

A Model of Structural Transformation and Demographic Transition in China and Dynamics of World Interest Rate

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Summary

This paper studies the theoretical implications of structural transformation and demographic transition in Mainland China for its domestic economy and the world interest rates. Our proposed model predicts that the transition from a manufacturing-oriented economy to a service-oriented economy affects the world interest rates through the balance of payment channel by changing the relative price of the non-tradables in the foreign country. Specifically, labour transfer without efficiency improvements in the tradable sector tends to lower the world interest rate, while economic transition triggered by initial productivity gains in the tradable sector tends to push up the interest rate. Our model also predicts that aging causes the real interest rate to fall, though by a small amount. Since interest rate movement during economic transition is small, its feedback effect on output and the real exchange rate is not large. Contrarily, labour transfer and aging have significant impacts on domestic output, besides the initial productivity gains (if any) in the tradable sector. Exchange rates and foreign output are also affected by domestic transition, especially when transition is triggered by efficiency improvement in domestic tradable sector.