Articles Economic Alternatives, 2019, Issue 3, pp. 345-359

China's Narrowing Current Account Surplus:

Evolving Trends and Policy Implications

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Abstract

The current account surplus that China has enjoyed for two decades has shown signs of narrowing. In the first quarter of 2018, China ran its first quarterly current account deficit after its accession to the World Trade Organisation in 2001. Although the current account turned from deficit to surplus in the later quarters of 2018, the period of consistent current account surplus has probably come to an end. China's once-significant goods trade surplus is expected to narrow steadily while the services trade deficit is set to widen further. Consequently, the current account balance is expected to lower in coming years, indeed even frequently entering negative territory. A narrowing current account surplus or current account deficit has important macroeconomic and policy implications. It is likely to exert pressure on the domestic currency and precipitate capital outflows, forcing the central bank to sell or drain foreign exchange reserves if the exchange rate is not flexible or remains tightly managed. Given that China's current account surplus is now unsustainable, the government may have to introduce more flexibility to the Renminbi, since a flexible exchange rate acts as an automatic stabiliser to counter domestic and external shocks. It should also consider liberalising the services industries so as to enhance the competitiveness of the service sectors and improve the service trade deficit.

Keywords: Current Account, China, Exchange Rate, Services

JEL: F21, F31, F32, F41

1. Introduction

China's persistent current account surplus has attracted considerable attention in the past. It is often regarded as one of the main sources of a perceived imbalance in global capital flows and as the mirror image of the persistent U.S. trade deficit. Since the early 1990s, China's annual current account balance had been in surplus, underpinned by strong growth of merchandise exports as the economy emerged as a global manufacturing powerhouse particularly after its accession to the World Trade Organisation (WTO).[1] In 2007, China's current account surplus peaked at 10% of GDP, and in 2008, stood at US$421 billion, registering the largest current account surplus of any economy in that year including those of Germany or Japan.

China's current account surplus has since fallen steadily and in 1Q 2018, it ran its first quarterly current account deficit after its WTO accession in 2001.[2] Although seasonal factor

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[1] China has become a major global exporter, with its share in world exports rising significantly from 4.3% in 2001 to 12.8% in 2017, based on data from WTO.

[2] China's quarterly current account deficit accounted for -0.3% of GDP in 2Q 2001.

is part of the reason behind the decline in surplus (as the balance usually tends to be the lowest in the first quarter of the year), other factors have also driven the decline. First, import growth had outpaced export growth. The deficit in 1Q 2018 was led by a rapid narrowing of the merchandise trade surplus which fell to US$52 billion (-37% y-o-y in USD terms) when the growth of imports (21.5% y-o-y) outstripped that of exports (11.3% y-o-y). Second, services deficit widened, expanding 16.1% y-o-y to a record-high of US$73.6 billion in 1Q 2018.

Although the current account turned from deficit to surplus in 2Q to 4Q in 2018 (Figure 1), the period of consistent current account surplus has obviously come to an end. It is expected that more frequent quarterly deficits will occur in the future, given the structural changes in its components. More specifically, China's once-significant goods trade surplus is expected to narrow steadily while the services trade deficit is set to widen further. Negative net investment gains are also likely to continue and weigh on the income components of China's current account balance.

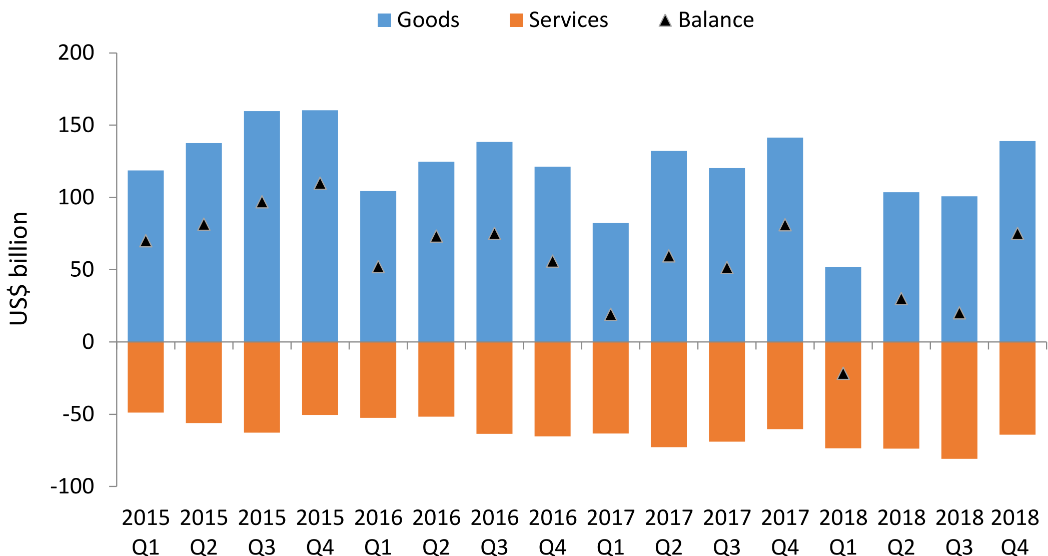

Figure 1. *Goods and Services Trade Balance*
Source: *CEIC*

There are important implications for macroeconomic management if China's current account surplus diminishes and turns into a deficit, particularly if the capital account is also being liberalised as part of the financial reform. Economic history suggests that current account deficits, if combined with fiscal deficits, are often associated with downward pressure on exchange rate and upward pressure on interest rate. China currently has a 3% budgetary fiscal deficit, which is even larger if off-budget and quasi-fiscal activities are taken into account. If China becomes a country with twin deficits, the renminbi (RMB) exchange rate will likely face depreciation pressures and precipitate capital outflows that would erode foreign exchange (FX) reserves if the exchange rate is tightly managed. This could potentially result in tighter domestic liquidity which would counteract the effects of accommodative monetary policy and pose a risk to growth.

To date, there have been many academic studies conducted to examine what drives China's current account surplus but hardly any research analysing why such surplus has narrowed. Instead, most of these studies explain the rationale behind China's high savings which is a key factor for the increase in current account surplus until 2008. While there are a couple of studies which postulate that China's current account surplus will not be persistent given demographic and structural changes (Imrohoroglu and Zhao, 2018), they stop short of exploring the policy implications of a possible trade and current account deficit. Another paper (Zhang and Tan, 2015) concluded that China's current account surplus was expected to reduce over time. The authors commented that the surplus might become a deficit under relatively extreme circumstances, for example if the RMB were to appreciate (thus causing a trade and consequently current account deficit) due to large capital inflows, which in turn could arise from the full liberalization of the RMB exchange rate formation. However, their study does not take into account important developments during and after 2015.

This paper contributes to the existing literature on China's current account balance by factoring in some significant developments in and after 2015 and analysing the underlying policy implications. In particular, the reform of the RMB central parity fixing mechanism in August 2015 has led to depreciating exchange rate pressures and corporate balance sheet adjustments which saw large and volatile capital outflows. Although capital outflows later became subdued after the episode, downward pressures on the RMB and capital outflows have remained due to China's weak growth momentum and the Belt and Road Initiative of encouraging outward investment. Further, as the China-US trade dispute continues, the magnitude of foreign direct investment (FDI) inflow may decline in the near future as there are already signs that foreign firms are shifting their supply chain activities from China to Southeast Asia. China may therefore not be able to finance its current account deficit by capital flows in its financial account.

The remainder of this paper is organised as follows. The next section discusses the changing and evolving trends in China's current account balance by analysing the various components (goods, services and income) while the third section explores whether the shrinking current account surplus will be offset by a surplus in the capital and financial account. The fourth section discusses whether China's foreign exchange reserves are sufficient if China's current account deficit becomes a permanent feature while the fifth section evaluates important policy implications. The final section presents conclusions.

2. Will Current Account Deficit become the "New Normal"?

According to standard growth theory, a developing nation that is expected to experience strong growth should borrow from the rest of the world to finance its capital stock. In other words, it should run a current account deficit given the low or negative gap between savings and investment (S – I), the national income identity that is equivalent to the current account balance [exports (X) *minus* imports (M)].

A number of explanations have been put forward as to why China has enjoyed huge current account surpluses in recent decades. Chinese households amass high levels of precautionary savings due to a lack of social safety net while Chinese state-owned enterprises' practice of retaining most of their dividends, rather than disbursing them back to the state, caused their cash holdings to

build up (Chamon et al., 2010; Yang et al., 2010; Cristadoro & Marconi, 2012; Choi et al., 2014; Chan et al., 2016; Laffrague & Yu, 2014; Imrohoroglu & Zhao, 2018).

From the macroeconomic perspective of savings and investment, although China's investment-to-GDP ratio has been exceptionally high, it has mostly been dwarfed by the high savings rate, resulting in a widening net savings surplus[3] or a rising (S-I) gap (Figure 2). Since 2008, China's current account surplus started to decline as a ratio to GDP, likely due to the large scale fiscal stimulus programme launched by the Chinese government which substantially led to a rise in domestic investment.

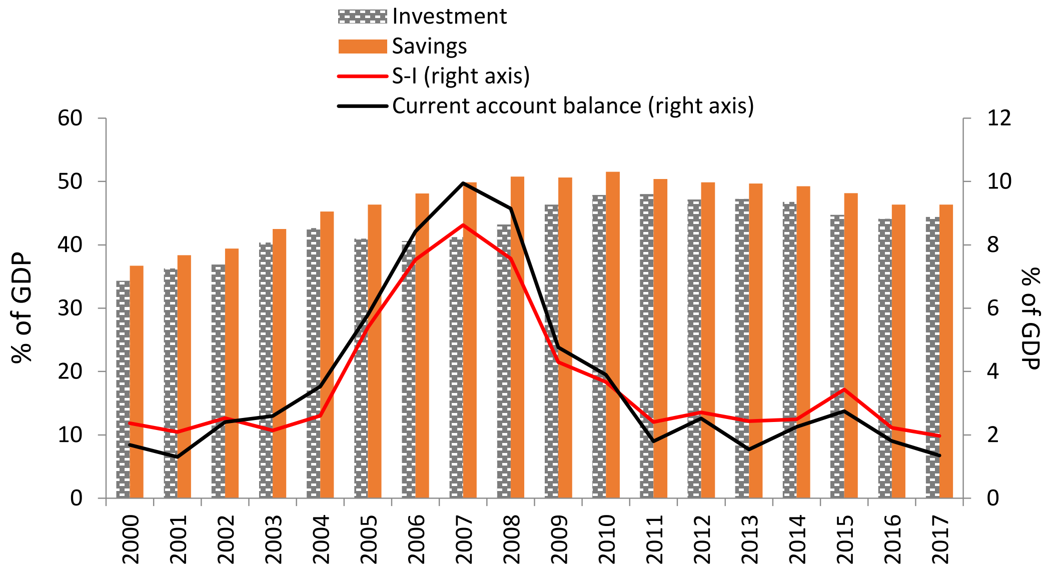

Figure 2. *China's Current Account, Gross Savings and Investment, 2000-2017*
Source: *CEIC*

Goods trade balance

China's once-significant goods trade surplus may narrow significantly in the years ahead. Structural shifts such as China's declining reliance on exports[4] and increasing spending power, driven by economic restructuring policies and demographic trend, would likely lead to a gradual and continuous narrowing of China's trade surplus in goods and increase its trade deficit in services. The environment for global trade has also been changing and turning more protectionist, with the continuation of the China-US trade tussle likely to weigh heavily on China's export outlook.

Further, China has passed the Lewis turning point of surplus labour. Shortage of cheap labour has led to rapidly rising wage costs in the economy and this may prompt many export-oriented companies to relocate their activities (particularly in labour-intensive industries)

[3] Given China's net savings (current account) surpluses, China has been described as an "immature creditor" (a term coined by Stanford Professor Ronald Mckinnon). It has difficulty financing its overseas investments in RMB due to a relatively under-developed domestic financial market and stringent capital controls. This limits the extent to which China can recycle or intermediate its net savings surplus.

[4] The share of China's exports in GDP slid from 33% in 2005 to 19% in 2017.

to neighbouring countries such as Vietnam, Malaysia or Cambodia. In addition, land prices have soared after a few rounds of property booms while artificially suppressed prices of resources such as energy, have climbed due to market price reforms and enhanced regulation on environmental protection. Such rises in the production cost may erode the competitiveness of China's exports and render the significant merchandise trade surplus unsustainable.

While export growth is likely to trend downward, China's goods imports could rise steadily in the coming years due to growing demand for commodities. China has become increasingly reliant on imports for many commodities such as crude oil and agricultural products like soybeans, corn, rice, cotton and sugar. In fact, China's imports of primary products (food and beverage, crude material, mineral fuel and lubricant, animal and vegetable oil) has surged over the past decade while exports of those products have remained subdued (Figure 3).

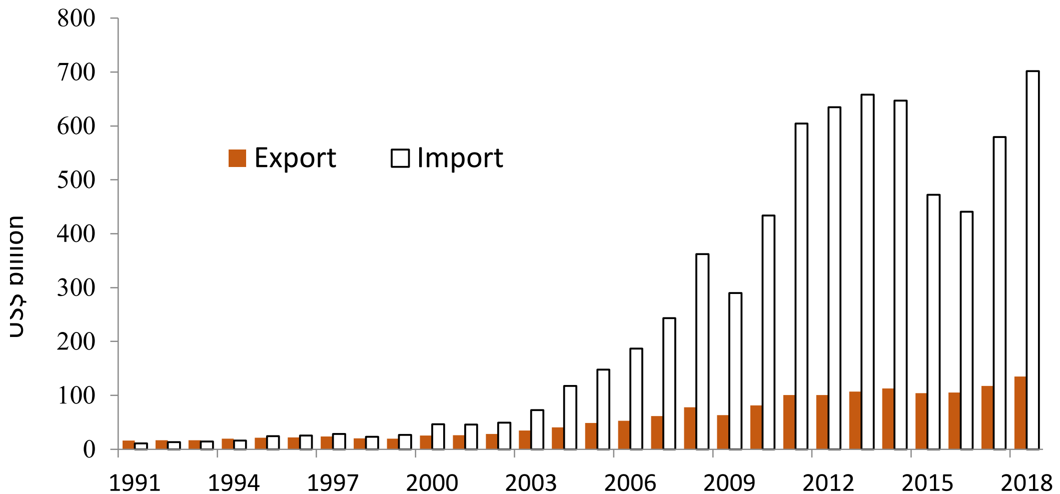

Figure 3. *China's Trade in Primary Goods*
Source: *CEIC*

An ageing population is expected to lead to less savings and more consumption. Just as importantly, China's economic rebalancing towards more consumption is expected to drive demand for goods imports. Although household debt levels have risen[5] and may weigh on household consumption to some extent, the emergence of a growing middle class as a result of increasing urbanization implies the propensity to increase consumption. The government's initiatives to support domestic consumption and to lower import tariffs for certain high-demand consumer products may also stimulate consumption.[6]

[5] According to data from the Bank for International Settlements, household debt as a percentage of GDP had increased from 33% in 2013 to 48% in 2017. However, not all of the debt included under "household" would be pure retail. In China, similarly in Korea, it also includes small and micro lending balances that are really a form of small and medium-sized enterprise lending. If one were to exclude this SME lending, then China's household debt to GDP ratio is estimated to fall from 47% of GDP to 36% of GDP.

[6] With effect from January 2016, the tariffs for some imported daily consumer goods, including bags, suitcases, apparel, scarves, blankets and sunglasses, have been reduced moderately. For instance, the import tax rates for some clothing, footwear and suitcase items have been lowered to 8%, 12% and 10%, from the previous rates at 16%, 24% and 20%, respectively.

In the current US-China trade tussle, the government has implemented some tariff cuts in 2018, reducing China's simple average tariff rate from 9.8% to 7.5%. China has announced it will import more American products; starting 1 January 2019, it will cut import tariff for US auto imports from 40% to 15% for three months. Additional cuts on import taxes in 2019 can be expected. These tariff cuts are likely to lead to more merchandise imports and adversely affect China's goods trade balance in the near term.

Service trade balance

While China's leading position in goods exports has been the main reason behind its trade surplus, its services trade balance has consistently been in deficit (Figure 4), even as large swathes of the domestic services sector are closed or grant only limited access to foreign service providers.

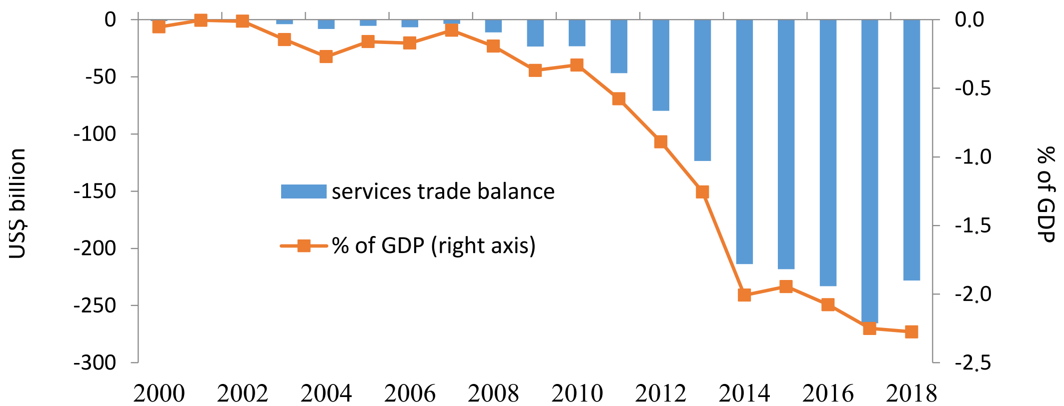

Figure 4. *China's Services Trade Balance*
Source: *CEIC*

China's service trade deficit is set to widen further. Figure 5 shows that tourism and transport were the two predominant components of the services trade balance between 2000 and 2018. The huge deficit in tourism has typically been accompanied by a deficit in the transport category since overseas travel requires transportation. Chinese outbound tourism along with travelers' overseas spending[7] has been rapidly increasing. Between 2013 and 2018, the number of Chinese nationals travelling overseas has grown by an annual average of 12% while growth of foreign visitor arrivals was only 2%. With rising income levels and easier access to foreign visas, overseas travel has become increasingly popular in China.

[7] For instance, Chinese travelers took the top spot in global tax-free shopping in 2015 and accounted for 30% of the world's total duty-free sales, ahead of the Middle Eastern, Russian, American and Indonesian travelers, according to Global Blue.

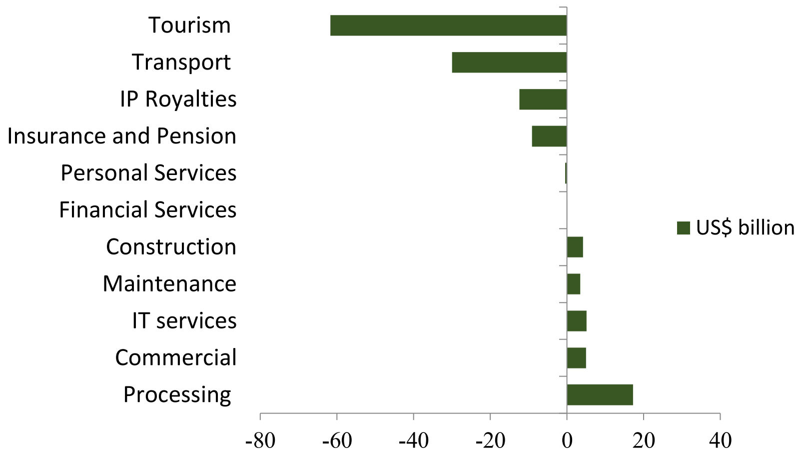

Figure 5. *Breakdown of Service Trade Balance (2000-18)*
Source: *CEIC*

China's service trade deficit has also expanded due to its growing demand for services protected by intellectual property (IP) rights, such as IT software and music (Figure 5). China's payments of licensing fees and royalties to other countries have soared in recent years, reaching almost US$30 billion in 2017, nearly a four-fold increase over the last decade (Figure 6). In 2018, China announced its intention to reorganize the State Intellectual Property Office, aimed at strengthening the protection of IP rights. It also passed the draft amendment to the Patent Law that significantly increases penalties for violation. It is becoming aware of the critical need to improve law enforcement of IP rights, and increased external pressures (i.e., China's alleged theft of US IP in the current China-US trade war) have also helped in pushing China to do more to prevent IP infringement.

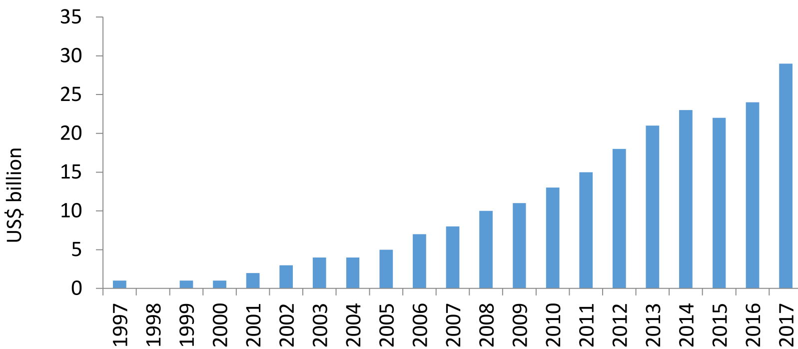

Figure 6. *Chinese Payments for the Use of Foreign Intellectual Property, 1997-2017*
Source: *SAFE*

In the coming years, the liberalisation of China's services sector might widen the service trade deficit and reduce the current account surplus. Service sector deregulation could accelerate on the back of a slowing industrial sector and the government's efforts to remove barriers to trade in services. In addition, China's domestic rebalancing towards more services-led growth is likely to increase import of services. China's service

trade deficit is thus likely to further widen and shrink the current account surplus.

Combined primary and secondary income component

The combined primary and secondary income components account for the smallest portion of China's current account compared to goods and services (refer to Figure 7). For most years over the past two decades since 1993, China has been facing continuous negative investment income. Between 2010 and 2017 (the latest year for which data is available), net investment gain (including interest, dividend returns and payments on China's foreign assets and liabilities) posted a deficit of around US$56 billion on average. This is mainly due to the huge amount of FDI in China as well as the relatively lower investment returns of China's overseas assets compared to the returns for foreign countries' assets in China.

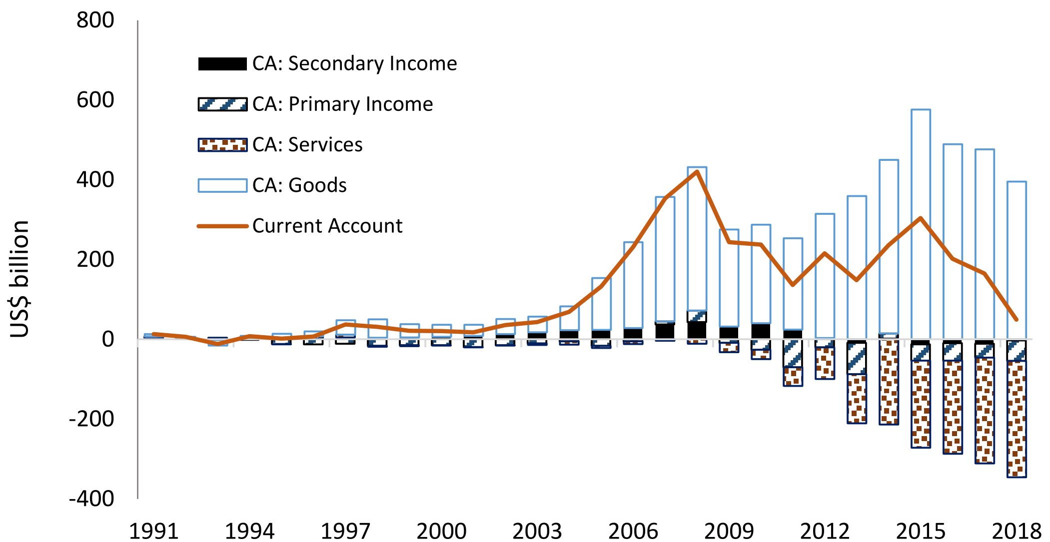

Figure 7. China's Current Account Breakdown
Source: *CEIC*

As shown in Figure 8, the yields on China's overseas assets (average of 3%) were significantly lower than those of China's overseas liabilities (average of 5.8%) during the period from 2004 to 2017. China's foreign assets are largely composed of foreign exchange (FX) reserves that are mostly invested in low-yielding foreign government bonds. As the government is unlikely to shift its components of FX reserves quickly, in the short term, negative net investment gain is expected to weigh on the income components of the current account.

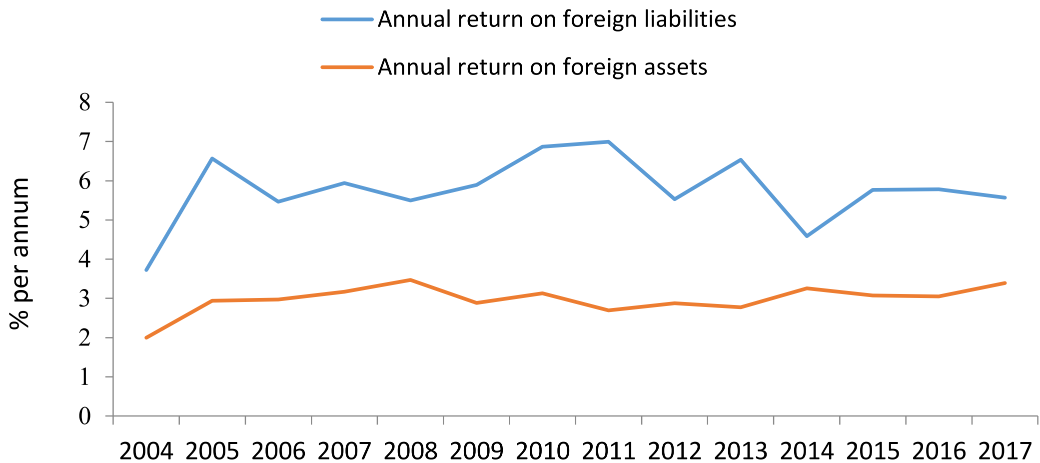

Figure 8. *Return Rate on Foreign Assets and Liabilities*
Source: *CEIC*

3. Will Shrinking Current Account Surplus Be Offset by Financial Account Surplus?

There are three components of the balance of payments (BOP) financial account. They are direct investment, banking-related, and portfolio investment. Direct investments tend to be stable compared to the more volatile banking-related and portfolio investment. Given that China's current account is unlikely to enjoy continued surpluses, could the financial account fill the void to offset the shrinking current account surplus?

For the direct investment component under the financial account, the structural adjustment of China's economy would weaken the incentive for FDI but the incentive for domestic enterprises to invest abroad would strengthen under the support of Chinese government, which would reduce the net direct investment inflow. As such, it may be insufficient to generate an overall surplus in the BOP.

Figure 9 (Panel A) shows that FDI has dominated capital inflows to China, partly because such flows are subject to fewer restrictions than other forms of capital flows. The expectations of high rates of investment (given rapid productivity growth) and China's WTO accession have led to an acceleration of FDI inflows in the aftermath of 2001. On the other hand, Chinese outward direct investment has been considerably smaller than FDI in China, amounting on average to only 1% of GDP over the past decade or so. However, it has been increasing in recent years, largely reflecting the expansion of Chinese firms overseas to acquire natural resources and seek new markets.

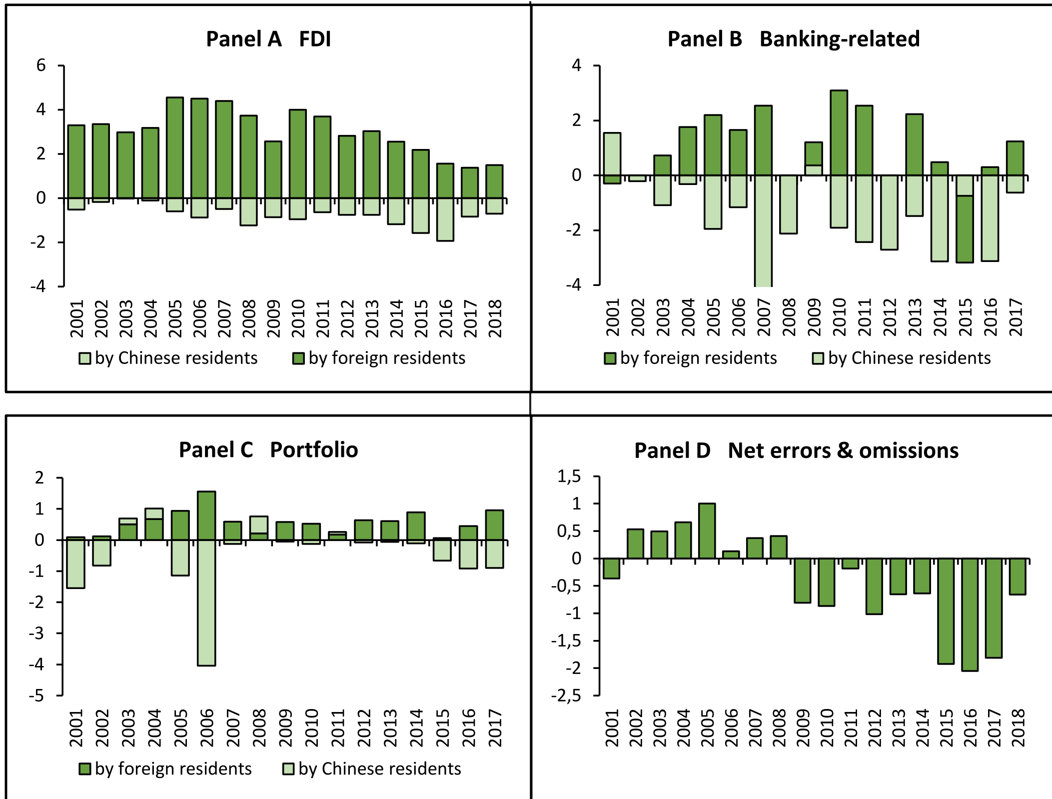

Figure 9. *Private Capital Flows (% of GDP)*
Source: *CEIC.*

As a result, net FDI flows became more balanced in the last three years. FDI inflows were historically larger but these have gradually slowed due to a rise in labour costs in mainland China. Concerns about a weaker RMB coupled with a slower rate of return on investment (as a result of over-investment and industrial overcapacity) in China have also led to the repatriation of FDI profits. At the same time, outward FDI had also picked up but moderated in 2017 as the authorities tightened surveillance of outbound FDI deals given the "irrational" or speculative investments by Chinese companies in sectors outside their core areas of business.

Aggregating China's FDI and outward direct investment (ODI), official data shows that the balance of direct investment plummeted from a surplus of US$231.7 billion in 2011 to a deficit of US$41.7 billion in 2016, before returning to a small surplus of US$ 66.3 billion in 2017.[8] In 2018, the balance of direct investment further improved (approximately US$107 billion) due to a jump in FDI to US$204 billion and a sharp drop in ODI to around US$96 billion.

As trade tensions with the US continue to unfold, some multinationals (MNCs) and domestic firms in China could divert their investment to other neighbouring countries in ASEAN. There are nascent signs that this is already happening. For instance, Harley

[8] Data from CEIC.

Davidson has shifted part of its automobile production processes to Thailand. Delta Electronics, which supplies power components to Apple Inc., is reportedly purchasing a Thai affiliate to expand production while Merry Electronics, which manufactures headphones for firms like Bose Corp, intends to shift some of its production to Thailand from Southern China. Chinese companies like Panhua Group and China Gezhouba (electronics manufacturing) are planning to invest in the Philippines while New Kinpo Group, a Taiwanese contract electronics maker, is also looking to build new facilities in the Philippines.[9]

Given that the annual FDI to China could trend down and the government continues to encourage ODI under the Belt and Road Initiative, the annual balance of direct investment is expected to remain in a small surplus. However, the other components of the BOP – banking-related and portfolio investment – could be zero or may even turn into deficit. Given the volatile nature of such cross-border capital flows, it could be difficult to gauge the trend of the BOP financial account. This is because compared to FDI which can have long investment horizons, banking-related flows, for instance, tend to be more responsive to prevailing market conditions and sentiment, such as changes in expectations for the future path of RMB.

Figure 9 (Panel B) shows that such capital flows accounted for most of the recent swings and variation in China's private capital. The start of the People's Bank of China's (PBOC) rate cut cycle in November 2014, along with moves to ostensibly increase exchange rate flexibility in August 2015 with the adjustment of the exchange rate regime (i.e. reform of the RMB central parity fixing mechanism) led to sizeable banking-related outflows. As a result of RMB depreciation expectations, many Chinese entities repaid foreign currency-denominated debt (i.e. reduced their foreign currency liabilities) and increased forex deposits in order to reduce their foreign exchange exposure. Such corporate balance sheet adjustment was one of the drivers behind capital outflows (approximately US$655 billion) in the seven quarters between 3Q 2014 and 1Q 2016.

Portfolio investment, whose flows are lesser compared to direct investment and banking-related flows (Panel C of Figure 9), is the most restricted component of China's financial account, reflecting various government controls on both debt and equity flows. Although the stock connect schemes (Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect) allow cross-border equity investment by a broad range of investors, the design of such schemes ensure that capital flight from China could be largely avoided.[10]

As China's capital controls have traditionally focused more on preventing outflows than inflows, the relaxation of controls will likely initially lead to more net outflows as domestic residents seek to diversify their assets offshore. On the inbound side, capital inflows are likely to be moderate due to concerns about transparency, regulatory interference and restrictive capital controls. In the short term, it is expected that inflow and outflow may roughly offset each other, leaving the

[9] UOB, "Asia: Are we seeing trade and investment diversion from US-China trade rift", 28 November 2018.

[10] For instance, the regulatory requirement that all foreign exchange trades for settling Stock Connect trades must be done in Hong Kong (HK) using only its offshore RMB funds clearly shows Beijing's intention to keep the onshore and offshore (Hong Kong) markets segregated in order to shield the onshore stock market from volatility, using only offshore RMB liquidity to support such schemes. Such closed-loop mechanism does not really allow free capital flows in and out of the country, but is merely extending the boundary of capital controls over mainland Chinese capital to Hong Kong. Refer to Chi Lo, 2017. Demystifying China's Mega Trends: the driving forces that will shake up China and the world. UK: Emerald Publishing.

annual balance of portfolio investment around zero.

4. Are China's FX reserves sufficient?

China has accumulated massive FX reserves over the years as a result of huge FDI inflows and past current account surpluses. However, the accumulation of FX reserves slowed when the "twin surpluses" of the current and capital account that China has experienced since the 1990s came to an end in 2014, driven by the changing role of China from a net capital recipient to a capital exporter due to government initiatives such as the Belt and Road strategy and the RMB internationalisation push which facilitated capital outflows. Intensified RMB depreciation pressures further facilitated capital flight that led to a decline in FX reserves, particularly following the unexpected PBOC's exchange rate reform of August 2015. China's FX reserves, for instance, fell to US$3.2 trillion by February 2016 (a loss of US$791 billion in the twenty months since its June 2014 peak) when the PBOC tried to stabilise the RMB and limit the currency's depreciation relative to the US dollar.

China's narrowing current account surplus may exert some pressure on FX reserves as capital outflows become sizeable and the capital account becomes more open, with domestic entities (corporates and households) diversifying into assets offshore. As of December 2018, the headline FX reserves totaled US$3 trillion. This seems to be at a sufficient level according to some metrics.

In terms of import coverage, the official FX reserves cover around 17 months of merchandise and service imports as of September 2018, which are far above the three months threshold, suggesting China's reserves can maintain enough months of imports in the event of adverse shocks. Further, China's short-term external debt coverage ratio of 255% as of September 2018 versus the threshold of 100% indicates that China's short-term external debt is unlikely to trigger a BOP crisis as the FX reserves provide sufficient buffer.

Additionally, in terms of reserves to broad money (M2 money supply), the ratio stood at 11.6% as of September 2018, which suggests that the risk of capital flight via residents selling highly liquid domestic assets is rather limited. In fact, given the strict capital controls implemented by the authorities in recent years since 2015, such a risk is contained.

Overall, China's FX reserves are basically sufficient in the event of adverse shocks. However, China's external vulnerability seems to be on the rise. First, the current account surplus that China has enjoyed for a long time has shown signs of narrowing and the current account deficit may become the new normal in the years ahead. Second, despite the US$3 trillion FX reserves, the episode of drastic capital outflows over 2015-16 (following the government's move to ostensibly increase exchange rate flexibility in August 2015) suggests that the reserves may not be as abundant as it seems at first sight.

China's external debt has risen. Based on estimate by the State Administration of Foreign Exchange (SAFE)[11], China's outstanding external debt rose to US$1.9 trillion in 3Q 2018 from US$1.7 trillion in 1Q 2015, the earliest quarter when the SAFE started to release the data series. However, China's external debt could be underestimated by official data. Total bond-related external debt estimated by SAFE was US$428.8 billion in 3Q 2018, which is also much smaller than

[11] SAFE defines its "external debt" measure as the total amount of funds a country borrows from foreign entities (households, corporates, governments and other entities).

US$751 billion based on Bloomberg data.[12] The discrepancy between SAFE data and the figure reported by Bloomberg is due to the fact that the issuance of offshore dollar bonds by some Chinese companies' foreign subsidiaries may not be fully included in the SAFE's external debt statistics.[13] In addition, some entities may under-report the numbers, especially for those which have no plans to repatriate those borrowed dollars back to mainland China despite SAFE requiring all entities with external debts to report the information regularly.

That said, the headline US$1.9 trillion of external debt is not a big number when compared with China's US$3 trillion of official FX reserves and US$12.2 trillion of nominal GDP. Further, most of China's foreign debt is mostly denominated in domestic currency, which poses less risk of currency mismatch compared to external debt denominated in foreign currencies.

5. Policy Implications

A declining current account surplus or current account deficit is likely to exert pressure on the domestic currency and precipitate capital outflows. It will also have implications for domestic monetary policy. Given a slower buildup (or outright decline) in FX reserves, the PBOC will have to focus on sources other than FX reserve accumulation to ensure adequate base money expansion. For instance, in the face of persistent capital outflow pressure since 2014, the PBOC has had to neutralize the liquidity impact (caused by a reduction in base money and tightening monetary conditions when the central bank sells FX reserves) by resorting to domestic liquidity injection instruments, including open market operations (OMOs) and repeatedly cutting banks' reserve requirement ratios (RRR), to maintain adequate liquidity.[14] The use of liquidity provisioning tools (OMOs) was to avoid sending too strong of an easing signal and to accommodate government's concerns about financial leverage and asset bubbles. However, by relying mostly on shorter-duration tools to fine-tune monetary conditions, bouts of onshore rates or liquidity volatility have become more frequent.

The government should introduce more flexibility to the RMB, since a flexible exchange rate acts as an automatic stabiliser to counter domestic and external shocks. Given the constraints posed by the Impossible Trinity[15], greater exchange rate flexibility is necessary if China were to maintain an independent monetary policy, especially given its gradually liberalised capital account and RMB internationalisation. One benefit of a flexible exchange rate regime is that the central bank need not have to spend its reserves to keep the exchange rate within a tight band, thus addressing the problem of rapidly depleting reserves. But more currency flexibility implies greater exchange rate fluctuations and volatility that could be destabilising for the economy, given banking fragilities and the lack of regulatory supervision in the banking

[12] According to Bloomberg, outstanding dollar-denominated Chinese corporate debt stood at US$751 billion in 3Q 2018, more than double the amount at end-2015.

[13] Since those subsidiaries eventually rely on their mainland-based parent companies for repayment, those debts should in general be technically counted as China's external debt.

[14] If the exchange rate is not flexible or remains tightly managed, the central bank has to sell or drain FX reserves to defend the currency and domestic liquidity necessitates constant replenishing, both of which undermine the effectiveness of monetary policy easing.

[15] The Impossible Trinity, also known as the trilemma, is a policy choice problem, based on the Mundell–Fleming model that suggests that it is impossible for a country to have a fixed exchange rate, an open capital account, and an independent monetary policy at the same time.

and financial system. The government's main current approach is therefore to seek a suitable balance between market and control by letting the RMB float down gradually and become increasingly more market based, using the trade-weighted basket of currencies as a guide. It is also likely to adopt macro-prudential measures to manage cross-border capital flows while cautiously pacing its capital account liberalisation in a calibrated manner to avoid a potential systemic crisis.

China's narrowing current account surplus has important implications not only for domestic macroeconomic management but also for the world economy. It would help to alleviate the global imbalances but only to a certain extent. Given that the current account deficit of debtor countries like the US are considered to be structural, it is unlikely that the deficit will vanish even if China's current account surplus diminishes. Current account surplus and deficit are driven primarily by savings and investment decisions; as such, addressing the structural problem of excessive consumption or over-indebtedness in countries with higher than desirable trade deficits is key to resolving the global imbalances. Further, many bilateral trade balances reflect international division of labour, with firms using China as a manufacturing platform to assemble or process goods for exports back to the destination countries. Protectionist measures are unlikely to be ineffective in resolving global imbalances and will instead redistribute the trade balances between different trading partners with little impact on the aggregate trade balance of the deficit country.

Conclusion

China's sizeable current account surplus is primarily a trade phenomenon, driven by its industrial ascendancy. It is by no means a longstanding phenomenon; since reaching 10% in 2007, the current account surplus-to-GDP ratio has been on a downtrend.

China's merchandise trade surplus could narrow significantly in the coming years as export growth slows while import growth rises, driven by cyclical and structural factors. The services trade deficit may widen further on increased spending in tourism, transport and IP royalties, while net investment gains are unlikely to turn positive quickly. Consequently, the current account balance is expected to trend lower in coming years, indeed even frequently in negative territory.

To address the challenges arising from a current account deficit, the government should further liberalise the service industries to enhance the competitiveness of the service sectors and improve the service trade deficit. Improving the macro and growth outlook by implementing structural and institutional reforms are just as important to mitigate any balance sheet vulnerability. Ultimately, as China's current account surplus narrows, it would have important implications for not just the economy itself but also globally.

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