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Asia's China Debate

Mixed Feelings:
East Asia's Debate about China's Economic Growth and Regional Integration

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Executive Summary

- Despite China's sustained, rapid economic growth and the contrasting recession in Japan during the past decade, Japan still leads China in key economic indicators such as gross domestic product, outward investment, and trade volume. China's large and increasingly wealthy population provides an attractive market and base for exports, luring foreign direct investment away from other countries in Asia.

- China has started to reform its economic system to conform to WTO requirements, but implementation has been slow and considerable regulations on foreign investments and barriers against imports remain.

- Most of China's exponential trade growth during the past decade has resulted from trade with the United States and the European Union, whereas Japan and ASEAN's proportional shares of China's trade have remained largely unchanged. For the ASEAN countries, China remains a secondary trade partner behind the United States and Japan. South Korea and Japan are deepening their economic interdependence with China, but liberalization of trade among the three countries lags behind the ASEAN-China Free Trade Agreement (FTA).

- Despite the increasing competition from Chinese producers, most Asian countries share with China a fear about negative social and political consequences of rapid economic reforms and possible exclusion of their exports from the U.S. and EU markets.

- Asian incentives for regional integration are intended to form an enhanced negotiation bloc vis-à-vis the United States and the European Union. ASEAN countries see FTA negotiations with China as a catalyst to bring a reluctant Japan into FTA negotiations.

- Faced with the declining U.S. dollar, Asian countries with floating or loosely pegged rates see China's strict dollar peg as problematic because a declining RMB against their currencies diminishes their relative trade competitiveness with Chinese products.

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INTRODUCTION

Spectacular growth of China's economy during the past decade, combined with its ambition for political leadership, has pushed China onto the center stage of global and regional economic integration. East Asian countries respond differently to the challenges and opportunities that a growing China offers. Complex interactions among their diverse interests will shape future East Asian economic integration.

CHINA'S ECONOMIC GROWTH

China' economy today, with a current gross domestic product (GDP) of $1.1 trillion (2002), is the second largest in Asia after Japan. It is astonishing that this achievement took place in a rather short period of time, pushed by consistently high growth rates. (See Table 1.)

Table 1. GDP Growth (%)

	1995	1996	1997	1998	1999	2000	2001
China	10.5	9.6	8.8	7.8	7.1	8.0	7.3
Japan		3.5	1.8	-1.1	0.7	2.4	-0.2
South Korea	8.9	6.8	5.0	-6.7	10.9	8.8	3.0
Taiwan	6.4	6.1	6.7	4.6	5.4	6.0	-2.2
Singapore	8.0	7.5	8.5	0.1	5.9	9.9	-2.0
Southeast Asia*	8.4	7.4	3.5	-9.0	3.1	5.1	2.1

* Excluding Singapore
Source: Asian Development Bank; APEC

China's dynamic domestic market and growing exports have also driven its rapid economic growth. (See Table 2.) China's export drive—at the same time as Japan increased its imports—has pushed the former to the unenviable status of number one source of America's trade deficit. China attracts more than half of global foreign direct investments (Table 3), creating a diversionary effect that has especially negative consequences for its Southeast Asian neighbors.

Table 2. Merchandise Trade/GDP, China (%)

Year	1990	1996	1997	1998	1999	2000	2001
	31.8	35.6	36.0	33.4	36.4	44.0	44.3

Source: Far Eastern Economic Review, Asia Yearbook

Table 3. Foreign Direct Investment (in U.S. million dollars)

	1994	1995	1996	1997	1998	1999
China	33787	35849	40180	44237	43751	38753
South Korea	810	1776	2326	2844	5415	9333
Singapore	8550	7206	8984	8085	5493	6984
Southeast Asia*	9662	12593	15889	17264	12717	6986
Global	54599	61993	72258	78893	72436	66928

* Excluding Singapore
Source: Asian Development Bank

CHINA'S ECONOMIC INTEGRATION EFFORTS

Enhancing Global Linkages and WTO Obligations

Asian countries must contend with China's calculated efforts to integrate economically with the region. China is doing this through its World Trade Organization (WTO) membership that mandates state-owned enterprise (SOE) and financial sector reforms. China was admitted to the WTO in 2001, ending its long struggle for permanent most favored nation (MFN) status with its major trading partners, including the United States—China's single largest trade partner. Prior to China's WTO membership, MFN status had to be annually renewed by the U.S. Congress. To achieve WTO membership and subsequent permanent MFN status, however, China had to commit itself to major economic reforms, including liberalization of its financial sector, privatization of SOEs, general lowering of tariffs, and more rigorous enforcement of intellectual property protection. China's acceptance of these terms indicates that its leaders recognize the importance of continuous expansion of trade with the United States, Japan, and the European Union for its further development and social-political stability.

China's WTO entry mandated it to gradually privatize its SOEs. China clearly recognizes the fact that rapid growth is being led by new jobs created by private enterprises, as in Shanghai, and not by SOEs. However, such development has not spread evenly across the country, and dependence on SOEs continues in most of the country. While China has initiated plans to encourage the creation of a vibrant private small-and-medium enterprise (SME) sector and to improve the social safety net for those who lost their SOE jobs, the SOE reform must proceed cautiously to keep the unemployment rate (especially in the politically sensitive urban areas) in check. In 2000, the estimated urban unemployment rate in China stood around 7 percent. For the purpose of maintaining social stability, temporary delays are likely in the WTO-mandated reforms and use of import-inhibiting measures, which violate the spirit (if not the letter) of WTO rules.

WTO also mandated that China allow RMB-denominated financial transactions to be handled by foreign financial institutions by the end of 2006. China's four state-owned banks hold the bulk of the non-performing loans (NPLs), which is nearly 2 trillion in renminbi (RMB) (or US$241 billion) as of September 2003. China's NPL problem poses a risk to its sustained economic growth. Asset management companies (AMCs) were set up to liquidate NPLs through debt-equity swaps. While banks could restructure their financial portfolio through these swaps, SOEs account for most of the NPLs, adding the balance to the remaining NPL account. AMC authority in management and operations of the indebted SOEs needs to be further enhanced, and more transparency needs to be brought into the valuation and disposal of state assets. Timely reform of the financial sector is essential for two reasons. First, liberalization will expose the financial sector to competition with foreign financial institutions. Second, a possible shift to the floating exchange rate (discussed below) would require strong and transparent financial institutions, if China wants to avoid a disaster similar to the Asian financial crisis of 1997–98.

The Chinese currency has been pegged to the U.S. dollar. Although floating RMB was not a part of the WTO-mandated reforms, the rapid growth of the Chinese economy and its exports has caused criticism from the major importing countries—including Japan, the United States, and the European Union—that China unfairly uses the exchange rate for its trade advantage. Calls to upwardly revise or float RMB reached a new height during the G-7 Finance Ministers' meeting and the Asia-Pacific Economic Cooperation (APEC) summit in 2003. However, cautious views also prevailed, citing the possibility of inciting instability in the exchange market and regional economy due to the delays in the SOEs and financial sector reforms. Opposition to the rate revision also comes from American multinational corporations (MNCs) in China, who would suffer rising costs and shrinking profits. The Chinese government so far has refused to change the rate. As China's trade surplus with the United States grows, this issue has already been politicized on Capitol Hill. In the long term, RMB's floating is inevitable in order to integrate China into the global economy without giving China an unfair trade advantage. However, in the short term, China's focus will remain on the WTO-mandated SOE and financial sector reforms.

Regional Free Trade Initiatives as Part of Global Strategy

As part of its focus on expansion of trade, China announced in 2002 its proposal to complete an FTA with ASEAN within ten years and partially implemented the opening of some agricultural product markets on a bilateral basis with select countries. Despite the fanfare surrounding the announcement of the China-ASEAN FTA, China's trade with ASEAN at present occupies only a small part of its overall trade. (See Table 4.)

Table 4. China's Trade Partners (%)

	U.S.	Japan	EU	SE Asia
1991	8.9	14.7	10.2	5.9
2001	24.8	15.0	18.6	5.9

Source: Asian Development Bank

For ASEAN, China also remains a rather minor trade partner. However, the reluctance of ASEAN's major trade partners (Japan and the United States) to form FTAs with ASEAN provided an opportunity for China to move ahead with its initiative.

China also entertains the idea of expanding free trade to Japan and South Korea. Among Japan, China, and South Korea, trade volumes are significant and FTAs between and among these three economic powers could have significant results. However, the process has gotten off to a slow start, and the only officially commissioned study of a free trade possibility is taking place between Japan and South Korea. Despite the rising volume of trade with China, Japan and South Korea have been very cautious in rewarding their potential economic and political rival. Also, for China, the utility of such a tripartite free trade area (or even that plus ASEAN) is that an enlarged and integrated Asian market offers a more attractive opportunity for the United States and the European Union. This works as an incentive to maintain free access to the Asian market, and in return keep their markets open to Asian exports. Unlike China's military-strategic calculations, in which China increasingly prefers exclusion of the United States from the region, China's economic interest is in keeping the United States and the European Union engaged.

EAST ASIAN RESPONSES TO CHINA'S ECONOMIC GROWTH AND INTEGRATION EFFORTS

East Asian countries respond differently to China's rapid economic growth. Their relative market sizes and technological levels vis-à-vis China, differing product focuses, and bilateral security relations with China are some of the factors that account for this divergence. At the same time, most East Asian countries and China share interests in cautiously proceeding with economic integration so as not to disturb their sensitive domestic socio-economic balances.

Japan

Japan's meta-historical and increasing geostrategic rivalry with China co-exists with increasing interdependence between the two economies. Japanese export manufacturers' need for cheap labor has led them to relocate to China, thereby de-industrializing Japan over the past fifteen years or so, while Japan continues to be an important source of investments and technology for China. Some of Japan's SMEs took advantage of the lower labor costs in China by relocating, but many that remain in Japan advocate protection of the domestic market from Chinese imports. Japanese farmers also take a protectionist stance. Japan has started reducing its Official Development Assistance (ODA) to China, but China continues to be among the three largest recipients. (See Table 5.) This reflects support of the Japanese MNCs to integrate the Chinese economy through improvement of the basic infrastructure.

Table 5. Major Recipients of Japanese ODA

	1	2	3
1997	China	Indonesia	India
1998	China	Indonesia	Thailand
1999	Indonesia	China	Thailand
2000	Indonesia	Vietnam	China
2001	Indonesia	China	India

Source: Japanese Ministry of Foreign Affairs

Japan is concerned about China catching up in manufacturing technologies, often through pirating. In addition to cooperating with other developed countries in pressing China to tighten its intellectual property rights (IPR) laws and enforcement, the government is assisting smaller Japanese firms in protecting their intellectual properties.

On the other hand, China is also viewed as a potential ally in the global financial competition. In the aftermath of the Asian financial crisis, Japan proposed an Asian Monetary Fund (AMF), modeled after the International Monetary Fund (IMF), in response to U.S. reluctance to commit IMF funds to Asia's liquidity crisis. China also opposed this initiative on the unspoken ground that in such an institution Japan would exercise dominant control due to its large subscription and the weighted voting system. Instead of establishing an AMF, Japan and China took part in the multilateral Chiang Mai Initiative, which created a regional mechanism for currency swaps. Japan and China together hold the great bulk of U.S. Treasury bonds in their reserves as a result of trade surpluses with the United

States and massive interventions to keep their currencies weak. Weakening of the U.S. dollar hurts their export performance. China's pegging of RMB to the U.S. dollar has resulted in a relative decline of Japanese producers' competitiveness vis-à-vis Chinese producers. The call to float the RMB by U.S. domestic manufacturing interests and Congress in the hope of RMB appreciation is shared by some of Japan's domestic manufacturers. However, on this issue, Japan's MNCs operating in China oppose RMB appreciation for the same reason U.S. MNCs oppose it. Japan's criticism of the Chinese peg is somewhat muted, because Japan's "dirty (managed) float" through heavy market interventions by the Bank of Japan is also a subject of U.S. criticism.

Different sectors in Japan react differently to China's integration into the global and regional economies. Though influential MNCs prefer further integration of Japan and China, smaller and sector-specific oppositions (such as SMEs and agriculture) yield considerable political clout. Lack of domestic consensus in Japan prevents it from solidifying any free trade initiative with China.

South Korea

Korea's trade with China has rapidly increased over the past decade. However, Korea shares some of Japan's wariness about China. Korea's exports are more exposed than Japan's to competition against China because Korea's technology level generally falls behind that of Japan. Korea also competes against China in attracting foreign investment.

Korea's free trade with China has usually been discussed in the context of a multilateral framework that also includes Japan. Free trade with Japan has been officially studied, and a framework negotiation is likely to start within the next few years. Korea will be able to draw more concessions from China by borrowing the weight of the Japanese market. Hence, it is important for Seoul to negotiate an FTA first with Japan, and then pursue one with China.

Korea leads China and most ASEAN countries in financial reforms. The Kim Dae-Jung administration's decision to fully embrace the IMF prescriptions after the Asian financial crisis resulted in a drastic reform of the banking and financial service sectors as well as restructuring of the insolvent conglomerates (*chaebols*).

However, Korea also floated its currency (won) and has adopted a less interventionist exchange rate policy. Still, like many other Asian countries, Korea is concerned about foreign exchange instability and its damaging impact on trade. Therefore, it too has taken part in the Chiang Mai Initiative.

Southeast Asia

China remains a minor trade partner for most ASEAN countries. Nevertheless, for each ASEAN country, China's large domestic market offers an attractive potential for trade growth. Even before China and Hong Kong concluded an FTA in June 2003, a considerable amount of ASEAN exports to Hong Kong was re-exported into China. ASEAN countries can expect further growth of trade from the FTA with China. China's FTA proposal with ASEAN was followed by similar proposals from Japan, the United States and India. Thus, the deal with China is expected to play a catalyst for ASEAN's free trade with other countries.

For the ASEAN countries, competition with China to attract global investments has been a losing proposition. China can offer not only cheap labor, but also a huge domestic market. In contrast, individual ASEAN countries have much smaller domestic markets, and many of them have much higher wage levels. Free trade with China would at least partially allow ASEAN countries to piggyback on the attraction of China's domestic market and offset their disadvantage in luring foreign investors.

On the issue of foreign exchange stability, China's decision to not devalue RMB during the Asian financial crisis boosted its credibility among the ASEAN countries. ASEAN countries are also more comfortable with the multilateral structure of the Chiang Mai Initiative to manage currency exchange rates than a Japan-dominated AMF. For this reason, they are likely to side with China on the issue of regional currency values.

IMPLICATIONS ON REGIONAL INTEGRATION

Trade

China has played a major catalytic role for the formation of regional FTAs. ASEAN countries' desire to form FTAs with Japan and the United States has been hindered by both factors within ASEAN (such as non-implementation of the ASEAN Free Trade Agreement—AFTA—by some members and AFTA's deferred liberalization for Vietnam, Cambodia, Laos, and Myanmar) as well as the reluctance of the Japanese and Americans. Having assured MFN status in the U.S. and European markets through its WTO membership, China now eyes a leadership role in the process of Asian economic integration. China's agreement with ASEAN to achieve free trade within ten years was a catalyst for later free trade proposals from Japan and the United States to ASEAN and Japan's bilateral free trade proposals with individual ASEAN members.

Within ASEAN, Singapore has been in an anomalous position. Its unique entrepot economy status gave the country an early push to join all sorts of FTAs, including bilateral agreements with Japan and the United States. Singapore's FTAs with most liberal trade partners (e.g., Chile and New Zealand) and other relatively liberal traders (e.g., the United States, Canada, and Australia) are at odds with other Asian countries whose domestic agriculture market is protected for political reasons. Singapore, not having an agriculture market, has no worry on this score.

Within APEC, Japan has led the camp that prefers an incremental and voluntary approach to free trade. Japan dealt with legal and binding trade liberalization only at the WTO negotiations, thereby showing little interest in regional FTAs until 2001. However, the disastrous failure of the WTO meeting in Seattle and China's FTA offensive with ASEAN completely reversed Japan's strategy.

Also, for the ASEAN countries, FTAs with China and Japan will ease the political cost of complying with the AFTA obligations. China and Japan are major food importers, and FTAs with these countries will divert a large part of agricultural exports from intra-ASEAN trade, thereby making farm exports under free trade within ASEAN more costly and allowing more domestic farmers to survive.

On the other hand, it is still unclear what an ASEAN-China FTA would entail. Except some immediate bilateral liberalization measures on certain tropical agricultural products of ASEAN's interest, the content of China's liberalization is yet to be known. Many factors—including the pace of SOE reforms, unemployment, and political stability inside China—will determine the extent of Chinese trade liberalization, which in turn would affect the content of Japanese proposals. If the Sino-Japanese rivalry works in a positive way toward a more open trade, ASEAN will gain most, and the resulting Asian FTAs will be more comprehensive (less excepted products and services) and consistent with the U.S. objective. Conversely, if Chinese reluctance gives the Japanese an excuse to go slowly and be less comprehensive, the United States would feel uncomfortable with the Asian FTAs. In the latter case, it is possible that protectionist forces in the United States will outweigh free traders, and APEC will be divided between East Asia and the Western Hemisphere, despite its original aim to bridge the Pacific.

Currency

Despite the signs of regional currency cooperation, it is unlikely that Euro-like currency integration will happen in East Asia in the near future for several reasons. First, not all Asian currencies are floating (e.g., Chinese RMB, Hong Kong dollar, Malaysian ringit), and those that are floating are still heavily managed by the central banks. In both types of currencies, the exchange rates are viewed as an important tool for export promotion. Internal rivalry between the pegged and floating Asian currencies and their external under-valuation against the U.S. dollar and Euro are likely to continue. Second, despite the increasing intra-Asian trade, the primary export market for many East Asian countries (including China) is the United States. Therefore, savings through the reduction of foreign exchange costs are relatively small. Third, currency integration requires a strong leadership that enforces fiscal austerity (e.g., Germany in the European Union) to control inflation in each member country. Neither Japan nor China can provide such leadership, and Asian countries are not likely to embrace such an assault on their sovereignty. Thus, currency cooperation in Asia will likely remain at the level of linking regional currencies by moderately revising the foreign reserve mix and implementing an enhanced emergency currency swap mechanism.

CONCLUSION

China has staked its future on integration with the global economy, but its pace is contingent upon domestic social stability. Given Japan's passivity, the extent of trade liberalization by China will likely shape the content of East Asian FTAs. The diverse foreign exchange policies in East Asia following the Asian financial crisis—ranging from strict pegging to the U.S. dollar to managed float with differing ranges—will likely limit the scope of currency cooperation. Asia's debate about China's economic growth and regional economic integration is therefore still in its early stages. Options for the United States will largely depend on how Asians respond to evolving Chinese policies.

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