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ECONOMICS

THE GLOBAL IMPACT OF CHINA'S GROWTH

by

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The Global Impact of China's Growth

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1. Introduction

Over the last two decades China's growth rate has matched, if not exceeded, the peak growth rates of the Asian miracle economies. The result has been the largest fall in absolute poverty in human history, and the emergence of a new "economic superpower". Because of its size, China is the subject of extensive introspection over world issues such as: manufacturing jobs; wages; investment and savings imbalances; exchange rates; environmental issues; as well as the balance of defence capabilities.¹ Nevertheless, despite the popularity of "China Bashing" in the media, relatively little analytical work exists on the overall economic impact of China's growth on the rest of the world – at least relative to its importance.

The two quintessential issues in the existing literature are: (i) concern from other manufacturing exporting economies that their export prices eroded by Chinese competition, and; (ii) fear that Chinese exports have hurt domestic import competing manufacturing in developed countries. Both concerns stem from the massive export biased growth in China. Perhaps ironically, economic theory tells us that this export biased growth has eroded China's terms-of-trade and generated welfare gain for its main trade partners. In what follows I consider how these differing views stand up against the evidence.

2. How Big is China?

Since China's size is the key issue it is useful to note that "economic size" is surprisingly difficult thing to quantify. First, in order to compare economies we must convert their GDP from domestic currency units into a common currency. It is well known that market exchange rates do not properly weight differences in living costs, may fluctuate by large amounts, and may be subject to manipulation by governments.

Thus, when comparing real incomes across countries analysts often use Purchasing Power parity (PPP) exchange rates. The World Bank's estimate of China's GDP in \$PPP places China's GDP at approximately 75% of USA's GDP in 2011. Other studies, however, argue that this estimate understates China's size by 50% (Feenstra *et al* 2012, Conference Board Total Economy Database, 2012). Hence there is an important measurement issue.

¹ Some of these aspects of China's international impact are discussed elsewhere in this volume. For additional discussions see for example Tyers and Zhang (2011) for a survey of exchange rate management issues Yang (2012) on global imbalances, Li *et al* (2011) on global research and education and Mckibbin *et al* (2008) on global environmental issues.

Second it is not obvious that these PPP measures are the best measure to use for measuring the size of China's economic impact on the world economy. Their principle purpose is to measure costs of living for the purpose of welfare comparisons. If, however, we wish only to know China's ability to affect world prices through its potential to supply or demand goods and services on world markets, then standard exchange rate measures are, arguably, the more appropriate measure.

China's GDP at current market exchange rates, however, is only half the size of USA.² Thus taking into account both of these conceptual and methodological issues, we are left with estimates of China's relative size that have a disturbingly large range of 50% to 125% of the USA's GDP.

An alternative indicator of China's size relative to the world economy is the relative size of its trade flows. According to the World Bank, China's merchandise exports represent 9% of the world total, the same as the USA, despite being half its size.

Trade flows, however, are recorded as gross values whereas the actual contribution of a country to world supply is represented by the value added content of its exports. This distinction is important for China, since much of China's exports represent assembly and packaging of imported components - the last stage of the "Asian value chain". Koopman, Wang, and Wei (2012) estimate that the value added share of China's exports, for the year 2004, was 62.8% which is somewhat smaller than the USA (74.6%) and Japan (84.9%).³

The cautionary tale from this discussion is that it is quite difficult to quantify China's size. Nevertheless it is clear that there has been rapid increase in the size of China's economy over the last two decades, moving from a negligible fraction of world trade and output, to its current level. Using market exchange rates China is still the second largest country in the world, passing Germany in 2007 and Japan in 2010, and accounts for 10% of world output and 9% of world trade.

² It would be even smaller if we used an average exchange rate over say 5 or 10 years since the Renminbi has appreciated sharply against the \$US since 2005.

³ This points to an interesting question of China's importance in facilitating the fragmentation of production globally and in particular the Asian production hub. Hadad (2007) and Hanson (2012) offer some useful discussions of these trends.

3. Quantifying the Impact on World Trade Flows

Being large is necessary condition for a country to have a non-negligible impact on the world prices, but it is not sufficient. The impact of one economy's growth on the world economy is transmitted through its impact on the terms of trade - which depends on the bias of its growth. (Hicks 1953, Corden 1956, Bhagwati 1958). In China's case there appears to have been a strong export bias, so that China's growth has most likely caused an improvement in the terms of trade for its trade partners (Amiti and Freund 2008, Harris *et al* 2010).

For manufactured importing countries, like the USA, this may cause structural adjustment, but also improve welfare. But for other manufacturing exporters, i.e. those competing with China in export markets, the terms-of-trade decline causing welfare losses.⁴

An extensive literature exists trying to assess the quantitative implications of these two effects on trade flows, (Ahearne et al. 2003, Lall and Albaladejo 2004;; Roland-Holst and Weiss 2005, Coxhead 2007, Eichengreen et al. 2007, Athukorala 2010, Hanson, and Robertson 2010). Overall the evidence is mixed. For example Lall and Albaladejo (2004) find evidence of strong competitive effects but Hanson, and Robertson (2010) find that, for the countries with the most similar trade patterns to China, its growth represents only a small negative shock in export demand. Eichengreen *et al.* (2007) find positive effect on the exports high income Asian economies that are significant exporters of capital goods, and a strong negative effect on low income Asian countries that are dependent on the production and exports of consumer goods.

Athukorala (2010), however, argues that these studies fail to take account of the complex Asian production networks. He finds that China's exports to third country markets have had complementary effects on Asian exports due to the effect of components trade, and that the impact of China's growth on Asia is overwhelmingly positive.

Another limitation of this gravity literature is that it is focused on trade flows only. To that end Wood, and Mayer (2011) use on a factor content approach, familiar from the "trade-wage" literature, to examine at the impact of China's emergence on industry composition in other countries.

⁴ An alternative mechanism emphasised in new trade theory is that restructuring of industries may cause changes in average productivity at the industry level as marginal firms enter or exit (Venables 1986, Redding 2010, Eaton and). Hisch and Ossa attempt to quantify these effects but find that they are very small.

They argue that an upper estimate of the effect of a world with China, relative to one without it, would be to increase the world share of basic skilled workers by approximately 10%. They find that this would reduce the output shares of other countries primary and manufacturing sectors by only up to 1-3.5%, with the Asian economies being the most severely affected.

In contrast Autor *et al* (2012) assess the impact of China's import penetration on USA manufacturing, focusing on not just wage effects but also regional employment effects. They find that the rising exposure to Chinese import competition explains between 33-55% of the U.S. manufacturing employment decline between 1990 and 2000. This is a dramatic contrast with much of the earlier trade wage literature that found minimal effects on wages from trade in the USA, though this can be accounted for the fact that China is now much larger than it was when most of trade-wage studies were undertaken.

4. General Equilibrium, Trade and World Growth

A limitation of the literature discussed above is that it does not inform us about the global growth or welfare effects of China's growth. To complete the picture, more theoretical structure is required that allows us to map changes in the terms-of-trade into economy wide adjustments and factor returns. This is where computable general equilibrium (CGE) models are particularly useful, allowing us to quantify the theory that is at the core of our understanding about how growth in one country can affect another.

Dimaranan *et al* (2007) consider Chinese productivity increases that amount to a 40% increase in income for China. They find relatively large income gains for some neighbouring Asian economies, particularly Malaysia, Taiwan and Hong Kong, and resource exporters such as Australia and Canada.⁵ These gains are in the order of a 0.4 to 0.8% increase in the countries incomes, which represents 1-2% of China's growth. Conversely they find modest losses for other neighbouring countries such as Singapore, Thailand and Philippines. The average gain is 0.5% of GDP for lower income countries and 0.6% for middle income countries, and approximately no change more developed countries as a whole, including the USA.

⁵ For our purpose however this study muddies the water a little since it the results are for China and India together

Harris *et al* (2010) however, find much larger impacts on the USA. They consider the impact of decade of China's growth, which amounts to an 80% increase in China's GDP above the world growth trend, and find that this increases USA GDP by 3.2 percentage points. This represents an annualised additional growth benefit to the USA of 0.32 percentage point per year. This is a significant boost for an economy with a long run growth rate of just under 2% per year.⁶

Robertson and Xu (2010) employ a similar model to assess the impact of China's growth on other Asian economies. They find a 12% increase in per incomes for the more developed Asian economies, or approximately 1.2 percentage point per of growth per year. They also find more modest but still positive gains to the ASEAN group, which contrasts with some of the previous studies that showed terms of trade declines.

Some of these differences in impacts on GDP may be accounted for by the difference between short run and long run analyses in these studies. Moreover all these CGE studies find that China's growth results in significant reductions in the output of manufacturing in other countries- whether the gains are positive or negative. This reiterates the point that while terms of-trade improvements may hurt import competing sectors through Rybczynski effects, this is also part of the process whereby terms-of-trade gains are realised.⁷

5. Conclusion

The closest precedent for China's rise and integration into the world economy is the USA, which emerged in at the start of the 20th century as the world's largest industrial nation. The USA's growth also created significant adjustments to the world economy, but a century ago, it would have been hard to imagine the dominance that the USA would exert over the next 100 years.

China's continued rise may pose just as many economic challenges and create as many or more benefits. Currently, however, China's size on the world market is still only half the size of the USA. A robust theme in the literature above is that the counties most affected by China

⁶ A feature of their model is that allows import prices to affect investment costs, and hence equilibrium capital-labour ratios. Thus the model relates terms-of –trade effects induced by China's growth into long run growth in the USA.

⁷ For example Harris *et al* (2011) find a large contraction in manufactured durables output in the USA – similar to that reported by Autor *et al* (2012) – but this was associated with significant income gains.

so far are its neighbouring Asian economies and the resource exporting countries. This confirms that China's main influence so far, has been as regional force rather than global one. Nevertheless at least some studies suggest that the terms-of-trade impacts have been quite large and that China's growth has been an important source of growth for Asia economies and other economies, including the USA.

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