

BOFIT Discussion Papers  
25 • 2013

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current account imbalances



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BOFIT Discussion Papers  
Editor-in-Chief Laura Solanko

BOFIT Discussion Papers 25/2013  
4.9.2013

Jiandong Ju, Kang Shi and Shang-Jin Wei: Trade reforms and current  
account imbalances

ISBN 978-952-6699-37-0

ISSN 1456-5889 (online)

This paper can be downloaded without charge from <http://www.bof.fi/bofit>.

Suomen Pankki  
Helsinki 2013

# Trade Reforms and Current Account Imbalances

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Current Version: September 2013

## Abstract

In partial equilibrium, a reduction in import barriers may be thought to lead to an increase in imports and a reduction in trade surplus. However, the general equilibrium effect can go in the opposite direction. We study how trade reforms affect current accounts by embedding a modified Heckscher-Ohlin structure and an endogenous discount factor into an intertemporal model of current account. We show that trade liberalizations in a developing country would generally lead to capital outflow. In contrast, trade liberalizations in a developed country would result in capital inflow. Thus, efficient trade reforms can contribute to global current account imbalances, but these imbalances do not need policy “corrections”.

**JEL Classification Numbers:** F3 and F4

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# 1 Introduction

This paper proposes a framework for studying the effect of trade reforms and factor market reforms on current accounts (or international capital flows). The theory embeds both a Heckscher-Olin structure (two sectors with different factor intensities) and an endogenous discount factor in the spirit of Uzawa (1968) into a dynamic intertemporal open-economy model. In such a model, reductions in import barriers by a labor abundant economy generates a current account surplus, which is exactly the opposite of the usual partial equilibrium intuition (that lower import barriers should reduce the trade balance and worsen the current account). On the other hand, reductions in import barriers by a capital abundant country tends to generate a current account deficit, which goes in the same direction as the partial equilibrium intuition. In addition, a country that engages in factor market reforms together with trade reforms is expected to produce a greater current account response than a country that does only trade reforms.

The theory has some novel implications for understanding the so-called global current account imbalances, which have exhibited a rapid rise since 2002. The notable features of the imbalances include a surge in China's current account surplus from a modest 2% of GDP in 2002 to over 14% in 2007, and a surge in the US current account deficit from about 3% to about 7% during the same period. This has generated anxiety and calls for measures to "correct" the imbalances. At the same time, world trade, measured as the ratio of imports plus exports over GDP has grown five times in real terms since 1980. In particular, the ratio of imports and exports to GDP in low income countries has increased from about 20% in 1990 to more than 40%, and the average tariff rate in low income countries has declined from about 60% to 15%. Interestingly, both the Chinese surplus and the US deficit started to narrow after 2007. Our theory suggests that both trade liberalizations and factor market reforms in China (as prompted by its accession into the World Trade Organization at the end of 2001) and the end of Multifibre Agreement in the United States in 2005 may have played a role in both the initial rise in the current account imbalances and the subsequent fall of the imbalances. By this perspective, instead of being driven by underlying distortions in an economy, current account imbalances can arise as an equilibrium response to welfare-improving trade reforms. Therefore, not all current account imbalances need

policy corrections.

We highlight some relevant features of the Chinese economy by Figure 1, which traces out the trajectory of its trade-weighted average tariff rate and that of its current account balance from 1998 to 2010. The current account balance (as % of GDP) was very mild before 2002, but started to rise noticeably afterwards until 2007 when it began to fall. The average tariff rate was as high as 14% before 2002 (with tariff rates on some individual goods in excess of 50%) but declined rapidly to close to a more modest 5% by 2004 and stayed that low afterwards.

We use a first vertical broken line to denote the time of China's formal accession to the World Trade Organization (which took effect in December of 2001). The accession protocol dictates a long list of trade reforms that China has to implement, many of which have a time table of up to three years. We use a second broken line in 2004 to mark the end of most of the trade reforms required of China. The WTO accession requires more than just reforms in the product market. A slew of factor market reforms, especially in the financial sector, were embedded in the accession protocol as well. Many of the financial sector reforms, such as the opening of the commercial and investment banking business to foreign financial institutions, were supposed to be completed by December 2006. By the end of 2006, the share of lending that was conducted by banks outside the traditional top-4 state-owned banks had gone up substantially. Both venture capital and private equity markets have developed. Overall, access to finance by private firms, while still less than perfect, has improved measurably. We use a third vertical line in 2006 to mark the end of important financial sector reforms required of China as part of its WTO membership. We mark the dates of both the trade reforms and the financial sector reforms because we will argue that both affect the patterns of the current account.

Does China's WTO entrance contribute to the jump in its current account surplus? One's first reaction may be no. The WTO accession requires China to reduce its import barriers without corresponding changes in its trading partners' import barriers. Shouldn't that lead to a rise in China's imports and therefore a fall in China's trade surplus? However, that reaction represents a partial equilibrium intuition. The general equilibrium effect could be very different. It is important to note that China's import competing sectors are likely

to be more capital intensive than its export sectors. A reduction in the import barriers on the capital-intensive good tends to reduce the domestic return to capital, all else equal. This is the intuition one gets from the Stolper-Samuelson theorem in classical (and static) trade theory. If the pre-liberation return to capital was equal to the world interest rate, the import liberalization upsets the equilibrium. To restore equilibrium, the country must export capital (i.e., run a current account surplus) until the domestic return to capital rises to the pre-liberalization level. This heuristic explanation takes savings as given. Of course, savings would be endogenous in a dynamic model. The first key objective of this paper, therefore, is to develop a dynamic model and clarify when this general equilibrium effect can happen.

It is important to note that trade liberalizations would generally induce an opposite current account response in a high-income (or capital abundant) country. Reductions in trade barriers in a capital-abundant country tend to raise the return to capital by the logic of the Stolper-Samuelson theorem. To restore the equilibrium, the country would attract a capital inflow, i.e., creating a current account deficit.

Factor market frictions could affect the current account response to trade reforms by blocking or slowing down structural transformations. The second key objective of this paper is to study interactions between trade reforms and factor market frictions. We find that factor market frictions tend to mitigate the effect of trade reforms on current account. This suggests that trade reforms in conjunction with factor market reforms, as was the case with China during 2002-2006, are likely to produce a greater current account response than without factor market reforms.

By coincidence, the quotas on many textile and garment products imposed by the United States and a subset of other high income countries through the Multifibre Agreement (MFA) were phased out by the end of 2004, and Chinese textiles and garment producers turned out to be one of the largest beneficiaries. Over a short space of a single year from 2004 to 2005, Chinese exports of the previously quota-constrained products grew by 119%, substantially faster than the average annual growth rate of 17% during 2000-2004 (Khandelwal, Schott, and Wei, forthcoming). Under our theory, this reduction in barriers to China's labor intensive exports would also lead to a reduction in the domestic return to capital. To restore

equilibrium, China would exhibit a surplus in its current account and export its capital. Given China's size, the rest of the world has to have a matching current account deficit. Moreover, the end of MFA also represents one of the most significant trade liberalizations for the United States (and to a lesser extent, the European Union) in recent years. This, by itself, could generate a current account effect for these countries. If the United States has a more flexible labor market than the European Union, our theory would predict that the effect is stronger for the United States.

Of course, this theory is not specifically about China or the United States. Instead, it is intended as a general framework for thinking about capital flows and current account responses to trade reforms. If a trade reform reduces a country's capital intensity, our framework suggests that the country is likely to experience a net capital outflow. On the other hand, if a trade reform increases a country's capital intensity, the opposite pattern on capital flows is expected to happen. In addition, if a trade reform is conducted in conjunction with factor market reforms, one should expect to see a bigger current account response than if the trade reform is done in isolation. These are general messages not specific to any particular country.

This paper is related to several papers on the cause of global current account imbalances. Caballero, Farhi, and Gourinchas (2008) and Mendoza, Quadrini, and Rios-Rull (2009) highlight the role of difference in financial development. Countries with a relatively low financial development (e.g., China) cannot produce enough financial assets at home to absorb all the savings. As a result, they have to export part of their savings to countries with better financial development (e.g., the United States). As a result, countries like China run a current account surplus, and countries like the United States run a deficit. Song, Storesletten and Zilibotti (2011) also feature the role of financial imperfections in China in generating its current account surplus. It stresses the inability of productive domestic private firms to borrow from the formal financial sector as key financial sector frictions. As the share of these firms grows in the economy, so does the country's current account surplus. In both sets of papers, when China's financial market develops (including improvement in access to finance by private firms), the country's current account surplus should decline rather than increase. This appears to be the opposite of what one observes in the data.

Our theory in this paper will suggest that factor market reforms such as improvements in the financial market will reinforce the effect of trade liberalization on the current account.

A different theory about the rise of current account imbalances is given by Du and Wei (2010), which suggests that a rise in the relative surplus of men in China since 2002 may have triggered a competitive race to raise household savings by families with a son. As the sex ratio deteriorates progressively, the faster rise of the savings rate than that of the investment rate produces a progressively larger current account surplus since 2002. Wei and Zhang (2011) provide empirical evidence that suggests that higher sex ratios may explain about 50% of the increase in Chinese household savings from 1990 to 2007. While this paper also has implications for understanding Chinese current account surplus (and global current account imbalances in general), the underlying mechanism is very different. Logically, these explanations (financial development, sex ratio imbalance, and trade reforms) can be compatible with each other, and collectively generate the type of current account imbalances that we see in the data. While all these papers suggest that current account imbalances can arise without exchange rate manipulations, they also have somewhat different policy implications. Both financial under-development and sex ratio imbalance can be thought of as distortions that can and should be corrected by targeted policy interventions, trade liberalizations are efficient policy changes per se, and do not require another policy to offset them.

A few papers have examined the empirical relationship between trade reforms and current account such as Ostry and Rose (1992) and Ju, Wu, and Zeng (2010). They generally find that the relationship is ambiguous. Our model provides a natural explanation: the effect of the current account response to trade reforms depends on whether a given change in trade policy leads to a rise or a fall in economy-wide capital intensity, and also on the nature of domestic factor market frictions. When one mixes different types of trade policy changes in a sample, and disregards factor market features, it is not surprising to find an ambiguous effect.

In terms of modeling methodology, our paper is related to a small but growing literature that considers multiple tradable sectors with different factor intensities in a general equilibrium framework. These papers include Cunat and Maffezzoli (2004), Ju and Wei (2007),

Jin (2012), Jin and Li (2012), and Ju, Shi and Wei (2011). None of the existing papers in this literature explicitly studies the effect of trade liberalizations on current account. (None of them introduces an endogenous discount factor to address a problem of interest rate over-determination.) As a result, existing papers do not link the patterns of global current account imbalances to China's WTO accession, the end of MFA quotas and other trade reforms.

The paper is organized as follows. Section 2 reports some suggestive empirical patterns. After a basic model is presented in Section 3, the effects of trade reforms on the current account and other macroeconomic variables are derived in Section 4. The interactions between factor market flexibility and trade reforms are discussed in Section 5. Finally, concluding remarks are offered in Section 6.

## **2 Suggestive Empirical Patterns**

Before we present a formal model, it is useful to have more stylized facts beyond the China example. To this end, we examine the current account experience of all countries that have experienced a major trade policy change in the last two decades. More precisely, we adopt a two-step procedure. First, we identify episodes of large trade policy changes for all countries since 1990 (for which the relevant data are available). Second, for each country in this sample, we measure changes in the country's capital intensity and examine its relationship with changes in the country's current account.

We define a trade reform episode as one that simultaneously satisfies two criteria: (a) there is a reduction in the country's average tariff rate (either the simple-weighted tariff or the trade-weighted tariff) by 3 percentage points or more in one or two years; and (b) there is an increase in the country's imports-to-GDP ratio by 3 percentage points any time in the first, second or the third year after the tariff reduction relative to the ratio in the year before the tariff change.

Some trade reforms may result in a decline in the country's capital intensity in its production, while others may produce an increase in capital intensity. Our theory suggests that the current account consequence of trade reforms may differ in these two cases. We now perform a simple check on whether, following a major trade policy change, the change

in a country's current account pattern is systematically related to the change in its capital intensity.

It is relatively straightforward to measure current account (as a percent of GDP) and its change. How do we measure a change in capital intensity? Our approach is to measure the capital intensity of the country's export structure before and after the trade policy change. (Ideally, we would like to measure the capital intensity of the country's entire production structure, but we do not have as good data on the sector-level production as that on sector-level exports.) We do it in two steps. First, we use the 2002 US Standard Make and Use Tables (from the US Bureau of Economic Analysis) to compute capital intensity for each HS 6-digit sector. Second, for a given country in the sample in any given year, we can compute the average capital intensity of its export bundle. Our maintained assumption is that the capital intensity of a sector is a technological feature that does not change across countries. (Actually what we need is a somewhat weaker assumption: the ranking of sectors in terms of capital intensity, rather than the absolute values of capital intensity, is highly correlated across countries.)

There are 38 episodes, involving 31 distinct countries, that satisfy the criteria to qualify as trade reforms. Unfortunately, 8 of the episodes involve missing data on either trade intensity (Bangladesh 2007, Bhutan, Lesotho, Pakistan, Philippines, Syria, Zimbabwe) or current account (Lebanon). Two episodes appear to be obvious outliers (Belize and Guyana) whose changes in trade composition are substantially bigger than other country-episodes. A list of the 38 trade reform episodes is provided in Table 1. A \* is affixed to the country episodes if we also have the relevant data on current account and capital intensity that are not obvious outliers. There are 28 country episodes that receive a \*.

We present a simple scatter plot in Figure 2 of changes in current account (as a share of GDP) against changes in capital intensity. A negative relationship between the two variables is visible, and is not driven by any obvious outlier. On average, a trade policy change that leads to a reduction in the capital intensity of the economy tends to be followed by an improvement in the current account balance.

We then perform the following simple regression:

$$\Delta\left(\frac{CA_j}{GDP_j}\right) = \alpha + \beta\Delta k_j + \theta X_j + \varepsilon_j \quad (2.1)$$

where  $\Delta\left(\frac{CA_j}{GDP_j}\right)$  and  $\Delta k_j$  represent the change in country  $j$ 's current account to GDP ratio, and the change in the average capital intensity of its export bundle, respectively, while  $X_j$  are other control variables such as the change in the real exchange rate. In Column 1 of Table 2, we report the basic regression result. The regression shows a negative and statistically significant relationship between the change in capital intensity and change in current account. The coefficient of course simply captures the slope of the fitted line in Figure 2. In other words, in episodes in which a trade policy change has led to a decline in the capital intensity of the country's exports (e.g., China after the WTO accession in 2002-2003), the current account balance tends to go up. Conversely, in episodes in which a trade policy change has led to an increase in capital intensity (such as India during 2005-2008), the current account balance tends to deteriorate.

In Column 2, we add the change in country  $j$ 's real exchange rate over the same period of the trade policy change as a control variable. Because we do not have information on price level (or inflation) for several countries in the sample, the regression sample is greatly reduced to only 13 countries. In any case, the coefficient on the real exchange rate is negative and statistically significant, suggesting that a rise in the real exchange rate tends to be associated with a decline in a country's current account. More importantly, we continue to find a negative coefficient on capital intensity: a rise in a country's capital intensity tends to be associated with a deterioration of its current account.

Because of the small sample size, we are not able to have many control variables. We also do not investigate potential endogeneity of the regressors. We therefore treat the empirical pattern as suggestive rather than definitive. In the rest of the paper, we provide a theory of current account response to trade policy changes that is consistent with this pattern in the data.

### 3 The Basic Model

Our model, in a nutshell, marries a Heckscher-Ohlin structure (with two tradable sectors of different factor intensities) and a small open-economy intertemporal framework. Importantly, we also incorporate a version of an endogenous discount factor (EDF) following Uzawa (1968), Obstfeld (1982), Mendoza (1991), Uribe (1997), Schmitt-Grohe (1998), and Choi, Mark, and Sul (2008), among others. The EDF has a built-in “keeping-up-with-the Joneses” feature - an economic agent tends to become more patient when others in the economy are more patient, and vice versa. Philosophically, this strikes us as having captured a realistic feature of the world that is especially relevant when it comes to topics related to savings and consumption.

Conveniently, the notion of an endogenous discount factor also helps us address an inherent tension between the classic HO trade model and the standard intertemporal framework, which is the problem of interest rate over-determination. In the standard intertemporal model of current account, the interest rate in the steady state is determined by the time discount factor from the demand side. In the HO model, if the economy is within the diversification cone, the interest rate is determined by the zero profit conditions from the supply side (i.e., the interest rate and the wage are completely determined by goods prices). In general, the two interest rates from the two approaches would not be the same except by coincidence. Even assuming the two are the same initially, a permanent shock such as trade liberalization would cause the two implied interest rates to diverge again. This problem was raised by Stiglitz (1970) when he shows that, in a dynamic HO model, unless two countries have identical discount factors one country must specialize. Once we have an endogenous discount factor, the problem of interest rate over-determination disappears. In that case, the interest rate is determined by the zero profit conditions in the HO model. For any given interest rate, through endogenous discount factor, the total consumption in the steady state is then determined.

Note that the usual motivation for an endogenous discount factor in a dynamic open-economy model is either to make the steady state different from initial conditions or to make the current account adjustment more persistent. We assume an endogenous discount factor because we find it both philosophically attractive in capturing a realistic feature of the

world and technically useful in addressing the problem of interest rate over-determination.

To complete our framework, we also have to address another technical challenge. In particular, the standard Heckscher-Ohlin model imposes a balanced trade assumption, which rules out capital flows and non-zero current account. To have a meaningful discussion of current account changes, we abandon the (unrealistic) restriction on balanced trade. But this raises a different issue, namely, capital flows and goods trade are perfect substitutes in the absence of any frictions, as was pointed out by Mundell (1957). In other words, the HO structure without the balanced trade assumption has inherently multiple equilibria. (Or the balanced trade assumption is a particular way to select an equilibrium out of infinite many possibilities.) To avoid multiple equilibria, we follow Neumeyer and Perri (2005) and Schmitt-Grohe and Uribe (2003) to assume convex costs of adjusting the international asset position.

Convex adjustment costs for international asset position can also make the steady state independent of initial conditions. In our context, this assumption helps to address the technical challenge of multiplicity of equilibria. With linear costs of trade in goods and/or capital, corner solutions occur: either goods trade or capital flow takes place, but the two do not coexist.<sup>1</sup> Once we assume convex costs of adjusting international asset position, we can pin down equilibrium capital flows and current account. In an extension of the model when we introduce costs of adjustment of labor and capital across sectors, the multiple equilibria problem is resolved as well.

### 3.1 Household

The economy is inhabited by a continuum of identical and infinitely lived households that can be aggregated into a representative household. The representative household's preference over consumption flows is summarized by the following time-separable utility function

$$U = \sum_{s=t}^{\infty} \theta_s U(C_s) \tag{3.2}$$

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<sup>1</sup>For more detailed discussions on this point, readers are guided to Ju and Wei (2007).

where  $C_s$  is the household's consumption of a final good at date  $s$ , and  $\theta_s$  is the discount factor between period 0 and  $s$  as given by

$$\theta_{s+1} = \beta(\tilde{C}_s, \tilde{Y}_s)\theta_s, \quad s \geq 0 \quad (3.3)$$

where  $\theta_0 = 1$  and  $\frac{\partial \beta(\tilde{C}_s)}{\partial \tilde{C}_s} < 0$  and  $\frac{\partial \beta(\tilde{Y}_s)}{\partial \tilde{Y}_s} > 0$ . We assume that the endogenous discount factor does not depend on the household's own consumption and income, but rather on the economy-wide average per capita consumption  $\tilde{C}_s$  and income  $\tilde{Y}_s$ , which the representative household takes as given.<sup>2</sup> The exact functional form of  $\beta(\tilde{C}_s, \tilde{Y}_s)$  will be presented later. The household owns both factors of production, capital  $K$  and labor  $L$ . For simplicity, we assume a fixed labor supply.

The final good is produced by combining two intermediate goods. Each intermediate good is produced by combining capital and labor. The household supplies labor to both intermediate good sectors through a competitive spot market. In the benchmark model, both labor and capital are assumed to be freely mobile across sectors. Factor market frictions will be discussed later. The household can hold foreign asset  $B_t$  to smooth consumption. Following Neumeyer and Perri (2005), we assume that trade in foreign bonds is subject to small and convex portfolio adjustment costs. If the household holds an amount  $B_{t+1}$ , then these portfolio adjustment costs, denominated in units of the final good, are  $\frac{\psi_b}{2}(B_{t+1} - \bar{B})^2$ ,<sup>3</sup> where  $\bar{B}$  is an exogenous capacity level of foreign asset management. For simplicity, we assume  $\bar{B} = 0$ .

Therefore, the budget constraint and the capital accumulation equation faced by the representative household are given, respectively, by

$$\begin{aligned} & P_t \left[ C_t + \frac{\psi_b}{2} (B_{t+1} - \bar{B})^2 \right] + B_{t+1} + I_t \\ = & w_t L + r_t K_t + (1 + r^*) B_t + T R_t \end{aligned} \quad (3.4)$$

$$K_{t+1} = (1 - \delta) K_t + I_t - \frac{1}{2} \psi_k \left( \frac{I_t}{K_t} - \delta \right)^2 K_t \quad (3.5)$$

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<sup>2</sup>This preference specification was pioneered by Uzawa (1968) and applied to the small open economy literature by Obstfeld (1982) and Mendoza (1991).

<sup>3</sup>As in Schmitt-Grohé and Uribe (2003), these portfolio adjustment costs eliminate the unit root in the economy's net foreign assets.

where  $I_t$  is investment in period  $t$ , and  $w_t$  and  $r_t$  are the wage and the domestic return to capital, while  $r^*$  is the world interest rate.  $\delta$  is the capital appreciation rate and  $\psi_k$  is the aggregate capital adjustment cost coefficient. The tariff revenue,  $TR_t$  is rebated in a lump sum to the representative consumer, which is taken as exogenous by the consumer.<sup>4</sup>

The first order conditions with respect to  $C_t$ ,  $I_t$ ,  $K_{t+1}$ , and  $B_{t+1}$ , give intertemporal and intra-temporal optimization conditions

$$\frac{U'_c(C_t)}{P_t} = \Omega_t \quad (3.6)$$

$$\Lambda_t(1 - \psi_k(\frac{I_t}{K_t} - \delta)) = \Omega_t \quad (3.7)$$

$$\Lambda_t = \beta(\tilde{C}_t, \tilde{Y}_t) \left[ \Lambda_{t+1} \left( 1 - \delta + \frac{\psi_k}{2} \left( \frac{I_{t+1}}{K_{t+1}} - \delta \right) \left( \frac{I_{t+1}}{K_{t+1}} + \delta \right) \right) + \Omega_{t+1} r_{t+1} \right] \quad (3.8)$$

$$\Omega_t [1 + \psi_b P_t (B_{t+1} - \bar{B})] = \beta(\tilde{C}_t, \tilde{Y}_t) [\Omega_{t+1} (1 + r^*)] \quad (3.9)$$

where  $\Omega_t$  and  $\Lambda_t$  are Lagrange multipliers for the budget constraint and the law of motion for capital, respectively.

### 3.2 Production

The production function for the final good is  $D_t = G(D_{1t}, D_{2t})$ , where  $D_{it}$  is the usage of intermediate good  $i$  by the final good producer. The production function for the intermediate good  $i (= 1, 2)$  is  $X_{it} = f_i(A_{it}L_{it}, K_{it})$  where  $A_{it}$  measures labor productivity.  $H_{it} = A_{it}L_{it}$  can be understood as units of *effective labor*. All production functions are assumed to be homogeneous of degree one.  $D_{it}$  and  $X_{it}$  can differ due to international trade.

The unit cost function for  $X_{it}$  is  $\phi_i(\frac{w_t}{A_{it}}, r_t)$ . Let  $P_i$  be the domestic price of intermediate good  $i$ . We assume that the country's endowment is always within the diversification cone so that both intermediate goods are produced. In each period  $t$ , free entry and zero profits in both the intermediate good and the final good markets imply that

$$P_{1t} = \phi_1\left(\frac{w_t}{A_{1t}}, r_t\right), P_{2t} = \phi_2\left(\frac{w_t}{A_{2t}}, r_t\right) \quad (3.10)$$

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<sup>4</sup>See Devereux and Lee (1999) for a similar assumption.

$$P_t D_t = P_t G(D_{1t}, D_{2t}) = P_{1t} D_{1t} + P_{2t} D_{2t} \quad (3.11)$$

### 3.3 Equilibrium

In equilibrium, trade in intermediate goods equalizes (tariff-inclusive) good prices between the home country and the rest of the world in every period. Without loss of generality, we assume that sector 1 is labor intensive while sector 2 is capital intensive. Considering a labor abundant country which exports labor intensive good 1, we have:

$$P_{1t} = P_{1t}^*, \quad P_{2t} = (1 + \tau)P_{2t}^*, \quad (3.12)$$

where  $P_{it}^*$  denotes the world price and is exogenously given, and  $\tau$  is the import tariff. Following the standard assumptions in the Heckscher-Ohlin model, we assume that production functions (and unit cost functions) in all countries are the same (although labor-augmenting productivity can be different). Therefore, in the foreign country we also have:

$$P_1^* = \phi_1\left(\frac{w^*}{A_1^*}, r^*\right), \quad P_2^* = \phi_2\left(\frac{w^*}{A_2^*}, r^*\right) \quad (3.13)$$

For simplicity, we assume that the rest of the world is in steady state so the return to capital,  $r^*$ , is a constant. We will leave out the time subscript for all foreign variables from now on. We have the following market clearing conditions in the home country

$$K_t = K_{1t} + K_{2t} \quad (3.14)$$

$$L_t = L_{1t} + L_{2t} \quad (3.15)$$

$$D_t = C_t + \frac{I_t}{P_t} + \frac{\psi_b}{2}(B_{t+1} - \bar{B})^2 \quad (3.16)$$

Equation (3.16) implies that the final good is used not only for consumption and investment, but also for covering the costs of adjusting the international asset position. The current account balance over period  $t$  is defined as  $CA_t = B_{t+1} - B_t$ ; thus, noting that  $P_{it}X_{it} = w_tL_{it} + r_tK_{it}$  and using equations (3.11) and (3.16)), we can rewrite the budget constraint as

$$CA_t = P_{1t}^*(X_{1t} - D_{1t}) + P_{2t}^*(X_{2t} - D_{2t}) + r^*B_t \quad (3.17)$$

That is, the current account balance is equal to the trade balance (evaluated at the world prices) plus the interest income from the net foreign asset position. For future reference, we define the gross domestic product as  $Y_t = \frac{P_1 X_{1t} + P_2 X_{2t}}{P_t}$ .

## 4 Equilibrium Analysis

To study the equilibrium explicitly, we adopt the following standard functional forms for preference and technology. The utility function is  $U(C_t) = \frac{C_t^{1-\gamma}}{1-\gamma}$ , where  $\gamma$  is the inverse of the elasticity of intertemporal substitution. The production function for the final good is  $G(D_{1t}, D_{2t}) = \frac{1}{\omega^\omega(1-\omega)^{1-\omega}} D_{1t}^\omega D_{2t}^{1-\omega}$ , where  $\omega$  is the share of intermediate good  $D_1$  in the final good production. The production function for intermediate good  $i$  is  $f_i(A_{it}L_{it}, K_{it}) = \frac{1}{\alpha_i^{\alpha_i}(1-\alpha_i)^{1-\alpha_i}} K_{it}^{\alpha_i} (A_{it}L_{it})^{1-\alpha_i}$ , where  $\alpha_i$  is the capital share in producing intermediate good  $i$ . We let  $\alpha_1 < \alpha_2$  so that sector 1 is labor intensive. The endogenous discount factor takes the following function form:

$$\beta(\tilde{C}_t, \tilde{Y}_t) = \beta \left( \frac{\tilde{C}_t}{\bar{C}} \right)^{-\psi_1} \left( \frac{\tilde{Y}_t}{\bar{Y}} \right)^{\psi_2} \quad (4.18)$$

where  $\psi_1 > 0$  and  $\psi_2 > 0$ .  $\bar{C}$  and  $\bar{Y}$  are, respectively, the consumption and output levels in the initial steady state with tariff  $\tau_0$ . This form is a variant of Choi, Mark and Sul (2008). It implies that in the steady state after tariff reforms, the endogenous discounted factor would deviate from the constant  $\beta$ . To make the model parsimonious, we assume  $\psi_1 = \psi_2 = \psi$ .

### 4.1 The Effects of Trade Liberalizations

For simplicity, we assume that  $A_1^* = A_2^* = 1$ . In equilibrium, given the production functions, from Equation (3.10), we have

$$\left( \frac{w_t}{A_{1t}} \right)^{1-\alpha_1} r_t^{\alpha_1} = P_1^*, \quad \left( \frac{w_t}{A_{2t}} \right)^{1-\alpha_2} r_t^{\alpha_2} = (1 + \tau) P_2^* \quad (4.19)$$

which give

$$r_t = r^* \left[ \left( \frac{A_{1t}}{A_{2t}} \right)^{(1-\alpha_1)(1-\alpha_2)} \frac{1}{(1 + \tau)^{(1-\alpha_1)}} \right]^{\frac{1}{\alpha_1 - \alpha_2}} \quad (4.20)$$

$$w_t = w^* \left[ \frac{A_{1t}^{(1-\alpha_1)\alpha_2}}{A_{2t}^{\alpha_1(1-\alpha_2)}} \frac{1}{(1+\tau)^{\alpha_1}} \right]^{\frac{1}{\alpha_2-\alpha_1}} \quad (4.21)$$

Three comparative statics can be immediately seen: (a)  $\frac{\partial r_t}{\partial \tau} > 0$ , (b)  $\frac{\partial r_t}{\partial A_{1t}} < 0$ , and (c)  $\frac{\partial r_t}{\partial A_{2t}} > 0$ . By inequality (a), trade liberalization in a labor abundant country (a reduction in  $\tau$ ) reduces the return to capital. Inequalities (b) and (c) pertain to sector-biased productivity shocks. While a technological progress in the labor intensive sector reduces the return to capital, the same change in the capital intensive sector produces the opposite effect. It can be verified that as long as there is a faster technology progress in the labor intensive sector relative to the capital intensive sector ( $\frac{A_{1t}}{A_{2t}}$  increases), the return to capital declines.

These results (in a dynamic setting) are consistent with the Stolper-Samuelson theorem in a static HO model. That is, an increase in the price of a good will increase the return to the factor used more intensively in that good, and reduce the return to the other factor. A tariff reduction in the capital intensive sector implies a decrease in the price of capital intensive goods, therefore,  $r_t$  decreases but  $w_t$  increases.

It is worth emphasizing that the discussion points to a natural asymmetry between developed (capital abundant) and developing (labor abundant) countries. Trade liberalizations tend to reduce the domestic return to capital for a developing country, but to raise it for a developed country.

#### 4.1.1 Net Foreign Asset Positions

We consider two cases of the effects on net foreign asset positions,  $B_t$ . First, in the transitional dynamics, we assume that the investment adjustment cost  $\psi_k$  is zero. Using equations (3.7), (3.8) and (3.9), we obtain:

$$B_{t+1} = \frac{1}{\psi_b P_t} \frac{r^* - r_{t+1} + \delta}{1 + r_{t+1} - \delta} \quad (4.22)$$

The holding of foreign bond  $B_{t+1}$  is a function of  $r_{t+1}$  and  $\frac{\partial B_{t+1}}{\partial r_{t+1}} < 0$ . Second, in the steady state, using first order conditions (3.7), (3.8) and (3.9), we obtain:

$$B = \frac{1}{\psi_b P} \frac{r^* - r + \delta}{1 + r - \delta} \quad (4.23)$$

That is, when the return to capital in the country decreases, capital flows out so that the net foreign asset increases in the steady state. Note that the result for net foreign asset positions does not likely depend on the assumption of an endogenous discount factor,  $\beta(\tilde{C}_t, \tilde{Y}_t)$ . For any form of discount factor (endogenous or exogenous), the net foreign asset position must increase if the domestic interest rate declines. We summarize our discussion by the following proposition:

**Proposition 1** *A trade liberalization, or a reduction in trade costs, in a labor abundant country leads to a decrease in the return to capital in the country, which results in an increase in foreign asset holding in the steady state. A technological progress in favor of the comparative advantage sector in a labor abundant country also reduces the return to capital and produces an increase in the net foreign asset position. An opposite set of results holds when a trade liberalization, a reduction in trade costs, or a productivity increase in favor of the comparative advantage sector, take places in a capital abundant country.<sup>5</sup>*

#### 4.1.2 Steady State

Using the Euler equation in the steady state (3.8) and the function of endogenous discount factor (4.18), we solve for the ratio of consumption to income.

$$c_y = \frac{\bar{C}}{\bar{Y}} [\beta(1 + r - \delta)]^{\frac{1}{\psi}} \quad (4.24)$$

where  $c_y = \frac{C}{Y}$  and  $\bar{C}$  and  $\bar{Y}$  are the consumption and income level in the initial steady state, respectively. Clearly,  $\frac{\partial c_y}{\partial r} > 0$ . Note that the interest rate is determined by the production side (along the demand curve of capital). A decrease in the interest rate implies

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<sup>5</sup>Let  $t_c$  be the iceberg trade cost, we will have:  $P_{1t} = \frac{P_1^*}{1+t_c}$  and  $P_{2t} = (1 + t_c + \tau)P_2^*$ . It is immediately seen that a reduction in trade cost will increase the price of the labor intensive good,  $P_{1t}$ , but reduce  $P_{2t}$ . Similar to the analysis of the tariff reduction, a reduction in trade cost will result in a decrease in  $r$ . On the other hand, if the home country were a capital abundant country and exporting good 2, we would have  $P_{2t} = \frac{P_2^*}{1+t_c}$  and  $P_{1t} = (1 + t_c + \tau)P_1^*$ . Now a reduction in tariff or trade cost would reduce the price of the labor intensive good,  $P_{1t}$ , but increase  $P_{2t}$ , which would increase  $r$ .

that the combined size of capital stock and foreign asset holding in the new steady state is larger, which requires that the household becomes more patient and consumes less relative to income.

The return to factors  $(r, w)$  and the holding of foreign asset  $(B)$  are given by equations (4.20), (4.21) and (4.23). Given that, we can solve for the demand for the final good,  $D$ , consumption,  $C$ , investment  $I$  and Gross Domestic Product,  $Y$  and sectoral outputs  $X_1$  and  $X_2$  from the set of equations listed in Appendix 7.1. We can write the sectoral outputs as below

$$P_1 X_1 = \frac{wL - (1 - \alpha_2)(1 + \tau)(\zeta PD - r^* B)}{(1 - \alpha_1) - (1 + \tau)(1 - \alpha_2)} \quad (4.25)$$

$$P_2 X_2 = \frac{(1 - \alpha_1)(1 + \tau)(\zeta PD - r^* B) - (1 + \tau)wL}{(1 - \alpha_1) - (1 + \tau)(1 - \alpha_2)} \quad (4.26)$$

where  $\zeta = \omega + \omega/(1 + \tau)$ . The optimization conditions for the final good producer yield  $P_1 D_1 = \omega PD$ . Thus the exports of intermediate good 1 are given by

$$NX_1 = P_1(X_1 - D_1) = P_1 X_1 - \omega PD \quad (4.27)$$

Finally, the factor usages and capital intensities in sector  $i$  are given by

$$K_i = \alpha_i \frac{P_i X_i}{r}, \quad L_i = (1 - \alpha_i) \frac{P_i X_i}{w}, \quad \text{and} \quad (4.28)$$

$$\frac{K_i}{L_i} = \frac{\alpha_i}{1 - \alpha_i} \frac{w}{r} \quad (4.29)$$

A tariff cut in the capital intensive sector will lead to an expansion of the labor intensive sector, and a contraction of the capital intensive sector. As a result, labor and capital flow from the capital intensive sector to the labor intensive sector, and both exports and imports go up.

## 4.2 Calibrations in the Basic Model

To calibrate the basic model, we follow the standard approach (as in Backus, Kehoe, and Kydland, 1992, 1994; and Kehoe and Perri, 2002) as much as possible. The parameter values are summarized in Table 3. We set the inverse of the elasticity of intertemporal

substitution  $\gamma = 2$ , the steady state discount factor  $\beta = 0.99$ , which implies a 4 percent annual world interest rate. We assume an equal share of the intermediate goods in the final good production, so  $\omega = 0.5$ . We choose  $\alpha_1 = 0.33$  and  $\alpha_2 = 0.7$  so that both the average labor share and the average dispersion of the labor shares in the model economy are the same as those estimated from China's input-output Table in 2002. We set capital adjustment cost  $\psi_k = 4$  so the elasticity of Tobin's Q with respect to the investment capital ratio is 0.1, which is within the range reported in the literature. We set the annual depreciation rate of capital at 10%, which implies  $\delta = 0.025$ . Following Schmitt-Grohe and Uribe (2003), the coefficient for bond adjustment costs,  $\psi_b$ , is set to be 0.0007. We set  $\psi = 0.1$ , which is close to the value chosen by Choi, Mark and Sul (2008). A summary of the parameter choices is presented in the following table.

Table 3: Parameter Values in the Calibrations

$\beta$	discount factor in steady state	0.99
$\gamma$	inverse of the elasticity of intertemporal substitution	2
$\alpha_1$	capital share in sector 1	0.33
$\alpha_2$	capital share in sector 2	0.7
$\omega$	share of goods 1 in final good	0.5
$\psi_b$	coefficient for convex bond adjustment costs	0.0007
$\delta$	capital depreciation rate	0.025
$\psi$	parameter of endogenous discount factor	0.1
$\psi_k$	coefficient of capital adjustment cost	4
$A_1$	productivity in sector 1	0.8
$A_2$	productivity in sector 2	0.50207

In the initial steady state, the economy is assumed to impose a 15% tariff on imports of the capital intensive good, while the rest of the world has no tariff. We further choose the values of the productivity parameters to make  $r = r^*$  so that  $B = 0$ , and the domestic wage is lower than that in the rest of the world. We cannot use the Euler equation to determine the level of aggregate consumption  $\bar{C}$  and output  $\bar{Y}$  as there are multiple equilibria. As long as the country's capital-labor ratio  $K/L$  is between  $\frac{K_1}{L_1}$  and  $\frac{K_2}{L_2}$ , any level of capital stock  $K$  could be an equilibrium. A smaller  $K$  simply implies that the country would export more

labor intensive good and import more capital intensive good. We use the country's export share, therefore, to select the equilibrium in the initial steady state. The mathematical derivations are relegated to Appendix 7.2.

For the initial productivity, we set  $A_1 = 0.8$  and  $A_2 = 0.50207$  so that in the initial steady state, given the tariff level, the returns to capital across countries are equalized and the wage in the domestic economy is lower than that in the rest of the world.

We consider two policy experiments of reducing the import tariff by 5 and 10 percentage points, respectively. In columns 2, 3 and 4 of Table 4, we report the values for both the initial steady state (when the tariff=15%) and the new steady states (when the tariff = 10% and 5%, respectively). Price variables, aggregate quantity variables, sectoral variables, and balance-of-payments (BOP) variables are organized in four panels. The numerical results confirm Proposition 1. In particular, the return to capital,  $r_1 = r_2$ , declines while the wage rate,  $w_1 = w_2$ , rises. In the new steady state after the tariff cut, aggregate consumption  $C$ , investment  $I$ , and GDP  $Y$  all increase. The labor intensive sector (Sector 1) expands so that  $K_1$ ,  $L_1$  and  $X_1$  all increase, while the capital intensive sector (Sector 2) contracts. Both exports ( $NX_1$ ) and imports ( $-NX_2$ ) expand. The trade volume to GDP ratio,  $TV/GDP$ , increases by 7 percentage points. Most interestingly, exports expand faster than imports, and capital flows out of the country so that the cumulative increase in the foreign asset holding as a share of GDP ratio, reaches the level of 29%. In other words, a relatively moderate tariff reduction (from 15% to 10%) results in a significant capital outflow.

In the second policy experiment, a more substantial (but still realistic) tariff reduction by 10 percentage points (from 15% to 5%) leads to an even greater increase in foreign asset holding to 56% of GDP.

There are also interesting byproducts of the trade reforms. In particular, consumption as a share of GDP declines while investment to GDP ratio increases. To be precise, both consumption and output expand from the old to the new steady state (see the row labeled as "C" in Table 4), so the decline in the ratio of consumption to GDP comes from uneven speeds of expansion, not from a decline in consumption in the steady level. This is an interesting bonus finding. Chinese data in recent years exhibit a declining ratio of consumption to GDP, and it is commonly interpreted to be a result of some policy distortions (either exchange

rate manipulation or financial repression). Our calibration generates such a feature as a result of a reduction in policy distortions (tariffs).

In Figure 3, we report the dynamic paths of the economy from the initial to the new steady state after a 5 percentage points cut in the tariff (from 15% to 10%). We assume that the trade liberalization starts to hit the economy in period 1. We find that the structural adjustment takes place immediately. In particular, sector 1 (the labor intensive sector) expands immediately with an increase in  $K_1$ ,  $L_1$ , and  $X_1$ , while sector 2 contracts immediately, with a decline in  $K_2$ ,  $L_2$ , and  $X_2$ . As a result, both the export share  $sx$  and import share  $-sm$  increase immediately. As noted, the consumption response is interesting. After a decline in the first several periods, consumption rises gradually. Intuitively, because the domestic return to capital declines after the trade reform, the endogenous discount factor specification implies that the representative household must become more patient. This in turn causes the household to have a lower ratio of consumption/income (or a higher savings rate) both during the transition and in the new steady state. (It is important to reiterate that we can see, from Table 4, that the absolute level of consumption does go up in the new steady state. In other words, trade reforms do raise consumption, but not the ratio of consumption to GDP.)

In Figure 4, we report the dynamic paths for some key balance-of-payments items. From the top left graph, we observe that the trade volume (the sum of exports and imports as a share of GDP) jumps immediately. This is not surprising as both imports and exports expand.

There are three ways of viewing a country's current account: (a) as net capital outflows, (b) as the sum of trade balance and net international factor payment, and (c) as the difference between national savings and national investment. In this case, thinking of the current account as net capital outflows turns out to be most convenient in terms of obtaining intuition for our result. Following a tariff cut (on capital intensive goods), Proposition 1 in Section 4.1.1 points out that domestic return to capital would decline if all other things can be held constant (including imposing a closed capital account). Of course, other things cannot be held constant. In particular, if the domestic return to capital falls, it immediately creates incentive for a capital outflow. This is why a current account surplus tends to follow

a tariff reform that reduces the domestic price of capital intensive goods. The thick line in the upper right graph traces out the trajectory of current account as a share of GDP which exhibits a positive current account for over 20 quarters before converging to zero. In our model economy, the bottom right graph shows how  $B/GDP$  increases gradually to the new steady state level (of 29% of GDP).

Of course, the other two ways of thinking about the current account also have to hold as a matter of identities. In the top right graph, the broken thin line traces the trade balance as a share of GDP. This variable jumps into a surplus immediately following the tariff cut, reaching somewhere around 5 percent of GDP, but goes into a deficit after about 20 quarters since it has to offset the positive interest payment the country receives from its foreign asset holdings in order to produce a zero current account.

The identity that current account is the difference between national savings and investment is also respected. The trajectories for savings and investment as shares of GDP are plotted in the lower left graph. In the graph, the savings rate goes up immediately after the trade reform, while the investment rate goes up after an initial and temporary fall. The gap between savings and investment is always equal to the current account indicated by the thick line in the upper right graph.

Note that the domestic investment (as a share of GDP) can go either up or down, depending on the parameter values. The initial decrease in investment ratio reflects the immediate expansion of the labor intensive sector and the contraction of the capital intensive sector after the tariff cut, which result in the lower domestic demand for investment. It is important to note that we only consider here a case in which there is no technological change accompanying a trade reform. In the real data, there is often technological improvement that accompanies a trade reform. In our model, technological improvements either uniformly across both sectors (both  $A_1$  and  $A_2$  increase proportionally), or just in the comparative advantage sector ( $A_1$  increases), would lead to an immediate jump in the investment to GDP ratio. (In other words, if a trade reform is modeled as a combination of a tariff cut and an increase in productivity, then there will be a large current account surplus without much initial fall in the investment/GDP ratio.)

We now perform some sensitivity analysis. First, we investigate transitional dynamics when we vary the aggregate capital adjustment cost  $\psi_k = 4, 8,$  and  $12$ . The results are presented in the top row of Figure 5. Although the steady state is not affected by changes in  $\psi_k$ , the trade volume, the current account and the foreign asset position in the transition dynamics become (moderately) larger when  $\psi_k$  becomes smaller. The overall dynamics of the balance of payments does not appear to be very sensitive to perturbations in the value of aggregate capital adjustment costs.

Second, we investigate the BOP dynamics at different bond adjustment costs. As equation (4.23) indicates, the change in the foreign asset position from the initial to the new steady state is affected by the bond adjustment cost,  $\psi_b$ . In the second row of Figure 5, we report the transitional dynamics under the assumption of two new values of  $\psi_b$ ,  $0.0005$  and  $0.0010$ , in addition to the benchmark value of  $0.0007$ . In all cases, the country still runs a current account surplus after a tariff cut with each of the two alternative bond adjustment costs. The quantitative effect, however, varies. As expected, a smaller bond adjustment cost results in a larger current account surplus in transitional dynamics, and larger trade volume and net foreign asset position in both transitional dynamics and the steady state. In Schmitt-Grohe and Uribe (2003), the parameter of bond adjustment cost is chosen to match the standard deviation of the current account/GDP ratio for Canada (which is  $0.015$ ). From the corresponding annual data for China during 1982-2010, after detrending with an HP filter, we calculate that the standard deviation of the CA/GDP ratio is  $0.019$ , which is close to the Canadian number. Separately, in calibrating a RBC model to explain the business cycles in the Chinese economy, Curtis and Mark (2010) also choose  $\psi_b = 0.0007$  as the value for the bond adjustment cost. Therefore, we regard  $\psi_b = 0.0007$  as the “right” benchmark value.

## 5 Factor Market Frictions

Factor market reforms can affect how a country’s current account responds to a given trade reform. For the current account to respond to trade reforms, a key intermediary step is a structural adjustment of the domestic economy. Logically, factor market frictions that block or reduce the extent of the domestic structural adjustment can also block or reduce

the current account response to trade reforms. We now turn to this topic.

We start with financial frictions in the form of credit constraints.

## 5.1 Financial Frictions

Following Antras and Caballero (2009), we make the simplifying assumption that financial frictions are asymmetric in the two sectors: while firms in the importing sector can employ any desired amount of capital at the equilibrium interest rate, firms in the exporting sector face credit constraints. Note that with a tariff cut on the capital intensive good, only the (labor-intensive) export sector would expand. Therefore, we essentially assume that credit constraints are more binding in the sector that needs expansion.

Credit constraints are introduced through the following (admittedly artificial) setting. Each capitalist owns one unit of capital so that the capital stock  $K$  is owned by a total  $K$  of capitalists. A proportion  $\xi$  of  $K$  are endowed with “entrepreneurial ability” and labelled “entrepreneurs”. Only the “entrepreneurs” know how to operate in the exporting sector. However, each entrepreneur can borrow only up to  $\theta$  amount of her own capital. Thus the total amount of capital employed in the exporting sector is given by,

$$K_{1t} \leq (1 + \theta)\xi K_t = \mu_k K_t \quad (5.30)$$

where  $\mu_k = (1 + \theta)\xi$ . We focus on the case in which financial frictions are binding (or  $\mu$  is sufficiently small) so that  $\mu_k K$  is less than the desired amount of capital that exporting firms would like to employ in the absence of financial frictions.

Let  $r_i$  be the return to capital in sector  $i$ . The financial frictions cause a wedge between the returns to capital in the two sectors,  $r_{1t} > r_{2t}$ . The budget constraint (3.4) now is changed to

$$\begin{aligned} & P_t \left[ C_t + \frac{\psi_b}{2} (B_{t+1} - \bar{B})^2 \right] + B_{t+1} + I_t \\ = & w_t L + \sum_{i=1}^2 r_{it} K_{it} + (1 + r^*) B_t + TR_t \end{aligned} \quad (5.31)$$

In addition to the capital accumulation equation, the representative household also faces

the credit constraint (5.30) and capital market clearing condition,  $K_{1t} + K_{2t} = K_t$ . When the credit constraint (5.30) is binding, we have  $K_{1t} = \mu_k K_t$  and  $K_{2t} = (1 - \mu_k) K_t$ . Using these results, the budget constraint (3.4) now becomes:

$$\begin{aligned} & P_t \left[ C_t + \frac{\psi_b}{2} (B_{t+1} - \bar{B})^2 \right] + B_{t+1} + I_t \\ = & w_t L + [\mu_k r_{1t} + (1 - \mu_k) r_{2t}] K_t + (1 + r^*) B_t + TR_t \end{aligned} \quad (5.32)$$

Therefore, the first order conditions with respect to  $C_t$ ,  $K_{t+1}$ ,  $B_{t+1}$ , and  $L_{it}$  in the consumer's maximization problem now remain the same as conditions (3.6), (3.8), and (3.9) except that we now replace  $r_{t+1}$  by

$$r_{t+1}^C = \mu_k r_{1,t+1} + (1 - \mu_k) r_{2,t+1} \quad (5.33)$$

### 5.1.1 The Steady State Equilibrium

The steady state equilibrium in the case of financial frictions is represented by 15 equations with 15 variables, and is summarized in Appendix 7.3. Similar to equation (4.23), in the steady state we have

$$B = \frac{1}{\psi_b P} \frac{r^* - r^C + \delta}{1 + r^C - \delta} \quad (5.34)$$

Thus,  $r^C = \mu_k r_1 + (1 - \mu_k) r_2$ , is a key variable in determining the country's net foreign asset holding  $B$ .

Because we are not able to obtain an analytic solution, we will resort to numerical results. Here we offer some intuition for the numerical results to come. When financial frictions become tighter ( $\mu_k$  declines), the capital usage in sector 1 declines. As a result, the marginal product of capital in the exporting sector,  $r_1$ , increases, but the marginal product of labor,  $w_1$ , declines. Since the wage rates are equalized in the two sectors in the steady state,  $w_1 = w_2 = w$ , using the zero profit condition in the import-competing sector,  $P_2 = \phi_2(\frac{w_2}{A_2}, r_2)$ , we infer that the marginal product of capital in the import-competing sector,  $r_2$  must rise. Since both  $r_1$  and  $r_2$  are larger, therefore,  $r^C$  becomes larger as financial frictions becomes tighter. Using (5.34), that results in a smaller  $B$ . That is, a lower level of financial development (a tighter credit constraint) results in a smaller net

foreign asset holding. To summarize, because financial frictions impede the expansion of the exporting sector, a given trade reform produces a smaller capital outflow.

Several recent papers (Caballero, Farhi, and Gourinchas, 2008; Mendoza, Quadrini, and Rios-Rull, 2009; Ju and Wei, 2010; and Song, Storesletten, and Zilibotti, 2011) have showed that a low level of financial development in a developing country can produce a financial capital outflow to developed countries. Therefore, a tighter financial friction would lead to more current account surplus in a developing country. Our paper, however, suggests the opposite. When credit constraint is asymmetric across sectors, for example, when there is a credit rationing in one sector but not in another sector, similar to the setup in Antras and Caballero (2009), we show that a tighter credit constraint induces capital inflow (or a smaller current account surplus). The two parts of the literature can be reconciled when one realizes that the first set of papers emphasizes the effect of financial frictions on the supply side of capital (financial frictions reduce the return on savings and generate incentives to move savings out of the country), while the current paper and Antras and Caballero (2009) stress the demand side effect (credit constraints could increase demand for capital by firms in the unconstrained sector). Our model is different from Antras and Caballero (2009) in that trade liberalization always leads to capital outflow (current account surplus) under credit constraints, although the amount of capital outflow could be made smaller by a tighter credit constraint.

## 5.2 Labor Market Frictions

We can model labor frictions in a similar fashion and obtain qualitatively similar results. Assume that labor employed in the exporting sector requires “exporting skills”, and the amount of labor with “exporting skills” does not exceed a certain proportion of the total amount of labor. In other words, when the labor-intensive sector expands, not all labor previously working in the importing sector can successfully function in the exporting sector. As an example, when the textile industry expands but the steel mills are shut down, not all former steel workers can be productive textile workers. Formally, we model the frictions by the following inequality:

$$L_{1t} \leq \mu_L L \tag{5.35}$$

Similarly, the budget constraint (3.4) now becomes

$$\begin{aligned} & P_t \left[ C_t + \frac{\psi_b}{2} (B_{t+1} - \bar{B})^2 \right] + B_{t+1} + I_t \\ = & [\mu_L w_{1t} + (1 - \mu_L) w_{2t}] L + r_t K_t + (1 + r^*) B_t + TR_t \end{aligned} \tag{5.36}$$

and all the analysis in the basic model goes through except that now we replace  $w_t$  by  $w_t^c = \mu_L w_{1t} + (1 - \mu_L) w_{2t}$ . Labor market frictions impede the expansion of the exporting sector. Thus a given trade reform produces a smaller response in both the trade volume and the current account.

### 5.3 Numerical Results

For numerical simulations, we focus on the case of credit constraints, while assuming no labor market frictions. (The results with labor market frictions are qualitatively similar.) We choose the same structural parameters as in the benchmark case. For financial frictions, we set the credit constraint parameter in the initial steady state  $\mu_k = 0.42$  so that the initial net export share is about 10%.

The case of a tariff reduction from 15% to 10% under financial frictions is presented in Columns 5 and 6 in Table 4. The return to capital in the importing sector,  $r_2$ , decreases, but  $r_1$  in the exporting sector increases. The labor intensive sector expands while the capital intensive sector shrinks, and both exports and imports increase. While the qualitative result is the same as the case without financial frictions (Columns 2 and 3 in Table 4), the magnitude of the changes is (much) smaller. Because the (labor-intensive) export sector cannot expand as much as before, the wage rate now declines. The ratio of the trade volume to GDP,  $\frac{TV}{GDP}$ , increases by 3.7 percentage points (from 21.1% to 24.8%), compared to an increase by 6.6 percentage points when there is not credit constraint. The increase in the net foreign asset position,  $B/GDP$ , is on the order of 10% of GDP when there is credit constraint, compared to an increase by 29% of GDP in the absence of credit constraints.

If the tariff is cut to 5%, the new steady state (with credit constraint) is presented in Column 7 of Table 4. Again, comparing the change in the country's foreign asset position from Columns 5 to 7, with the change in the same variable from Column 2 to 4, it is clear that credit constraint can substantially reduce the change in a country's foreign asset position for a given trade reform.

We present, in Figure 6, the transitional dynamics of the economy after a tariff cut from 15% to 10% in the case with credit constraints. Compared to Figure 3 (the transitional dynamics after an identical tariff cut but without credit constraint), the adjustments are smaller. The implications of credit constraints for the balance-of-payments variables are best seen in Figure 7. For ease of comparison with the case of no credit constraint, we use thick bold lines to represent the transitional dynamics when there is credit constraint, and thin lines to represent the case of no credit constraint. From the upper left graph, it is clear that credit constraints reduce the impact of a given tariff cut on trade volumes. Similarly, in the lower left graph, we can see that credit constraints induce a smaller current account response to the same tariff cut than the case of no credit constraints. From the upper right graph, we can see that the smaller current account response comes from a combination of a smaller savings response and a smaller investment response. Unsurprising, as shown in the lower right graph, the accumulation of foreign assets is also stunted by credit constraints.

## 6 Concluding Discussion

A wave of trade liberalizations take place in both developing and developed countries, including China's trade reforms during 2001-2006 following its WTO accession and the end of import quotas on textiles and garments in the United States and Europe in 2004. At the same time, both China's current account surplus and the US deficit have risen to an unprecedented level. We suggest that the two developments are intimately related. By embedding a modified Heckscher-Ohlin structure and an endogenous discount factor into an intertemporal model of current account, we obtain two key results. First, trade liberalizations in a developing country that reduce its capital intensity would generally lead to quantitatively large capital outflow, while trade liberalizations in a developed country that increase its capital intensity would result in capital inflow. Thus, trade reforms can

produce or contribute to global imbalances (even though they do not call for a policy correction). Second, factor market frictions can reduce the current account response to trade reforms by reducing the extent of economic structural change.

This model offers an interesting interpretation of the Chinese experience with trade reforms and current account dynamics (both the rapid rise during 2002-2007 and the fall after 2007). In particular, there are two phases of trade policy changes that appear to be associated with different current account patterns. Before China's accession to the WTO at the end of 2001, while there had been trade reforms, financial sector frictions may have blunted the current account response. In comparison, the WTO accession represents a watershed event in two senses. First, not only the dismantling of tariff and non-tariff barriers on imports was accelerated, there was also a dramatic reduction in trading costs faced by firms in the exporting sector. In particular, Chinese firms that did not enjoy export rights before the WTO accession acquired an automatic right to exports as a result of the accession. (This reduction in trade costs is not even captured by any measured reduction in tariff rates.) If one counts the number of trade reforms China has to undertake, it is more than two standard deviations greater than the median value for an accession country since 1990 (Tang and Wei, 2009). In that sense, China's trade reforms associated with its WTO accession may be called the mother of all trade reforms. Second, the accession protocol also obligates China to engage in a series of financial sector reforms over a five-year transition period after the accession. These reforms have also greatly facilitated the economic adjustment in the direction of expanding China's comparative advantage sectors and reducing its comparative disadvantage sectors.

The difference between the trade reforms in the 1990s and those associated with the WTO accession can be seen from the time series of the import-to-GDP ratio. The tariff cuts before 2001 had led to only a small change in the import/GDP ratio. In comparison, the WTO accession was followed by a large and sustained increase in the imports from 5% of GDP in 2001 to close to 30% of GDP by 2007. Interpreted in light of our model, the combination of trade reforms and factor market reforms brought out by the WTO accession has the effect of producing a large and positive current account response. Because both trade reforms and financial reforms were conducted over a multi-year phase, the current

account response gains strength over time in the first few years after the WTO accession before it peters off.

Our theory also sheds new light on the relative decline in China's current account surplus after 2007. A common explanation for the current account contraction is a temporary reaction to the contraction of global trade associated with the global financial crisis. The implication is that the Chinese current account surplus could return to its pre-2007 level once the world economy is out of the recession. However, our model provides an additional explanation. In our model, the current account response to a trade policy shock is temporary (even though it can last for 20 quarters). Therefore, part of the decline of the current account surplus could result from the end of major trade reforms. The change in current account due to this factor is not likely to be reversed.

The end of the import quotas on textiles and garments by the United States and Europe in 2004 represents another important event that reduces trading costs. Since this was a reduction in trade barriers on a labor-intensive product in the United States, our theory would predict that the U.S. responds by running a current account deficit. More importantly, because textiles and garments are an important comparative advantage sector for China, the end of quotas in 2004 represented a big decline in the export costs for Chinese exporting firms. Therefore this event also reinforces the rise of China's current account surplus in recent years. Because Europe is commonly said to have a less flexible labor market, our theory would predict a smaller current account response to the trade policy response, which appears to be consistent with the pattern in the data.

Note, however, that we do not wish to claim that trade reforms are the only factor that matters for the evolution of a country's current account. Rather, it is an important contributing factor that is thus far neglected in the discussion of current account imbalances. Such a neglect could incorrectly color our understanding of the source of current account imbalances and appropriate policy responses. To put it simply, if a portion of the current account imbalances is caused by efficient trade reforms, we do not need to view it as a problem that needs a policy correction.

The basic general equilibrium logic linking trade reforms and capital flows is not unique to China. We will see many more trade policy changes in both developed and developing

countries (not always in the direction of reducing trade barriers). We will also see many more changes in factor markets around the world that could either enhance or reduce their flexibility. This paper provides a way to think about the general equilibrium implications of trade reforms for international capital flows.

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## 7 Appendices

### 7.1 Equations for the Steady State

Given the factor prices  $(w, r)$  and the holding of foreign asset  $B$ , the output  $Y$ , consumption  $C$ , investment  $I$ , aggregate demand  $D$ , and sectoral outputs  $X_1$  and  $X_2$  can be determined by the following six equations.

$$\frac{C}{Y} = \frac{\bar{C}}{\bar{Y}} [\beta(1+r-\delta)]^{\frac{1}{\psi}} \quad (7.1)$$

$$D = C + \frac{I}{P} + \frac{\psi_b}{2} B^2 \quad (7.2)$$

$$PY = P_1 X_1 + P_2 X_2 \quad (7.3)$$

$$\alpha_1 P_1 X_1 + \alpha_2 P_2 X_2 = r \frac{I}{\delta} \quad (7.4)$$

$$(1 - \alpha_1) P_1 X_1 + (1 - \alpha_2) P_2 X_2 = wL \quad (7.5)$$

$$P_1 X_1 + P_2 X_2 / (1 + \tau) + r^* B = \zeta PD \quad (7.6)$$

where  $\zeta = \omega + (1 - \omega)/(1 + \tau)$ . Equation (7.6) is derived from the current account equation in the steady state,  $P_1^*(X_1 - D_1) + P_2^*(X_2 - D_2) + r^* B = CA = 0$ .

## 7.2 Equilibrium Selection in the Initial Steady State

In the initial steady state, we assume an exogenous export share,  $sx$ , and an import share,  $sm$ , to select the equilibrium. Let

$$sx = \frac{NX_1}{P_1X_1 + P_2X_2} > 0 \quad (7.7)$$

$$sm = \frac{NX_2}{P_1X_1 + P_2X_2} < 0 \quad (7.8)$$

Since  $B$  is initially zero, using expressions of sectoral output, we have

$$P_1X_1 + P_2X_2 = \frac{(\alpha_2 - \alpha_1)(1 + \tau)\zeta PD - \tau wL}{(1 - \alpha_1) - (1 + \tau)(1 - \alpha_2)} \quad (7.9)$$

Using the expressions for  $X_1$  and  $D_1$ , we have

$$sx = \frac{wL - PD[(1 - \alpha_2)(1 + \tau)\zeta + \omega((1 - \alpha_1) - (1 + \tau)(1 - \alpha_2))]}{(\alpha_2 - \alpha_1)(1 + \tau)\zeta PD - \tau wL} \quad (7.10)$$

This implies that given the initial share of export  $sx$ , we can determine the initial ratio of wage income to final good expenditure as below

$$\frac{wL}{PD} = \frac{sx(\alpha_2 - \alpha_1)(1 + \tau)\zeta + (1 - \alpha_2)(1 + \tau)\zeta + \omega((1 - \alpha_1) - (1 + \tau)(1 - \alpha_2))}{1 + sx\tau} \quad (7.11)$$

Let  $\kappa = \frac{wL}{PD}$ . We can solve for the initial output  $\bar{Y}$  as

$$\bar{Y} = \frac{wL}{P} \frac{(\alpha_2 - \alpha_1)(1 + \tau)\zeta\kappa^{-1} - \tau}{(1 - \alpha_1) - (1 + \tau)(1 - \alpha_2)} \quad (7.12)$$

In the initial steady state, the consumption is given by  $C = D - \frac{I}{P}$ , and the investment is given by  $I = \delta K = \frac{\delta}{r}(\alpha_1 P_1 X_1 + \alpha_2 P_2 X_2)$ . From the determination of sectoral output, we have

$$I = \frac{\delta}{r} \frac{(1 + \tau)(\alpha_2 - \alpha_1)\zeta PD - (1 + \tau)(\alpha_2 - \alpha_1)r^*B - (\alpha_2(1 + \tau) - \alpha_1)wL}{(1 - \alpha_1) - (1 - \alpha_2)(1 + \tau)} \quad (7.13)$$

For simplicity, we rewrite it as

$$\frac{I}{P} = \phi D + \Phi \quad (7.14)$$

where

$$\phi = \frac{\delta}{r} \frac{(1 + \tau)(\alpha_2 - \alpha_1)\zeta}{(1 - \alpha_1) - (1 - \alpha_2)(1 + \tau)} > 0 \quad (7.15)$$

$$\Phi = -\frac{\delta}{rP} \frac{(1 + \tau)(\alpha_2 - \alpha_1)r^*B + (\alpha_2(1 + \tau) - \alpha_1)wL}{(1 - \alpha_1) - (1 - \alpha_2)(1 + \tau)} \quad (7.16)$$

Note that  $\Phi$  is an investment component determined by the supply side. Therefore, substituting them into the aggregate demand equation, the initial consumption can be expressed as

$$\bar{C} = D[(1 - \phi) - \frac{\Phi}{D}] \quad (7.17)$$

where

$$\frac{\Phi}{D} = -\frac{\delta}{r} \frac{\alpha_2(1 + \tau) - \alpha_1}{(1 - \alpha_1) - (1 - \alpha_2)(1 + \tau)} \frac{wL}{PD} \quad (7.18)$$

Finally, we obtain the initial consumption as below:

$$\bar{C} = \frac{wL}{P} \left[ \frac{1 - \phi}{\kappa} + \frac{\delta}{r} \frac{\alpha_2(1 + \tau) - \alpha_1}{(1 - \alpha_1) - (1 - \alpha_2)(1 + \tau)} \right] \quad (7.19)$$

### 7.3 Steady State Equilibrium with Credit Constraint

$$B = \frac{1}{\psi_b P} \frac{r^* - r^C + \delta}{1 + r^C - \delta} \quad (7.20)$$

$$\left(\frac{w}{A_1}\right)^{1-\alpha_1} r_1^{\alpha_1} = P_1^* \quad (7.21)$$

$$\left(\frac{w}{A_2}\right)^{1-\alpha_2} r_2^{\alpha_2} = (1 + \tau)P_2^* \quad (7.22)$$

$$\frac{K_1}{K_2} = \frac{\mu_k}{1 - \mu_k} \quad (7.23)$$

$$L_1 + L_2 = L \quad (7.24)$$

$$r_1 K_1 = \alpha_1 P_1 X_1 \quad (7.25)$$

$$r_2 K_2 = \alpha_2 P_2 X_2 \quad (7.26)$$

$$wL_1 = (1 - \alpha_1)P_1X_1 \quad (7.27)$$

$$wL_2 = (1 - \alpha_2)P_2X_2 \quad (7.28)$$

$$r^C = \mu_k K_1 + (1 - \mu_k)K_2 \quad (7.29)$$

$$P_1D_1 = \omega PD \quad (7.30)$$

$$P_2D_2 = (1 - \omega)PD \quad (7.31)$$

$$D = C + \frac{\delta(K_1 + K_2)}{P} + \frac{\psi_b}{2}B^2 \quad (7.32)$$

$$P_1X_1 + P_2X_2/(1 + \tau) + r^*B = \zeta PD \quad (7.33)$$

$$\frac{C}{Y} = \frac{\bar{C}}{\bar{Y}}[\beta(1 + r^C - \delta)]^{\frac{1}{\psi}} \quad (7.34)$$

**Table 1: Episodes of Trade Reforms (1990-2010)**

Country Name	Period	Tariff Change		Imports Change
		(Simple Average)	(Weighted Average)	
Albania*	2001-2002	-3.21	-2.93	8.01
Algeria*	2001-2003	-3.44	-3.19	3.8
Bangladesh*	2003-2005	-4.21	0.86	3.01
Bangladesh	2006-2007	-0.72	-8.62	3.51
Belize	1999-2001	-9.18	-0.48	6.31
Bhutan	2005-2007	-0.24	-5.01	4.27
Brazil*	1989-1993	-30.01	-18.9	3.63
Brazil*	1998-2001	-1.76	-5.52	4.56
Cambodia*	2003-2005	-2.14	-5.54	4.35
Canada*	1995-1997	-3.3	-2.34	3.4
China*	1992-1997	-24.57	-16.35	4.86
China*	2001-2003	-4.52	-7.63	6.88
Georgia*	2002-2004	-3.1	-1.33	4.02
Guyana	1999-2001	-9.73	-3.59	6.14
India*	2004-2008	-16.86	-16.55	4.93
Indonesia*	1989-1990	-3.48	0.36	3.55
Indonesia*	1995-1996	-2.99	-3.16	15.57
Indonesia*	1999-2001	-4.3	-1.74	3.03
Kenya*	2004-2006	-4.11	-3.44	3.1
Kyrgyz Republic*	2002-2003	-3.33	-2.52	7.92
Lebanon	2000-2001	-8.72	-8.69	4.01
Lesotho	2006-2007	0.05	-3.04	5.22
Malawi*	1996-1998	-6.67	-4.37	6.23
Mauritius*	1995-1997	-0.99	-4.91	3.19
Mauritius*	2005-2006	-2.96	-3.5	7.05
Morocco*	2006-2009	-6.13	-4.61	5.19
Nigeria*	2001-2002	3.9	-3.02	8.15
Pakistan	2001-2003	-3.01	-3.43	3.85
Paraguay*	2004-2006	-1.91	-5.21	5.6
Peru*	2006-2008	-4.11	-4.04	7.23
Philippines	1989-1990	-8.68	-7.66	3.02
Seychelles*	2005-2006	-3.64	-0.45	4.13
St Lucia*	2000-2001	-9.76	-4.25	4.16
Syrian Arab Republic	2009-2010	0	-4.03	4.61
Thailand*	1993-1995	-22.66	-21.7	6.39
Thailand*	2003-2005	-3.46	-4.15	6.94
Tunisia*	2002-2008	-12.4	-10.46	3.36
Zimbabwe	1996-2003	-25.1	-22.45	8.67

Note: \* denotes countries for which data on current account and capital intensity are also available.

**Table 2: Changes in Current Account and Changes in Trade Policy, 1990-2010**

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Dependent variable =  $\Delta$  (CA/GDP)

	(1)	(2)
$\Delta$ K-Intensity	-61.69*	-139.77*
	(30.26)	(63.12)
$\Delta$ RER		-0.08*
		(0.04)
Constant	-0.82*	-1.93**
	(0.43)	(0.77)
# of Observations	28	13

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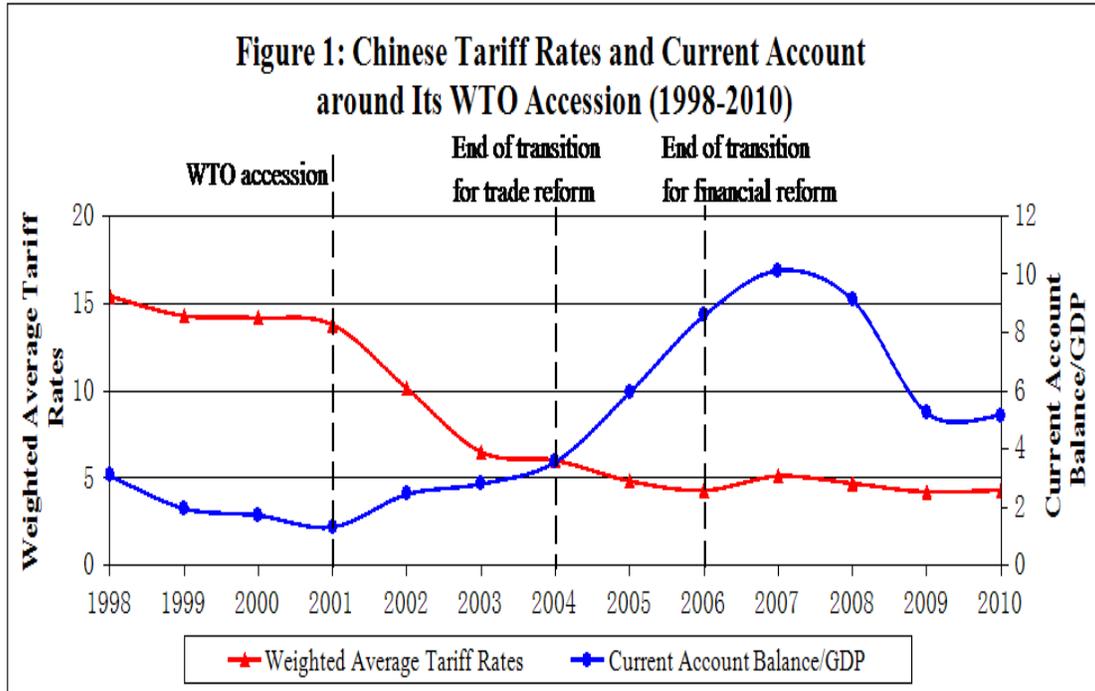
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\* indicates significant at 10% level, \*\* 5% level, \*\*\* 1% level

Table 3: Summary of Parameters Used in the Calibrations  
(In the text)

Table 4: Steady States Before and After a Tariff Reduction

Variable	Benchmark (No Credit Constraint)			With Credit Constraint		
	tariff=0.15	tariff=0.1	tariff=0.05	tariff=0.15	tariff=0.1	tariff=0.05
(1)	(2)	(3)	(4)	(5)	(6)	(7)
$r^c$	0.0351	0.0324	0.0298	0.0351	0.0342	0.0336
$r_1$	0.0351	0.0324	0.0298	0.0351	0.0357	0.0370
$r_2$	0.0351	0.0324	0.0298	0.0351	0.0331	0.0312
$w_1$	28.038	29.172	30.408	28.038	27.802	27.31
$w_2$	28.038	29.172	30.408	28.038	27.802	27.31
$P_1$	3.5882	3.5882	3.5882	3.5882	3.5882	3.5882
$p_2$	0.3205	0.3066	0.2926	0.3205	0.3066	0.2926
$P$	1.0724	1.0488	1.0247	1.0724	1.0488	1.0247
$C$	8.356	8.457	8.477	8.3575	8.289	8.1641
$D$	12.536	13.052	13.412	12.549	12.538	12.366
$B$	0	3.8497	7.5797	0	1.3129	2.0814
$K$	179.32	192.57	201.49	179.81	178.23	172.17
$I$	4.483	4.8141	5.0372	4.4951	4.4558	4.3043
$Y$	12.351	12.841	13.210	12.366	12.379	12.258
$K_1$	75.648	87.886	104.18	75.518	74.858	72.312
$K_2$	103.67	104.68	97.315	104.29	103.38	99.86
$L_1$	0.1923	0.1981	0.2071	0.1920	0.1952	0.1991
$L_2$	0.0556	0.0498	0.0408	0.0560	0.0527	0.0489
$X_1$	2.2424	2.4037	2.6191	2.2386	2.2575	2.2612
$X_2$	16.221	15.798	14.143	16.317	15.927	15.197
$D_1$	1.8733	1.9075	1.915	1.8753	1.8324	1.7657
$D_2$	20.973	22.327	23.483	20.995	21.448	21.652
$NX_1$	1.3245	1.7806	2.5263	1.3038	1.5255	1.7778
$NX_2$	-1.5232	-2.0014	-2.733	-1.4994	-1.6926	-1.8888
CA/GDP	0	0	0	0	0	0
sx	0.1	0.1322	0.1866	0.0983	0.1175	0.1415
sm	-0.115	-0.1486	-0.2019	-0.1131	-0.1304	-0.1504
B/GDP	0.0%	28.6%	56.0%	0.0%	10.1%	16.6%
TV/GDP	21.5%	28.1%	38.9%	21.1%	24.8%	29.2%
C/GDP	67.7%	65.9%	64.2%	67.6%	67.0%	66.6%
I/GDP	33.8%	35.7%	37.2%	33.9%	34.3%	34.3%



**Figure 2: Scatter Plot of Delta CA/GDP vs Delta k-intensity (from t-1 to t+1): Major Trade Policy Changes around the World (1990-2010)**

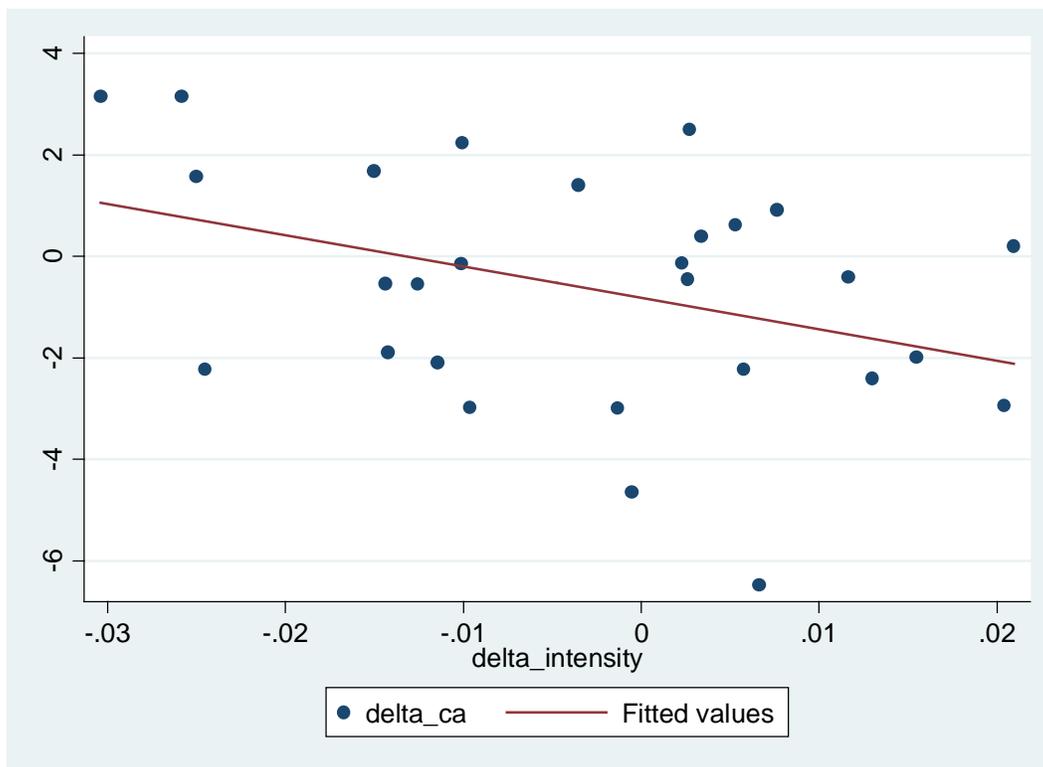


Figure 3: Transition Path of the Economy after a Tariff Reduction by 5 Percentage Points (from 15% to 10%)

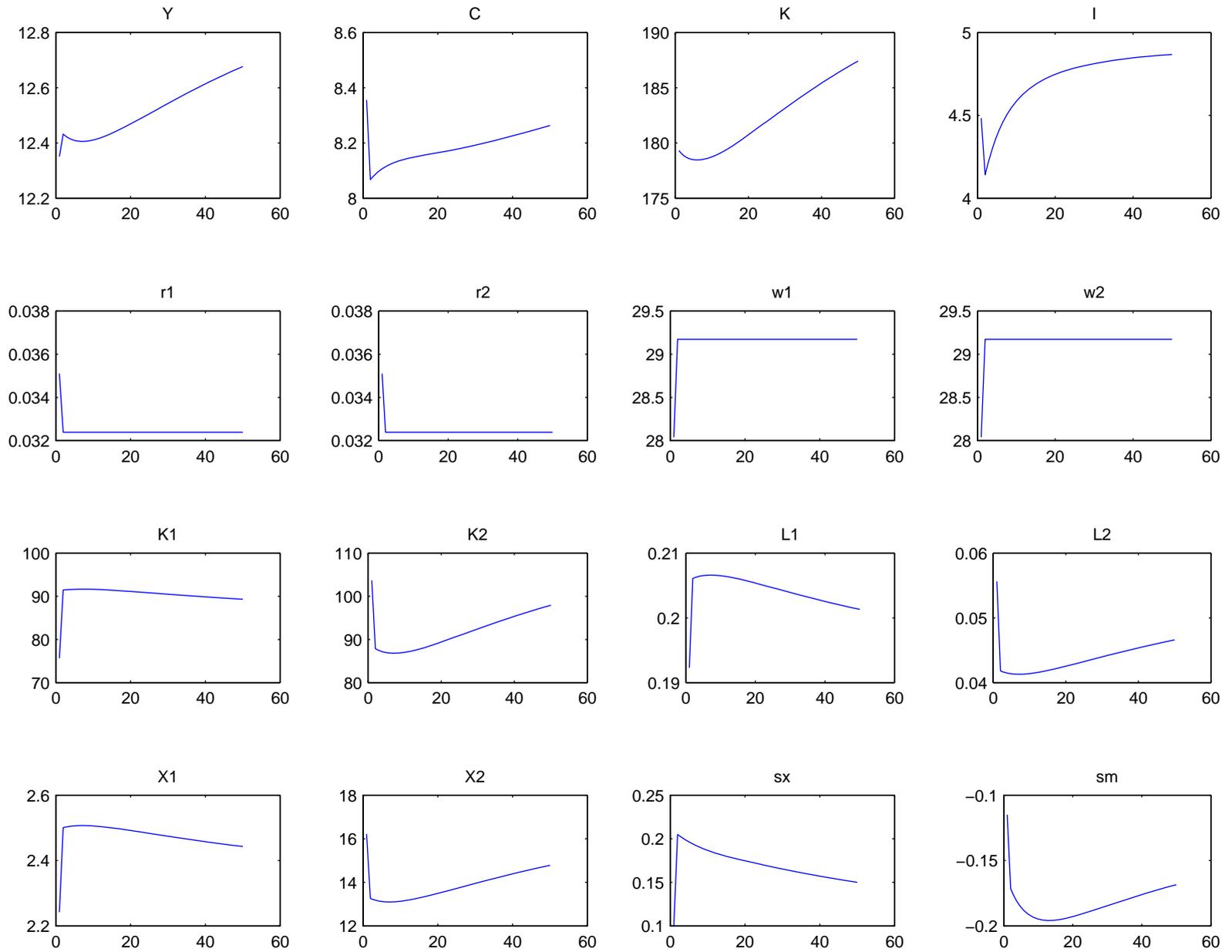


Figure 4: Dynamic Responses of Trade Volume and BOP Variables to a Tariff Reduction by 5 Percentage Points (from 15% to 10%)

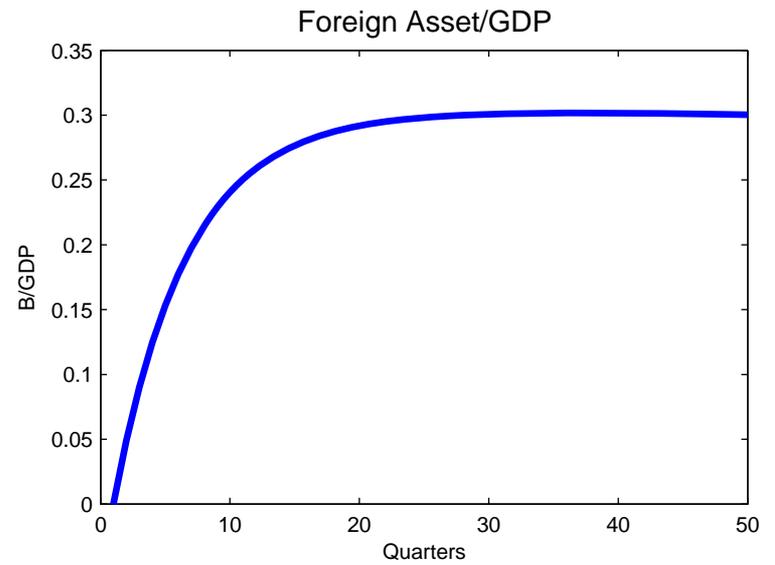
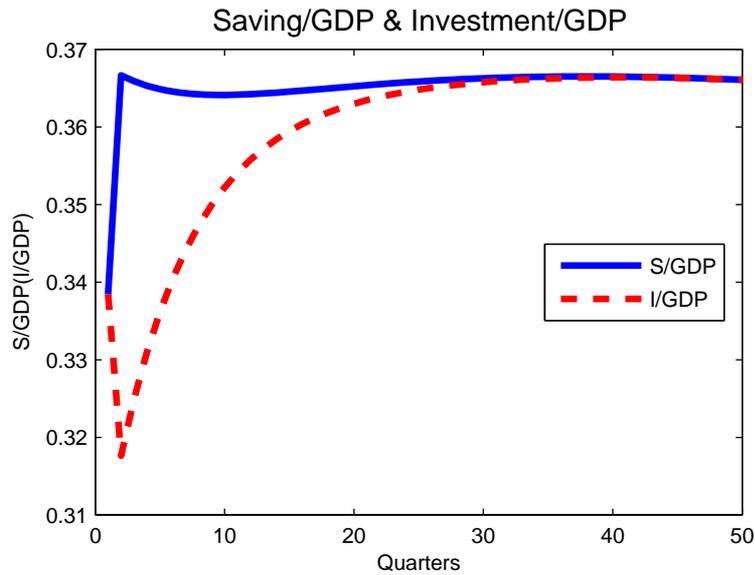
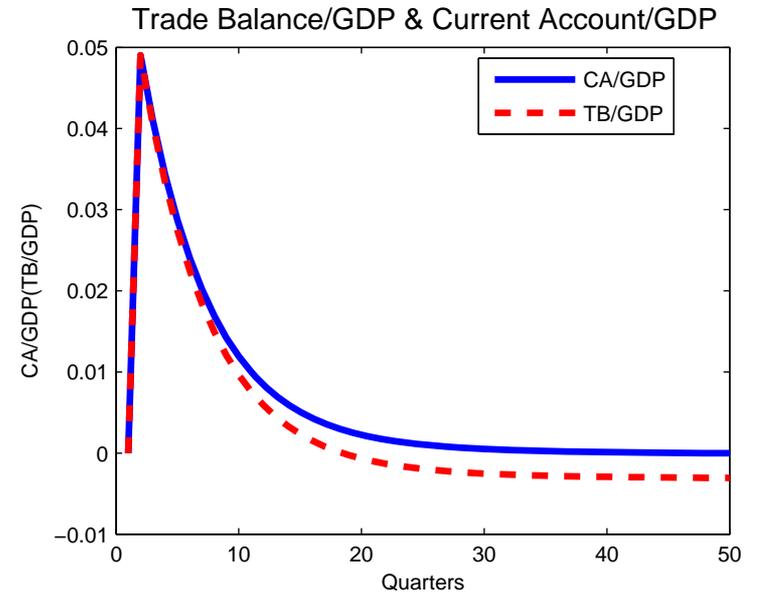
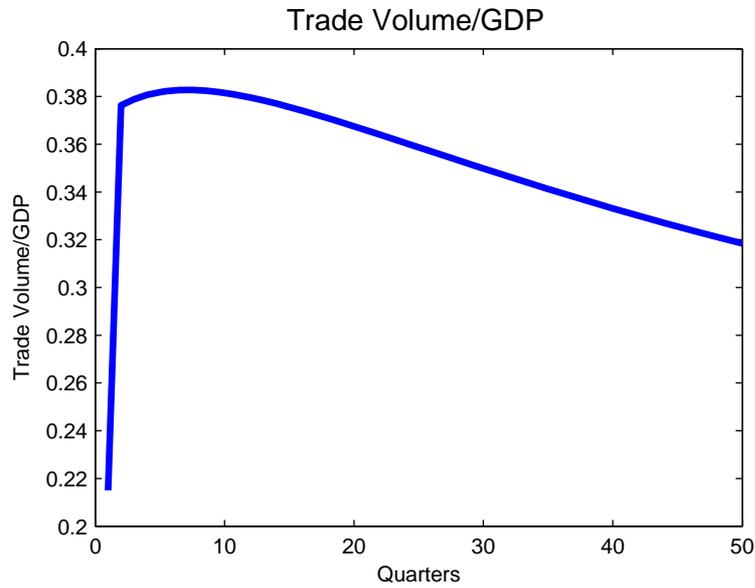


Figure 5: Transition path for different adjustment costs

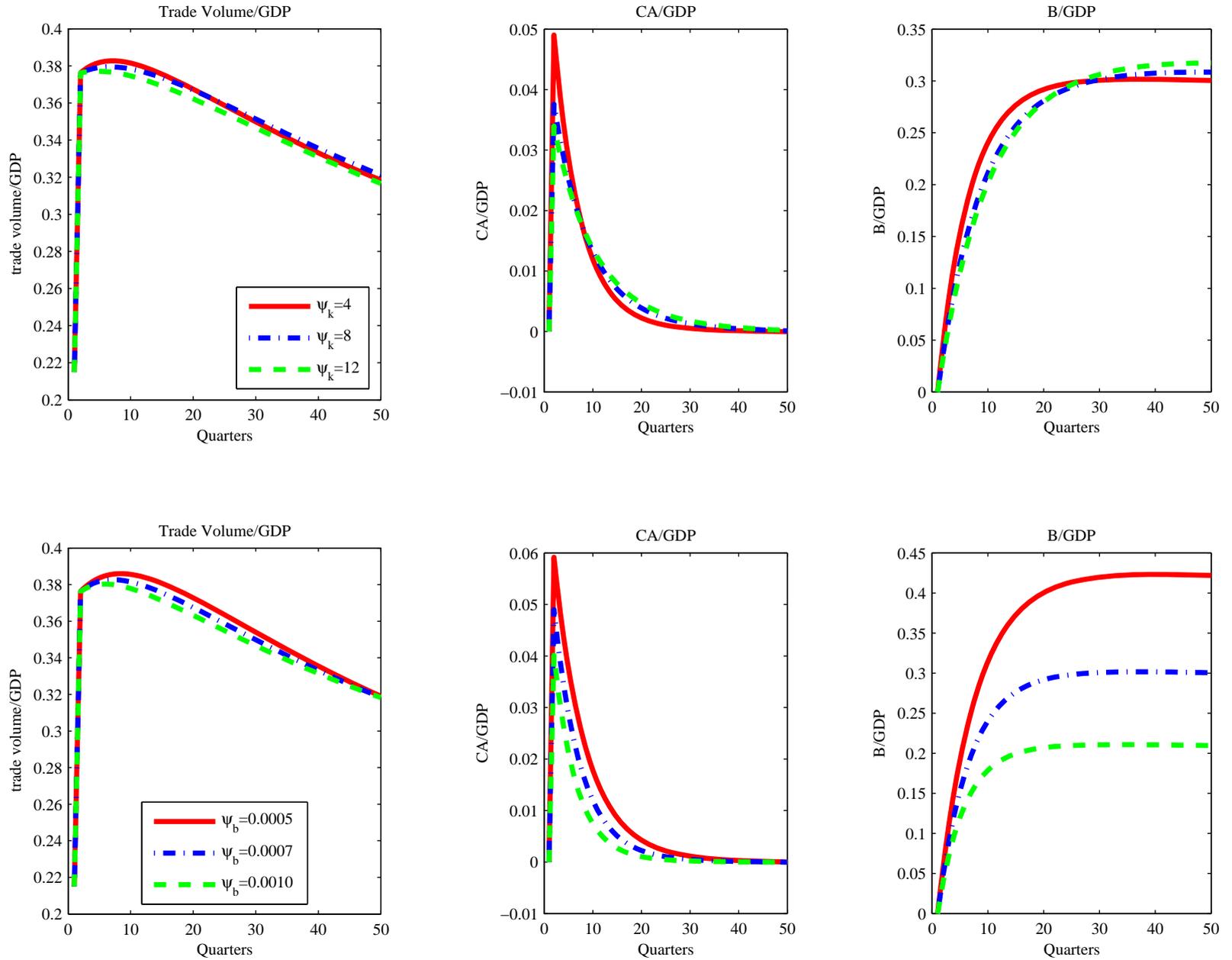


Figure 6: Transition Path under Credit Constraints after a Tariff Cut by 5 Percentage Points (from 15% to 10%)

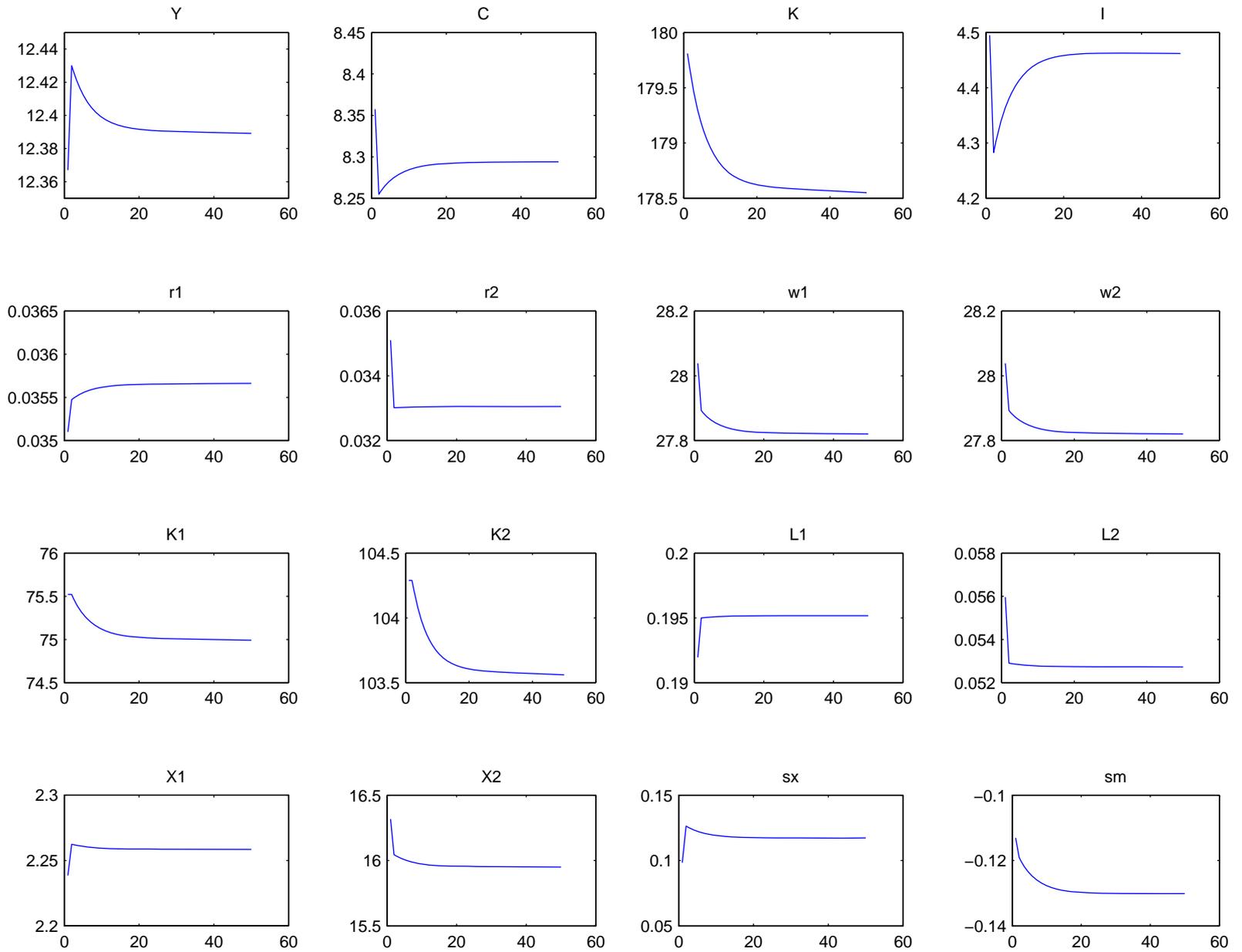
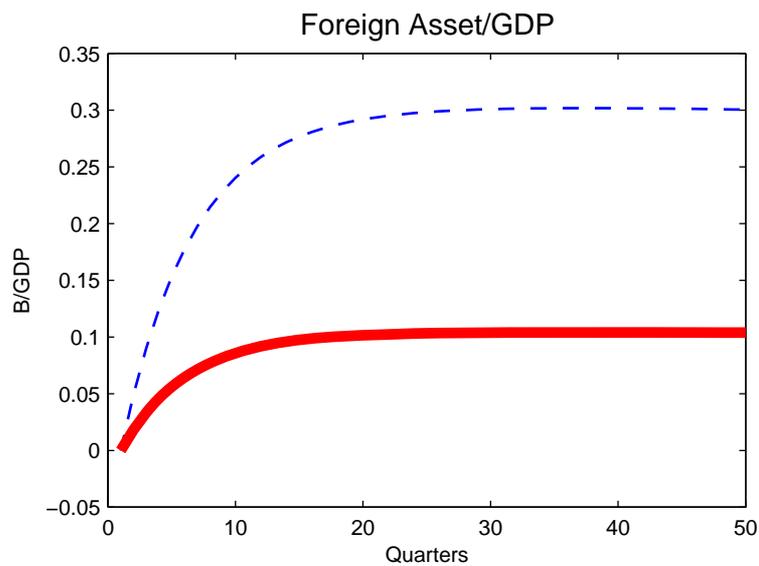
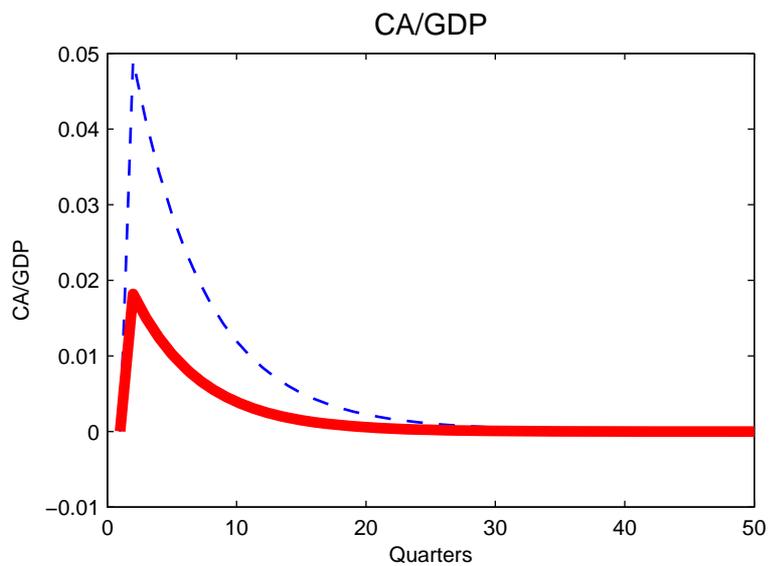
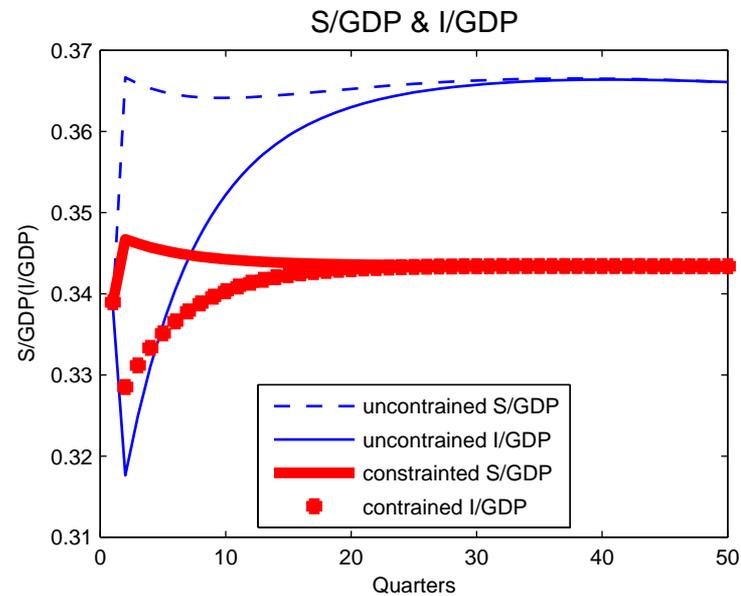
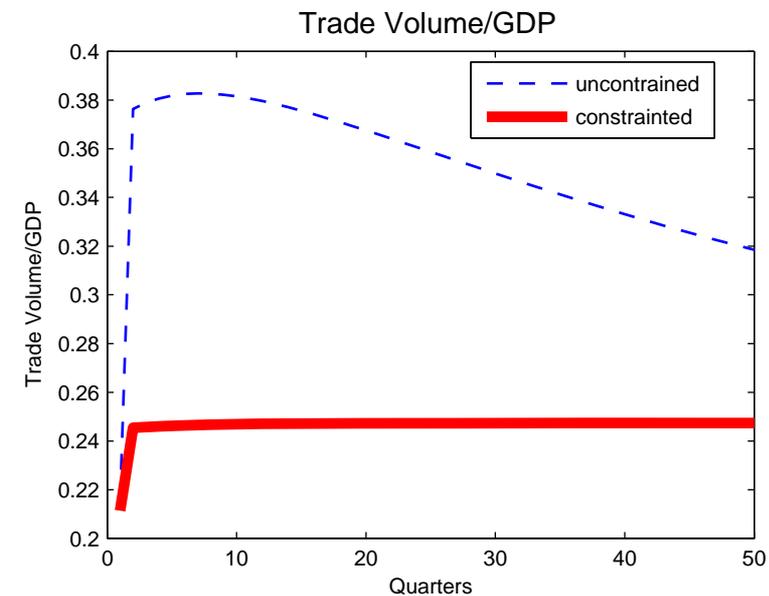


Figure 7: Responses of BOP Variables with and without Credit Constraints to a Tariff Cut by 5 Percentage Points (from 15% to 10%)



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