The export juggernaut

Good for China, but good for its neighbours too

Reuters
Mulling a new export model

WHEN China joined the World Trade Organisation (WTO) in 2001, many developing neighbours felt more than a twinge of discomfort. With China already an export juggernaut, they feared that the dismantling of tariff and other barriers that went with WTO membership would make the country irresistible to manufacturers, diverting foreign direct investment that might otherwise have gone to them.

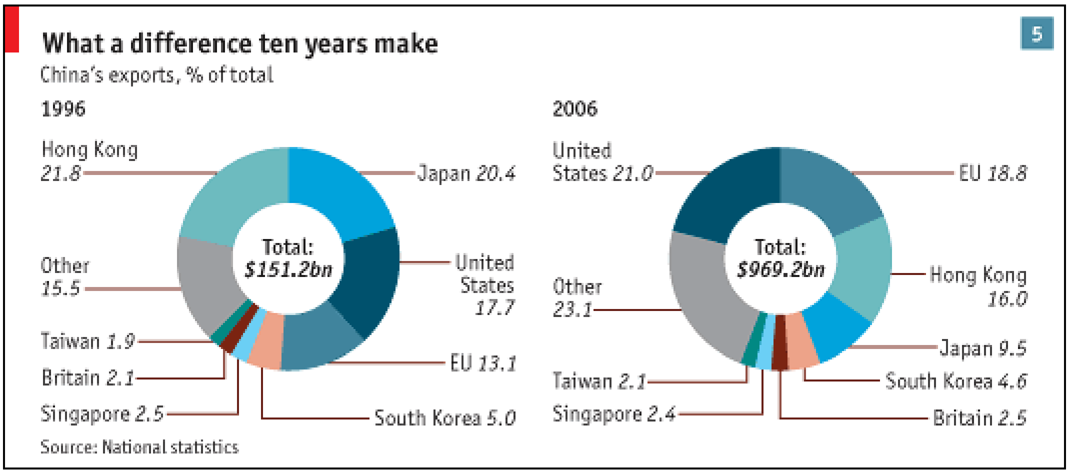
This appears not to have happened. Certainly, foreign investment in China has increased, as have China's already heady exports, which since 2003 have been growing at their fastest pace since the early 1990s. In 2004 China overtook Japan to become the world's third-largest exporter, behind America and Germany.

But foreign investment has grown elsewhere too. The ten ASEAN countries saw a record $37 billion of investment in 2005. For some manufacturers, South-East Asia (or India) serves as a hedge against something going wrong in their China operations—be it social unrest, economic problems or a business climate that turns against foreign investment.

But much investment outside China is in fact contingent on the China boom. So supercharged has the Chinese export machine become that it has sucked in vast quantities of parts and components for final assembly from other parts of Asia—Thailand, Malaysia, Singapore, the Philippines and Indonesia, as well as richer Taiwan and South Korea. The effect of WTO membership, in other words, has been to bind China more tightly into existing and highly sophisticated pan-Asian production networks, a task greatly facilitated by the internet. Everybody has benefited, even rich Japan, which in 2002-03 was pulled out of a decade and a half's slump by Chinese demand for top-notch components and capital goods. South-East Asia has got a further boost: rich in resources, including rubber, crude oil, palm oil and natural gas, it looks likely to profit from China's appetite for raw materials for a long time to come.

Trade within East Asia has grown even faster than the region's trade with the rest of the world, suggesting deeper specialisation and integration. But China's impetus has also profoundly altered the course of trade flows in Asia. As a paper last year by the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) in Paris describes, the China effect over the past decade or more has been the driving force behind a shift in Japan from exporting finished goods to Europe and North America towards exporting parts and components for assembly on the mainland. In turn, Japan now imports finished goods (such as office machines and computers) from China where previously they came from America and Europe.

For South Korea, Taiwan, Hong Kong and Singapore, trade has also turned from the rich world towards China. For Hong Kong, Taiwan and this year probably even Japan, China is the biggest trading partner.



In China, according to the CEPII paper, the processing and assembly of imported parts and components now accounts for more than half of all exports. China's growing trade surplus, it argues, is explained entirely by this kind of assembly. William Fung, managing director of Li & Fung, a Hong Kong company that leads the field in finding suppliers and managing supply chains for Western retailers and brands, uses a talking toy as an example: the plush fabric was made in Korea and the voice chip in Taiwan, and the final assembly was done in Shanghai.

Toys are mostly relatively simple things. But China has recently recorded phenomenal growth in exports of high-tech products too, principally notebook and desktop computers, DVD players, mobile phones and the like. Nicholas Lardy of the Institute for International Economics notes in a new book, "China: the Balance Sheet", that between 1998 and 2004 American imports of Chinese laptops jumped from $5m to $7.7 billion and display units from $860,000 to $4.9 billion. Some now ask whether China is vaulting up the technology ladder or even threatening American national security. These concerns are grossly overblown.

A recent edition of the China Economic Quarterly (CEQ) looked at the top exporters among foreign companies that had set up in China. In 2004 eight of the top ten were Taiwanese electronics companies—known as original design manufacturers (ODMs)—to which the world's top computer brands, such as Dell, Apple and HP, outsource their production and, increasingly, much of their design and innovation. At the start of this decade less than 5% of these firms' laptop production was on the mainland. Since 2001, when the Taiwanese government lifted restrictions preventing laptop-makers from investing in China, they have shifted virtually all of their production there. Thanks to much lower labour and land costs, each machine costs $20-30 less to make.

A surge in high-tech exports (in 2005, telecoms equipment, electronics and computers accounted for 43% of China's exports by value) might look like a leap up the value chain. Yet assembling many "high-tech" products is not that different from making Mr Fung's talking toy. Mr Lardy argues that a better label might be "mass-market commodities": after all, the laptops are simply assembled from foreign components. As CEQ points out, most of the firms involved are foreign, accounting for three-fifths of all Chinese exports, four-fifths of exports assembled from imported parts and components and nearly nine-tenths of the high-tech stuff. China's export model, then, still consists in big measure of renting out cheap labour and land to foreigners. Even China's most successful domestic computer firm, Lenovo, which acquired IBM's personal-computer business in 2004, contracts its production out to Taiwanese companies.

Yet the model may already be changing. Home-grown exporters, especially privately owned ones, are honing their skills in China's cut-throat markets. Huawei, a telecoms company, already supplies handsets to Vodafone, the world's biggest mobile operator. Bo Xilai, China's commerce minister, promises vigorous support for his country's native car industry, which has leapt from nowhere to capture a quarter of the domestic market and is now poised to start exporting small, cheap cars.

Not the bargain it was

The next question is whether more of the foreign-owned production networks that currently span Asia will be moved to China. There is some anecdotal evidence that this is happening, though statisticians cannot yet put their fingers on it.

A more identifiable trend is working in the opposite direction. As the World Bank's country director for China, David Dollar, points out, wages in China are now rising two or three times faster than in other low-wage Asian economies, and companies are having problems keeping talented staff. Encouraged by the government, companies are moving further inland to take advantage of cheaper labour. Yet the further inland they go, the less skilled the employees and the higher the transport costs to market.

Source: "China's Emergence and the Reorganisation of Trade Flows in Asia" by Guillaume Gaulier, Françoise Lemoine and Deniz Unal-Kesenci

Along China's eastern seaboard, where most of the manufacturing for export takes place, total monthly pay averages $250-350. Some parts of Thailand have higher average wages in manufacturing, but elsewhere in that country, as well as in the Philippines and Indonesia, manufacturing wages are $100-200 a month. Two decades ago all export-sector wages in these countries were higher than in China.

So some argue that in many sectors the era of the "China price"—exporters being able to offer the world's cheapest goods—will soon have run its course. CEPII highlights how the terms of trade have worked against China. Between 1995 and 2004, it finds, China's export prices rose by 4% whereas imports rose by 38%, a total deterioration in China's terms of trade of 24% (see chart 6). Today exporters enjoy more of the benefit of an undervalued renminbi. Yet as CEQ points out, brow-beating by an American government concerned about its bilateral trade deficit with China suggests that the exchange rate is likely to rise in future. It has already gone up by 6% since 2005.

Yet even for some of the cheapest goods, productivity increases have more than offset a deterioration in the terms of trade. A new paper by staff at America's Federal Reserve points out that between 1989 and 2005 China increased its share of exports to America in 41 industries, among them clothing and shoes. It is too early to write off China's export machine, even at the cheap end.

Either way, the consequences for China's neighbours depend on whereabouts on the manufacturing ladder they are. For those increasingly competing with China, the challenge is to make their manufacturing more sophisticated or their design more specialised. Last year

America's Intel greatly expanded its research facilities in Malaysia that design microprocessors, motherboards and chipsets. A number of high-tech firms, particularly Japanese ones, are wary of putting such centres in China, fearing that their best design work will get pirated. But for countries such as Taiwan that are losing their manufacturing to China, the emphasis should be on fostering competition in the service industries that now account for the bulk of the economy. Hong Deshang of the Taiwan Institute for Economic Research says that his country's future should be in research and development, design, branding, financing and logistics.

For poorer countries, says Mr Dollar, China's rise opens up opportunities. Vietnam, which recently joined the WTO, is already a beneficiary, with annual growth accelerating to nearly 8%; on the plain between Hanoi and the coast, South Korean and Japanese assembly plants are springing up among the paddy fields to take advantage of the country's low wages. Extraordinarily cheap jeans recently sold by Tesco, Britain's biggest supermarket chain, were made from Chinese fabric stitched together in Bangladesh. Yet in much of developing Asia the starting point needs to be to make up for past omissions: opening up to trade, creating a favourable climate for investment and ensuring an adequate infrastructure for manufacturing. Mr Dollar argues that success will be determined more at the local than at the national level. After all, China's industrial revolution nearly 30 years ago began in a small handful of experimenting cities.

Consumers galore

Moreover, China's exports have to be put in context. Though very open to trade, China's economy, like America's, is essentially driven by its own huge domestic demand. This demand is now growing at a clip of 9% a year and starting to act as a regional engine of growth, sucking in imports. The World Bank forecasts that this will be the first year in which China's imports will be growing by more than America's, becoming the biggest source of import growth in the world. Goldman Sachs, an investment bank, reckons that China's imports for domestic use are now roughly the same as those used in assembling exports, whereas five years ago they were only half as big. Much of what is imported is in the form of raw materials—oil, copper, gas, timber—to feed the China boom. The next article will look at the environmental implications of that boom.

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