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Long run sustainability of current account balance of China and India: New evidence from combined cointegration test

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ABSTRACT

This paper investigates the long run sustainability of current account balance (CAB) in two fast growing emerging economies of Asia, China and India, using annual data from 1980 to 2014. Sustainability of current account balance is analyzed by examining the long run equilibrium relationship between exports and imports of goods and services. We use the Bayer-Hanck (2013) combined cointegration test to examine the long run relationship between exports and imports. The results indicate that while China has a sustainable current account balance, India's current account balance is not sustainable in the long run. Therefore, in terms of maintaining the growth momentum, India has to enhance the rate of growth of its exports while China has to maintain high levels of export growth, even in an era of sluggish global demand.

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1. Introduction

Since 2010, global sum of external imbalances has broadly remain stable with some changes in its composition. Notable changes have been in emerging Asia where India's current account deficit narrowed sharply after 2012–13 while the current account surplus of China declined over the recent years. Apart from the decline in trade balance, in China high investments since the global financial crisis of 2008 has brought down the current account surplus and there has been sizable appreciation of the real exchange rate which, currently is not undervalued. This fast decline in the trade surplus of China has important implications not only for its own growth but also for other emerging market economies. As regards to its own growth, an apparent secular deterioration in China's terms of trade and sustained increase in imports particularly in commodities and capital goods are linked to strong domestic demand relying on investments which raises concerns about domestic imbalances at a time when external imbalances are retreating. For China's trading partners in Asia, this rebalancing in China offers benefits which could be long lasting if they expand their access to Chinese markets. However, if the rapid growth of Chinese exports witness slowdown then the Asian trading partners might also have slower exports due to their supply linkages with China, which are basically downstream in nature. Thus countries with large trade exposure to China are vulnerable to a slowdown in China.

China's current account upsurges are in line with the oil trade balances. The non-oil current account is essentially stable as the effect of REER appreciation is offset by productivity gains and slower growth of domestic demand. This underscores

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the importance of oil prices in shaping external account balances of China, as current account is dominated by the impact of oil price drop which is only partly offset by related currency movements. After several years of relative stability the price of oil declined steeply in 2014. Since then oil importing economies have been enjoying the fruits of plummeting crude oil prices globally. This can help in restoring their external sector balances and moderate inflation as the prices of goods and services do not increase because of lower energy prices and transportation cost. Moreover, a reduction in the oil prices can reduce the import bills for oil importing countries, which will have a favorable impact on the trade and current account balances. Falling oil prices also can help to reduce the subsidy burden and thereby lead to cutting down the fiscal deficit, as oil is subsidized in developing economies. Thus this episode of decline in oil prices raises two important questions. First, whether the effects of falling oil prices are temporary or permanent. Second, if it is temporary, can any long term macroeconomic policy help in mitigating the cyclical effects which gets transmitted globally due to fluctuations in oil prices? This leads to an important question on the long run sustainability of the external sector balances of an economy, ensuring which, is a prerequisite for achieving stable rates of growth.

Given this background, this paper examines the sustainability of the current account balance in the two prominent emerging economies, China and India. Our motivation to examine this issue stems from the fact that China and India are fast growing economies in Asia, which is propelling global growth currently. Besides, both these countries are trading partners with voluminous bi-lateral trade between them. Though the current account of China shows surplus for a longer period of time, India's current account lies in the deficit zone for most of the years since 1980, except during 2001–2003. China is also considered as one of the main source of a perceived imbalance in global capital flows and as the mirror image of the persistent U.S. trade deficit (Hoffmann, 2013). On the other hand, India is continuously being affected by the increasing deficits in its current account, which raises questions about the financing of such deficits as India's current account deteriorated to 4.8% of its GDP in 2012–13. This was one of the major cause for the depreciation of the Indian Rupee and rapid increase in inflation. In recent years, both China and India have been prone to domestic and external shocks. China witnessed stock market crash of 8.48% on 24 August 2015, marking the biggest fall since 2007. Further the rates of growth of exports have also slowed down from 27.74% in 2010 to 3.96% in 2014. Therefore, fundamental questions are being raised about the sustainability of the external sector balances and growth of China.

This paper contributes to the existing literature by revisiting the current account sustainability in the case of two growing open economies by incorporating the recent 'domestic market' re-shaping policies of these economies. We apply structural break unit root test and combined cointegration test to examine time series properties and long run relationship between variables, respectively. The VECM Granger causality is applied to investigate the direction of the causal relationship between the variables. Although most empirical studies have used the univariate unit root testing procedures to investigate the sustainability hypothesis, there has been an increasing interest to test the sustainability hypothesis by examining the long run equilibrium relationship between the exports and imports of goods and services. Holmes, Panagiotidis, and Sharma (2011) show that the existence of the long run relationship between exports and imports is a necessary condition for current account sustainability. Further, the conventional unit root testing procedures suffer from the well-known low power, when the time series under analysis is short and/or stationary and subject to non-linear behavior (Lanzafame, 2014). Therefore, this study uses the Bayer and Hanck (2013) and the Pesaran, Shin, and Smith (2001) test of cointegration to examine the sustainability of the current account balances of China and India.

The rest of the paper is organized as follows. Section 2 reviews the literature. Section 3 presents the recent trends in exports, imports and current account balance for both China and India. Section 4 describes the model, data and methodology. Section 5 presents the results and discussion. Section 6 concludes.

2. Literature review

Implications of current account imbalances and its sustainability is an important issue in international macroeconomics. An economy's current account reflects its economic performance because of which it is considered as an important barometer for assessing growth by both policy makers and investors (Baharumshah, Lau, & Fountas, 2003). Temporary current account imbalances may arise because of the reallocation of capital to the countries that gives higher possible returns to factors of production, especially higher returns to capital (Hakkio, 1995). Such differences in returns to capital might even out in the long run and hence does not create persistent imbalances for an economy. On the other hand, large and persistent deficits in current account tends to pose serious problems and may necessitate proper policy response. More specifically, in the long run, rising current account deficits tend to depreciate domestic currency and increase the domestic interest rate as compared to foreign interest rate. This results in further increase in the volume of imports and accumulation of larger external debt which indirectly imposes greater burden on the future generations.

The intertemporal approach, developed by Sachs (1981) and latter extended by Obstfeld and Rogoff (1996), has been considered as an important theoretical development to explain whether disequilibrium in an economy's current account is sustainable in the long run or not. This approach is based on the assumptions of perfect capital mobility and the consumption-smoothing behavior. The 'sustainability hypothesis' as elucidated in intertemporal approach defines the condition under which current account imbalances are consistent with a country's intertemporal budget constraint (IBC), which can be met in the long run without any drastic corrections (Lanzafame, 2014). While non-stationary current account does not necessarily violate the IBC (Bohn, 2007; Quintos, 1995), stationarity can be considered as the sufficient condition for the sustainability of the current account.

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