China in the World Trade System

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A Preview

- Chinese International Trade
- Long-Term Global Economic Trends
- The Entry of China into the World Trade System
- The Prospects of an East Asian Free Trade Area
- China Can Take the Lead to Advocate Further Improvements of the World Trade System

Chinese International Trade

- Chinese international trade has been growing at double-digit rates in recent years and is expected to continue to do so in the future.
- Total exports and imports of goods amounted to almost US$1.15 trillion in 2004 compared to US$20 billion in the early 1980s.
- China is now the world's third largest trading nation.
- Chinese trade balance (in goods) vis-à-vis the world has been relatively small in recent years—US$32 billion in 2004—despite the large bilateral surplus vis-à-vis the U.S.

Chinese International Trade

- More than 50% of Chinese international trade is foreign-direct-investment (FDI)-led, i.e., conducted by "foreign-invested enterprises".
- More than 50% of Chinese international trade consists of intra-company trade.
- A large percentage of Chinese international trade consists of trade in raw materials, "intermediate inputs," "semi-finished goods" and "services" rather than finished "products".
- China is often the last link of the global supply chain—thus, it has trade deficits with almost every economy in East Asia but large trade surpluses vis-à-vis the U.S. (and to a lesser extent the other developed economies).

Chinese International Trade

- Chinese exports is still characterized by a relatively low domestic value-added content—estimated to be 30% for all exports and 20% for exports to the U.S. (Thus a 10% revaluation of the Renminbi will result in only a 2% increase in the cost of Chinese exports to the U.S. in U. S. $ terms, and a very limited impact on the volume of trade.)

Long-Term Global Economic Trends

- De-verticalization or fragmentation of production, resulting in even finer division of labor and specialization (out-sourcing).
- De-verticalization has been greatly facilitated by the "Information and Communication Technology (ICT) Revolution".
- Rising globalization.
- The complementarity of de-verticalization and globalization.
- The resulting rapid growth of world trade (in gross terms).

Long-Term Economic Trends: Rising Globalization

- Falling barriers (legal, technical, and institutional) to movements and virtual movements of goods, services and factors (particularly capital (including foreign direct investment), but also human capital); more expeditious and impartial cross-border resolution of commercial disputes.
  - Reduction and/or elimination of tariff and non-tariff barriers
  - WTO, European Union, NAFTA, ASEAN Free Trade Area, other free trade areas
- Falling costs of (international) communication and transportation.

Long-Term Economic Trends: Rising Globalization

- Falling transactions costs in terms of both money and time brought about by the information and communication technology (ICT) revolution
  - The rise of English as a global medium of communication
- The increasing acceptance of the concept of national treatment for foreign direct investment.
- Benefits of economies of scale create large global niche players.
- Global competition has also brought down further the costs of relocation/out-sourcing.

Implications of Rising Globalization

- A new impetus for the growth of world trade
  - The finer division of labor increases the gross volume of world trade, even if total value-added grows much more slowly
  - Over time, both exports and imports as percentages of GDP will tend to rise worldwide; however, net exports, and value-added from exports as a percent of GDP will tend to rise much more slowly
  - Trade in “Intermediate Inputs,” “Semi-finished Goods” and “Services” rather than finished “Products”
    - A substantial proportion of world trade is intra-firm and intra-industry trade
  - Many services not previously traded have become tradable—e.g., back office work, call centers.
  - Tourism is one of the few non-tradable services left because it is location-specific
- Rising globalization induces an expansion of potential world output

The Complementarity of De-Verticalization and Globalization

- Specialization in tasks rather than products by firms—finding a niche in the global supply chain that maximizes value-added based on “core competence”; higher-value-added parts of the supply chain have much less competition (Intel, Microsoft, TSMC)
- Specialization in tasks enables the realization of economies of scale and learning by doing effects—It is more efficient for firms to expand horizontally (to supply multiple customers around the globe) rather than to integrate vertically

The Entry of China and Other Major New Players (India and Russia)

- The emergence of the Chinese economy on the global market was the one important new development during the past quarter of a century.
- Major re-alignment of comparative advantages
  - Both existing and new players can benefit
  - Comparative advantages will change
  - Adjustments will be necessary
  - There should be sufficient gain for everyone to more than compensate all the losers
- China as the “world’s factory”.

The Entry of China and Other Major New Players (India and Russia)

- The Chinese market as an "engine of growth"--increased demands for goods and services (oil, minerals, raw materials, aircrafts, cell phones, computers and tourism services).
- China as a source of unskilled labor--there will be little upward pressure on the real wage rate of unskilled labor in the world for many years to come (factor-price equalization) and hence little inflationary pressure.
- Outbound Chinese foreign direct investment will lead to further significant growth of Chinese international trade.

China and Its Large Domestic Market

- Minimum efficient scale can be readily achieved.
- Leveraging intangible capital (R&D capital, knowledge capital, intellectual property broadly defined)--economies of scale in the utilization of intangible capital implies that the rate of return depends on reaching as large a market as possible.
- Standardization and standard setting and establishment of brand names generate market economies of scale (the higher the market share, the higher the profit margin).
- No global player or aspiring global player can leave the Chinese market alone to its competitors or potential competitors (an opening to establish themselves).

The Macroeconomic Implications of the High Domestic Savings Rate

- Chinese domestic savings rate is in the mid-40s, among the highest in the world.
- If it were not for the similarly high domestic investment rate, China will be running a huge trade surplus vis-à-vis the world (largely independently of the exchange rate).
- The promotion of domestic consumption is therefore essential for long-term economic equilibrium.
- Promotion of domestic consumption depends on the successful establishment of credible and sustainable systems for the financing of pensions, health care, education and housing—Private personal consumption is unlikely to be sensitive to the rate of interest—it may even be negatively related to the rate of interest because of target savings for various purposes—retirement, college tuition for children and grandchildren, down payment for purchase of own residence, down payment for purchase of consumer durable, vacation, etc.

East Asian Economies: ASEAN + 3 (including Hong Kong, Macau & Taiwan)

- ASEAN (Association of Southeast Asian Nations)—Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
- + 3 (Mainland China, Japan, South Korea)
- + Chinese Economic Areas (Hong Kong, Macau and Taiwan)

Rising Intra-East Asian Interdependence from Trade and Capital Flows

- Over the last two decades, the shares of exports of East Asian economies destined for other East Asian economies have been increasing rapidly. The share of Japanese exports for East Asia rose to almost 50% in 2004. Similarly the share of East Asian exports in Japanese imports also rose to almost 50% in 2004.
- Over time, China has become increasingly one of the most important destinations for the exports of other East Asian economies.
- By the early 2000s, more than 50% of the exports of the East Asian economies are destined for other East Asian economies. The increasing shares are a manifestation of the increasing economic interdependence.
- In contrast, the share of U.S. exports destined to East Asian economies as well as the share of U.S. imports originated from East Asian economies have declined slightly during the last decade.

Intra-East Asia Capital Flows and Technology Transfer

- The wild geese flying pattern of East Asian economic development (Kaname Akamatsu (1962))
- Japan, Hong Kong, Singapore, South Korea and Taiwan have become major direct investors in the East Asian developing economies. More recently, Chinese enterprises have also begun to make direct investments abroad.

Economic Complementarity or Competition

- Within East Asia, there exists significant economic complementarity between the developed economies (principally Japan) and the developing economies (China and the ASEAN without Singapore)—there is very little overlap and hence competition between what Japan exports on the one hand and China and the ASEAN without Singapore export on the other hand. Japan is still the premiere source of capital goods and technology within East Asia. This complementarity is borne out by the trade statistics at the disaggregated commodity level.
- The Newly Industrialized Economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan are actually competitive with the developed economy, Japan, on their high ends and with the developing economies on their low ends (and with one another).

Economic Complementarity or Competition

- Moreover, the bulk of the Japanese exports as well as exports from the East Asian Newly Industrialized Economies consists of intra-industry and intra-firm trade, which reflect that the exports are mostly based on long-term supplier-user relationships and/or direct investment by parent firms. Globalization of supply chains and the concomitant de-verticalization of production and outsourcing have accounted for much of the expansion of intra-industry and intra-firm trade.
- The largest potential gains from the economic complementarity is therefore a (China-Japan-ASEAN) free trade area (FTA). The continued economic development and growth of East Asian economies, including China, therefore present enormous economic opportunities for the capital and technology goods industries of the more developed economies in the region.

The Formation of Free Trade Areas
The ASEAN Free Trade Area (AFTA)

- Intra-ASEAN tariff rates have been lowered to 5% on Jan. 1, 2002 with the inauguration of the ASEAN Free Trade Area (AFTA) among Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. The goal is to reach zero tariff rate within AFTA by 2010. The reduction in tariffs applies to 90% of products provided the ASEAN content of the product exceeds 40%.
- Khmer Republic, Laos, Myanmar and Vietnam are expected to join AFTA in 2006 and reach zero tariff rate within AFTA by 2015.
- Specific protection on manufactured and agricultural products still remains.

The China-ASEAN Free Trade Area

- Chinese Premier ZHU Rongji first proposed in Brunei in November, 2001 a new free trade area, covering China and the ASEAN (Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), to be created within ten years.
- A 3 trillion US$ market and 1.7 billion consumers
- Complementarity (primary raw materials) and competition (light manufactures)
- Opening the economies for trade—China will become a major export market for the ASEAN and vice versa

The China-ASEAN Free Trade Area

- The free trade area will promote foreign direct investment in the ASEAN region itself through the enlargement of the potential market and the resulting attainment of the minimum efficient scale.
- Further agreement was reached in a second meeting in Phnom Penh, Khmer Republic in November, 2002 at which a framework agreement for the establishment of the China-ASEAN Free Trade Area was signed.
- Negotiations to be completed in Laos in 2004 with "early harvest" for ASEAN countries in the reduction of tariffs on agricultural and food products. Full free trade between China and Brunei, Indonesia, Malaysia, Philippines and Singapore by 2010; full free trade extended to Khmer Republic, Laos, Myanmar and Vietnam by 2015.

Identifying a Sequence of Implementable Measures

- Harmonization of standards and facilitation of exchangeability
- Coordination of foreign direct investment policies
- Coordination of capital market policies
- Common issues on trade
- Coordination and stabilization of exchange rates can provide potential Pareto improvement to all economies
  - Distinguishing liquidity problems from solvency problems

Harmonization of Standards and Facilitation of Exchangeability

- Technological standards—e.g., mobile telephones, television, data transmission, financial data protocols
- Grading, inspection and certification standards for commodities
- Software standards
- Certification standards
- Harmonization of rules and regulations for e-commerce

Coordination of Foreign Direct Investment Policies

- Investment protection
- Tax treaties—elimination of double taxation and exchange of information
- Harmonization of investment benefits for foreign direct investors (differentiation by host countries can be permitted based on real GDP per capita)
- Elimination of export requirements on foreign direct investment
- Common policy for the free movement of employees of foreign direct investors (on residence, tax, pension and other related matters)

China Can Take the Lead to Advocate Further Improvements of the World Trade System

- Rules of origin incompatible with the global trends for de-verticalization (fragmentation) and out-outsourcing—China and other developing economies should take to lead to move to a system of tariffs (if any) that is based on only commodity categories regardless of origin (so long as the entire chain of production occurs within members of the World Trade Organization (WTO)—perhaps a separate protocol among subscribing members within WTO).
- Dumping and anti-dumping rules to be based on comparison of the levels of export prices and wholesale prices in the exporting country

China Can Take the Lead to Advocate Further Improvements of the World Trade System

- Import surge rules to be based on changes in the total imports of a commodity category rather than changes in the imports from a given country of origin. If there is no surge in total imports of a commodity category, then presumably no domestic production is being replaced and no domestic worker is being damaged. There is a change in the composition of total imports of the commodity category by countries of origin but presumably that is a voluntary choice of the consumers of the importing country and should result in a net increase in consumer welfare.

China Can Take the Lead to Advocate Further Improvements of the World Trade System

- "Equitable" labor standards and environmental standards consistent with the level of economic development of different countries
- Internalization as a possible win-win solution to environmental and pollution problems (e.g., the reduction of acid rain).
- The possibility of internalization of costs of adjustment (e.g., exporting textile machinery in exchange for increased imports of textiles; firms in exporting country assuming the responsibility for the displaced workers in the importing country).
- The emergence of a new reserve/settlement currency—a common currency (or asset) that East Asian economies are willing to accept for settlement purposes among themselves (and hence to hold)