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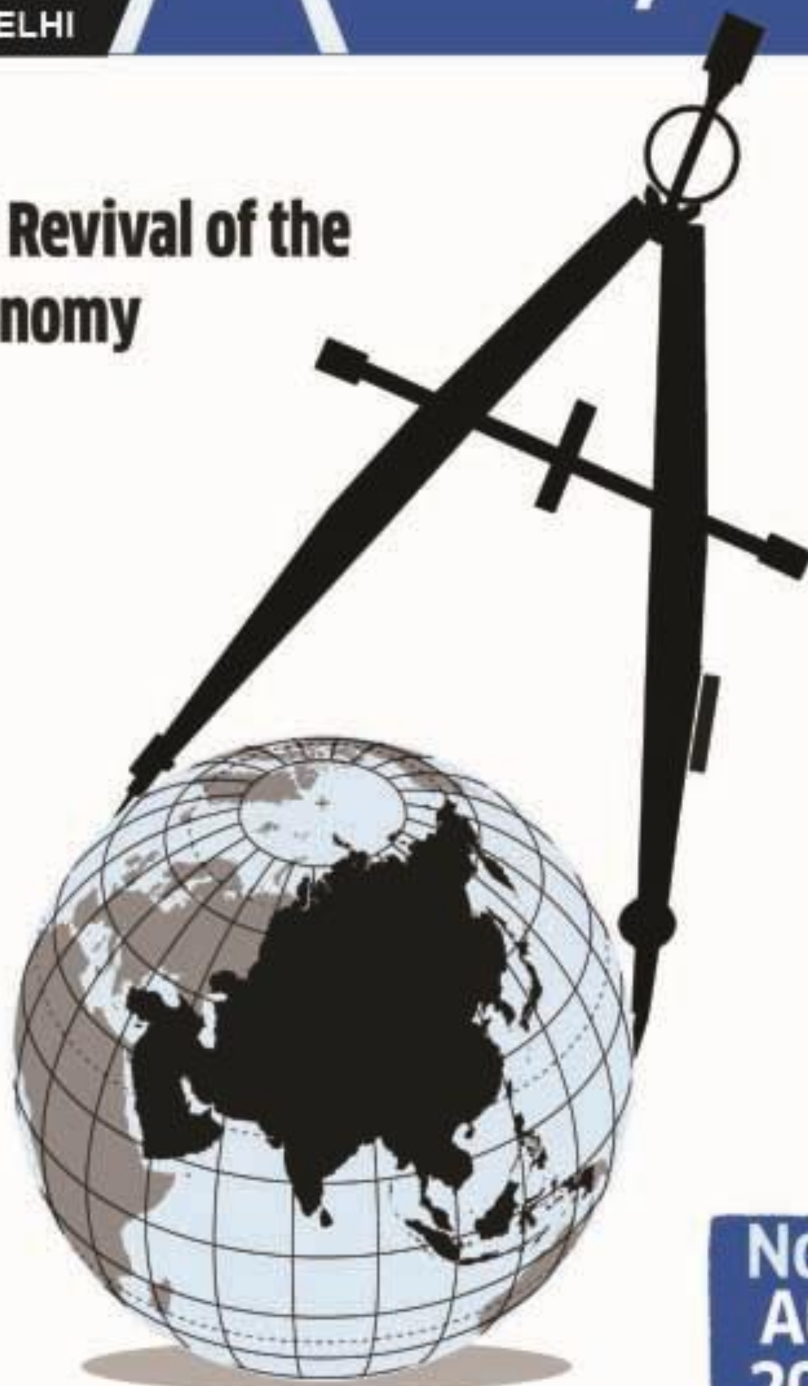
China and Revival of the World Economy



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China and Revival of the World Economy

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The recent economic slowdown in China has evoked mixed reactions. Those who see China's rise as a threat to the current order are relieved. Others - and this is no small number - are disappointed, as they expected Chinese growth to help world economic recovery. These latter analysts, believing in a slow recovery of growth in the developed countries, have looked to China and the emerging economies in general, to help generate a stronger recovery. This expectation has been based on the increasing importance of developing countries in the world economy and the belief, that developing economies can continue to grow unaffected by the crisis. This belief seemed to be borne out by the recovery of growth in China and India in the years immediately after the crisis.

Importance of Developing Countries for the World Economy

Developing countries raised their share of the increase in the world's GDP from 17% in the early 1990s to almost 50% in recent years. While all developing regions have increased their share, East Asia and Latin America are more significant, accounting for 13% and 12% respectively of the increased world income in recent years. Another trend is that exports have become more important to the GDP of both developed and developing countries. For the developing countries, the share of exports in GDP increased between 1990 and 2009 from 23 percent to 27 percent, and for developed countries from 21 percent to 24 percent. More significant, perhaps, is that the share of world exports destined for markets in developing countries has increased from 23% to over 30% during the same period, with more exports from both developed and developing countries destined for developing countries. How do these shifts affect the potential of developing countries to foster growth in the world economy?

Can China be an Engine of Growth?

The US economy's share of world income is 25% at official exchange rates and household consumption is 70% of US GDP, so household consumption is about 17.5% of world demand. On the other hand, China's GDP is about 9% of world GDP and household consumption in China, which has been falling, is only about a third of its GDP or about 3% of world demand. If the household savings rate in the US rises by 5%, it would reduce world demand by 1.25%. For Chinese consumers to compensate for this decline, household consumption in China would have to increase by more than 40%. The most important factor in household savings is the age structure of the population and this is not amenable to policy action especially in the short run. The propensity to consume has increased in East Asian economies over time; the increase, however, has been about 5% of GDP and has occurred over a prolonged period. Another way to look at the impact of changes in the Chinese economy, is to look at the problem from the view of balance of payments. The current account surplus in China is about 10% of its GDP. Halving it would add 5% of China's GDP to world demand. This would add less than 0.5% to world demand, obviously not enough to revive the world economy.

What would be the effect of higher growth in China, on other economies. The multiplier effect of higher expenditures in China on the rest of the world economy, depends on the savings rates in the two economies and the propensities to import. Given the high rate of savings in China and the increasing import propensities (the corollary to the increasing share of exports in GDP) the multiplier effect of higher expenditures in China on other countries is relatively small. So Chinese actions alone will not significantly raise economic activity in the world, though there may be beneficial effects on particular exporting countries.

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Even the large developing economies that are labeled emerging economies, cannot play an important role in the revival of the world economy. For instance, the shares of Brazil, India, Mexico and Russia are each only about 2% of world income and South Africa's share is 0.5%, and their share of exports from the developed countries is quite small. Growth enhancing expenditures of 1% to 2 % of GDP would add only about a few hundredths to world demand.

Growth in Developing Countries as a Group

Growth in developing countries as a group has the potential to bolster the world economy in so far as these countries provide a significant portion of current global growth and are important export destinations. We find that the effect of a stimulus in the developing countries on incomes of other countries is much larger than the effect of the stimulus in the developed countries as a whole. This is particularly true for the US and Japan because more of their exports are destined for markets in developing countries than is the case for Europe. Among developing countries, countries in South Asia and Sub-Saharan Africa are particularly likely to benefit from larger expenditures in other developing countries. China unlike India does not benefit much from expansionary policies in developing countries as more of its exports go to markets in developed countries and it has a higher savings rate.

While the entire group of developing countries has a substantial influence on the world economy, few individual countries have a large impact. For instance, exports to the whole of developing East Asia account for only about 8 % of US exports. Although exports to Latin America account for over 20% of US exports, only Mexico is significant as it takes in more than half of these. Since many of these are incorporated into re-exports to the US, these exports essentially depend on demand in the U S economy and cannot on their own generate increased demand in the US economy. Exports to developing countries are important only for Japan. But these are almost entirely to East Asia, which takes in about a quarter of Japan's exports. The share of Europe's exports destined to markets in developing countries is small so that growth in developing countries provides only a limited stimulus to European exports and growth.

Realization of the potential of developing economies

The potential impact of developing countries, however, is limited in the short run because of balance of payments (BOP) and fiscal limitations. For instance, in South Asia,. Pakistan has been following restrictive monetary and fiscal policies to rein in inflation. Bangladesh has expanded programmes to protect the vulnerable sections of its population. But in order not to create a fiscal imbalance it is cutting back on other expenditures so that there is little net stimulus. Even India's fiscal stimulus immediately after the crisis was small compared to China's, because the budget already had a large deficit. The deficit continues to be large, limiting fiscal policy. Furthermore, its monetary policy is constrained by the high rate of inflation. Many developing countries have responded to the crisis by trying to boost exports largely by providing easier credit to exporters. But in a stagnant world economy this might lead to terms of trade losses. Such losses were partly responsible for the very slow growth in Africa in the 1980s and 1990s. Improved terms of trade in the years before the crisis because of demand in China and India, resulted in better performance in Africa and a worsening of the terms of trade may lead to a set back again.

The potential of the developing countries could be better exploited if the manner of operations of the international financial institutions (IFIs), namely the World Bank (WB) and the International Monetary Fund (IMF) were changed. The IFIs lend to individual countries. Loans to one country, however, increase incomes in that country and raise its imports from other countries. But, this spillover effect is ignored by individual countries *and* the IFIs. If this was taken into account and the IFIs lent to groups of countries to maximize spillover effects their operations would buoy up the world economy more significantly. Such concerted and coordinated action would prevent the emergence of a BOP deficit that would face a particular country if it implemented growth-enhancing policies on its own. However, if other countries were also

implementing growth-enhancing policies, then their incomes would increase and their imports from this particular country would increase, so that the latter would not face a BOP problem. In other words, each country would find that demand for its exports would rise because of policies in other countries and this would balance the increase in imports following its own policy. Consequently, an integrated program covering a number of countries would have a larger expansionary effect than lending to individual countries.

Conclusion

Developing countries as yet, are individually too small for a higher level of economic activity in these economies to have a substantial effect on the world economy. This holds true even for China. So recovery from the current recession is going to depend largely on increased economic activity in Europe and the US. Developing economies are, however, becoming more important and will have a larger influence in the future. Coordinated expansionary policies in a number of developing countries could raise growth in the world economy. Implementation of such policies in developing countries would be encouraged by the IFIs implementing integrated lending programs that increase spill-over effects, rather than following their traditional country-by-country approach.

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