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The Region Adjusting to China

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China in the Asia-Pacific: Regional Adjustments to China's Growing Importance in the Region & Globally

Introduction

In the period since China's entry into the World Trade Organization, the country has experienced phenomenal economic growth, becoming in the process one of the world's largest recipients of foreign direct investment and the world's third largest trader. China's explosion onto the scene has presented its neighbours with both challenges and opportunities. The country's relatively recent transformation into a market-oriented economy has led to a situation where not all the "dust" has yet settled. In this context, both traders and their governments have tried to hedge their bets in the Chinese market, wanting a "piece of the action" while protecting their exposure.

Consistent with its own white-hot rate of economic growth, China's relationships are rarely characterised by moderation. In investment and in trade, large and often growing imbalances are typical in the region and globally. China's trade surplus with the United States grew by 283 percent from 2000 to 2005 and with the EC-25 by 631 percent over the same period. Its combined trade surplus with the U.S. and EC amounted to \$184,289 million at the end of 2005, but China also had a trade deficit with Asia (not counting Hong Kong) of \$134,117 million that year. A considerable amount of study has been devoted over the past few years to the analysis of these trade patterns and there are some interesting conclusions being drawn that do not appear to support conventional wisdom on the topic.

According to UNCTAD, global inflows of FDI in 2005 reached US\$ 916 billion, an increase of 29 percent over 2004 inflows, with US\$ 542 billion, or 59 percent, of this total going to developed countries. In the developing world, East Asia saw US\$ 118 billion in FDI inflows in 2005, US\$ 72.4 billion of which went to China. South East Asian developing countries accounted for US\$ 37.1 billion in FDI inflows. The markedly different performance of developing countries in attracting FDI is demonstrated by the fact that South Asia received just US\$ 9.8 billion in FDI inflows and the developing countries of the Pacific attracted just US\$ 400 million in FDI. The level of FDI going to China is so much greater than that which has been flowing to other developing countries in the region – including India – that it is worthy of study in itself.

In recent years, there has been an explosion of interest in bilateral and regional free trade agreements in the Asia-Pacific region. How much of this has to do with China and increasingly apparent global supply chain networks in the region. Different countries in the region are reacting differently to supposed indicators of regional economic integration. For its part, China seems prepared to use the full variety of tools at its disposal.

China and the Pattern of Regional Trade

Today, global production and distribution is to a large extent the product of efforts by multinational corporations (MNCs) to realize maximum efficiencies and profits through global organization of their business model. In the globalized world of 2007, many economists refer to the fragmentation and distribution of production through global supply chains as the world economy's second "unbundling". China and its neighbours appear to be right in the middle of this unbundling phenomenon.

What distinguishes the modern phase of unbundling from the first phase is that what is going on now is the segregation of production by tasks. Modern MNC supply chains are more and more based on the location of tasks where they can be most efficiently performed. It might

make sense for a silicon wafer to be produced in Vietnam, a motherboard in Singapore and final assembly of a product to take place in China. Among other things, this has important implications for the ability of important sectors of even a developed country economy to remain competitive. Whether it is characterized as slicing up the value chain, offshoring, vertical specialisation or production fragmentation, today's unbundling activities – which increasingly are found in services as well as goods production – are changing the way MNC's make their decisions about investment and production in the developing world.

One economist who has done a considerable amount of work on production fragmentation and its influence on trade and investment patterns in Asia is Prema-Chandra Athukorala at the Australian National University in Canberra. Athukorala has written extensively about the reasons for production fragmentation in East Asia and its consequences for economic development in countries in the region. In his studies, he points out that fragmentation-based trade is far more important and growing rapidly in East Asia than elsewhere, but that because the phenomenon is not properly understood, many people draw the wrong inferences about regional trade, the relative importance of global markets and also the extent to which participation in a supply chain network necessarily implies involvement in a sophisticated, high value-added manufacturing process.

Earlier, international specialisation within a MNC would normally have taken the form of a company building a facility abroad that might produce some parts to be used in its vertically integrated manufacturing process. Trade in the essentially "in-house" parts and components had a direct relationship to the MNC's FDI. This pattern is changing. Instead of producing all of what it needs for the supply chain in the local subsidiary of the MNC, the subsidiaries now often subcontract with local host country firms. There can be an important technology transfer element here as the MNC will often need to supply the local firm with some of its production technology as well as detailed specifications in order to obtain the quality it needs from the subcontractor. In addition, because today many parts used in the production process have effectively become what Athukorala calls "standard fragments" it is often possible for MNCs to use independent contract manufacturers in their established supply chains. Over the past four decades, researchers have seen these MNC production networks – based on a complex trade in product fragments – expand from their origins in the clothing and electronics industries and spread into a wide range of industries including power and machine tools, cameras and watches, automobiles, sport footwear, televisions and radio receivers, office equipment, sewing machines and even printing and publishing.

The operation of these international supply chains through trade in product fragments has been the object of some very interesting analysis by Athukorala. In a soon to be published chapter of a new book¹, he points out that the share of components in total intra-regional exports in the ASEAN Free Trade Area (AFTA)² countries increased from 89.1 percent in 1992 to 92.3 percent in 2004. On the import side, the increase was from 75.3 percent to 84.4 percent. The regional share of total Chinese imports of components increased over this period from 37.6 percent to 77.7 percent. Athukorala points out that the most notable development in China's import trade over this period was the rapid growth of the combined share of AFTA countries, from a mere 0.9 percent in 1992 to 19.3 percent in 2004. Are these trade patterns indicative of an increase in two-way trade of a type that supports regional economic integration theories?

¹ Prema-Chandra Athukorala (2007) "Multinational Production Networks and the New Geo-Economic Division of Labour in the Pacific Rim Countries", forthcoming in Juan Palacios (Ed) New Geo-Economic Division of Labour in the Pacific Rim, London: Rutledge.

² Only the six largest AFTA countries (Indonesia, Malaysia, the Philippines, Thailand, Singapore and Vietnam) are included in the analysis.

Apparently not. A look at the pattern of China's export trade shows a dramatically different story.

“On the export side, China's aggregate intra-regional share has declined persistently in both total manufacturing and component exports. Overall, China's evolving export patterns exhibit a clear and increasing extra-regional bias, in contrast to greater regional integration on the import side. This difference reflects the increasingly important role for China as a final product assembler for advanced country markets using middle products procured from the region. Since about the mid-1990's, China's net imports from countries in developing East Asia have increasingly exceeded its exports to those countries. The main reason for this trade deficit has been China's increasing reliance on countries in the region for parts and components for its booming final-goods assembly activities.”³

The author goes on to point out that one should not misinterpret China's growing exports of final products as an indication of the increasing sophistication of Chinese manufacturing. Rather, the focus of the MNC subsidiaries in China on final goods assembly activities suggests that most MNCs have located their investments in the country to take advantage of China's low-paid assembly-line workers. If that is the case, what are the implications for China's longer-term economic development and what happens if China loses its cheap labour advantage?

Is the situation documented by Athukorala indicative of a pattern that is likely to persist into the future? Have MNCs operating in the region – both those from advanced countries and increasingly those based in developing countries in East Asia – locked themselves into supply chains where all roads lead to China for final assembly and export to the developed world?

The Straits Times reprinted an article from *The Economist*⁴ documenting MNCs' increasing unwillingness to put too many of their “eggs” in the China “basket”. As a potential market for final products, China will always be an attractive location for doing business, but many of the features of doing business in China that helped boost MNC competitiveness are fast eroding. Both rising costs and a desire to diversify are cited by experts as mitigating against too much activity in the Middle Kingdom.

According to the *Economist* article, for several years pay rates for Chinese factory workers in busy coastal areas have been accelerating at double-digit rates. Average factory workers in Shenzhen now get a total monthly remuneration (including benefits) of around US\$ 250, with labour costs US\$ 100 per month higher still in Shanghai. This compares to monthly wages of around US\$ 100 in Indonesia, US\$ 150 in Thailand and US\$ 200 in Manila. While pay scales are rising for factory workers in Indonesia and Vietnam, they are still up to 35 percent lower than in the cities of coastal China. Office rents and land values are also skyrocketing in eastern China. Moving a manufacturing investment to western China might work for some MNCs (Intel built a US\$ 525 million plant in Chengdu in 2004), that does not work for others. Flextronics executives maintain that the lower wage costs are, for them, more than outweighed by the expense of getting products produced in western China to Europe and America. Part of the increased expense is related to the relatively less developed infrastructure in western China.

But for the multinational corporations building their supply chains and coordinating their fragmented production networks, labour and other costs are not the only factors that count.

³ Athukorala (2007) in Juan Palacios (Ed) *New Geo-Economic Division of Labour in the Pacific Rim*, London: Routledge

⁴ “The Problem with Made in China”, *The Straits Times*, edition of 27 January 2007, pp. S12 and S13.

The Economist article points out that in a research report commissioned by the Japanese External Trade Organization, the authors reached a conclusion about doing business in China that should worry Beijing:

“Due to the country’s increasing business risks and rising labour costs...Japanese firms employing a “China-plus-one” strategy – in which they invest in China and another country, namely in ASEAN – should consider placing more emphasis on the “plus one” country.”⁵

Not only Japanese MNCs seem to be heeding this message. Intel has recently invested over US\$ 1 billion in Vietnam. Flextronics has made a big investment in a new factory in Malaysia producing computer printers on contract to Hewlett Packard. Yue Yuen, a Hong Kong-based footwear manufacturer is ramping up production for its Nike and Adidas clients in factories in Vietnam and Indonesia.

From what we can see through the research and also from anecdotal evidence, the nature of the trading pattern between China and its near-Asian neighbours is not necessarily indicative of a growing economic integration arguing for deepened links through preferential agreements. In addition, while the current pattern where China imports huge volumes of product fragments from Asia and exports final products mainly to extra-Asian markets may be a more fragile pattern than some think. China’s failure to maintain itself as a choice location for final assembly or negative developments in extra-Asian markets could bring down the house of cards.

China’s Free Trade Agreements

There is considerable speculation in the region and elsewhere that much of the recent FTA-related activity in the Asia-Pacific relates in one way or another to countries trying to cement particular relationships with China. With China having invested so heavily in WTO membership, it is perhaps a bit surprising to see China now so heavily involved in regional trade initiatives. It is easy to understand why China felt it desirable to negotiate FTAs with Hong Kong, China and with Macau, China. Production-sharing arrangements also probably argued for greater economic integration with the ASEAN member states. Other Chinese FTA efforts are slightly more difficult to appreciate. China is now involved in separate FTA negotiations with Australia and New Zealand. An FTA with Chile has recently been concluded and entered into force. Beijing is also in negotiations with Pakistan, the Southern African Customs Union and the Gulf Cooperation Council. A partial trade agreement has been signed with Thailand and China and ASEAN have reportedly recently completed a trade in services agreement complementing the existing ASEAN-China Agreement. All told, China is reportedly in FTA talks with 27 regions and countries whose combined trade with China in 2005 came to \$350 billion about one quarter of the country’s total⁶.

China’s protocol of accession to the WTO contains a discriminatory provision that permits other WTO members (under certain circumstances) to treat China as a “non-market economy” for purposes of antidumping action. This special provision does not terminate until 2015 unless individual WTO members determine in their own legislation that China should no longer be considered as a non-market economy. Beijing has always bristled at the suggestion that China has not made the transition to a market economy and has used the promise of free trade agreements to gain market economy status with its key trading

⁵ Ibid.

⁶ From a statement made by Chinese MOFCOM spokesman Chong Quan reported in the People’s Daily newspaper on 16 September 2006 and accessed by the author through the website for bilaterals.org.

partners. For example, in the case of Australia, Australian permanent recognition of China as a market economy was a prerequisite for Chinese agreement to start FTA negotiations.

That Beijing has embraced FTAs as an important policy tool is clear from government statements made at the time of WTO Director General Pascal Lamy's visit to Beijing in September, 2006. The spokesman for China's Ministry of Foreign Commerce (MOFCOM), Chong Quan, was reported to state that free trade agreements were seen by China as important supplements to the WTO and important channels to facilitate global trade and liberalized investment. Chong also said that China sees the development of free trade areas as in keeping with the trend of regional economic integration underway in the Asia-Pacific region⁷.

What is the nature of the Chinese approach to FTAs? Are China's FTAs likely to be high-quality arrangements that satisfy the rules for FTAs found in GATT Article XXIV and GATS Article V? How do the FTAs reflect regional attempts to adjust to the growing importance of China? China's FTAs with ASEAN and Chile are reviewed below.

China's FTA with ASEAN is a work in progress. Launched with the initial "Framework Agreement" signed at Phnom Penh on November 4, 2002, the initial agreement was supplemented in November 2004 with a complementary agreement on trade in goods. Negotiations on services trade have reportedly resulted in an agreement to enter into force in July. Recognizing that this is a trade agreement among developing countries and that, from the start, it was envisaged as a multi-stage negotiation, the agreement (at least so far) shows a perhaps surprising possibility of becoming a WTO-consistent high-quality FTA. In fact, written directly into the text of the initial Framework Agreement are the objectives of negotiating an agreement on trade in goods that "shall fulfil the WTO requirements to eliminate tariffs on substantially all the trade between the Parties".⁸ In the case of trade in services, the agreement calls for negotiations to liberalize trade in services with "substantial sectoral coverage", progressively eliminating "substantially all discrimination" and expanding the scope of liberalization beyond commitments undertaken by the Parties under the GATS⁹. On investment, the Parties undertake to enter into negotiations to progressively liberalize the investment regime, strengthen cooperation in investment and provide for the protection of investments.

The ASEAN members and China agreed to a progressive approach to the liberalization of trade in goods. At the very start of the agreement, an "early harvest" package provided for the elimination of tariffs on live animals, meat and edible meat offal, fish, dairy produce, other animal products, live trees, edible vegetables, fruits and nuts and a number of other specified products. The Parties agreed to categorize all other goods as being subject to liberalization under either a "Normal Track" or "Sensitive Track" procedure, with the former due to be liberalized over the period 2005-2010 for the more developed "ASEAN 6" and China and over the period 2005 –2015 for newer ASEAN member states. Generally speaking, "Normal Track" liberalization is carried out with reference to five tariff bands. The supplementary 2004 ASEAN-China agreement on trade in goods incorporates two annexes that set out modalities for liberalization of both "Normal Track" and "Sensitive Track" tariffs.

While we do not yet know the details of the outcome of ASEAN-China talks addressed to services trade or investment-related negotiations, there are a number of other interesting features in the ASEAN-China FTA (ACFTA). ACFTA-specific safeguard measures are permitted only during a period that ends five years after the completion of tariff elimination for the product. Another provision obligates the Parties to ensure that the obligations and

⁷ Ibid.

⁸ ASEAN-China Framework Agreement of 2002, Part I, Article 3, Paragraph 6.

⁹ Ibid, Part I, Article 4

commitments of the ACFTA are observed by regional and local governments and by non-governmental bodies exercising government-delegated powers within their territories. In the 2004 agreement, each of the ten ASEAN member states recognize China as a full market economy and agree not to apply sections 15 and 16 of China's WTO protocol of accession.

According to China's Ministry of Commerce, bilateral trade between Chile and China has been growing at an average annual rate of 20 percent since 2000. Two-way trade in goods reached \$7.1 billion in 2005, with Chile now ranked second in importance among China's trade partners – mainly due to trade in copper. Copper accounts for 30 percent of Chile's exports to China and statistics from the International Copper Association show that half of China's imported copper comes from Chile.

With bilateral trade booming, and with both Chile and China very active on the FTA front, it is hardly surprising that China's first FTA with a Latin American country would be with Chile. The agreement went into effect on 1 October 2006 and is forecast to eventually exempt 97 percent of all bilateral goods trade from tariffs. At this stage, the CCFTA is a "trade in goods" only FTA without provisions addressed to trade in services or investment. However, in the explanatory document for the CCFTA produced by the Chilean Ministry of Foreign Affairs Directorate for International Economic Relations (dated May 2006),¹⁰ it is indicated that in a second phase of the negotiations, it is planned to incorporate in the FTA provisions addressed to services and investment. Also signalled in the explanatory document is Chile's intention to pursue negotiations with China on air transport and double taxation.

In terms of the CCFTA trade in goods agreement's compliance with WTO rules for FTAs, it would appear to comply with the "substantially all trade" rule. After the ten-year phase-in period, only one percent of Chile's exports to China (214 tariff lines or 3% of all lines) will be excluded from duty-free coverage under the agreement. 92 percent of all Chilean trade (37% of tariff lines) went to duty-free immediately on 1 October, with negligible additional trade (but 39% of tariff lines) being fully liberalized in year 1 and year 5 of the implementation period. At the ten-year mark, a further seven percent of trade (21 percent of tariff lines) will go to duty free. Included among the goods considered by China as "sensitive" and therefore held up until year 10 are beef, dairy products, eggs, clementines, kiwis and dried fruits, marmalades, juices, wines, plastic products, tires and certain woods. The agreement gives Chile geographic indication protection in China for "Pisco".

Chile's trade liberalization on imports from China is divided according to immediate, five-year and ten-year tariff elimination timetables, with three percent of all Chinese trade and 2 percent of Chilean tariff lines (152 lines) excluded from duty elimination. Just 50% of China's exports (75% of tariff lines) to Chile benefit from duty elimination at the start of the FTA implementation period. A further 21 percent of trade and 13 percent of tariff lines go to duty-free after five years. 26 percent of all trade and 10 percent of tariff lines are held up until year ten. Chile's list of sensitive products liberalized only in year ten, includes cements, certain chemicals, paints and resins, tires, wood products, textiles, glass products, windows, doors and parts of aluminum, clothes washing machines and wooden furniture.

The CCFTA's rules of origin appear complicated, being a mixture of CTC, regional value added rules and certain rules addressed to manufacturing processes. Both parties retain all of their rights and ability to use WTO-consistent trade remedies and a special CCFTA-specific safeguard system is established that, under agreed circumstances, can lead to restoration of tariff levels to MFN rates or suspension of further reductions. Additional chapters in the FTA address SPS issues and technical barriers to trade.

¹⁰ "Tratado de Libre Comercio Chile – China, documento elaborado por la Dirección General de Relaciones Económicas Internacionales, Mayo 2006.

Like China's FTA with ASEAN, there is a good possibility that the eventual fully elaborated CCFTA will be in the category of high quality Asia-Pacific FTAs. The two parties seem to have made a good start with the trade in goods agreement. Chile clearly hopes that the final agreement – incorporating investment and double taxation provisions – will help to make Chile a launch-pad for Chinese investment into Latin America.

Chile, like ASEAN, has seen the conclusion of an interim trade agreement with China as an important part of its strategy to adjust to China's growing importance in the region and globally. As trade agreements go, and looked at solely from a trade policy perspective, these agreements are pretty good agreements. But will they have the effect desired by their promoters?

Conclusions

What conclusions might we try to reach about the efforts of China's trading partners in the Asia-Pacific region to adjust to the growing importance of China both regionally and globally?

Certainly, when we look at ASEAN and Chile, we can say that these partners' free trade agreements with China seem to have little to do with aspirations of long term economic integration and much more to do with a short-term desire to "lock-in" what appears to be some very good business. The situation with Chile is perhaps a bit more straightforward than is the case of ASEAN, but in both cases, the desire to link their own exports and national economic development to trade with China needs to be accompanied by a more sophisticated understanding of the patterns of China's imports and exports.

As Professor Athukorala has concluded in his studies, the growing dependence on China by its East Asian suppliers of parts and components in effect makes these suppliers increasingly dependent on China's healthy extra-regional trade. Although not addressed in this paper, Chile's all-important exports of copper to China are likely similarly linked to China's continued ability to export final products to the United States and Europe. The same is true for Australian wool producers who readily acknowledge that China's demand for their product depends upon that country's access to major developed country markets for clothing.

This means that a focus on regional or bilateral trade agreements may be somewhat misguided and is certainly misguided if it ignores the necessity of progress on trade at the multilateral level. If a failure at the WTO damages China's access to extra-regional markets, the trade agreements will not mean much. The regional and bilateral agreements are not adjustments that are guaranteed to lead to long term security, especially as there are factors internal to China that could also make the ongoing pattern of trade less secure in the future.



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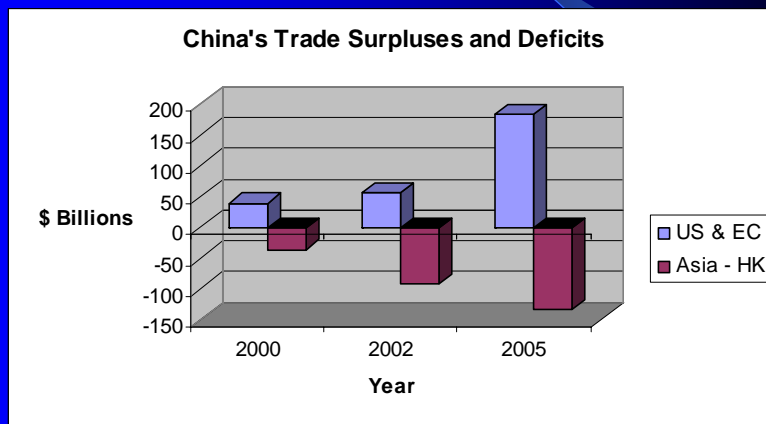


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China's Trade Imbalances

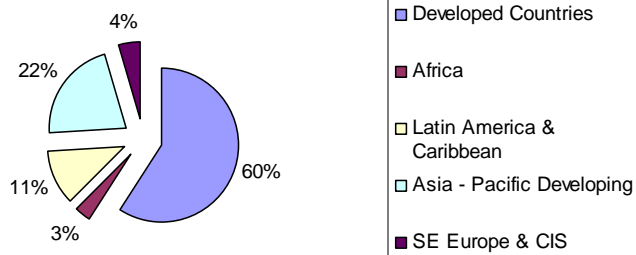


Source: WTO Trade Policy Review of China – Table AI.5 (Derived)



FDI Imbalances

Global FDI Inflow Shares 2005

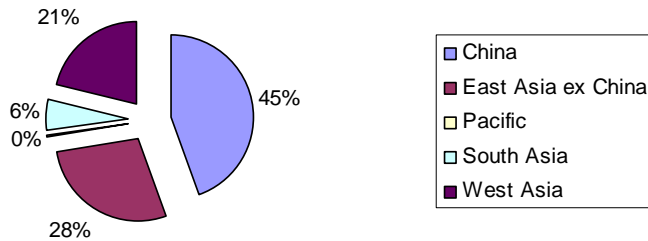


Source: UNCTAD World Investment Review - 2005



Unbalanced FDI in Asia

Developing Asia-Pacific FDI Shares 2005



Source: UNCTAD World Investment Review - 2005

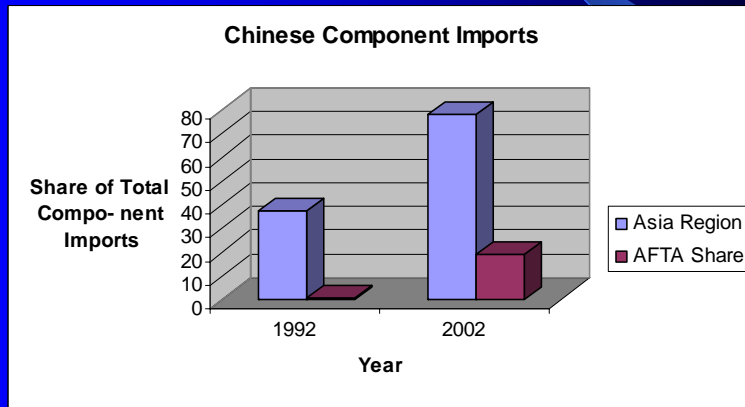


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Components Trade in China Trade



Source: Athukorala (2007)

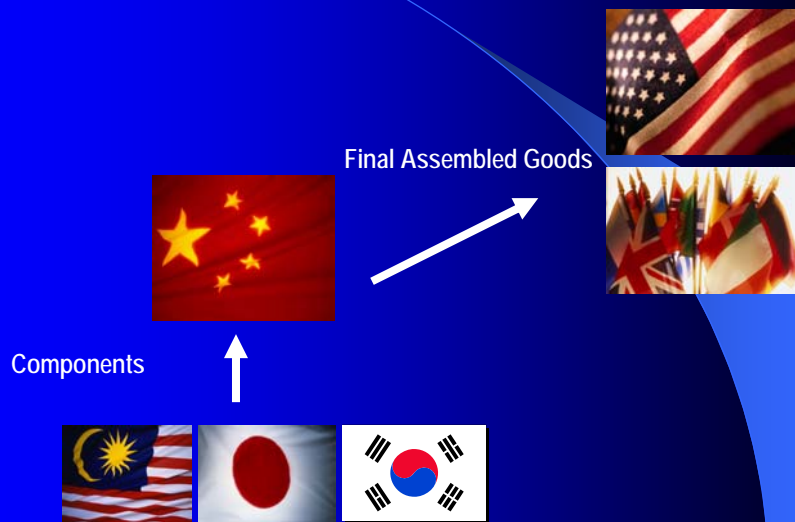
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6



Will assembly in China stay competitive?

Location	Monthly Wage Average
Shanghai, China	\$350
Shenzhen, China	\$250
Philippines	\$200
Thailand	\$150
Indonesia	\$100

Source: The Economist

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China's RTA Initiatives

- Currently in talks with 27 regions and countries
 - Trade coverage \$350 billion (1/4 of China total)
- Talks underway with:
 - Australia, New Zealand, Pakistan, SACU, GCC
- Agreements on the books with:
 - ASEAN, Chile, Hong Kong, Macau

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China - ASEAN

- Trade in Goods
 - Normal and Sensitive Tracks
 - Full liberalisation by 2015
- Trade in Services
 - Agreement signed in January with July implementation
 - Reportedly 60 additional (to WTO) services subsectors
 - Ongoing rounds of bilateral services negotiation
- Market Economy Status for China

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China - Chile

- Trade in Goods
 - After ten years' implementation, duty-free status for all but 3 percent of China's exports and 1 percent of Chile's exports
- Trade in Services / Investment
 - Agreement to address in subsequent negotiation

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Conclusions

- Regional trade patterns not indicative of two-way economic integration.
- Trade dependent on continued access by China to extra-regional markets and continued attractiveness of China for assembly operations.
- RTAs no long-term guarantee of prosperity.
- Serious risk associated with inattention to state of play in global trade talks.