The Economist

China's current-account surplus

Incredibly Misleading Forecasts?

How not to predict one of the world's most sensitive numbers

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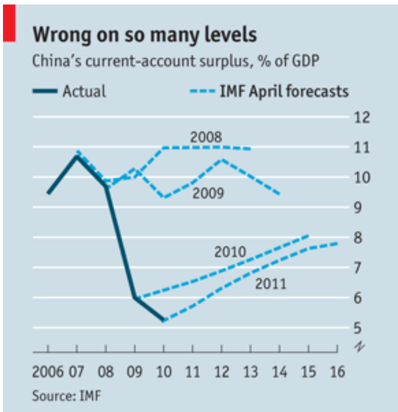
THE leaves of the compass plant always point north. The International Monetary Fund has developed a similar trait. Over the past four years, in successive editions of its "World Economic Outlook", the fund has forecast that China's current-account surplus would widen over the next five years, or at least remain constant. Instead the surplus has consistently fallen, from 10.6% of GDP in 2007 to 5.2% last year (see chart). Undeterred, in its latest forecast the IMF says that China's surplus will rise to 6.8% of GDP in 2013 and almost 8% by 2016.



Wrong on so many levels
China's current-account surplus, % of GDP
Source: IMF

The decline in China's surplus is partly due to the slump in its exports caused by the unexpectedly deep recession in rich economies. Could this explain the IMF's overshooting? Not really: the IMF was wider of the mark than most forecasters. In April 2009, when it predicted a surplus of 9.3% of GDP for 2010, the average forecast of five investment banks was 6% of GDP.

The IMF may have been too pessimistic about growth in China's domestic demand (and hence its imports), but a bigger problem is the exchange rate it uses. The fund always assumes that real trade-weighted exchange rates remain constant, and because China has higher inflation than America this has often implied a depreciation in its nominal exchange rate. (The IMF does not actually spell out its forecast for the yuan but this can be calculated by dividing GDP in yuan terms by dollar GDP.) For example, its latest forecast implicitly assumes that the yuan will weaken to an average rate of 7.04 to the dollar in 2013 from a current rate of 6.53. Most forecasters assume a further appreciation against the dollar. Paul Cavey at Macquarie has pencilled in a rate of 5.8 yuan to the dollar for 2013, for example, when he expects the current-account surplus to be 3.6% of GDP.

Since 2007 the yuan's real trade-weighted value has not been constant, as the IMF always assumes, but has risen by 15-20%, helping to trim China's surplus. A forecast which assumes that the yuan steadily depreciates against the dollar seems unrealistic. Yet by predicting a widening current-account surplus in China, the IMF provides respected fodder for protectionists who want to slap tariffs on Chinese goods. The fund badly needs a new compass.

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