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Macroeconomic consequences of the real-financial nexus: Imbalances and spillovers between China and the U.S.

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ABSTRACT

Relying on quarterly data since 1998 we estimate, for China and the U.S., small scale econometric models that economize on the number of variables employed and yet are rich enough to provide useful insights about spillover effects between the two countries under different maintained assumptions about the exogeneity of the macroeconomic relationship between them. We conclude that inflation in China responds to credit shocks. Indeed, the monetary transmission mechanism in China resembles that of the U.S. even if the channels through which monetary policy affects their respective economies differ. We also find that the monetary policy stance of the PBOC was helpful in mitigating the impact of the 2008–9 global financial crisis on China's financial conditions. Finally, spillovers from the U.S. to China are significant and originate from both the real and financial sectors of the U.S. economy.

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1. Introduction

Interest in China's rising economic influence has come at a time when there is recognition that economic interdependence has also increased. Similarly, the global financial crisis and its aftermath made clear that macroeconomic policies in large economies such as the U.S. create both real and financial spillovers. Indeed, even before controversy erupted over whether the extraordinarily loose monetary policy of the U.S. Federal Reserve in recent years generated negative outcomes, particularly in emerging markets, there was an ongoing debate that asked whether China was effectively exporting

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low inflation to the rest of the world. The impact of globalization more generally is apparent not only in the trading of goods and services but also in finance. Therefore, both real and financial shocks should be considered when one is investigating the aggregate relationship between these two large economies.[1]

It would seem natural then to explore the links between China and the U.S. in a framework that not only recognizes their macroeconomic interdependence but one where real and financial shocks jointly play a role. This is the principal aim of this study. Relying on quarterly data since 1998 we estimate small scale models that economize on the number of variables employed and yet are rich enough to provide useful insights about spillover effects between economies. We are not aware of any extant study that considers the nexus between real and financial conditions, together with an attempt to measure the size of spillover effects, for both China and the U.S.

We investigate the transmission of real and financial conditions between these two large economies and assess whether implications drawn from a modification to a standard macro model stand up to this kind of scrutiny. Juxtaposing China and the U.S. is of particular interest for several reasons. First, the issue of supply side shocks is nowhere more glaring than when addressing the issue of China's growing global economic influence. Second, whereas the U.S. has engaged in unconventional monetary policies over several years while being constrained by the zero lower bound (until December 2015), China has not suffered the same fate. Third, in several respects, China is still an economy that possesses several of the features highlighted by Rey (2013), who supports as seemingly sensible the Chinese authorities' responses to the failure of floating exchange rates to deliver complete monetary policy independence. Hence, an empirical evaluation of spillovers and their macroeconomic consequences seems appropriate.

The rest of the paper is structured as follows. The next section summarizes the relevant literature. The methodology and some stylized facts are described in section 3. Empirical results are reported in section 4 prior to a concluding section that provides some policy implications and suggestions for future research.

Briefly, we conclude that inflation in China responds to credit shocks. Indeed, some elements of the monetary transmission mechanism in China resemble that of the U.S. even if the channels through which monetary policy affects their respective economies differ. Next, we find that the monetary policy stance of the PBOC was helpful in mitigating the impact of the 2008–9 global financial crisis on China's financial conditions. Finally, spillovers from the U.S. to China are significant and originate from both the real and financial sectors of the U.S. economy.

2. Literature review

China's macro economy has some unique features that, in principle, can potentially complicate any kind of empirical macroeconomic analysis. Among these, of course, is the level of state involvement in the macroeconomy, the type and management of the exchange rate regime, and restrictions on capital mobility, to name but three such characteristics. In addition, there is the unusual structure of China's labor market.[2]

Until recently, some effort was devoted to asking whether and how inflation on a global scale was being influenced by rapid growth in China together with an exchange rate regime that exacerbated pressure on producers around the world to moderate price increases. For example, Bailliu and Blagrave (2010) find that foreign demand shocks impact China's economy more than those in advanced economies. Eickmeier and Kühnlenz (2013) also report that, while Chinese aggregate demand shocks impact oil prices, global shocks play a relatively more important role in global inflation dynamics than do aggregate demand shocks that originate from China. The bottom line is that China's culpability in keeping world inflation rates low since the 1990s is not proven.

[1] This result may be generalized leading to the conclusion that all that is left from the trilemma is a dilemma (e.g., see Aizenman et al., 2015). Hence, the choice is between monetary independence and capital mobility, with no effective role for the exchange rate regime. Consequently, the transmission of financial shocks has come to dominate economic links between countries.

[2] This is the starting point of Dollar and Jones's (2013) model. The challenge is to explain the country's extraordinary aggregate economic performance at least over the past two decades.

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