

The Rise of China and Structural Changes in Korea and Asia

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3. China's rise and East Asian economies: towards a Sino-centric regional grouping?*

John Wong

3.1 RELENTLESS GROWTH

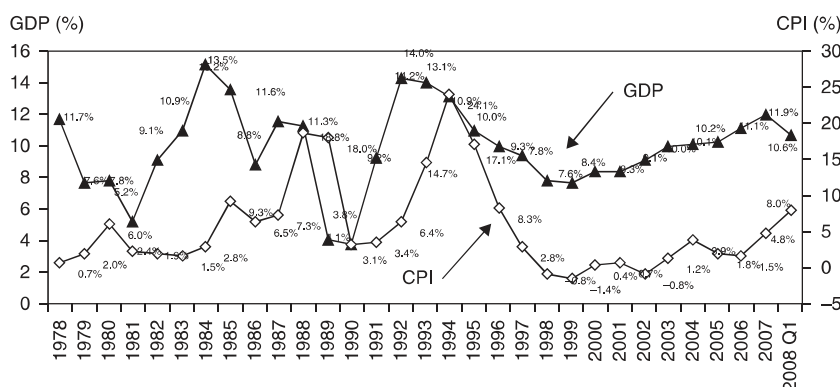
The Chinese economy since 1978 has experienced spectacular performance on account of its successful economic reform and open-door policy. Average annual economic growth for the period of 1978–2007 was 9.8 per cent, with many ups and downs in the process. Real growth for 2007 was 11.9 per cent, up from the high rate of 11.2 per cent of 2006.

In fact, China has chalked up double-digit rates of growth for five years in a row, averaging at 10.8 per cent a year (2002–2007), since its accession to the World Trade Organization (WTO) in 2001. This is truly phenomenal, especially because such 'hyper-growth' took place amidst a low annual inflation rate, below 3 per cent for the whole period – inflation only appearing in the last quarter of 2007.

As shown in Figure 3.1, China's economic growth process in the 1980s (its first decade of reform) fluctuated quite a lot, due to the so-called 'reform cycles'. Since 1990, the growth process has displayed two spurts of high growth. One was sparked off by Deng Xiaoping's *Nanxun* (tour of South China) in early 1992 and the other by China's accession to the WTO in 2001.

The *Nanxun* effect, as it may be called, signals China's long march into a market economy by deepening and broadening economic reform, as Deng started a bold move to convert China into the so-called 'socialist market economy'. The extensive marketization that followed tremendously enhanced the economic efficiency and productivity of China's economy.

The WTO effect marks the rapid integration of China into the global economy. It was the climax of Deng's open-door policy that started in the early 1980s. This has made it possible for China to capture the mechanism of international capitalism – mainly through trade, foreign direct



Source: National Bureau of Statistics (various years).

Figure 3.1 *China's economic growth and inflation, 1978–2008 Q1*

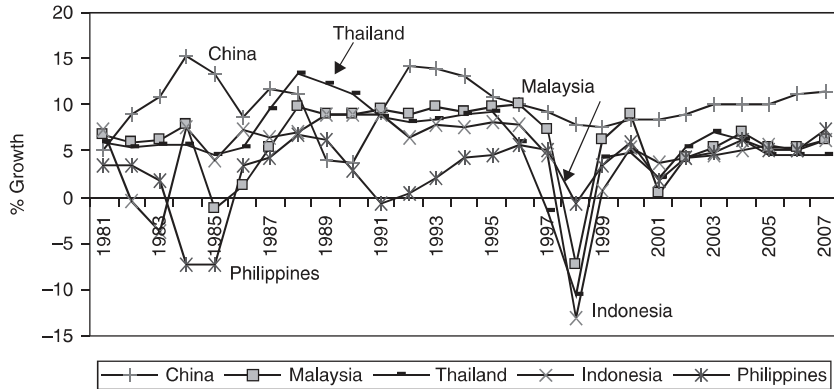
investment (FDI) and technology transfers – to raise its own economic growth to an even higher level.

In retrospect, the second spurt of growth after 2001 was far more significant, not just because it chalked up a double-digit rate of growth, but also because growth occurred on a much larger base at the tail end of the long growth period. Thus, China's total gross domestic product (GDP) in 2007 almost doubled its 2002 level.

When Deng introduced economic reform and the open-door policy at the historic Third Party Plenum in December 1978, China's total GDP was only 365 billion yuan. By 2007, total GDP had increased to 24000 billion yuan or about 67 times more. In 1978, China's nominal GDP per capita was only 380 yuan. In 2007, it increased 45-folds to 17000 yuan or about US\$ 2500 at current market exchange rate.

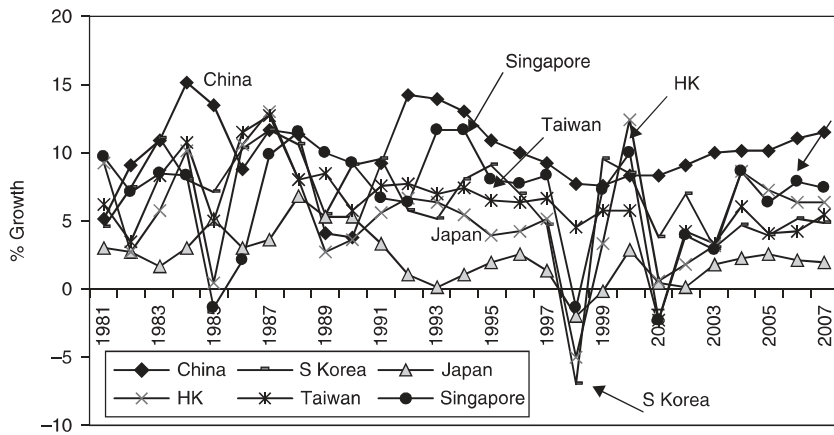
Many dynamic East Asian (EA) economies like Japan, Korea, Taiwan and Singapore had sustained similar high growth for two to three decades before, basically in the 1960s, 1970s and most of the 1980s. But they had never registered double-digit rates of growth continuously for five years in a row. China's recent dynamic growth is therefore historically unprecedented, even in the context of past high-performance East Asian economies.

In fact, whereas the 1997 Asian financial crisis brought down many EA economies, China's economy was hardly affected by the crisis as it continued to grow at 9.3 per cent in 1997 and 7.8 per cent in 1998. After this crisis, while economic growth in most of Asia had fallen to low or negative rates, China's economy alone was steaming ahead with strong growth.



Source: National Bureau of Statistics (various years).

Figure 3.2 Economic growth of china and ASEAN-4, 1981–2007



Source: National Bureau of Statistics (various years).

Figure 3.3 Economic growth of China and other East Asian economies, 1981–2007

In 2003, despite disruptions caused by severe acute respiratory syndrome (SARS) and global economic recession, it still chalked up a hefty 10 per cent growth. Furthermore, high growth momentum has been sustained until the outbreak of the 2008 financial crisis with double digit-rates of growth (Figures 3.2 and 3.3).

As a matter of fact, China's hyper-growth in recent years has been

unexpected even by China's own economic policy-makers, who originally conceived China's warranted rates of growth to be around 8 per cent. The planners of the 11th Five-Year Programme (2006–10) envisioned the potential growth rates at only 7–8 per cent.

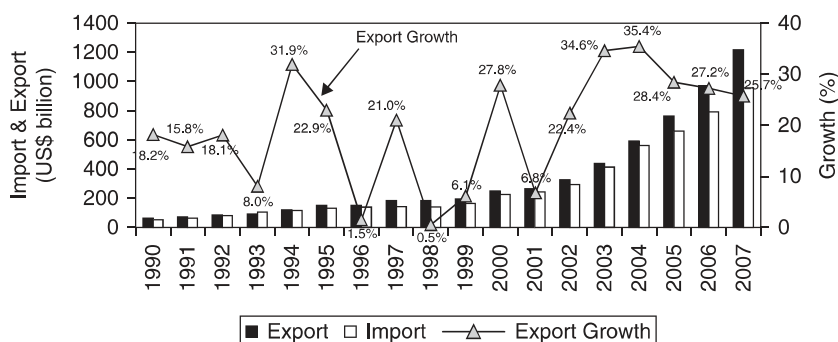
Not surprisingly, the Chinese government was initially quite worried about the possibility of economic 'overheating'. Premier Wen Jiabao in 2003 did try to cool the high growth administratively with macroeconomic control measures, but without success. For several years, many foreign commentators also predicted an imminent 'hard landing' for the Chinese economy, which nonetheless refused to cool down, and instead kept on growing and growing, and at higher rates.

3.2 THE ECONOMIC RISE OF CHINA

By 2007, China has become a huge economy of US\$3.3 trillion at market exchange rate and was about to displace Germany as the world's third-largest economy. In PPP (purchasing power parity) terms, China has long been the world's second-largest economy after the USA, even though the PPP measure often tends to exaggerate the reality, particularly for the non-tradable service activities. It may be noted that the World Bank has since revised downward China's PPP-based GDP substantially; but China is still ranked as the world's second-largest economy in PPP terms.

China's foreign trade has also grown rapidly during the period 1980–2007, averaging 17 per cent, after the adoption of the export-oriented development strategy. In 1978 when Deng Xiaoping announced the introduction of the 'open door policy', China's total exports amounted to only US\$9.8 billion or 0.6 per cent of the world's share. By 2007, China's exports increased 124 times to US\$1.2 trillion, accounting for 8 per cent of the world's total exports. In fact, with its total trade of US\$2.17 trillion in 2007, China has overtaken Germany as the world's second-largest trading nation.¹ In particular, China's exports (95 per cent being manufactured exports) have been growing at a phenomenal rate of 30 per cent a year since its accession to WTO in 2001. As shown in Figure 3.4, because exports have been for many years growing faster than imports, China has chalked up a huge trade surplus, which in 2007 amounted to US\$260 billion or about 8 per cent of GDP.

For FDI, China has since the early 1990s become the world's most favoured destination in comparison with all other developing countries. Between 1990 and 2007, China attracted a total of US\$610 billion in FDI. For years, China has consistently captured more than half of all FDI in Asia. Not surprisingly, more over 80 per cent of the world's 500 largest



Source: National Bureau of Statistics (various years)

Figure 3.4 China's trade growth, 1990–2007

companies and its top 100 information technology firms have already set up businesses in China.²

Above all, on account of its strong external balance as result of its persistent 'twin surplus' (that is, surplus in both current and capital accounts), by 2007 China's total foreign exchange reserves soared to US\$1.5 trillion to become the world's largest, surpassing Japan. This, in turn, had led to mounting international pressures on China to revalue its renminbi (RMB). Indeed, the much-anticipated revaluation of the RMB took place on 21 July 2005, when the RMB officially went off the US dollar peg for a process of gradual appreciation. By mid-2008, the RMB had appreciated nearly 20 per cent against the US dollar while at the same time it had also depreciated about 10 per cent against the euro, though less against the Japanese yen – this is because the RMB's float is being managed on a basket of currencies. In any case, all the world's major financial markets have since been watching closely the movements of the RMB.

Another indicator of China's rising global financial clout is associated with the sudden rise of its capital markets. In September 2007 the Shanghai Stock Exchange, with its index reaching the all-time high of around 6000, became the world's fourth-largest, after New York, Tokyo and London, in terms of total capitalization, even though the Shanghai bourse was only partially opened to foreign investors. At its peak in October 2007, five of the world's ten largest corporations were from China, headed by China Petroleum. (Just as in the early 1990s a number of Japanese corporations also counted among the top ten in the world.)

Suffice it to say that, starting in the early 2002, the meteoric rise of China's economy has become a 'hot' topic in the international and

Table 3.1 Production of major industrial products, 1978–2007

	1978	2007	2007 over 1978 %
Coal (million tons)	618	2536.0	310
Crude steel (million tons)	22	489.6	2125
Cement (million tons)	65	1360.0	1992
Electricity (billion kwh)	257	3277.0	1175
Automobiles (million units)	0.15	8.7	57
Colour TV sets (million units)	*	84.3	—
Refrigerators (million units)	*	43.9	—
Air conditioners (million units)	*	80.1	—
Personal computers (million units)	0.08 (1990)	120.7	—

Note: *Output just a few hundred.

regional media.³ Many Asian economies were concerned about the potential displacement effect of China becoming the factory of the world. A few years ago, some pointed the finger at China for exporting deflation to the world, because of China's massive exports of low-priced manufactured products; and lately, China was accused of 'exporting inflation'. Even the Japanese were initially quite worried by China's recent dynamic industrial expansion. The noted Japanese economist Kenichi Ohmae even used a sensational title, 'Asia's next crisis: "Made in China"', to talk alarmingly about the rise of China.⁴ And not surprisingly, other smaller countries in Southeast Asia have been watching the rise of China with apprehension.

In the early 2000s China was mostly referred to as a rising regional economic power, with its growth producing mainly regional impact. In recent years especially after 2005, China's economy reached a new plateau whereby its domestic production, consumption and foreign trade started to carry significant global ramifications.

Indeed, as a huge and diverse economy, every item of production and consumption in China inevitably becomes a 'jumbo number'. Thus, as shown in Table 3.1, China is the world's top producer of coal (2.5 billion tons), steel (490 million tons) and cement (1.4 billion tons), and the world's second-largest producer of electricity (3277 billion kwh). Viewed from a different angle, China is also (and necessarily so) the world's top consumer of a wide variety of mineral resources and primary commodities from iron ores to oil and gas, and from palm oil to timber. China's rising demand for these products has driven up their world prices. For instance, the oil price hike in 2007 was attributed to China's increased demand for oil as it has now become the world's second-largest consumer of oil (about

9 per cent). Worse still, as the world's leading producer of those basic industrial products, China has also become the world's leading polluter, being the world's second-largest emitter of the GHG (greenhouse gases), after the USA.

In an economic perspective, the fact that China in 2007 produced 8.7 million of automobiles and 121 million personal computers (PCs), signifies not just China's mammoth manufacturing and technological capacities but also points to its enormous productivity potential. Any producer turning out such a large volume of output will naturally enjoy the advantage of economies of scale, with low average cost and near-zero marginal cost. Such is China's inherent comparative advantage for a wide range of manufactured products, particularly vis-à-vis its much smaller neighbouring economies in the EA region.

Size always matters when it comes to the economics of production. In China's case, its economic rise can also be attributed to the outcome of the dynamic combination of speed and scale. Human history has never before experienced such a massive scale of industrialization proceeding at such a breakneck speed as it is taking place in China today. Hence, for boom or for bust, the operation of China's economy inevitably carries significant regional and global ramifications.

3.3 GROWTH AND INTEGRATION IN EAST ASIA

East Asia (EA) as an economic region is conventionally defined to comprise Japan, China, the four East Asian NIEs (newly industrialized economies) of South Korea, Taiwan, Hong Kong and Singapore, and other Southeast Asian economies that constitute ASEAN (Association of South East Asian Nations). Politically, this corresponds to the current regional concept of 'ASEAN+3'.

Situated on the western rim of the Pacific, many EA economies registered dynamic growth for a sustained period until 1997 when they were hit, in varying degrees, by the regional financial crisis. The World Bank in its well-known study referred to EA's high-growth phenomenon as the 'East Asian Miracle'.⁵ Rapid economic growth of the EA economies has also brought about greater economic integration among them, mainly through trade and foreign investment, that is, through market-driven, open integration.

Historically speaking, the EA growth process is marked by three waves. Japan was the first non-Western country to become industrialized. Its high growth dated back to the early 1950s amidst its rapid post-war recovery, and carried the growth momentum over to the 1960s and much of the

1970s. Japan's economic growth engine was initially based on the export of labour-intensive manufactured products. But it was soon forced by rising wages and increasing costs to shed its comparative advantage for labour-intensive manufacturing in favour of the four NIEs, which started their industrial take-off in the 1960s. These four NIEs, once dubbed 'Asia's Four Little Dragons', were arguably the most dynamic economies in Asia, as they had sustained near double-digit rates of growth for over three decades, from the early 1960s to the 1980s. The rise of the NIEs constituted the second wave of the region's growth and integration.

By the early 1980s, high costs and high wages had also caught up with these four NIEs, which had to restructure their economies towards more capital-intensive and higher-value-added activities after passing their comparative advantage in labour-intensive products to the latecomers of China and the four ASEAN economies of Indonesia, Malaysia, Thailand and the Philippines (dubbed 'Asia's Tiger Economies') and thereby spreading economic growth to the latter. In this way, China and some ASEAN economies were able to chalk up high growth through the 1980s and the 1990s. This constitutes the third wave of high growth. Many Japanese scholars like to depict this pattern of development in Asia as the 'flying geese' model⁶ (see Table 3.2 and Figure 3.5).

Furthermore, the EA region has already developed a high level of intra-regional trade. As shown in Table 3.3, the EA region in 2006 absorbed 46 per cent of Japan's total exports (22 per cent in 1980), 37 per cent of China's total exports; (39 per cent in 1980); 44 per cent of Korea's (24 per cent in 1980); 62 per cent of Taiwan's (63 per cent in 2000); 62 per cent of Hong Kong's (48 per cent in 1980); 60 per cent of Singapore's (40 per cent in 1980); and 45 per cent of the average of the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand) (51 per cent in 1980).

The sharp rise in the intra-regional trade over the past two decades for Japan, Korea, Hong Kong and Singapore (and possibly for Taiwan) is undoubtedly due to the rise of China. The decline in the regional share for China and the ASEAN-4 is because of their high trade orientation towards the USA and the EU, and also their global trade diversification. Japan's shift in its export orientation towards a greater regional focus is even more remarkable.

Apart from intra-regional trade, intra-regional FDI flows have also operated as a powerful integrating force for the EA region, especially since a great deal of regional FDI is trade-related in nature. As essentially open and outward-looking economies, the EA economies are, in varying degrees, dependent on foreign trade and foreign investment for their economic growth. In particular, both China and ASEAN have devised various incentive schemes to attract FDI, which is generally treated not

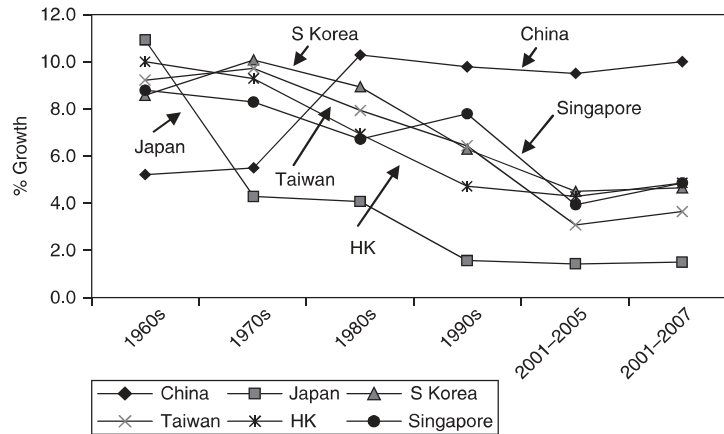
Table 3.2 East Asian economies: performance indicators

	Population (mn)		GDP per capita (US\$)		PPP estimates of GDP per capita (US\$)		Growth of GDP (%)						
	2007	2007	2007	2007	2007	2007	Total GDP (US\$ bn), 2007	1960–70	1970–80	1980–90	1990–2001	2000–2005	2006
China	1321	2460	5292		3250	5.2	4383	5.5	10.3	9.7	9.3	11.1	11.9
Japan	128	34312	33576		4383	10.9		4.3	4.1	1.3	1.5	6.4	2.1
NIEs													
South Korea	48	19750	24782		957	8.6		10.1	8.9	5.7	4.6	5.2	4.9
Taiwan	23	16605	30126		383	9.2		9.7	7.9	5.7	3.4	4.3	5.7
Hong Kong	7	29650	41995		206	10		9.3	6.9	3.8	3.9	6.4	6.2
Singapore	4.6	35162	49713		161	8.8		8.3	6.7	7.4	3.4	6.9	7.7

Table 3.2 (continued)

	2007	2007	GDP per capita (US\$)	PPP estimates of GDP per capita (US\$)	2007	Total GDP (US\$ bn), 2007	Growth of GDP (%)						
							1960–70	1970–80	1980–90	1990–2001	2000–2005	2006	2007
ASEAN-5													
Indonesia	225	1924	3724	433	3.9	7.2	6.1	3.8	4.8	5.2	6.3		
Malaysia	27	6947	13315	186	6.5	7.9	5.3	6.5	4.4	5.5	6.3		
Philippines	88	1624	3377	144	5.1	6	1	3.3	4.4	5	7.3		
Thailand	66	3736	7900	245	8.4	7.1	7.6	3.8	5.0	4.5	4.7		
Vietnam	86	818	2586	570	–	–	–	7.3	7.4	8.8	8.5		
For comparison													
India	1123	977	2659	1098	3.4	3.6	5.8	5.5	6.3	8.8	8.7		

Sources: Based on data from *China Statistical Yearbook* and IMF sources.



Sources: IMF *World Economic Outlook*; National Bureau of Statistics of China; Hong Kong Statistics; *Korea Statistical Yearbook*; www.stat.gov.trw; www.singstat.gov.sg; *Japan Statistical Yearbook*.

Figure 3.5 East Asia economic growth: The 'flying geese' pattern

just as an additional source of capital supply but, more importantly, as a means of technology transfer and export market development. What is more important is that an increasing share of EA's FDI flows originates from the region itself. Overall, this also points to the ongoing process of EA's growing economic interdependence.

3.4 THE REGIONAL IMPACT OF CHINA'S RISE

3.4.1 Challenges for Japan

In the post-war Asia, Japan played a leading role in the region's economic growth and integration. Japan's sustained high growth spilled over first to the four NIEs and later to some ASEAN economies and China. Japan was the natural economic leader of the group because of its ability to provide the needed capital and technology for the other EA economies, first the NIEs and then China and ASEAN. For years, Japan's economic presence was most prominent in the EA region. As a result, it rendered the EA region economically oriented towards Japan.

However, Japan's strong economic presence in the EA region has now slowly and steadily been eroded by the rise of China. Initially, China's dynamic economic growth complemented well and even reinforced Japan's

Table 3.3 *Origins and destinations of East Asian intra-trade*

Origin of regional exports	Year	Total exports (US\$ Millions)	Share of regional exports designated for: (%)							
			Japan	China	Korea	Taiwan	Hong Kong	Singapore	ASEAN-4*	EA SUM
Japan	1980	130441		3.9	4.1	—	3.7	3	7	21.7
	1988	264856		3.6	5.8	—	4.4	3.1	4.9	27.2
	2000	479249		6.3	6.4	—	5.7	4.3	9.5	39.7
	2004	565675		13.1	7.8	—	6.3	3.2	9.1	46.9
	2006	649931		14.3	7.7	—	5.6	3.0	8.1	45.5
China	1980	18099	22.3		—	—	24.1	2.3	4.3	53
	1988	47540	16.9		—	—	38.4	3.1	2.8	61.2
	2000	249203	16.7		4.5	2	17.9	2.3	3.7	47.1
	2004	593439	12.4		4.7	2.3	17	2.1	4.1	42.6
	2006	969380	9.5		4.6	2.1	16.0	2.4	4.0	38.6
Korea	1980	17505	17.4	—	—	—	—	1.5	4.6	23.5
	1988	60696	19.8	—	—	1.6	5.9	2.2	2.8	32.3
	2000	172268	11.9	10.7	—	4.7	6.2	3.3	7.2	44
	2004	253845	8.5	19.6	—	3.9	7.1	2.2	5.8	47.1
	2006	325465	7.4	19.4	—	3.6	5.3	2.7	5.1	43.5
Taiwan	1980	—	—	—	—	—	—	—	—	—
	1988	60667	—	3.7	—	—	—	—	—	—
	2000	148321	11.2	16.9	2.6	21.1	3.7	7.4	62.9	59.7
	2004	182370	7.6	19.9	3.1	18	3.7	7.4	61.8	59.7
	2006	243801	7.3	23.2	3.2	16.6	4.2	7.3	61.8	61.8

Hong Kong	1980	19 730	6.1	34.9	1.5	2.5	2.6	0.5	48.1
	1988	63 163	5.2	34.4	1.0	2.5	2.3	0.3	45.7
	2000	201 860	5.5	34.6	1.9	2.5	2.3	0.5	47.3
	2004	259 314	5.3	44.0	2.2	2.4	2.2	3.3	59.4
	2006	316 816	4.9	47.0	2.1	2.6	2.0	3.2	61.8
Singapore	1980	19 375	8.1	1.6	1.5	–	7.7	20.8	39.7
	1988	39 306	8.6	3.0	2.0	2.8	6.2	20.3	42.9
	2000	137 804	7.5	3.9	3.6	6.0	7.9	24.9	53.8
	2004	179 615	6.4	8.6	4.1	4.6	9.8	21.7	55.2
	2006	271 799	5.5	9.8	3.2	3.5	10.1	28.3	60.4
ASEAN-4	1980	47 100	34.5	1.1	1.7	–	1.9	11.8	51.0
	1988	80 080	19.5	2.2	2.8	2.0	2.9	9.0	38.4
	2000	269 099	16.0	3.4	3.7	4.2	4.2	12.6	44.1
	2004	333 108	15.0	6.8	2.9	3.5	5.1	10.4	43.7
	2006	442 265	13.7	8.3	3.9	3.3	4.7	11.3	45.2

Note: * ASEAN-4 denotes Indonesia, Malaysia, the Philippines and Thailand.

Source: *Direction of Trade Statistics Yearbook, 2007*, IMF.
Taiwan's data are obtained from Bureau of Foreign Trade website.

leading role in the region. Subsequently, as China's rapid economic growth was sustained and continued, China started to pose a challenge to Japan's leading economic role in the region, particularly as Japan's economy was trapped in a prolonged recession.

Since the structure and pattern of China's recent economic growth is different from that of Japan's in the past, the regional impact of China's rise is also substantially different from that of Japan. To begin with, China's economic growth process is more 'inclusive' than that of Japan, and it has therefore produced a more extensive regional impact in a very short span of time. In fact, China's rise today also embraces Japan, helping Japan to pull itself out of its economic doldrums. Furthermore, China's economic rise is occurring in a world that is today much more globalized. As the world's foremost manufacturing powerhouse, China is also home to numerous regional and global production networks, which operate to integrate a lot of manufacturing activities in its neighbouring economies, including Japan, to their mutual benefit. In this sense, China's economic growth has generated far-reaching spillover effects, both regionally and globally. China is not just a new engine of economic growth, but increasingly it is also taking on the role of integrating EA's economic activities for global outreach. This point will be further discussed later.

If China's economy were to continue at its present pace of dynamic growth for a decade or more (not an unrealistic assumption), China would eventually dwarf Japan's leading economic role in the EA region as the major force for growth and integration, simple because of China's size and diversity on the one hand, and Japan's growing ageing population on the other.

There is, of course, a great deal of uncertainty pertaining to the exact pattern of economic relationship of China and Japan vis-à-vis the EA region in the years to come. Economic relations between powerful states are much more complicated, often operating in a win-win situation rather than in zero-sum terms. Japan has already developed a new economic symbiosis with China to each other's benefit, and both economies have thrived on this economic relationship, for example each being a leading trade partner of the other.

China's rise may gradually change the geopolitics and geo-economics of the EA region, but Japan is likely to maintain its high level of economic presence in the region and stay on as one of its key development partners for a long time to come. In the meanwhile, the region is actually blessed with two engines of economic growth – a two-engined flying geese formation is inherently a more powerful one.

3.4.2 China as the 'Dragon-Head' for the EA Economies

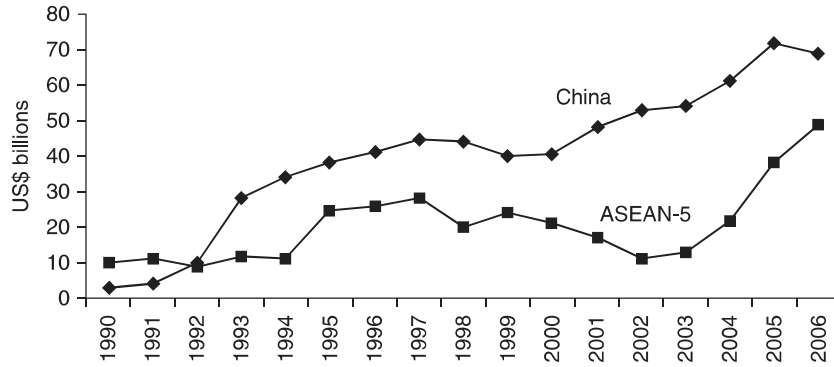
China's economic growth actually fits in quite well with the overall EA growth pattern. Since the EA region absorbs around 50 per cent of China's exports and supplies about 60 per cent of China's FDI, it is not hard to explain why China's rapidly growing economy since 1978 has impacted significantly on many EA economies. However, the actual impact of the fast-growing Chinese economy on the EA economies has been quite uneven. China's dynamic economic growth has produced both positive and negative effects for the individual EA economies in the region.

From the outset, Japan and the four NIEs have been able to benefit a lot from China's open-door policy first by trading with China and then investing in China, that is, capital and technology to China. Deng's open-door policy presented Hong Kong, Taiwan and South Korea with a god-sent opportunity to upgrade their own manufacturing industries by conveniently shifting their labour-intensive production bases to China. In the process, they also forged very close economic linkages with China. Hence China has become their leading trade partner.

In contrast, China and the ASEAN economies initially tended to be more competitive than complementary with each other. In many ways, China's dynamic economic growth has exerted strong competitive pressures on the ASEAN economies, which are vying for FDI with China as well as competing head-on with China's manufactured exports in the developed-country markets. Figure 3.6 does show up some prima facie evidence for this view, even though the actual situation is not so straightforward.⁷

Initially, China's success in economic reform and development produced very little impact on the ASEAN countries to its south, because Sino-ASEAN trade was then very small – in fact, only a small fraction of each other's total trade and with a large part of it being centred in Singapore (Figure 3.7). For FDI, it had soon become apparent that China and ASEAN were not really directly competing with each other. Even by the late 1990s, when massive FDI began to flow into China, there was no clear-cut evidence that China had 'sucked' in a lot of capital from the ethnic Chinese in Southeast Asia.⁸ A study by the United Nations Conference on Trade and Development (UNCTAD) has also confirmed that China's growth has not adversely affected FDI inflow to other East Asian economies. Furthermore, China 'appears to be crowding in rather than crowding out FDI in the region'.⁹

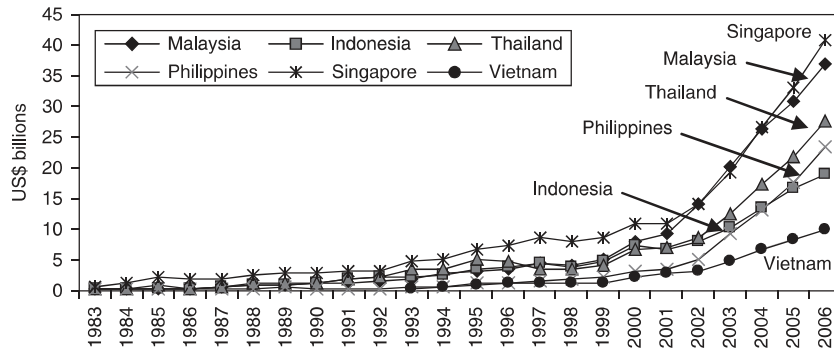
Still, many ASEAN economies were apprehensive about the economic rise of China, particularly in the aftermath of the 1997 Asian financial crisis. While many ASEAN countries were plagued by persistent economic crises and domestic political instability, China was intent on its



Note: ASEAN-5 includes Indonesia, Singapore, Malaysia, Philippines and Thailand.

Sources: National Bureau of Statistics (various years).

Figure 3.6 Asean-5 and China competing for FDI

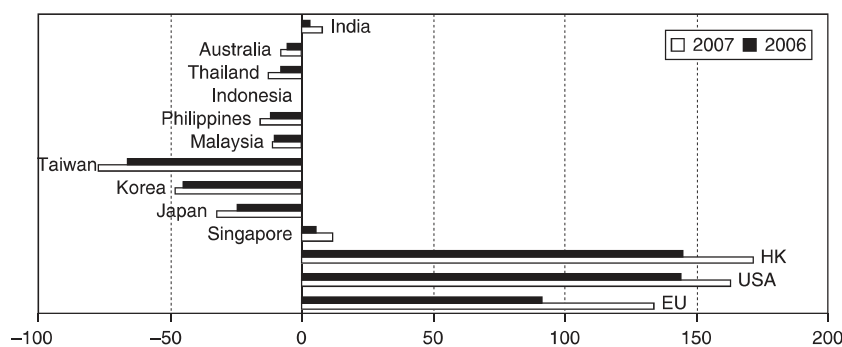


Source: UN Comtrade; Direction of Trade Statistics.

Figure 3.7 China's trade with ASEAN, 1980–2006

single-minded pursuit of economic modernization, adding to ASEAN members' fears that they might eventually be left behind by China's continuing relentless economic growth.

More significantly, China's recent spurt of dynamic economic growth since its WTO membership has transformed the old pattern of China's economic relations with the EA region. In the short span of just a few years, China's economic growth and exports have started to alter the region's trade patterns and FDI flows.



Source: China Monthly Customs Statistics; Ministry of Commerce, www.mofcom.gov.cn.

Figure 3.8 China's trade balance with selected countries (US\$ billions)

Take China's trade relations with EA. In recent years, China has become the top trade partner (No. 1 or No. 2) of most of its neighbouring economies. China's unique pattern of trade balance with its major trading partners has been the major driving force behind the region's economic growth after the 1997 Asian financial crisis. As shown in Figure 3.8, China in 2006 and 2007 continued to run substantial trade deficits with its neighbouring economies, from Japan, Korea, Taiwan and ASEAN-5 to Australia and India. China turned around by incurring a large trade surplus with the USA and the EU. In this way, China could still end up with an overall trade surplus. China's trade deficits with its neighbours also mean that it has opened up its vast domestic market for their exports (both manufactured products and primary commodities), thereby operating as an engine for their economic growth.

The underlying economic implications of China's overall trade pattern for both trading partners and trade balance are even more profound. Since most of China's exports are processed products (53 per cent of total exports in 2006) or final products generally with low domestic value-added and low domestic content (domestic content is generally around 40 per cent, but can be 20 per cent or lower for some products), China must import in order to export. Since over half of China's foreign trade is handled by its foreign-invested enterprises (on average 59 per cent in 2006, with much higher proportions for IT products), particularly those from Japan, Korea, Taiwan and Hong Kong, China's foreign trade has become a critical link in the East Asian supply chains.

It can further be argued that, as shown in Figure 3.9, China's foreign trade is also an important force for regional economic integration. As the

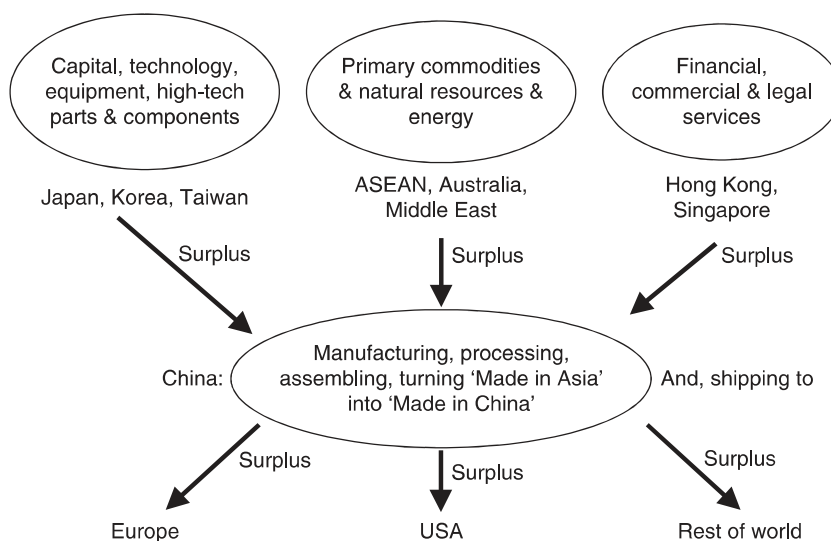


Figure 3.9 China at the centre of global and regional production networks

world's foremost manufacturing processing base, China occupies a central place in various EA supply chains. It imports raw materials, intermediate products, machinery and equipment, and services from different EA economies, converting 'Made-in-Asia' into 'Made-in-China' products for export to different markets in the region and beyond. In this way, China operates as an important 'integrator' of regional and global manufacturing activities.

In this way, ASEAN's old fears that the rising China could create competitive pressures on its manufactured exports and divert FDI from ASEAN, have largely dissipated. Now, as China and other EA open and outward-looking economies have become increasingly integrated into many common international supply chains, the resultant new global trade–FDI–technology linkages will further bring economic growth to the EA region as a whole.

3.4.3 China's Regional Initiatives with ASEAN

It needs to be emphasized that the increasing regional impact of China's economic growth has been largely market-driven. But this market-based pattern of economic integration has been further reinforced by Beijing's far-sighted diplomatic policies, thereby lending strong institutional support to forge China's further economic integration with the EA region.

Mindful of ASEAN's worries over the possible disruptive effects of its

rapid economic rise, China has been under mounting pressure to dispel the 'China threat' fears by improving its overall relations with its ASEAN neighbours. The process started in 1992 when China formally became a 'Dialogue Partner' of ASEAN. Prior to this, China took steps to defuse the issue related to the hotly disputed Spratly Islands in the South China Sea by agreeing to joint consultation and joint development with the relevant ASEAN states. During the 1997 Asian financial crisis, Beijing's steadfast refusal to devalue its renminbi was much appreciated by ASEAN as such a move could have further aggravated the region's financial woes. But the single most important step ever undertaken by China in recent years to upgrade its long-term political and economic relations with the ASEAN region is China's bold Free Trade Area (FTA) initiative.

At the ASEAN–China Summit in November 2001, former Chinese Premier Zhu Rongji proposed the creation of a free trade area between China and ASEAN within ten years. On 4 November 2002, China and the ASEAN countries signed a framework agreement in Cambodia to establish a FTA by 2010.¹⁰ To show its serious intentions and to expedite the process, China on 1 January 2004 further initiated the Early Harvest Programme with some ASEAN countries by cutting tariffs on 500 items of agricultural products.

On 29 November 2004, China and ASEAN formally concluded in Vientiane, Laos, the Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Cooperation between the two sides for tariff liberalization under the China–ASEAN Free Trade Area. Tariff liberalization would be under a 'normal track' and a 'sensitive track'. Duties on many commodity items under the normal track would be eliminated by 2010.¹¹ On 20 July 2005, China and ASEAN started to cut tariffs on more than 7000 commodity items.¹² China's average tariff on ASEAN products was reduced from 9.9 per cent to 8.1 per cent in 2005, and would be further reduced to 6.6 per cent in 2007. By 2010, 93 per cent of ASEAN products are expected to be tariff-free when the China–ASEAN FTA is fully implemented.¹³

The formation of the China–ASEAN FTA, on paper, signifies the creation of an economic region of nearly 2 billion consumers with a combined GDP of more than US\$5 trillion. It could offer an effective means for smaller ASEAN states to overcome their disadvantage of smallness by pooling their resources and combining markets. This would in time lead to greater economic integration between China and ASEAN, clearly a win–win situation.¹⁴ The much-touted Chinese 'economic threat' would then turn into an opportunity for ASEAN.

In the short run, however, ASEAN has to deal with the initial risks of a potential trade diversion effect and related structural adjustment, as to be

expected in any such regional integration process.¹⁵ In general, the FTA scheme could give rise to an uneven distribution of costs and benefits for different industries, different sectors, and even different ASEAN countries. After the initial process of adjustment, individual ASEAN economies would then develop their own niches in their economic relations with China.

With China continuing its dynamic economic growth, opportunities will certainly arise for the ASEAN countries to exploit China's vast growing market. Apart from its primary commodities, ASEAN's resource-based products will be in great demand in China. The recent years have witnessed an upsurge of ASEAN's exports of natural resource products, from timber to palm oil, to China to satisfy the voracious demands of its manufacturing sector. China is such a vast and differentiated market that East China, South China and Southwest China can individually offer different opportunities to different ASEAN producers. Not surprisingly, Sino-ASEAN two-way trade had surpassed US\$130 billion in 2005, with ASEAN becoming one of China's largest trading partners.¹⁶ In 2007, the two-way trade reached US\$190 billion, with ASEAN and China each being the fourth-largest trade partner with the other. Total trade between China and ASEAN is expected to reach US\$200 billion by 2008, one year ahead of schedule.¹⁷

Beyond merchandise trade, FTA also promotes trade in services, including tourism. China may generally have a strong comparative advantage in manufacturing because it enjoys the economies of scale, which however may not apply to many service activities. In fact, a lot of China's service activities, on account of their past socialist legacies, are known to be more backward than those in ASEAN.¹⁸

In the years to come as the China-ASEAN FTA scheme is gradually phased in, multinationals in the region will gradually restructure their supply chains and rationalize their production networks by taking China and ASEAN together as a single market. This will eventually lead to a reshuffle of regional production networks and hence also a redistribution of the regional FDI flows. The new regional production patterns will then be based on a bigger and more diverse market. In short, both trade and FDI in the region should continue to grow under the impact of the China-ASEAN FTA. And this would certainly be a win-win outcome.

China's FTA initiative with ASEAN, as the first of its kind (the first ASEAN+1 trade arrangement), also created new impetus for the region to revitalize its integration process. In fact, the China-ASEAN FTA exerted tremendous pressure on Japan and Korea to follow suit, prompting similar responses from them. Accordingly, in the wake of the China-ASEAN FTA, Japan had to take action by signing a Framework for Comprehensive Economic Partnership with ASEAN, which is not a

true FTA but can comprise Japan's bilateral FTA arrangements with individual ASEAN member countries. Korea also made a similar move. The EA economies in the region were virtually scrambling to set up bilateral FTAs or EPAs (economic partnership arrangements) with each other or with countries outside the region.¹⁹

China, too, did not stop at the China–ASEAN FTA. In June 2003, China signed the Closer Economic Partnership Arrangement (CEPA) with Hong Kong (and subsequently with Macau). CEPA is obviously aimed at the eventual integration of these Greater China economies after the inclusion of Taiwan in future.²⁰ Prior to this, China had agreed to initiate a joint study with Japan and Korea on possible Northeast Asian economic cooperation. In October 2003, Premier Wen Jiabao attended the 9th ASEAN Summit in Bali, where he signed with the heads of government from Japan and Korea the Joint Declaration on the Promotion of Tripartite Cooperation among these three Northeast Asian countries. This tripartite cooperation is not just for the promotion of economic cooperation and peace dialogue in Northeast Asia, but is also aimed at strengthening the process of ASEAN economic integration with other EA economies, that is, a more concrete way of accelerating the realization of the greater East Asian economic integration through the ASEAN+3 process.

Of equal importance, Premier Wen at the Summit also signed the Treaty of Amity and Cooperation (TAC) with ASEAN in order to express China's goals of establishing a strategic partnership with ASEAN for 'peace and prosperity'.²¹ China is the first country to accede to ASEAN's TAC, which is a distinctive regional code of conduct governing state-to-state relations within ASEAN. The most important principle in the TAC is the provision that requires all parties involved to renounce the use of force in the settlement of any dispute. In concluding this historic treaty, China has signalled to the ASEAN countries its acceptance of ASEAN's norms and values, and its willingness to play by the rules. In other words, 'China wants to be seen as a responsible member of the international community'.²² Since India also followed China by concluding a similar TAC with ASEAN, Japan was once again under tremendous pressure to follow suit.

Besides the China–ASEAN FTA initiative, China has also undertaken several subregional cooperation schemes to facilitate economic integration with relevant ASEAN countries. A few years back, Guangdong Province started the '9+2' (nine provinces in South China plus Hong Kong and Macau) scheme for greater interprovincial economic integration among these provinces and Hong Kong and Macau, and as a vehicle for Chinese enterprises to 'go out' (*zou chu qu*), particularly to Southeast Asia.

Later on, in 2006, Guangxi Province took the initiative to develop the 'Pan Beibuwan' cooperation, which would promote a wide area of

cooperation between China's three provinces of Guangxi, Guangdong and Hainan, and eight ASEAN states including Vietnam, Cambodia and Thailand. More recently (March 2008), Premier Wen Jiabao attended the Third Greater Mekong Sub-region (GMS) Summit in Vientiane, endorsing China's active participation in the GMS development, which will benefit China's several land-locked provinces like Yunnan and Sichuan.²³

While China's economy is increasingly globalized, it has also intensified its subregional cooperation efforts vis-à-vis individual EA economies, mainly on a decentralized basis. This makes much sense for China, as a large and diverse continent-sized country, to encourage individual provinces to forge closer economic links with adjacent EA economies so that they can better maximize each other's comparative advantages. It may be remembered that many of China's provinces are huge entities on their own: for example Guangdong has a population of more than 80 million. In effect, China is 'one country with many economies'.

In summary, China's drive for globalization and regionalization go hand in hand. Regionally, it places greater priority on cooperation initiatives with ASEAN, partly because of history and geography and partly in order to meet China's specific geopolitical needs. China's rapid economic rise has been perceived by as a disruptive force by some of its neighbours, giving rise to the 'China threat' perception. In response, Beijing put forth its 'peaceful rise' argument. China is making use of Southeast Asia as the best diplomatic space for it to demonstrate that its rise is indeed peaceful and benign.

3.5 TOWARDS A SINO-CENTRIC EAST ASIAN ECONOMIC GROUPING?

China's economic rise has far radically transformed the region's growth patterns and its landscape for trade and investment. What is the future shape of China's changing economic relations with the EA region? When people are talking about 'China's rise', they are actually referring to China's dynamic economic growth and its consequences for both China and other countries. For a more realistic projection of the future scenario, two immediate questions need to be posed: Is China's dynamic growth sustainable? How will its neighbouring economies respond and adapt to China's future growth?

3.5.1 Sustainability of China's Dynamic Growth

To begin with, China's future growth cannot consistently remain at double-digit rates. Now bigger and more mature, the Chinese economy

just cannot keep on growing at such a speed without getting overheated or running into physical and structural constraints. More sustainable levels of long-term growth should be at the warranted rate of around 8 per cent, which is still high growth by all accounts. China's high growth over two decades essentially stemmed from its exceedingly high levels of domestic investment, at more than 40 per cent of GDP, and equally high levels of domestic savings, also at more than 40 per cent, much like other East Asian economies in their early periods of growth.

For domestic investment, China will continue to have an enormous need for infrastructural investment in transportation, communications, ports, airports and power plants. Take railways as an example. China's railway network in 2006 amounted to 77 000 km, and China is target is to extend its total railway track length to 100 000 km. Big cities like Beijing, Shanghai, Guangzhou are also building high-speed railways for inter-city links. Furthermore, large cities like Beijing, Shanghai, Guangzhou, Tianjin, Chongqing, Shenyang Wuhan, Xian, Wuxi and Suzhou are all busy expanding their subway systems, all at huge capital costs.

In the years to come, China will also need to invest a lot for environmental protection like cleaning up the rivers and water supply sources. With rapid urbanization, there will be rising demand for social infrastructure like housing, schools, hospitals and recreation facilities. This explains why fixed asset investment will continue to be a highly significant source of growth for China at least up to 2020. For a capital-surplus, high-saving economy like China, it is the abundance in investment opportunity, not the availability of investment capital, that is more critical.

China's future economic growth can also be boosted by rising consumption. Rapid income growth, particularly for the urban population, has created a fast-growing *xiaokang* (moderately affluent) society, with a rising middle class of over 200 million. Their appetite for durable consumption goods like automobiles is enormous. When the urban elites have satisfied their basic material consumption needs, they will go for consumption in services like travel and entertainment. The same thing has happened to Japan and the four NIEs before.

Above all, by considering the historical patterns of EA economic growth, one can be easily optimistic about China's future growth potential. Historically, as shown in Table 3.2, Japan enjoyed over 25 years of high economic growth while the four NIEs of Korea, Taiwan, Hong Kong and Singapore had over 30 years. Why not China? China's present run of high growth has barely reached 30 years, and it could easily continue for another one or two decades. China's is a much larger and more diverse economy, and it should therefore have much greater internal dynamics to sustain higher growth for a longer period. In other words,