The Rise of China and its Global Implications: some comments

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My comments focus on three current perceptions about China's economic emergence: (1) as a destination for foreign direct investment (FDI) and its role in world trade; (2) China's alleged role in global deflation; and (3) China as a regional leader in East Asia.

1. China as the world's factory

Starting with FDI and trade, it is now well known that China recently surpassed the United States as the world's leading destination for FDI. Behind this statistic is the fact that China has become the destination for manufacturing production chains in electronics, telecommunications equipment, automotive products, and textiles and apparel. In 2000, the United Nations, which keeps track of the available data, estimates that as much as 7 percent of China's total exports are now accounted for by the foreign affiliates of multinationals, with Motorola and IBM alone accounting for nearly 1.5 percentage points of this total. American and Japanese multinationals each account for nearly 2 percentage points of the total; EU 1 percentage point; followed by South Korea and Taiwan with less than 1 point each.

The reasons are obvious. China has low cost skilled labour in abundant quantities; the export processing zones and special economic zones of the 1980s are turning into significant economic clusters that facilitate innovation and attract new investment. And of course the size of the domestic market is an added inducement. Many of these factors are not new, they are common to other successful East Asian economies during the past 30 years. What we are seeing in China is a stock adjustment in response to WTO accession and related reduction in uncertainty and risk as it adopts WTO rules of the road.

The surge of FDI has implications for the way China's trade balance is measured in future. Current measures show a growing China-US trade deficit; but if the measures were modified to remove the trade of US affiliates, the resulting balance might have more meaning.

2. **China and global deflation**

China is now the world's sixth largest trading nation, accounting for a 4.3 percent share of world exports (36% of the US share) and 3.8 percent of world imports (21% of the US share). The world's consumers are beneficiaries of the low-priced commodities produced in China. But as its export penetration grows and as its foreign reserves position grows, there are calls to revalue the real exchange rate, fixed to the US dollar in nominal terms at RMB 8.3 since 1995. ASEAN economies and Japan are particularly interested in such a revaluation, but this is partly due to their own reluctance of undertake painful structural adjustments required to avoid direct competition with Chinese-manufactured commodities.

Yesterday we heard about the need to speed structural reforms in Japan. China, in contrast, has to slow the speed of adjustment to manage the social consequences. China is experiencing a domestic deflation because of these adjustments. Indeed falling domestic prices and a weak US dollar led in 2002 to a real depreciation of 4 percent – that reversed a 5 percent appreciation in 2001. China faces a dilemma: it cannot raise the market value of the RMB without worsening its own deflationary forces and reducing the credibility of its fixed exchange rate policy. It is left with few options. One is further US disinflation. The other is for China to reflate its own economy. Given the still-immature structure of its domestic financial institutions, however, there are reasons to doubt that this course would be as easy for China to control as it might be for the Bank of Japan or the European Central Bank (which so far have refused to go this route).

This means we will have to wait until China undertakes further strengthening and modernization of its financial institutions, particularly banks and other financial intermediaries, and reform of its financial markets.

Yet even then, when one might expect that China would be able to float the exchange rate, Japan's past experience is instructive. It is quite possible that, like Japan in the past, China will continue to run trade surpluses and, because of its extremely high savings rate, current account surpluses as well. This would mean that even with a floating exchange rate, China could continue to be accused of behaving in a mercantilist fashion.

3. **China as the regional economic leader**

While China is now a significant manufacturer and exporter, it is also a major importer, particularly of regional goods and services. In 2002, imports into China and Hong Kong from the rest of the region accounted for 16 percent of the region's total regional exports. (US accounted for 20%; Japan for 13%). China ran a trade deficit with the region as a whole.

China's and the ASEAN nations' decision to work towards a FTA 10 years from now is a powerful signal of China's long-term interest in deeper regional integration. But it also raises some interesting questions. First, what are the likely consequences for the ASEAN economies of becoming spokes to a Chinese "hub"? China is also becoming an outward investor into ASEAN, but anecdotal evidence suggests that many of these investments aim to source natural resources. Yet ASEAN's ambition is to move up the technology ladder into higher valued added goods and services. Second, does the deepening of trade ties, mean that China might seek deeper financial ties as well, at the expense of the network of bilateral swap agreements that underpin the Chiang Mai Initiative, itself seen by some of its members as the forerunner of an Asian Monetary Fund? Third, what does this greater interest in integration with its southern neighbors mean for China's interests in its Northeast Asian neighbors? Of course, an Asian FTA is not precluded; indeed it might be easier for all if the northern "three" negotiated among themselves.

4. Risks in China's emergence

The worries about China's emergence might more appropriately be aimed at whether its substantial domestic weaknesses are potential systemic threats. The new Chinese leadership has signaled its concern with rising domestic income and development disparities. Progress has been made to modernize the financial system, but much remains to be done to remove the overhang of domestic debt from the books of the banks, to break the links with loss making state owned enterprises and to introduce modern practices of accounting, corporate governance and transparency. In addition, China's response to the conflict in the Middle East has been tempered by its growing dependence on imported oil.

I do not think that these weaknesses and risks pose systemic threats. But they underline good reasons why China will continue for the foreseeable future to be preoccupied with domestic challenges.

5. Conclusions

In conclusion, there are two main global economic implications of China's changing economic role. First, China's interdependence with the rest of the world is growing, most notably with the United States. Modernizing and industrializing the economy means growing cross-border sinews of trade, FDI, technology and people and growing dependence on imported resources, particularly oil. Such interdependence implies that it is not in China's interest to be a global economic or security threat. Tension and conflict will amount to China shooting itself in the foot. It is now a significant engine of growth in the region. China is not a major source of global deflation, and for reasons explained earlier, it will be difficult for China to contribute to global reflation. Because of its size, China can expect calls for it to join in international economic policy cooperation. For such calls to be credible, however, the G-8 should first enlarge itself into the G-9.

Second, China is too preoccupied, even stretched, by domestic challenges to try to reshape multilateral institutions to its own ends, or to operate actively against US interests, at least for the foreseeable future. Instead, China is likely to continue its record of being a responsible member of global institutions. The first year's report card at the WTO is mixed but the direction is a positive one. Thus, from the economist's perspective, the risk that an economically emerging China will also become a security threat is partly one of perception. If all other members support the multilateral institutions, China will be a good member too. If others turn their backs on these institutions, however, there may be another story.