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International effects of China's rise and transition: Neoclassical and Keynesian perspectives☆

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ABSTRACT

Opinion over the global implications of China's rise is divided between critics and proponents. Critics see it as having developed at the expense of both investment and employment in the US, Europe and Japan. Proponents emphasise improvements in the terms of trade and reductions to the cost of financing that stem from China's supply of light manufactures, its demand for Western capital and luxury goods and its high saving. The criticism implies Keynesian assumptions while proponents take a neoclassical perspective. In this paper, both are embodied in a global macro-model that emphasises bilateral linkages via trade and investment, with monetary spill-overs represented by globally integrated bond markets. Net gains are suggested for the US and Europe from China's successful export-oriented growth, though there are partially offsetting Keynesian effects. China's recent slower, more consumption focussed, growth appears also to be beneficial in those regions and in Japan notwithstanding terms of trade losses.

1. Introduction

The rise of China and other Asian, heretofore developing, economies since the 1980s has not only underwritten global economic performance but, by cheapening traded light manufactures and supplying substantial excess savings, it has conferred on the developed regions terms of trade gains in both product and financial markets.[1] Real interest rates on long term instruments peaked in the mid-1980s and have fallen since, in part because of the relative expansion of high-saving regions. Yet the international changes wrought by China have been regarded by critics as having been at the expense of both investment and employment in the US, Western Europe and Japan. Moreover, in the US and Europe at least, through no fault

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[1] The terms of trade gain transmitted financially has been commonly referred to as the Asian "savings glut". To the extent that the glut extended beyond Asia, the major contributors were the petroleum-exporting countries. See Bernanke (2005), Chinn and Ito (2007), Choi, Mark, and Sul (2008) and Ito (2009). Yet the "savings glut" hypothesis has important detractors, whose stories are discussed later in the paper.

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of China's, the cheap credit tended to flow into debt-financed consumption, property and deficit government spending (Chinn, Eichengreen, & Ito, 2012).[2]

This pattern of interaction with Asia began to change, first with the slowdown in Japan in the 1990s but more recently with the poor performance of the other large regions after the global financial crisis (GFC). It has become clear that the export-led growth model is unsustainable for China, for two main reasons. First its light manufacturing exports now loom large in global trade and, with slowing demand outside China, there is insufficient scope for continued expansion at recent rates. Second, the demographic contraction that has already occurred in Japan is now imminent in China (Golley & Tyers, 2012). It will reduce the availability of surplus agricultural workers, raising labour costs and slowing productivity growth. The more inward-focussed alternative will be slower because new growth-sustaining reforms must now venture into politically sensitive areas, including the heretofore protected heavy manufacturing and services sectors and the *hukou* system that constrains labour mobility. Moreover, political stability will dictate that more attention be paid to environmental costs and to controlling income inequality. Importantly, Asia's contribution to global saving will also decline as reforms ensure that Chinese households are offered the choice to consume from more of their corporate income and as populations age, particularly in China and Japan.[3]

The world now has much larger East Asian economies than it did in the 1980s. Slowing growth and declining excess saving in this region since the GFC therefore not only offers the rest of the world shocks that are the opposites of the Asian shocks in the two prior decades but this time their impacts on global economic performance will be larger. Where the earlier shocks generated excess product supply and hence were deflationary in the developed world, inducing substantial and continuing monetary expansions, the new Asian changes will therefore be inflationary. Real rates of return must eventually rise, causing private portfolios to cease hoarding money and raising liquidity and price levels. Thus, Chinese consumption is very likely a key Keynesian stimulus that is helping to rescue demand and reduce unemployment queues in the advanced economies. Moreover, the higher interest rates that seem inevitable will increase their saving and therefore their domestic investment. For these reasons, and because of the extraordinary scale of sovereign debt in the developed regions, there will be pressure on monetary authorities to accommodate this inflation (Rogoff, 2013).

This paper offers a brief review of both the empirical and the modelling literatures concerning the global impact of China's growth to date, along with an analysis of both its retrospective and prospective impacts that employs a global macroeconomic model. The model is structured so as to quantify international effects that stem, on the one hand, from purely neoclassical changes to the product and financial terms of trade and, on the other, from shifts in factor demand in the presence of Keynesian sticky wages. Accordingly, it incorporates bilateral linkages via both trade and investment, with monetary spill-overs represented by globally integrated bond markets. The results suggest the effects of peak Chinese growth on the developed regions were large (Eickmeier & Kuehnlenz, 2013) and included reduced employment and investment on the downside, balanced by valuable terms of trade gains on the upside. With compensation for the displaced and unemployed, however, the results suggest that the pre-transition pattern of China's expansion would have yielded net real income gains in these regions. It is further suggested that the impending Chinese transition to slower, more inward-looking growth will be net beneficial to the US, the EU and Japan and of sufficient magnitude to be helpful in their real recoveries.[4]

The section to follow reviews the empirical and modelling literatures on China's global impacts. Section 3 then briefly describes the pre-GFC pattern of China's growth, the reasons for a transition towards more inward-focussed growth and the consequences of this for China's consumption and saving. The model used for quantitative analysis is then presented in Section 4 and assessments both of pre-GFC growth shocks and post-transition shocks are described in Section 5. Conclusions are offered in Section 6.

2. The debate over China's global impact

The modern literature on the effects in developed regions of trade with developing ones surged in the late 1980s following deterioration in the labour market performance of low-skill US and European workers. An extensive survey, grounded in the Stolper-Samuelson Theorem, was offered early on by Wood (1994). The subsequent literature broadened and can be thought of as divided amongst labour economics, global general equilibrium analysis and the combination of applied macroeconomics and international finance.

2.1. Labour studies

The early empirical studies of the links between trade and US labour market performance were by Bound and Johnson (1992), Borjas and Ramey (1994), Berman, Bound, and Griliches (1994) and Leamer (1996). These studies apportioned the blame for low wages or low employment of production workers variously between trade with developing countries

[2] Makin and Narayan (2009), while supporting the pretext, use growth accounting to suggest that foreign borrowing also contributed significantly to raising US output and hence living standards prior to the GFC.

[3] Japan's long time and substantial excess savings, embodied in its current account surplus, has been trending down in recent years and it briefly fell to zero in the fourth quarter of 2012. See Tyers (2012).

[4] The results are contrary to those of N'Daiye, Zhang, and Zhang (2010) and Genberg and Zhang (2010), who find that the international effects of increased Chinese consumption are small. Their results stem from their use of a model in which spill-over effects stem primarily from trade, and financial flows are only weakly represented.