

Trade Reforms and Current Account Imbalances

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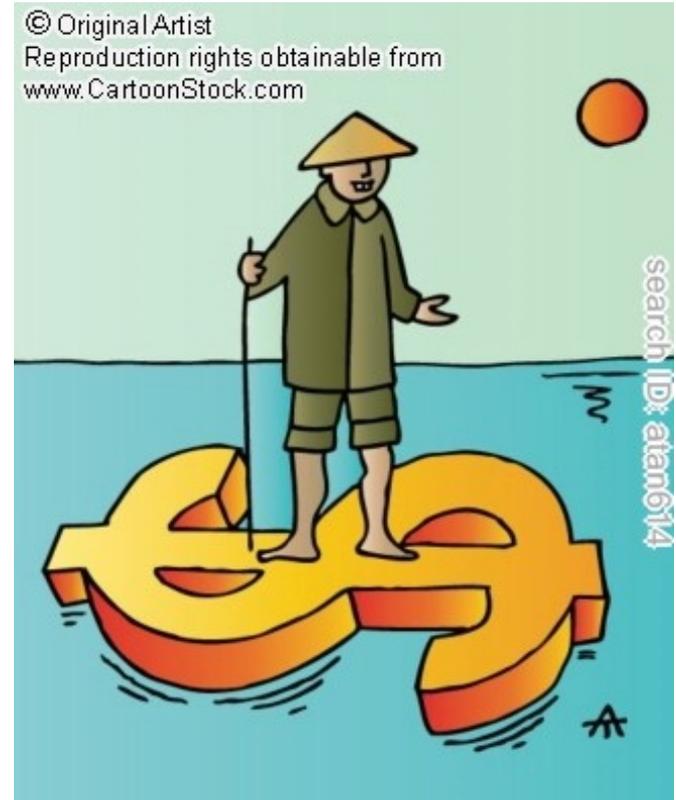
“Street Views” of China

- “China’s high growth is good”
 - Could be a major source of growth for other countries’ exports
 - Could be a source of stability for the world economy
- “China’s high current account surplus is bad”
 - “takes away our jobs”
 - A source of global current account imbalances
 - Force the financial institutions in the US to “search for the yield,” and do more risky things

Mutual hostages?

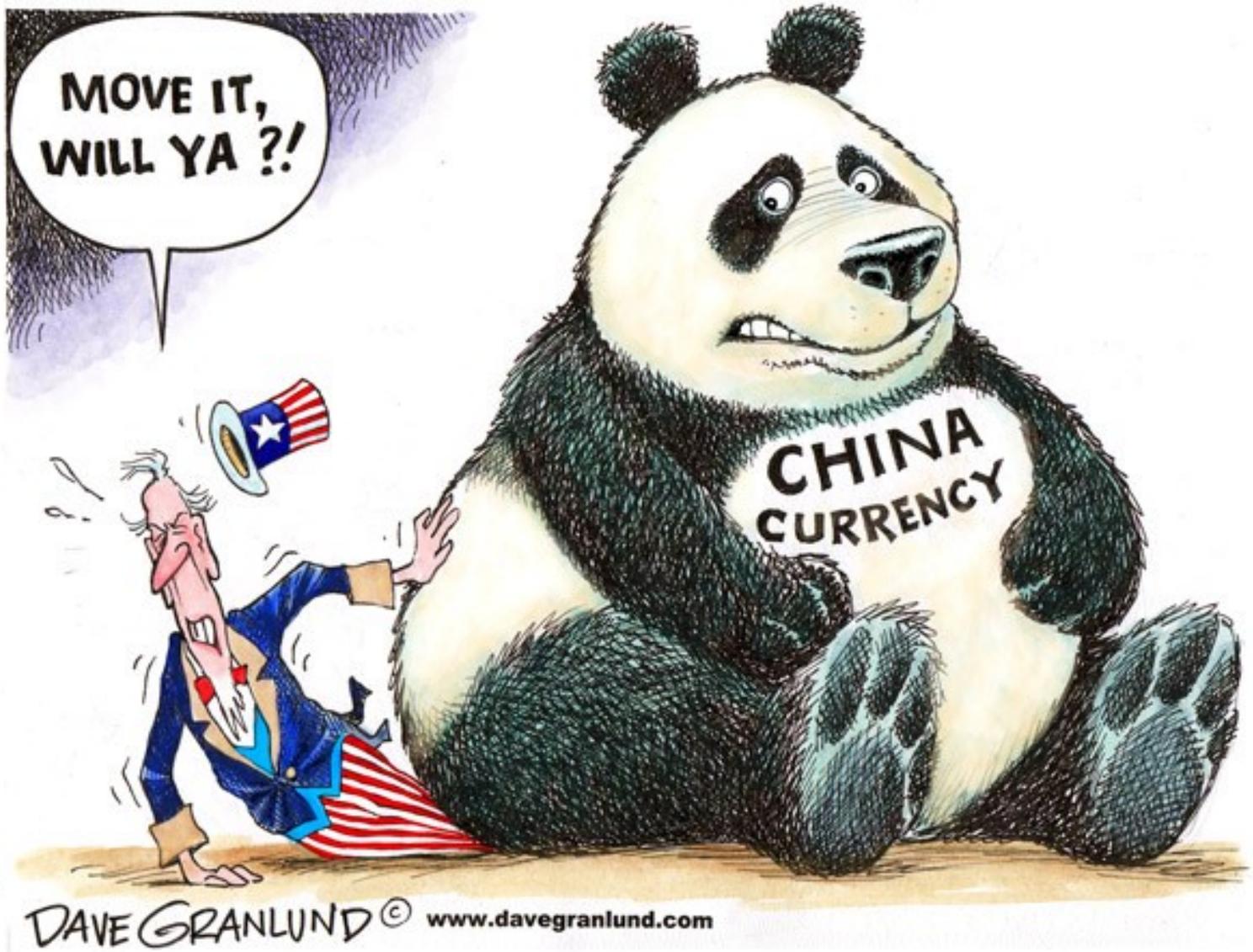


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How to reduce China's current account surplus?

- Move to a more flexible exchange rate regime
- Build a better social safety net
- Develop the financial sector
- Reduce the sex ratio imbalance
- Reduce import barriers for foreign goods



Won't work – Chinn and Wei, RESTAT, forthcoming

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- Higher sex ratios can induce an increase in both the household savings rate and corporate savings rate
- -> higher CA surplus



- Wei and Zhang (JPE2011, NBER wp16800) and Du and Wei (NBER wp 2011)

How to reduce China's current account surplus?

- Move to a more flexible exchange rate regime
 - Won't work (Chinn and Wei, Review of Economics and Statistics, forthcoming)
- Build a better social safety net
 - Less effective than many think (Bai and coauthor wp)
- Develop the financial sector
 - Less effective than many think
- Reduce the sex ratio imbalance
 - Takes a few years for the effect to show up
- Reduce import barriers for foreign goods
 - Focus of today's talk

Would further trade liberalization reduce China's current account surplus?

- The lawyer's logic:
 - If import barriers are reduced, China's imports must go up.
 - If foreign trade barriers are unchanged, this must result in a reduction in China's trade surplus and a reduction in its current account surplus.

- The lawyer's logic = partial equilibrium thinking
- The general equilibrium effect would overturn this: An export expansion triggered by trade liberalization could more than offset the increase in imports, such that the country's current account surplus could go up, not down.

- The discussion will be based
- J. Ju, K. Shi, and S.-J. Wei, 2011, “Are Trade Reforms a Source of Current Account Imbalances?”

- Important to realize trade reforms mean different things for a developing country like China versus a developed country like the United States
- For China, the import barriers (before the trade liberalization) are largely on capital-intensive goods (e.g., machine manufacturing)
- A reduction in the import barriers would lead to an increase in the imports of capital intensive goods, and a contraction of the domestic capital intensive sector

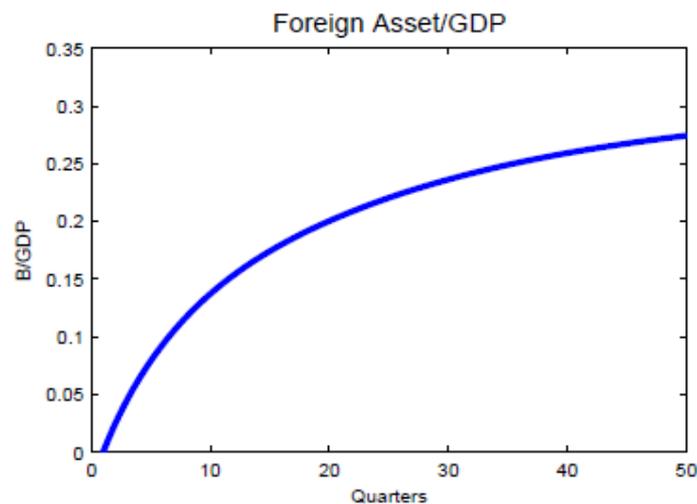
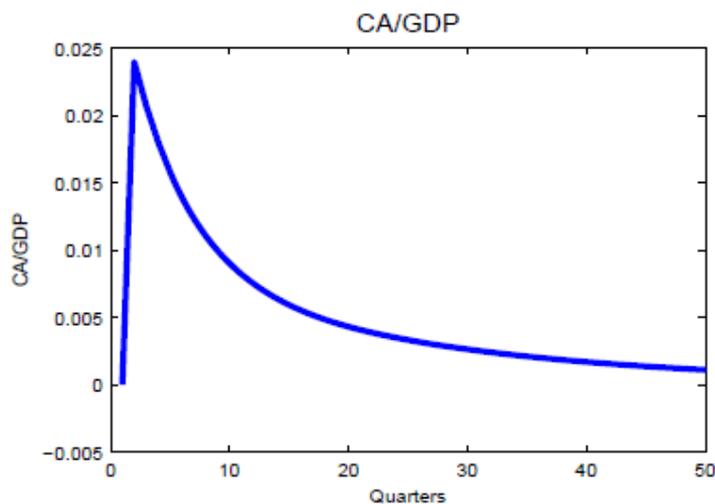
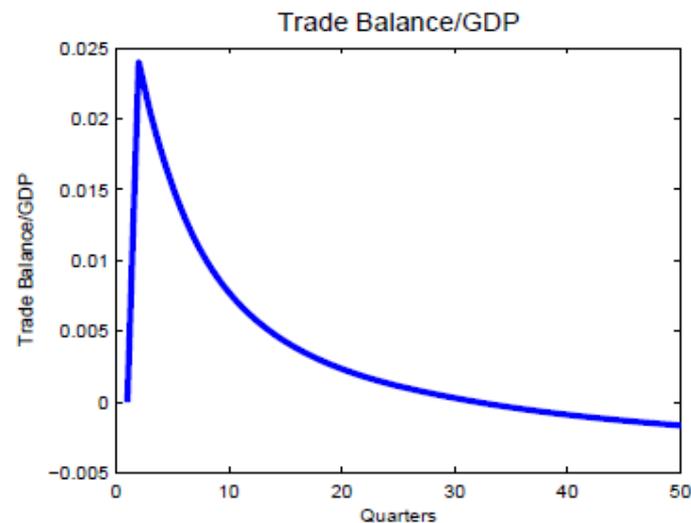
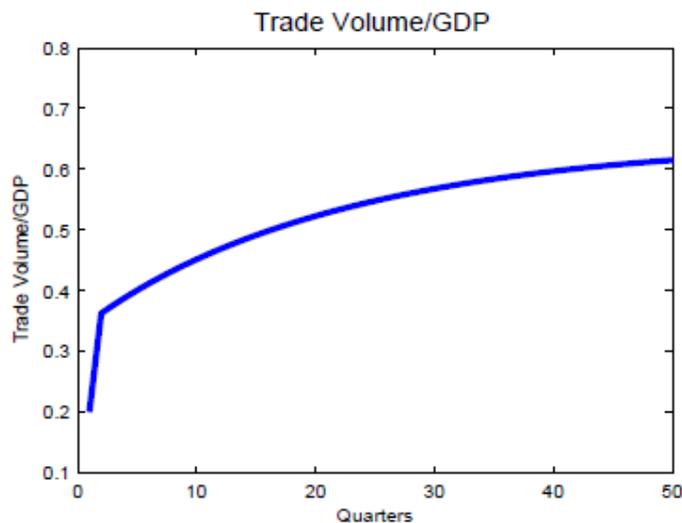
- Resources (capital, labor, etc) are released from the capital sector. But they have to go somewhere.
- Output from the labor-intensive sector (comparative advantage sector) has to expand, and the exports from the sector would also increase

- Here comes a subtle point:
- Because the expanding export sector (e.g., garments) is less capital intensive than the contracting import-competing sector (e.g., semiconductor products), in order to fully absorb all the capital (savings), the export sector has to expand by an extent greater than the increase in the imports of the capital intensive goods.
- So the current account surplus has to increase

- This can be shown more rigorously
 - Ju, Shi, and Wei 2011

When I say the export sector is more labor intensive, it would be the type of “tasks” that are exported are labor intensive

Responses to a one-time 5 percentage points cut in tariff (Calibration of the Ju, Shi, and Wei model)



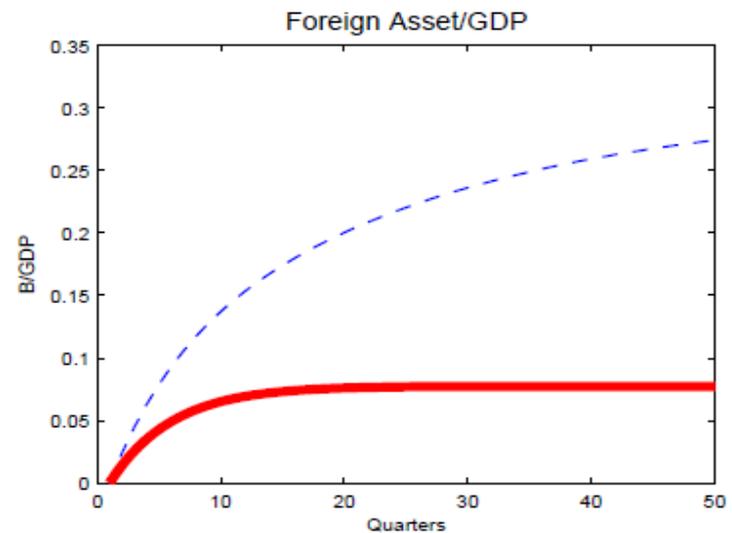
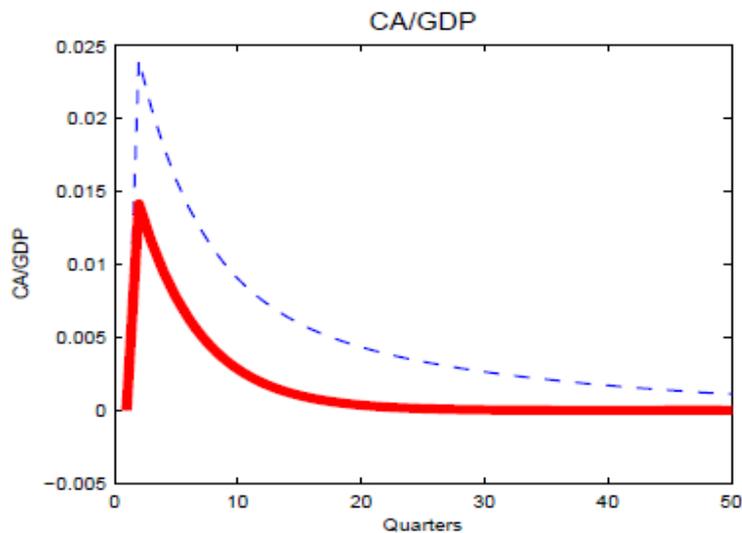
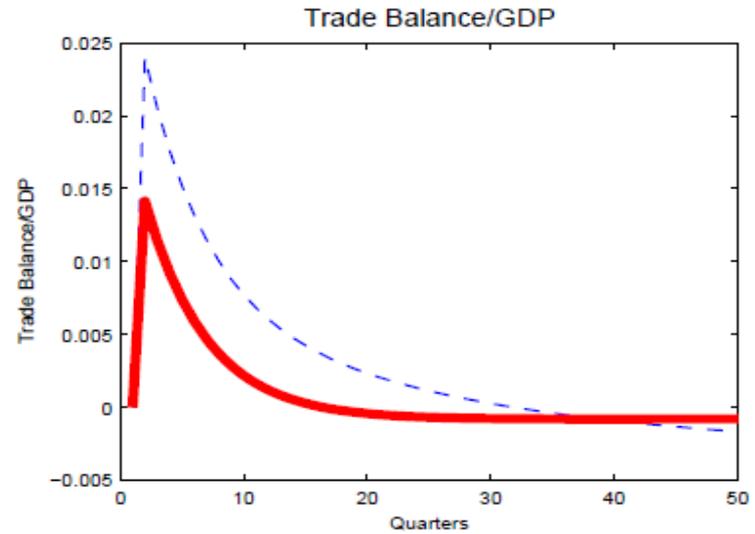
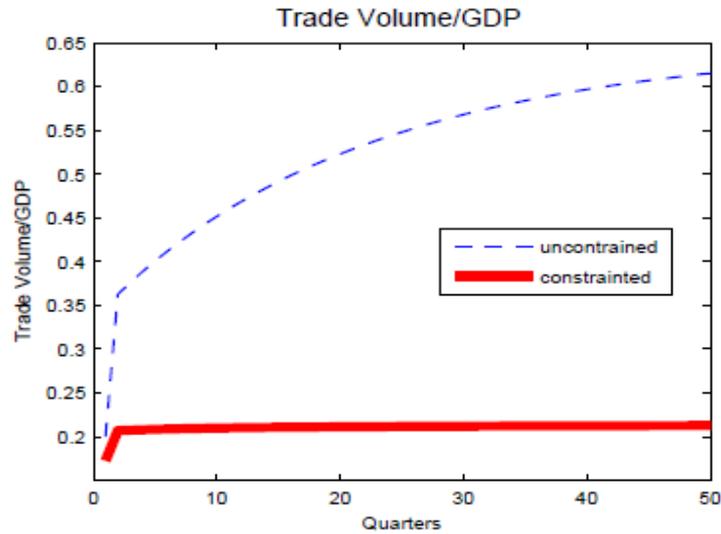
- This is not the only effect:
Trade liberalizations in a labor abundant country tends to induce relatively more technological progress in the labor intensive sector, that augments the country's existing comparative advantage
- Example from England (Walker Hanon)
- Example from China

- To summarize:
- Proposition 1: For a labor abundant country, a reduction in the import barriers on the capital intensive good, or an increase in the productivity in the labor intensive sector, would lead to an increase in the net capital outflow (and an increase in the net foreign asset position)

- Proposition 2: Factor market reforms tend to augment the current account response to a given trade reform

- Factor market frictions could slow down structural adjustment and therefore reduce the CA effect of trade reforms. For this reason, factor market reforms could enhance the CA effect of trade reforms.
- The magnitude of capital outflow due to trade liberalizations by a poor country is significantly larger without financial frictions than with credit constraints. .
- Example 1: financial sector reforms in China (2002-2007)
- Example 2: India

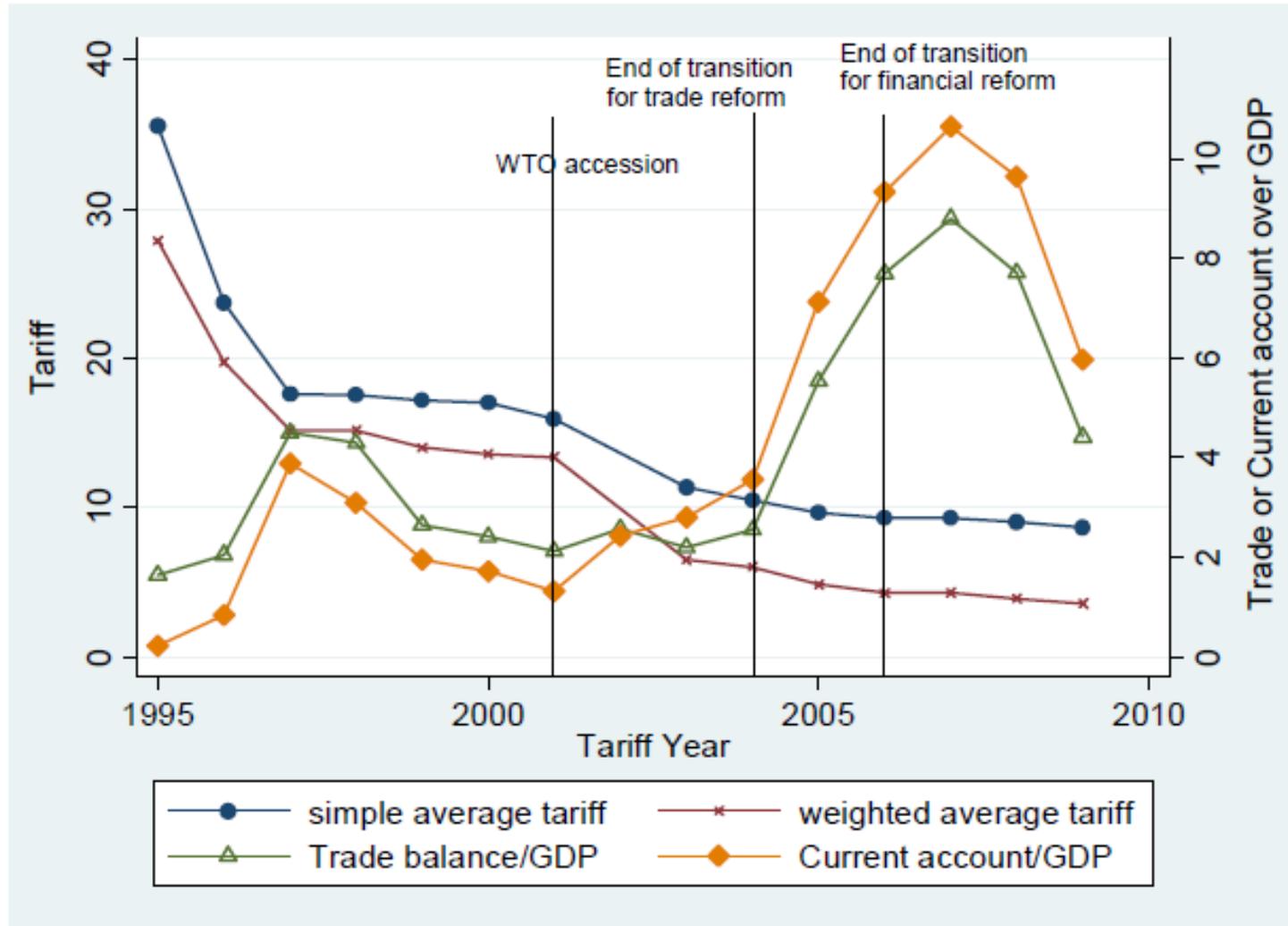
Responses to trade reforms with or without financial market frictions



Re-interpreting China's experience since 2001

- **WTO accession:**
 - Direct effects
 - Reduction in import barriers
 - Reduction in trade costs by “democratizing” trading rights
 - Financial services sector reforms
 - Indirect effects
 - Productivity growth that further reinforces China's comparative advantage
- **Contemporaneous Development**
 - End of the Multi-fiber Agreement (MFN) in 2002
 - One of the largest trade reforms for the United States
 - Also a favorable shock to China's labor-intensive sector

Demystifying China's current account surplus



Source: WITS and World bank database

- Looking forward
 - The aggressive wave of trade liberalizations are petering off
 - Chinese economic structure is going back to be more capital intensive due to the rising labor cost (but is still much less capital intensive than high-income countries)
 - The contribution of the trade reforms to the CA surplus is diminishing
- New rounds of trade reforms could again lead to an increase in the current account surplus

- Asking China to further liberalize import regime ...
- It is good for China
- But it could increase rather than decrease China's current account surplus in the short run



- Thank you!

