Implications of China's Regional and Global Integration

Participation of Vittorio Corbo, Governor of the Central Bank of Chile at the Conference "China's Peaceful Rise: Implications for the Asia-Pacific Region"

In the last two decades, China has achieved an impressive growth performance. Indeed, China has grown at an annual average rate of 9.5% in the period from 1980 to 2003. Although there is some evidence that this figure could be overestimated to a tune of 1.2 to 3.8 percentage points (World Bank, OECD and the National Economic Research Center of China) still growth has been very high by any standard. This process has been accompanied by increasing integration into the global economy, although the country has still a way to go. Today, adjusted by PPP, China is the world's second largest economy; at market exchange rates, the sixth; and in terms of international trade, the third. Prospects suggest that strong growth could continue in the near future.

China's growing international significance is changing the specter of the world economy and, undoubtedly, will have important implications for the world's economic performance. Indeed, during 2001-2003, China alone accounted for close to one-quarter of world growth at PPP. It has become also a major buyer of developing countries exports, third only to the US and the EU.

<u>China's Economic Development and Integration to the World Economy</u>

China, with a PPP per capita income of US$ 4,900 (US$ 1,060 at market rates), has plenty of room to grow further, based on multiple factors that we will review below.

First, China's investment rates are high (currently over 40% of GDP), and have been financed with domestic savings. In fact, China's recent growth pattern is comparable to those experienced by Japan and other South East Asian economies during their expansion, although an important difference is that China has maintained current account surpluses for the past ten years.

Second, China has been moving gradually to become a more market-oriented economy, and in doing so, it has welcomed foreign participation in several industries. Investments and human resources have been increasingly flowing in from abroad, contributing to a significant boost in FDI and bringing in new technology and know-how. Multiple joint ventures have been created with foreigners, and currently these account for almost 30% of the country's overall industrial production. It is also important to consider that, although FDI from Japan to China has increased by more than 300% in the last four years, it still accounts for only 9% of total Japanese investments abroad, showing that there is plenty of space for further increases in foreign investment.

Third, removal of restrictions to labor mobility has also helped to attain rapid growth in productivity, drawing migrant workers from rural areas to the more productive industrial sectors. In fact, the economy is currently concentrated mainly on labor-intensive production of manufactured goods, taking advantage of low wages, a well-educated work force (given China's low per capita income) and good infrastructure.

Fourth, gradually, other major structural reforms have been made in various areas. For example, the privatization of the housing sector and advances in the creation of safety nets. In addition, the functioning and development of the Chinese foreign exchange market have been improved by eliminating several restrictions and requirements to participate. In the banking sector, a decisive move was made a few weeks back, when the elimination of caps on commercial banks interest rates was announced. This enables banks to charge interest rates according to risks involved in each operation, as part of a wide-ranging effort to reduce non performing loans, currently estimated at around 18% of total assets.

Fifth, privatization has modified the ownership structure of the economy substantially. For example, in the early nineties 55% of companies in the industrial sector were either owned or controlled by the state. Data for 2002 shows that this percentage had been reduced to 42%, and that companies funded by foreigners accounted for nearly one third of industrial enterprises. However, in the manufacturing sector public enterprises are still significant in terms of fixed assets and the use of working capital (over 70%).

Finally, China's commercial integration with the rest of the world has played an important role as well: average tariffs have been cut down from over 40% in 1992 to just 6% today. Many other trade barriers have also been removed. The opening of the economy has favored not only China but also the rest of the world, as China has become not only an important supplier of low-cost products to world consumers, but also a sizeable demander of goods and services from the rest of the world. China's imports are both for local consumption and for processing trade. Its successful integration in the world economy is reflected in its share of world trade of over 6% today, up from only 1% in 1979. Going forward, commitments acquired in 2001 when it became a full member of the WTO, will improve conditions for trade. In fact, among others, China will give all WTO members National Treatment, it will eliminate dual prices and subsidies to exports of agricultural goods and, of course, tariffs will continue being reduced in several areas, a process that will be completed no later than 2010.

In the meantime, international trade has already been affected by the integration of China to the global economy. Its trade pattern has changed over time, as in the early eighties, 73% of China's total imports came from industrialized countries, compared with only 43% in 2003. Today, its most important export market is the US and imports come primarily from other Asian countries.

Changes in the relative weight of trading partners are closely related with the type of goods produced and exported. In fact, China's export growth is increasingly more dominated by manufactured goods and it has been moving up the value ladder towards higher-technology goods. China imports electronic components from other East Asian countries and exports computers, telephones, microwave ovens, among other products**,** to the rest of the world. Changes in goods exported have also boosted demand for commodities and other primary goods, while prices have soared. Clearly, countries producing such goods have benefited and other south East Asian economies have found in China a new and dynamic market for their more skilled-labor-intensive goods. Similarly, commodity-producing economies, like Latin American countries, have seen rapidly growing demand for their products.

However, some are harmed in the process. This is the case of producers of similar manufactured goods intensive in labor to China's. A clear example will be countries producing textiles, as global quotas for textiles and clothing are set to expire next January, and in many cases will most likely switch to low cost producing China.

China and Latin America

Regarding the effects of China's integration in Latin America, one of the most important benefits has been Latin America's improved terms of trade, as China has become the world's main consumer of copper, steel and cement, pushing prices up. Also, China's growing demand for oil has made it the second largest consumer of crude in the world, explaining 40% of the increase in crude consumption in the past four years.

Despite rapid growth in exports, Latin America has not become a very significant trade partner for China yet, as only 3.6% of Chinese imports come from this region. And, despite the fact that commodity producing countries have benefited from the rise in their export prices, countries like Mexico —direct competitors of China, especially in machinery and transport equipment, and manufactured goods— have been harmed by their competition and do virtually no trade with China. Countries producing apparel and footwear are facing increasing competition as well.

Another benefit for our region comes from the fact that as other economies have been favored by China's performance, Latin America's exports to them have also surged, providing second-round benefits of China's take-off.

Besides trade, China's integration also opens investment opportunities for Latin American companies, and some have already been taking advantage of them. Good examples are the new branch of Petrobras in Beijing and Embraer from Brazil's airplane building operation in China.

China and Chile

Chile has been one of the most benefited countries by China's surge, as**,** in relative terms, it is currently Latin America's main exporter to China, with 8.6% of Chile's total exports. The increased demand for copper and its consequent increase in price has been reflected in the fact that more than 70% of Chile's total exports to China correspond to copper. But also, other Chilean products are gaining some market in China, like fishery and wooden products.

Strengthening commercial links with China can reinforce the mutual benefits that our relation is already reaping. In this matter, a Free Trade Agreement between both countries would be highly welcomed.

Challenges Ahead

The rise of a giant like China in the global economy has been one of the best news the world has had in three decades. Judging by the historical experience of Japan and other Asian countries, China could have another couple of decades of high growth, especially given the opportunities to continue to incorporate surplus labor as well as to improve total factor productivity (TFP). The opportunities to enhance TFP are in the areas of more competition in import-competing and service sectors, improvements in the legal framework, and the restructuring of the banking and SOE sectors). Keeping a high rate of growth is crucial to avoid social tensions in order to provide employment to the new entrants to the labor force (11 to 12 million per annum), to the surplus labor in the rural sector (around 150 million workers) and to the surplus labor in the state-owned enterprises (SOE) (10 to 12 million workers).

Maintaining this process successful poses still major challenges not only for China, but also for the rest of the world. In fact, important structural reforms are pending, and authorities in Beijing have a difficult task forward. Special importance should be given to the restructuring of the banking system, SOE reform and institution building. While there has been an effort to advance in these matters, there is still a long way to go. In particular, the banking system is fragile, dominated by large state banks with weak lending practices and a large share of non-performing loans. The weak financial system is an important source of contingent liabilities for the public sector. In the banking system, further progress has to be made on capitalization, enhancing regulation and supervision, introducing adequate risk control measures, and improving governance. This is becoming more urgent as foreign bank competition is coming in 2006. But to be able to progress on banking reforms, parallel work has to be done on improving the governance and financial statements of the business sector and on reforming the SOE sector. In particular, the SOE sector is the main culprit for the non-performing loans of the banking system. Creating a modern, efficient, safe and sound financial system is important not only to support the growth effort, but also to prepare China for its gradual integration to world financial markets. On the institutional side, China needs to make progress in improving the legal framework, on the development of appropriate financial regulation and supervision, in upgrading its bankruptcy laws and their enforcement, and in improving companies' accounting practices and financial statements. Weak institutions and non-transparent rules could hinder growth in the future.

Consolidation of a market-based economy has to include progress in capital account liberalization. Foreign exchange market liberalization and flexibility should be approached because sterilization costs that current authorities have to face are considerable, and limit policy flexibility.

However necessary transformations may be to guarantee a healthy growth path in the future, the reform process should not be precipitated, so as to assure that the domestic economy is prepared and to limit its effects on international financial markets.

With respect to the labor market, an important challenge is related with the capacity of the industrial sector to absorb workers moving from rural areas, as well as those that may come from privatized state enterprises. Certainly, if the economy lacks this capacity, reforms to state enterprises will still be limited, since a faster pace could have bad consequences for the population.

Aging population will surely be one major challenge in the future. The fiscal burden of pensions and associated health costs should not be overlooked, especially considering the fiscal deficit of nearly 3% of GDP that the economy has had in the past four years.

For the rest of the world, the future is equally challenging. Increasing mobility between sectors and improving education will be key. Flexibility, especially of the labor market, will help countries whose firms have moved production to China to take advantage of lower costs. And education is fundamental for countries willing to move towards exporting higher value added goods. Certainly, growing competition coming from China will intensify protectionist pressures in many countries, posing a big challenge for authorities to resist.