Nout Wellink: China's rise and its impact on Western economies

Speech by Dr A H E M Wellink, President of the Netherlands Bank, on the occasion of the China Congress, 'The Culture of Sharing Knowledge', Amsterdam, 3 October 2005.

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Thank you for inviting me to this conference organised by the Asia house. China is returning to the place it occupied in the world economy hundreds of years ago, when it was a centre of trade and innovation. Direct trade relations between the Netherlands and China go back to the early 17th century, but it is largely due to the opening of the country in the past decades that China's image as a 'mysterious' and 'inaccessible' country has changed radically. China is already one of the leading world economies, yet as in every rapidly developing country, its economic policy faces challenges. In addition, I would like to share my views on China's impact on the European economy. Note that while I will focus on China during my talk, we should not forget the other large, Asian country – India. The challenges faced by India might be of a slightly different nature, yet it reinforces the points I will make about the economic impact of China on Western economies.

How important is China now?

China dominates newspaper headlines. China's economic growth has averaged almost 10 percent per year over the past two decades, so that during that time its national income has been doubling every 8 years. Compare this to the euro area: our last doubling of national income took 30 years. In brief, China's growth represents one of the most sustained and rapid economic transformations seen anywhere in the world economy. And it has led to a significant reduction in poverty levels, too: by some accounts, over half of the reduction in absolute poverty in the world between 1980 and 2000 occurred in China.

While the shock itself occurs in China, it is transmitted to the Western world. Direct effects can occur through trade, leading to more international competition. The term 'globalisation' is typically used to describe changes in the world economy resulting from dramatically higher international trade. The ratio of worldwide exports to worldwide GDP rose from about 8 percent in 1960 to 27 percent last year. The Netherlands imported for almost 15 billion euro goods from China in 2004. This is about 6 percent of total Dutch imports.

In addition, there are indirect effects. For instance, China's appetite for resources drives up prices for commodities, including – as you may have experienced at gas stations– oil. Oil consumption from China has risen by 15 percent in the past year, helping global oil demand to grow at the fastest pace since 25 years. Not surprisingly, such increases drive up oil prices. Moreover, a redistribution of wealth takes place from oil-importing countries to oil producers.

Looking forward: policy challenges for China

Economic expansion can result from two sources: first, use of more inputs (growth in employment and the capital stock); second, increases in the output per unit of input (increases in productivity). Productivity in China is rising, but so far an even more important part of China's success story is driven by an astonishing mobilisation of inputs: China's population is about 1.3 billion people, and there is still a large amount of surplus labour in the rural area. As the Chinese economy is transformed, around 25 million jobs are created every year. In the same period, about 2-3 millions jobs are created in the U.S., and only about 1.5 million in the euro area! China's rise is a shock to world labour supply of unprecedented magnitude. If the pace of job creation is sustained, China's rapid growth could last for another decade or so. Clearly, if economic growth is based on expansion of resources, its pace is not sustainable.[1] At some point all inputs are fully used. From that point on, China's growth will slow down to its pace of productivity growth.

At present, China's growth gets an additional boost from keeping its currency undervalued. This improves its international competitiveness and fuels export growth. But a country cannot keep its real exchange rate fixed forever. Eventually a revaluation will occur: If a country grows faster than the rest of the world, economic fundamentals require an appreciation of one's currency over time. The adjustment can occur via two channels: a nominal appreciation, or high inflation. By fixing the nominal exchange rate, the pressure on inflation will increase. By limiting the room for an interdependent monetary policy, it also magnifies the risk of financial imbalances, such as bubbles in asset markets. Moreover, liberalisation of capital flows and financial globalisation implies that keeping one's exchange rate undervalued nowadays has become more difficult than in the 1980s.

There is a second issue to having a flexible Chinese exchange rate. To restrict exchange rate flexibility, capital controls are used. At present, Chinese control the outflow of capital. The Chinese savings rate is extremely high (40 percent), but interest rates offered to Chinese investors are relatively low. Therefore, an opening up of the capital account could lead to high outflows of Chinese capital, causing difficulties for the banking sector. Therefore, changes to the exchange rate system must go hand in hand with efforts to strengthen the banking sector.

China's accession to the World Trade Organisation (WTO) comprised commitments to substantially liberalise its financial sector by 2006. Clearly, the pace at which market participants need to comply with international practices may differ – e.g. different requirements may be in place for local banks than for international banks – but large commercial banks will certainly have to adopt international standards. To ensure a level playing field, this will also imply that at some point, large Chinese financial institutions will have to follow the same international rules and practices as European financial institutions – including Basel II. In a general sense, Basel II represents an improved and internationally comparable way to look at risk taking in financial organisations over time. This also implies that the supervisory framework needs to be strengthened, in order to be able to cope with the supervisory challenges resulting from advanced instruments to manage risk.

Finally, no discussion of China's growth would be complete without mentioning the notoriously poor quality of China's statistical data. When browsing through China's official statistics, one cannot fail to notice inconsistencies, such as shares of investment per sector adding up not to 100 percent, but to 120-or-so percent. I suspect that data for the service sector could be even more unreliable, given the particular difficulties of measuring output and detecting underreporting. To take good decisions a policymaker needs good data. Part of the problem could lie in the fact that private parties are not allowed to compile statistics. That said, progress is being made almost as I speak, as Chinaworks hard to improve the quality of statistical data and to bring it up to international standards, such as those of the OECD.

How should western economies react?

Despite the policy challenges there can be little doubt that China's presence in the world economy will grow further. Emergence of new economic powers is not a new phenomenon: since the 1950s, for instance, we have witnessed the rapid rise of Japan.

The rise of China is different from that of any other country in terms of its size. It is not different in the sense that the world as whole will benefit. If the productivity of 1.3 billion people increases, world production increases and we all benefit. Consumers experience this every day: international competition has resulted in cheaper goods, and has contributed to the success of central banks in maintaining price stability.[2] But it is not just that prices have fallen, in addition consumers can also choose from more variety: where Henry Ford once joked that his famous T-model comes in 'any color as long as it is black', today's consumers can purchase a wide array of goods not available in the past.

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1 P. Krugman. The myth of Asia's miracle. Foreign Affairs 73 (6):61-79, 1994. Krugman's main message is confirmed in Duo Qin, Marie Anne Cagas, Pilipinas Quising, and Xin-Hua He. How much does investment drive economic growth in China? Queen Mary University of London Working Paper 545, 2005.

2 K. Rogoff, 2003, Globalization and global disinflation, paper prepared for Jackson Hole conference, August.

A recent U.S. study found that the welfare gains from consumers having a broader choice of goods are equivalent to 2.8 percent of GDP.[3]

China has a huge cost advantage in producing labour-intensive goods. Consequently, Europe's economic structure will change: as Chinese wages are much lower than European wages, production of labour-intensive goods is shifted to China. Europe will specialize in capital-intensive production. One area where massive relocation of business activities is already taking place is the textile sector. We must acknowledge the hardship imposed on those who find themselves out of work. And we must ask ourselves: which policies are needed to ease the adjustment?

Let me be clear: protectionism is not the answer. This would not only hurt Chinese workers, it would also deprive European consumers from the benefits of international trade. Instead, competitive, sound firms in Europe must have opportunities to grow, while policymakers should limit assistance to firms that will no longer remain competitive. Structural change brought about by globalisation is not very different from structural change imposed by technological progress. Had we banned cars, we would still be using horses and buggies. Viewed from that angle, it is clear that we would become poorer by protecting industries that cannot compete with cheaper foreign products, or by protecting employment in these sectors. Europe's advantage lies in the production of capital-intensive goods. And given that the most severely affected jobs are typically those requiring the least education, our efforts must be directed to improve education and to offer training for those affected.

I am often asked whether Dutch wages are too high in the face of competition from low-wage countries. I believe that the gap in wages will fall, but there are two sides to that issues: (1) what will happen in China, and (2) what will happen in Europe. A consequence of China's rapid productivity growth will be that real wages in China will rise. Economic history offers no example of a country that experienced long-term productivity growth without a roughly equal rise in real wages. The idea that somehow the old rules no longer apply and that China will always pay low wages, despite rising productivity, has no basis in actual experience.

The second issue is what will happen in Europe. Here my approach is a pragmatic one: we should not a priori exclude the possibility that part of the adjustment could occur via wages. I would like to remind you that we are dealing with a world labour-supply shock of unprecedented magnitude. We simply do not know what the exact effects on European wages will be, but one thing is clear: if real adjustment is needed, we cannot prevent it from happening. The more restrictions we impose on the adjustment process the worse off Europe will be in the end. Restricting wage adjustment could result in adjustment occurring via a lower exchange rate. But with one important downside: wage adjustment can allow for sectoral differences, while adjustment via the exchange rate hits the entire economy. This is most likely not an optimal solution.

Conclusion

The world economy is increasingly integrated. Therefore, China's rise transmits shock waves to Western economies as that country continues to develop and prosper. Europe will face tough competition. New possibilities will open up for European firms, but Europe's production of labour-intensive goods is likely to come under pressure.

China offers tremendous opportunities for Western consumers and firms, and there is little reason to be scared of China's rapid development. To fully reap the benefits of China's rise, European policymakers must not hesitate to reform our economies. In particular, our labour markets need to become more flexible, as the pace of change is likely to increase. Changes imply that in the short run, there will be winners and losers. Overall, however, welfare will rise, as was the case when we moved from the horse to the car. Changes in the European production structure towards more capital-intensive production will imply that some workers will have to change jobs. We have to continue to stimulate an environment of lifelong learning to facilitate retraining and to ease this transition period.

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[3] C. Broda and D. Weinstein. Are we underestimating the gains from globalization for the United States? Current Issues in Economics and Finance (Federal Reserve Bank of New York) 11 (4), 2005.