What Drives China’s Current Account?

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Summary

China’s persistent current account surpluses challenge the standard view of what determines the direction of international flows; we would expect a quickly growing emerging market to borrow rather than to lend.

This paper first shows that a standard model that incorporates non-tradeable goods explains more than 70 percent of China’s current account variability over the period 1982-2007, including the persistent surpluses since 2001. The paper then goes on to offer an empirical taxonomy of the factors driving China’s current account. The most important factor is expected increases in the prices of non-tradeables – notably housing and medical care. I interpret this pattern as evidence for the role that precautionary savings and, possibly, changing demographics play for China’s current account: households anticipate the declining provision of public goods and protracted price increases for housing and education. This provides a strong savings motive which explains more than half of the variability of the current account in most specifications. The next most important channel is changes in national cash flow: the current account surplus predicts declining net output – periods in which growth in investment and government spending exceeds GDP growth. This pattern – that at first looks like consumption smoothing – may be the outcome of financial frictions that require firms to finance future investment from retained earnings.

The analysis also reveals that much of China's external dynamics is driven by very persistent shocks that are associated with declines in the world real interest rate. This suggests that the factors identified here – most of which are related to domestic financial development – are key in understanding the global implications of China’s surplus.