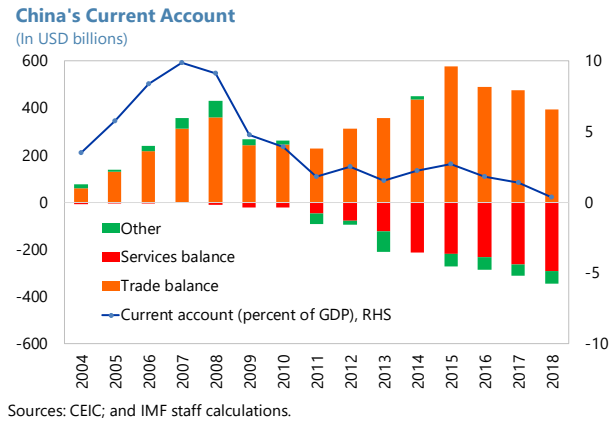


Summary. Since its peak, China’s current account surplus has been declining due to structural factors, namely,

- rebalancing;
- increase in outbound tourism; and
- moderation in goods surplus due to market saturation and growth differentials with trading partners.

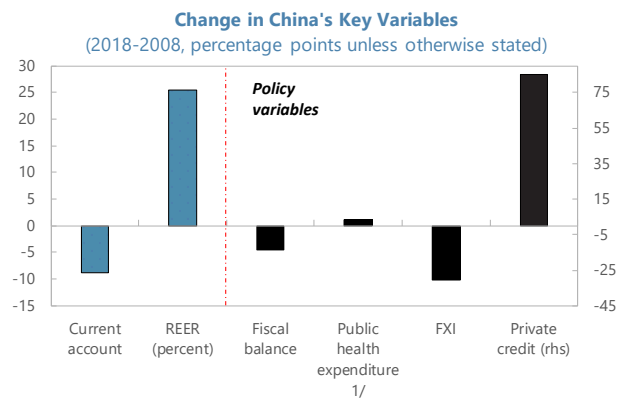
But the 1.2 percent decline in 2018 was in part driven by cyclical factors.

- Price impact of oil and semiconductor prices on import is estimated to be 0.4 and 0.2 percent of GDP respectively.
- Impact on CA likely to be smaller (due to higher export prices) and is estimated at around 0.4 percent of GDP.



C. Role of Policies

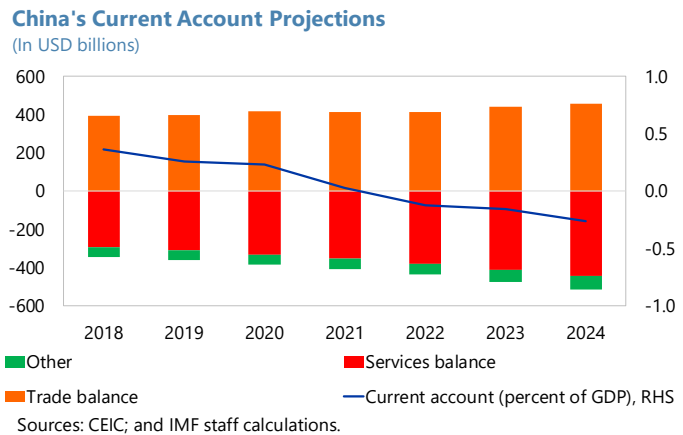
Domestic policies have supported the current account surplus decline, but at the expense of internal imbalances. Relative to 2008, China’s structural fiscal balance (share of GDP) has deteriorated by 4.5 percentage points, private credit (share of GDP) has expanded by 85 percentage points (which has contributed to a decline in net corporate saving), and reserves (share of GDP) have declined by 10.3 percentage points, all of which contributed to the narrowing of the current account surplus. The appreciation of the currency also supported the lowering of the surplus. However, such expansionary credit and fiscal policies contributed to the buildup of domestic leverage and vulnerabilities. Achieving a lasting external balance would thus require that the gradual reining in of expansionary macroeconomic policies be accompanied by structural reforms (for example, improving the social safety net, undertaking state-owned-



enterprise reforms, and opening markets) that place China on a sustainable path, with higher consumption and lower overall saving.

IV. LOOKING AHEAD

Over the medium term, under the baseline of continued rebalancing, the current account is expected to remain close to balance. Going forward, the small current account surplus recorded in 2018 is expected to turn into a small deficit in the medium term as the structural factors outlined above continue to drive up imports and moderate exports. Specifically, the baseline assumes:



- Import demand increases as savings fall faster than investment – a rise in share of private consumption
- Export growth slows due to market saturation and continued higher growth in China relative to trading partners
- Benign outlook for commodity prices
- Tourism deficit increases in line with GDP
- No significant change in income account and the structure of assets
- Trade tensions do not escalate markedly and tariffs remain at current (July 2019) levels. Assessment of the impact of further escalation of trade tensions (see Caceres, 2019) or the impact of tensions in the area of high-tech exports is beyond the scope of this paper and is not taken into account in the baseline.

Despite sizeable foreign assets, China’s income account remains in deficit. This is because less than 30 percent of China’s external assets consist of higher yielding risky assets such as direct and equity portfolio

investment. Most assets comprise of lower-yielding investments such as international reserve assets, trade credit, and foreign currency deposits. In contrast, 70 percent of China’s external liabilities comprise of riskier and therefore higher (expected) return instruments such as direct and

China's International Assets

| | USD bn | % | | USD bn | % |
|---------------------------------|--------------|-------|----------------------------------|--------------|-------|
| International assets | 7,324 | | International liabilities | 5,194 | |
| Reserve assets | 3,168 | 43.3% | Direct investment in China | 2,762 | 53.2% |
| | | | Equity portfolio investment | 684 | 13.2% |
| Debt portfolio investment | 228 | 3.1% | Debt portfolio investment | 412 | 7.9% |
| Trade credit | 597 | 8.2% | Trade credit | 393 | 7.6% |
| Currency and deposits | 394 | 5.4% | Currency and deposits | 483 | 9.3% |
| Loans | 710 | 9.7% | Loans | 417 | 8.0% |
| | | | | | |
| Direct investment | 1,899 | 25.9% | | | |
| Equity portfolio investment | 270 | 3.7% | | | |
| Other | 59 | 0.8% | Other | 42 | 0.8% |
| Net international assets | 2,130 | | | | |

Sources: Haver Analytics; and IMF staff calculations.

portfolio equity investments. While this has been a long-standing feature of China’s International Investment Position, a significant shift in the asset composition can lead to a higher return on assets and push up the current account surplus via the income account. Some of this is already underway, with the share of direct investment abroad in total assets increasing steadily from less than 5 percent in 2007 to around 26 percent in 2018.

Current account deficits could emerge if growth surprises on the upside. Commodity prices, particularly oil prices, are expected to remain moderate in the baseline. However, if they turn out to be higher than projected, it can materially shrink the goods surplus and lead to higher current account deficits. At the same time, higher than projected growth – via domestic demand or credit – would increase imports and push up the current account deficit. Complicating the analysis is the fact that China is not a price taker in commodities market – higher Chinese growth would push up commodity prices, further pushing up imports. Furthermore, although the tourism deficit has been stable as a percentage of GDP over the last few years, and there is some evidence of a slowdown, it is nevertheless plausible that tourism may pick up further as per capita incomes rise and grow faster than GDP. Real appreciation, beyond those warranted by fundamentals, can boost imports and increase the current account deficit, as can higher than projected IP payments.

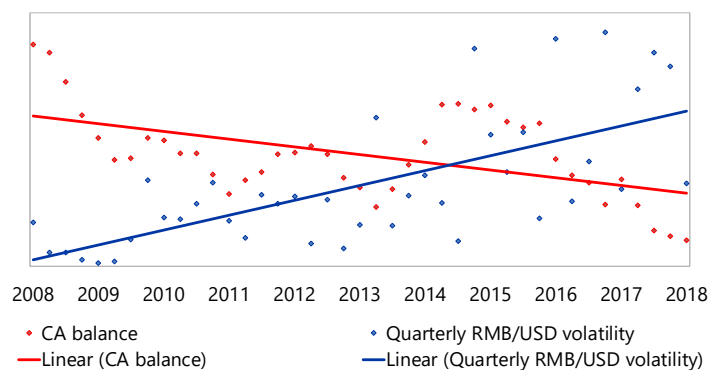
Lower growth or a slowdown in rebalancing can lead to higher current account surpluses and a return of external imbalances. Lower growth can decrease import demand and increase the current account surplus. This is particularly the case if, unlike in the past, offsetting stimulus is via tax cuts, which are likely to have lower import intensity compared with higher public and quasi-public investment in infrastructure. A slowdown or reversal in rebalancing and a return to

high savings and less consumption has the potential to undo the progress made in correcting external imbalances. Finally, faster progress in import substitution through initiatives like Made in China 2025 or technology upgrading – e.g. semiconductors – can lower import demand and increase global market share, increasing the current account surplus. In addition, greater availability of high-end and luxury products in the domestic market can diminish overseas spending by Chinese tourists, thereby moderating the services deficit and pushing up the overall current account.

Policies should focus on continuing rebalancing and accelerating opening up to ensure excessive surpluses do not return. On the domestic front, rebalancing efforts should continue and be accelerated to increase consumption demand. Regulatory and supervisory reforms should continue to address excess leverage and pursue “debt neutrality” with SOEs. “Made in China” should focus on comparative advantage and not import substitution. At the same time, China should deepen and accelerate opening up and continue to support the international trading system that has benefitted China and the world. Concretely, this would involve further reduction in import tariffs and increased trade openness; further opening up of the service sector; liberalization of restrictions to trade and investment regime; and addressing structural issues such as intellectual property enforcement.

While the end of large current account surplus has moved the Chinese economy towards equilibrium, it has also diminished a source of global savings, with implications for the Chinese and global economy and internationalization of the RMB. The large current account surplus in China contributed to the global savings glut, pushing down long-term yields. With an end to large surpluses, less global capital will likely be available for US debtors and other Overseas Direct Investment (ODI), which can contribute to higher long-term yields. At the same time, the large current account surpluses have meant a steady flow of capital into China, providing a large cushion of foreign exchange reserves and the countercyclical tools to offset any slowdown or shocks. Going forward, without this backstop, more volatile components of the financial account, such as portfolio capital flows, are likely to have a much larger impact,

RMB Volatility vs Current Account



Sources: National authorities; CEIC; and IMF staff calculations.

particularly as Foreign Direct Investment becomes less important. This would likely mean less flexibility for economic and currency management in China and the Renminbi exchange rate may become more volatile and sensitive to capital flows. China, however, could support more stable capital inflows by encouraging the internationalization of the RMB. For example, China might sell more bonds to foreign investors – including to long term investors such as pension funds – or settle transactions in RMB (instead of USD). This would increase the availability of RMB assets for foreigners and make it available and used more widely, but would also require more flexibility and transparency in the management of the RMB.

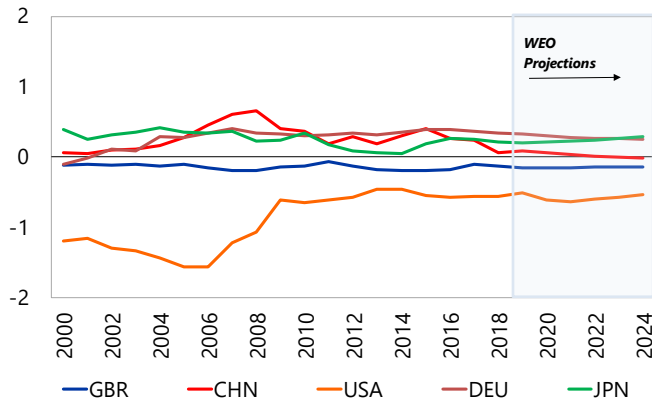
The financial system needs to prepare to handle greater volatility and larger capital inflows. The authorities should continue with financial de-risking and associated micro and macro-prudential reforms. At the same time, policy should focus on encouraging higher quality, stable and diversified inflows by further opening up of the capital account; transparency and regulatory reforms to adhere to international standards and encourage investment by institutional and long-term investors – e.g. reforms to the ratings industry; increase availability of internationally traded instruments; continued RMB internationalization; and a more diversified external asset portfolio to generate higher returns. The currency should also be allowed to respond more to short-term moves and allow for greater two-way flexibility of the exchange rate, building on the gradual reforms to the exchange rate regime since the move away from fixed exchange rates in 2005. This should be complemented by further steps to develop the FX market, improve FX risk management, and modernize the monetary policy framework (see Das, 2019).

V. INTERNATIONAL IMPACT OF CHINA'S DECLINING CURRENT ACCOUNT SURPLUS

A. The Global Perspective

As a share of global GDP, China's current account imbalance has declined and is expected to continue to shrink. Peaking at 0.66 percent of global GDP in 2008, China's current account surplus has declined to 0.06 percent of global GDP in 2018 and is currently lower than other major surplus countries like Japan and Germany. Going forward, the current account is expected to continue to decline, reaching about -0.01 percent of global GDP in 2024.

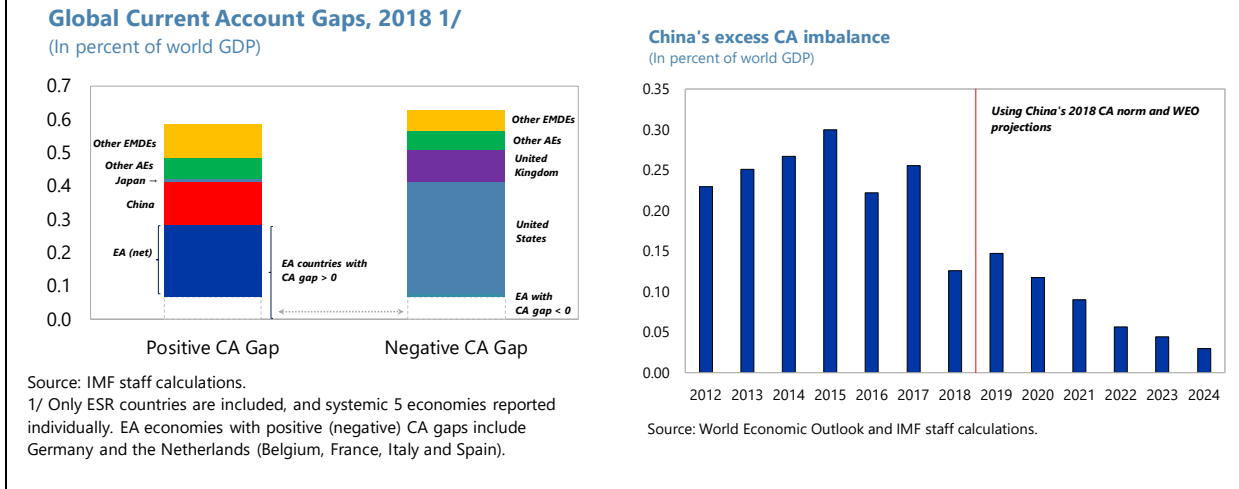
Current Account Balances, 2000-2024
(In percent of world GDP)



Source: IMF, World Economic Outlook.

Further declines in the current account surplus will reduce excess global imbalances—a positive development for global stability. China has historically (over the period 2012-17) run an excessive current account surplus, with the actual (cyclically-adjusted) current account deemed to be moderately stronger than its underlying norm—the level consistent with the country's fundamentals and desired medium-term policies (see Figure 1.14, IMF 2019a, IMF 2018). In 2018, China's external position was assessed to be in line with fundamentals and desirable policies, as its current account surplus narrowed further. As the second largest economy of the world, the country's excess current account surplus was one of the highest contributors to global excess current account surplus, reaching a peak of around 0.3 percent of global GDP in 2015. The projected decline in China's current account surplus should narrow global excess imbalances (Figure 8). As large and sustained excess external imbalances in the world's key economies pose risks to global stability, a continued decline in China's excess external imbalances will thus be a positive step towards reducing global imbalances and strengthening the international monetary system.

Figure 8. China's Current Account from a Global Perspective



B. The Individual Country Perspective

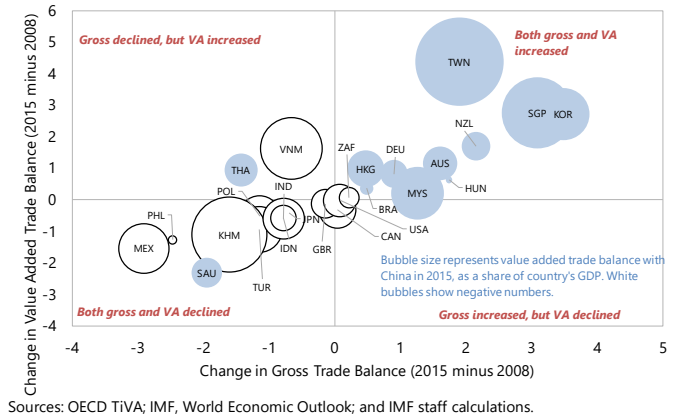
Some Asian economies have benefitted from China's current account decline...

In line with China's rapid increase in imports of computers, electronics, and electrical equipment, the trade balance vis-à-vis China—in both gross and value-added terms—has improved the most for Asian economies exporting those items to China (Taiwan Province of China, Singapore, and Korea). The rise in Korea's trade

balance—supported by the depreciation of the currency vis-à-vis the renminbi towards end of 2007—has been predominantly due to electronics exports, which constituted 41 percent of total exports to China in 2017, up from 28 percent in 2008.

...while the trade balance of others (e.g. Japan, India, Indonesia) deteriorated. Notably, Japan's trade balance with China, though improving in recent years, deteriorated by around USD 33bn in the period 2008-2015—equivalent to a decline of 0.7 percentage points, when expressed as a share of Japan's GDP. Japan's imports from China, owing to items like electronics and textiles, outpaced exports, where the sales of electronics—the country's top

Change in Gross and Value Added Trade Balances vis-à-vis China
(Share of country's GDP, percentage points)



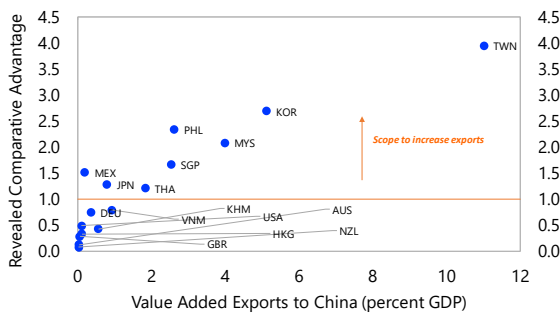
exports to China—slowed possibly due to China’s own increase in high-tech electronics production.

Outside Asia, Germany’s trade balance with China improved markedly, predominantly due to the rise in exports of motor vehicles and machinery. The share of vehicles—Germany’s top exports to China in 2017—increased to 24 percent of Germany’s total exports to China from 15 percent in 2008. In addition, the commodity exporters (Brazil, Australia) witnessed higher trade balances with China. For the U.S. and Canada, as a share of their GDP, the gross trade balance with China improved marginally while the value-added trade balance deteriorated moderately.

Figure 9. Exposure to China’s Growing Import Industries

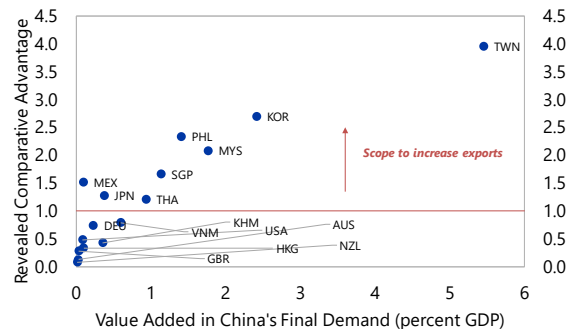
Computers, electronic, and electrical equipment

Exposure to China's Imports



Sources: National authorities; OECD TiVA; and IMF staff calculations.

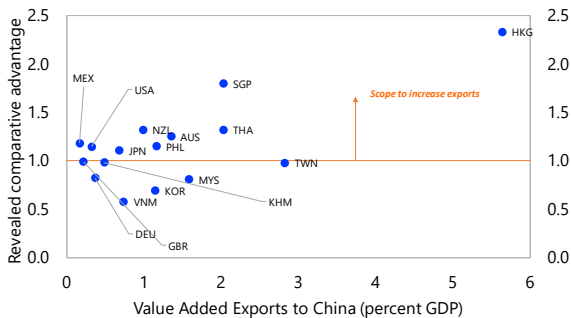
Exposure to China's Final Demand



Sources: OECD TiVA; and IMF staff calculations.

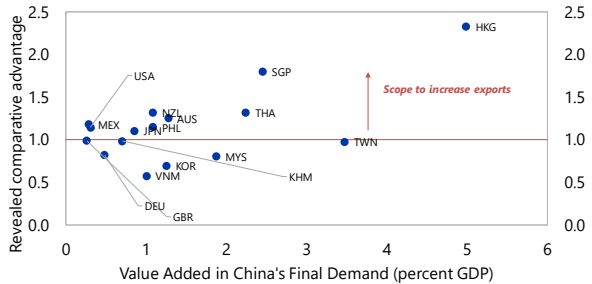
Distributive trade, transport, accommodation, and food services

Exposure to China's Imports



Sources: National authorities; OECD TiVA; and IMF staff calculations.

Exposure to China's Final Demand



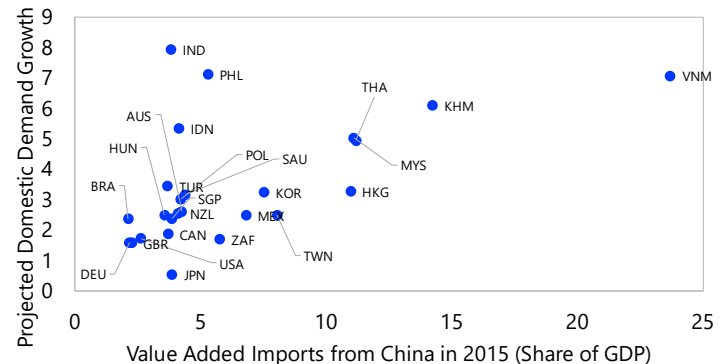
Sources: OECD TiVA; and IMF staff calculations.

Advanced economies (e.g. U.S., New Zealand, Japan) have the potential to increase exports to China. The two sectors that have contributed towards China’s import growth are electronics and services (to be more precise, distributive trade, transport, accommodation, and food services). The combination of the revealed comparative advantage of economies in these sectors (economies have an edge on exporting these products compared to others) and the current exposure to China in these sectors (economies have an existing relationship) provides a simple metrics of gauging which economies can benefit from China’s rising imports (Figure 9).

- Focusing on electronics, some Asian economies (Taiwan Province of China, Korea, Malaysia, Philippines) have both high revealed comparative advantages and significant exposure to China. Hence, these economies are likely to benefit if China’s import growth in electronics continues. However, the exposure to China’s final demand for these products is less than exposure to China’s imports—hence, the benefits may not be as high as the gross numbers indicate.
- Some Asian economies (Hong Kong SAR, Singapore, Thailand) have high comparative advantages and high exposure, while some of the advanced economies (U.S., New Zealand, Australia, Japan) have comparative advantages as well as decent exposure to China’s growing imports in services. To the extent that the advanced economies have some existing relationship but relatively low exposure, there is potential for these countries to increase exports in this area.

Potential to increase exports may not necessarily translate into higher trade balances—some economies may also have strong imports from China. Countries like India and Philippines are expected to have strong domestic demand growth in the medium-term, while Hong Kong SAR, Korea, and Thailand have significant import exposure as well as domestic demand increase in the medium-term. Outside Asia, the expected domestic demand growth of advanced economies like Germany, Canada, and the U.S. could also translate into high import growth from China.

Domestic Demand Growth (2020-2024) vs. Import Exposure to China



Sources: OECD TiVA; and IMF staff calculations.

VI. CONCLUSION

Since its peak in 2008, China's current account surplus declined due to structural factors, especially the increase in outbound tourism, the economic rebalancing from investment to consumption, moderation in goods surplus due to market saturation and growth differentials with trading partners and the appreciation of the REER towards equilibrium. However, the 1.2 percent decline in 2018 (compared to 2017) was in part driven by cyclical factors related to oil and semiconductor prices.

Domestic policies have supported China's current account decline from its peak in 2008, but at the expense of internal imbalances (decline in fiscal balance, increase in private credit). Achieving a lasting external balance requires the gradual reining in of expansionary macroeconomic policies while accelerating reforms to boost consumption and reduce savings, in particular, improving the social safety net, undertaking state-owned enterprise reforms, and opening up markets to the private sector and foreign firms. At the same time, the financial system needs to be prepared to handle greater volatility and greater capital inflows through continued de-risking and associated micro and macro-prudential reforms.

Given that China had historically run a current account surplus that was moderately stronger than warranted by the country's fundamentals and desired medium-term policies, further declines in the current account surplus will reduce *excess* global imbalances—a positive development for global stability. For the rest of the world, the decline in China's current account surplus has generated differential impact across countries, with the trade balances of Korea, Germany, Brazil improving vis-à-vis China, while that of Japan, India, and Indonesia deteriorating. Going forward, advanced economies (e.g. USA, New Zealand, Japan) could increase exports to China, as they have comparative advantage in some of her growing import sectors, but this potential to increase exports may not necessarily translate into higher trade balance — some of the economies have strong imports from China, which would act as an offsetting force.

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