Oceans Apart? China And Other Systemically Important Economies

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Summary

Two notable events mark the last decade. They are: the rise of China as a systemically important economy and two major financial crises, the first of which has come to be referred to as either Great or Global but was certainly international in scope, followed shortly thereafter by the Eurozone sovereign debt crisis. Unlike the US, the Eurozone, and Japan, economies considered systemically important, China is not an advanced economy (AE). Nevertheless, according to the IMF, China is the only emerging market economy (EME) with a truly global reach. It is surprising then that most empirical studies of large economies either leave out a role for China or view its impact as if it only exogenously affects large advanced economies. This study addresses this omission by treating China as a systemically important economy that not only generates globally important shocks but is also a recipient of them.

Our study reveals that the ‘locomotive’ effect of China on economic growth when it simultaneously interacts in a model with the other systemically large economies, namely the US, Japan, and the Eurozone, is stronger than previously thought. Equally important, the model proposed in this paper explicitly allows for financial shocks to interact among the four large economies considered. Despite progress made in trying to explain the transmission mechanism of macroeconomic shocks from a variety of sources the role that global factors play, and the relative contribution of systemically important economies to global economic outcomes, also remains a work in progress. This paper also provides new empirical evidence of the extent to which, individually and jointly, systemically important economies are an engine of global real economic conditions.

Briefly, our principal findings are as follows. The importance of global shocks rests on treating China as part of the group of systemically important economies that endogenously interacts with the US, the Eurozone and Japan. Omitting China or treating it as an exogenous vis-à-vis the other large economies significantly understates its influence on the global economy. Moreover, spillover effects operate in both directions, that is, not only does China impact the US, Japan, and the Eurozone but monetary and financial shocks also affect China’s economy. We also conclude that monetary policy shocks have a significant global component. As such, there is the risk that a domestic tightening can be augmented by a further global tightening with negative real economic consequences. Leaving out a role for financial shocks results in the omission of an important channel through which shocks propagate in the global economy. Consistent with recent research inferences about the impact of shocks is significantly influenced by this kind of mis-specification.

Our findings also have implications about whether large economies ought to cooperate. There is considerable synchronicity in real economic conditions but much less so between the financial conditions. The same is true for monetary policies which seem to be driven primarily by its domestic component. The fact that global shocks can amplify domestic shocks ought to be sufficient for policy makers to at least cooperate. In the meantime, however, China's role among the systemically important economies cannot be ignored. Its links with the US, the Eurozone, and Japan are quantitatively and economically significant.