

## **INTRODUCTION**

### **THE SYMPOSIUM ON ‘CHINA’S IMPACT ON THE GLOBAL ECONOMY’**

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Over the past decade, China’s presence in the global economy has grown increasingly large. Along many dimensions, China is, rightly or wrongly, perceived to have an enormous impact. In the trade arena, China is now widely considered to be the world’s workshop, displacing some traditional exporters of labour-intensive goods, even as its economy is ever more closely woven into the fabric of the increasingly fragmented chain of production. The development of trade linkages has been accompanied by such rapid economic growth that the resulting demand for inputs has driven up commodity prices: at least that is the popular view. China has also become a large net saver in the world economy, as its current account has expanded in recent years. Figures 1 and 2 highlight these trends.

In this volume, our contributors examine several aspects of China’s economic interactions with the world economy. In so doing, they cast some light on the Chinese economy’s prospects.

In ‘A New Estimation of China’s Exchange Rate Regime’, Jeffrey Frankel takes up the issue of characterizing China’s exchange rate regime. Extending his earlier work on the subject, Frankel synthesizes a technique that has been used in the past to estimate implicit de facto currency weights with another technique used to estimate the de facto degree of exchange rate flexibility when considering an anchor to the dollar or some other single major currency. The critical innovation involves the inclusion of an ‘exchange market pressure’ variable into the currency basket equation. Frankel concludes that by mid-2007, the RMB basket had switched a substantial part of the dollar’s weight onto the euro. This means the single minded focus on the dollar/RMB exchange rate as a measure of the intentions of Chinese policy-maker’s might be misleading.

The exchange rate is also the topic of investigation in the paper by Steven Dunaway, Lamin Leigh and Xiangming Li. In ‘How Robust are Estimates of Equilibrium Real Exchange Rates: The Case of China’, the authors examine the sensitivity of estimates of the equilibrium exchange rate to alternative modelling approaches, including the macroeconomic balance approach and the extended purchasing power parity approach. The former involves estimating the determinants of the saving–investment balance to determine the normal

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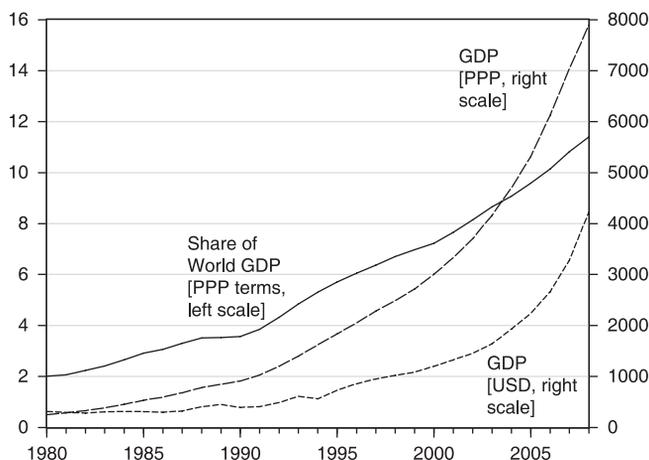


Figure 1. Chinese share of world GDP, in purchasing power parity terms (solid line, left scale, in percentage points); Chinese GDP in billions of International dollars (long dashed lines, right scale) and Chinese GDP in billions of US dollars (short dashed lines, short dashed lines)

Source: IMF, *World Economic Outlook*, October 2008. 2008 observations are forecasts.

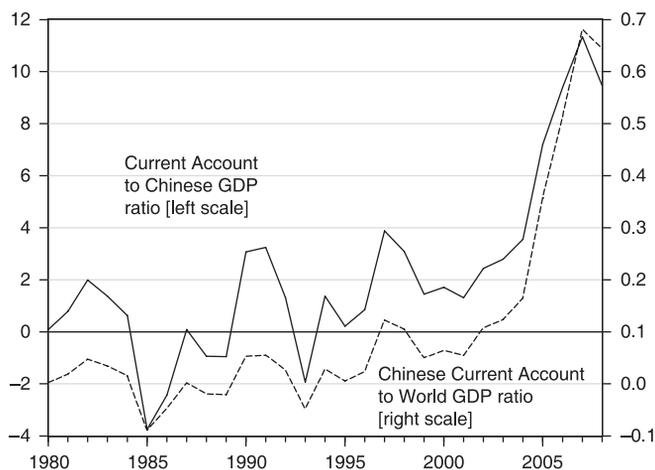


Figure 2. Chinese current account to GDP ratio (solid line, left scale); Chinese current account to world GDP (short dashed lines, right scale), all in percentage points

Source: IMF, *World Economic Outlook*, October 2008. 2008 observations are forecasts.

current account balance, and backing out the exchange rate that would achieve that current account balance. The latter approach relates the real effective exchange rate to measures of relative productivity and net foreign assets, in addition to other variables. They show that small perturbations in specification,

variable measures or samples can lead to big differences in the implied equilibrium exchange rate (in either approach), which in turn suggests caution in using these estimates.

The identification of the equilibrium exchange rate presupposes the proper measurement of the exchange rate. In the case of China, this issue has taken on heightened importance, as charges of RMB misalignment have proliferated. Charles Thomas, Jaime Marquez and Sean Fahle tackle the challenge of properly measuring the relative price of Chinese goods. The key insight they provide is that the standard method of creating exchange rate indices – essentially weighting changes in bilateral exchange rates by trade weights – provides an inaccurate picture of relative prices when trade patterns vary substantially over time. The authors show that, with China's trade patterns changing substantially, both Chinese and American relative prices are poorly represented by traditional indices. When these alternative indices are used in the stead of standard exchange rate measures, the asymmetry in US import and export elasticities essentially disappears. However, for Chinese net exports, a stronger currency is associated with a larger trade surplus. While this runs counter to the standard elasticities approach to the trade balance, it is reconcilable with a more general model incorporating supply-side considerations.

Turning to the determinants of China's trade flows, Willem Thorbecke and Hanjiang Zhang address the issue of how a revaluation would affect the labour-intensive component of Chinese exports. The sensitivity of these exports to exchange rate movements has long been identified as a source of resistance to faster RMB appreciation on the part of Chinese policy-makers. Thorbecke and Zhang find that, after taking into account the competition coming from other exporters of labour-intensive goods, this concern is well-warranted.

In the last paper, François Lescaroux and Valérie Mignon investigate the impact of energy prices on the Chinese economy. They use a factor augmented vector autoregressive approach, estimated over the 1980–2006 period, to trace out the various effects. The results indicate that an oil price shock leads to a contemporaneous, albeit brief, increase in price levels, a decrease in GDP, investment and consumption, and a delayed increase in coal and power prices. While the authors do not stress this point, one implication of the study is that despite some of the non-market elements of the Chinese energy sector, an increase in energy prices (partly driven by international oil prices) does have a measurable and negative impact on Chinese output, consumption and investment. And, although there is an impact on the consumer price index and producer price inflation in the short run, this dissipates over time.

Rounding out the symposium is a study by Joshua Aizenman and Yothin Jinjarek. They quantitatively assess the characterization of the USA as the 'demander of last resort', and link this to an examination of the prospects for China's current account balance going forward. The assessment involves analyzing a panel of 69 countries for the period running from 1980 to 2006. A key finding is that a 1.0 percentage point increase in the (lagged) US imports to GDP ratio induces a 0.3 percentage point increase in the current account balance of other countries, but only in those already running surpluses. This

asymmetry is robust to alternative specifications. Using these estimates, Aizenman and Jinjarek project a substantial decline in the Chinese current account to GDP ratio to 6.0 percentage points by 2013, which is markedly lower than the IMF's forecast of nearly 10.0 percentage points.

A change in the Chinese current account balance of this magnitude would definitely represent a change in the global economic landscape, one which all countries would have to adjust to. In this sense, China's impact on the global economy might over time change, but it will not diminish.