Economic Watch

China | When its current account turns deficit…

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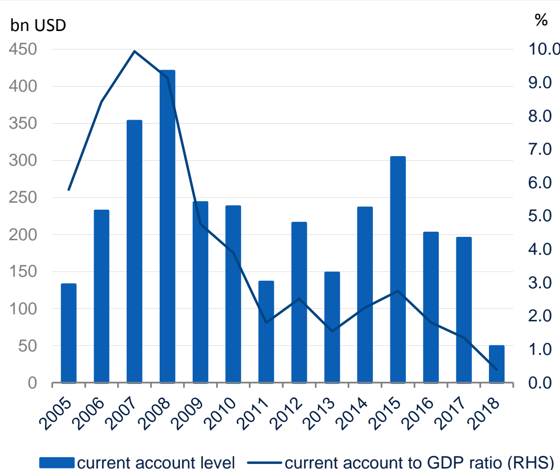
China's long-lasting "twin surplus" of both current and capital account have already changed when capital flows become more unpredictable in the aftermath of 2015 "811" RMB devaluation. Recently, the surplus of the current account also narrowed significantly. Looking ahead, a combination of "current account deficit" and "capital account two-way fluctuation" could become a "new normal" for China's Balance of Payments (BoP). The US-China trade war negotiation (i.e. China will buy more US goods and reduce its trade surplus against the US), the continuing expansion of service trade deficit, the shrinking saving-investment gap due to aging population will all contribute to this change. This new situation is set to bring new challenges to Chinese policymakers in maintaining domestic financial stability and pushing forward necessary financial liberalization reforms.

An important change of China's Balance of Payment

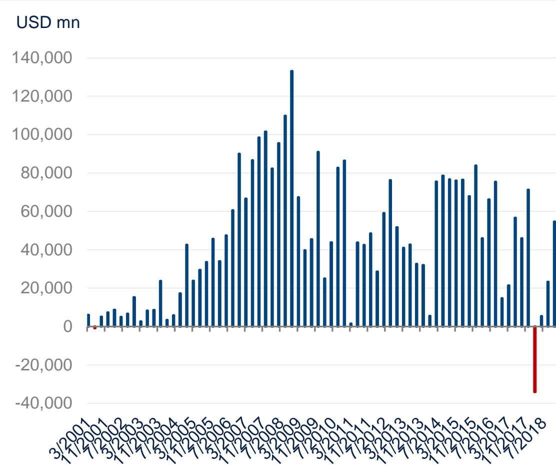
China's Balance of Payments (BOP) has experienced profound changes over the past few years. Chief among them is the continuous narrowing of its current account surplus. In particular, the ratio of current account surplus to GDP, after reaching its peak in 2007 at 9.9%, declined to 0.4% in 2018. Although the persistent expansion of China's GDP played some role in this declining ratio, the diminishment of current account surplus is also remarkable. (Figure 1) Moreover, in the first quarter of 2018, a quarterly deficit of the current account appeared for the first time since 2001 Q2. (Figure 2)

Figure 1. **CURRENT ACCOUNT TO GDP RATIO HAS SHRANK SIGNIFICANTLY AFTER ITS PEAK IN 2007**



Source: BBVA Research and CEIC

Figure 2. **Q1 2019 CURRENT ACCOUNT APPEARED DEFICIT, THE FIRST TIME SINCE 2001 Q2**



Source: BBVA Research and CEIC

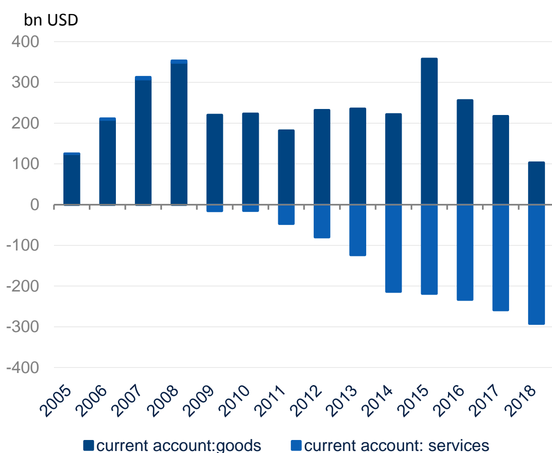
Reasons behind China's shrinking current account surplus

Several reasons might have contributed to the shrinking surplus under the current account, including (i) the ongoing trade tensions with the US; (ii) the expanding service trade deficit, and (iii) structural changes of domestic saving-investment gap due to the long-term demographic change.

First, trade conflicts with the US, starting from early 2018, have put a great pressure on China's goods exports. In particular, we observe a sharp decline of 52.6% of goods trade surplus from 2017 to 2018, from USD 217 billion to USD 102.9 billion. (Figure 3) Actually, China's surplus with the US has taken account of a large share of China's total surplus. For instance, in 2018, this share reached 92.4%; while in most of years before 2011, this share was more than 100%. (Figure 4) The tariff imposed by the US to China's exports so far, is estimated to decrease China's exports to the US by USD 55.5 billion, which is around 2.6% of China's total exports. (See our previous China Economic Outlook: Q3 2018, page 18) Even the two sides reached a trade deal sometime, it will avoidably include measures for China to reduce its trade surplus against the US.

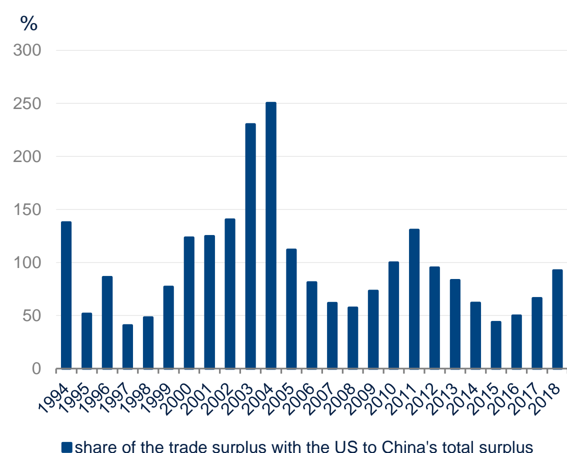
Second, a continuously expanding service trade deficit also leads to a declining current account over time. Since 2015 August 11th, RMB exchange rate has been going into a depreciation trend, leading Chinese households and enterprises to diversify their portfolio to change RMB to USD, triggering large amount of capital outflows. Under this circumstance, service trade, especially the "traveling" item under the service trade account became a good choice to disguise their portfolio diversification behaviour to circumvent the tight capital control by the authorities. Actually, service trade deficit expanded from USD 218.3 billion in 2015 to USD 292.2 billion in 2018. Beyond that, the lack of high quality service in the domestic market and an increasing of households' income could also explain a gradually expansionary service trade deficit.

Figure 3. **A SHRINKING CURRENT ACCOUNT IS DUE TO A DECLINING GOODS TRADE SURPLUS AND AN EXPANSION OF SERVICE DEFICIT…**



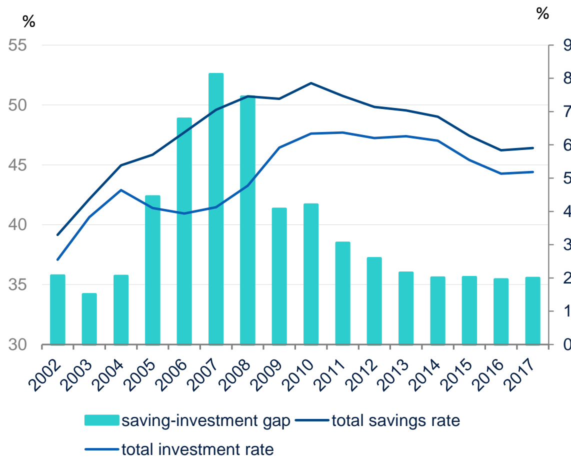
Source: BBVA Research and CEIC

Figure 4. **CHINA'S TRADE SURPLUS WITH THE US HAS BEEN A LARGE SHARE TO CHINA'S TOTAL SURPLUS**



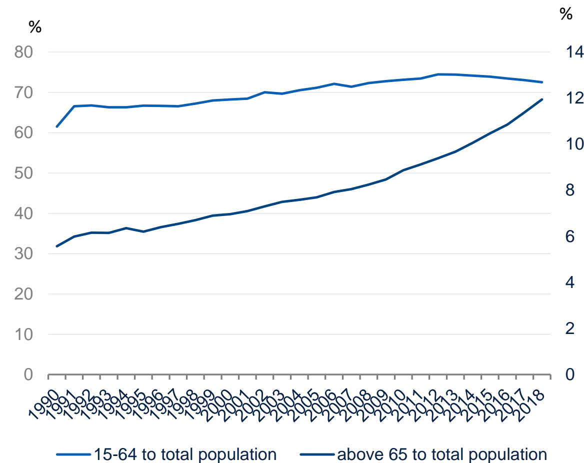
Source: BBVA Research and CEIC

Figure 5. **A NARROWING SAVING-INVESTMENT GAP**



Source: BBVA Research and CEIC

Figure 6. **CHINA'S AGING PROBLEM CANNOT BE UNDERESTIMATED**



Source: BBVA Research and CEIC

Third, a decreasing of saving-investment gap domestically also leads to a shrinking current account surplus. After its peak in 2010, China's total saving rate declined significantly, from 51.8% in 2010 to 46.4% in 2017. (Figure 5) From a perspective of medium to long term, the declining saving rate is related to China's aging population. As the labor population (i.e. from 15 to 64 year old) declines while aging population increases, the income growth rate is slower than the consumption, leading to a decreasing saving rate. (Figure 6) Thus, a declining saving-investment gap in the medium to long term implies a gradual shrinking of current account surplus and a possible turning to a deficit current account.

Projections of China's current account in the coming years

We decompose Chinese current account into the four categories: goods trade, service trade, primary income and secondary income, the same way that the State Administration of Foreign Exchange (SAFE) does. And then we make the prediction of each category and finally form our forecasts of current account level as well as its ratio to GDP in the coming years.

In particular, the assumptions and the prediction method are summarized as follows (Table 1):

(i) Goods trade: for the exports prediction of 2019, we follow the methodology of our previous China Economic Outlook: Q3 2018 (page 18) that the US 25% tariff imposing on Chinese USD 200 billion exports to the US will lead to USD 55.5 billion decreasing of China's exports to the US in 2019. The methodology is based on global value chain and we use the information from the joint OECD – WTO Trade in Value-Added (TiVA) database, which decomposes the value of final goods or services into the value added by each country. By applying the elasticity estimates provided by the World Bank, we estimate to what extent the tariff will affect China's exports.

For the annual exports and imports prediction of 2019 to 2021, we apply the Bloomberg consensus results combined with our own judgment. In particular, the 2019 to 2021 exports growth rates are predicted to be 2.5%, 4% and 5%; imports growth rates are 1%, 3% and 4% for 2019 to 2021.

(ii) Service trade: this category basically includes processing service, transportation, insurance, financial service, travel, foreign education etc. The prediction of 2019-2021 service trade balance is based on the average growth rate of 2015-2018, reflecting the growing demand of Chinese citizens to foreign traveling, education, financial service etc. in the recent years.

(iii) Primary income: mainly including payroll for employees and investment returns. Given that this term's scale is comparatively small and very fluctuate, we use the average level of the past four years to predict the 2019-2021 primary income.

(iv) Secondary income: mainly including personal transfers. Given that this term's scale is comparatively small and very fluctuate, we use the average level of the past four years to predict the 2019-2021 primary income.

Table 1. **CURRENT ACCOUNT FORECASTING**

	2017	2018	2019 (f)	2020 (f)	2021 (f)
Current account	195	49	-27	-18	-5
Current account to GDP ratio (%)	1.59	0.36	-0.18	-0.11	-0.03
Goods trade	419	351	335	370	411
Exports	2,263	2,487	2,492	2,592	2,722
Imports	1,844	2,136	2,157	2,222	2,311
Service trade	-259	-292	-316	-342	-370
Primary income	-10	-51	-37	-37	-37
Secondary income	-12	-2	-9	-9	-9

(f) Forecast.
Source: BBVA Research and SAFE

Table 1 shows the forecasting results. Altogether, based on our assumptions, in 2019, China's current account will shrink from USD 49 billion in 2018 to USD -27 billion, and this figure will further declining to USD -18 billion and USD -5 billion in 2020 and 2021. Correspondently, current account to GDP ratio will shrink to -0.18% in 2019 from 0.36% in 2018, and further decline to -0.11% and -0.03% in 2020 and 2021.

Challenges to domestic financial stability and policy making

China's shrinking surplus under the current account could have significant implications for China's economy and financial system. Indeed, the fluctuations of flows under China's capital account have become pronounced in the aftermath of China's "811" RMB devaluation in 2015. That being said, the overall situation of China's Balance of Payments is likely to transit from the "twin surplus" (surplus under both current and capital account as observed during the period of 1999-2011) to a combination of "deficit current account" and a "two-way fluctuation of capital account". Such a significant change will bring new challenges to domestic policy-making in the following perspectives:

First, the change of BOP will push the authorities to explore more effective new monetary tools. During the “twin surplus” period, in the face of large net inflows, the central bank frequently used some quantitative policy tools, including the rise in required reserve ratio (RRR) and the issuance of central bank bills, to conduct sterilization for the excess funds outstanding for foreign exchange.

However, the profound changes in China’s BOP have prompted the authorities to accelerate the upgrading of the monetary policy framework to make it suitable for the new environment. In particular, when external inflows under current and capital account cannot provide adequate liquidity, the central bank needs to adjust the size of their own balance sheet to manage the liquidity in the banking sector. Under such a circumstance, the use of traditional quantitative policy tools could have strong knock-on effects on financial markets and even lead to financial instability. Therefore, the authorities are in need of an efficient price tool of monetary policy, such as to seek the unification of the previous “dual track” interest rate system (to combine the money market rate DR007 and the benchmark lending rate). (See our previous Economic Watch: Putting the final piece into the new monetary policy framework: timing is the key)

Second, the combination of “deficit current account” and “two-way fluctuation of capital account” makes it challenging to maintain RMB exchange rate stability. The shrinking of current account, mainly led by a declining trade surplus, together with a fluctuating capital account, will give more uncertainties to China’s foreign reserve. Under this circumstance, given that foreign reserve has been always a powerful weapon for the PBoC to maintain exchange rate stability, Chinese authorities might need to develop more new tools to maintain RMB stability instead of depending heavily on foreign reserve to intervene RMB exchange rate market.

Third, the change of BOP also makes it difficult to press ahead capital account liberalization. Capital account liberalization has been long-lasting in China’s financial liberalization reform agenda. Although many economists believe that further opening-up China’s capital account to attract capital inflows into China’s financial markets is one of the solutions to offset the current account shrinking, it also adds a lot of uncertainties of capital flights. For instance, the capital account opening could only absorb capital inflows when Chinese financial markets are better-performed than other financial markets but it will trigger significant capital outflows when it performs worse. That means, when the previous “twin surplus” becomes “deficit current account”, if the authorities continue to push forward to open the capital account, it might enlarge the possibility of “twin deficit”, increasing the shocks to China’s RMB exchange rate, asset prices, housing market etc.

Thus, it becomes more challenging for the authorities to make a balance between pressing ahead the capital account liberalization and maintaining domestic financial stability. Under this circumstance, the authorities might have to slow the pace of capital account opening and might revert back to capital control and other financial regulation tools.

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