Does China's Globalization and Structural Reform Pose a Threat to Japan?

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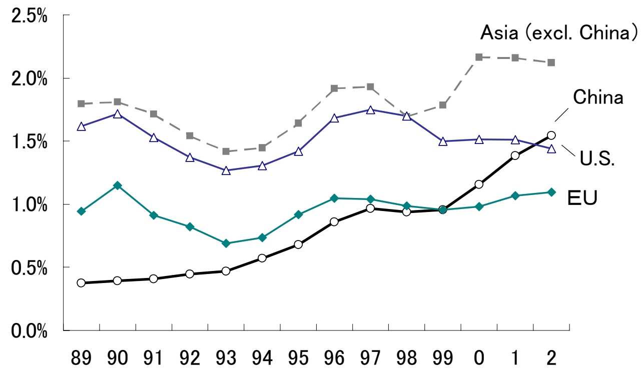
1. Introduction

Perspectives on China's economy tend to separate into two extremes—one camp views China's growing foreign presence as a threat, while the other camp questions China's ability to sustain growth due to structural impediments.

Of Japan's trading partners, China runs the largest trade deficit with Japan, and was the largest exporter to Japan in 2002. Moreover, China overtook Japan in market share in the U.S. import market. These trends, along with related concerns about Japan's deindustrialization, have heightened the perception of China as a threat to Japan.[1] However, this perception is off the mark, considering that China's imports still account for only 1.5% of Japan's GDP and are thus limited in macroeconomic impact (Figure 1). Moreover, it ignores the benefits to Japan of the growing interdependence and division of functions, which will aid structural reform by reallocating factors of production to higher value added areas.

Figure 1 Import Market Share in Japan by Origin (GDP Ratio)



Source: Ministry of Finance.

In this paper, we examine how China is leveraging its WTO accession to build momentum as

[1] According to Japan's statistics, Japan posted a trade deficit of $21.8 billion with China in 2002. However, China's statistics indicate that China posted a $5 billion trade deficit. The difference arises because China includes Japanese imports to Hong Kong, while Japan separately records its trade surplus with Hong Kong of $24.4 billion.

"factory to the world," as well as how it will use growing competitive pressures to propel structural reform as a "large, continental emerging economy in transition" in its first five years of membership to 2006. Our purpose is to deepen understanding of the current status of China's economy, and to contribute to the discussion on the economic relationship between China and Japan.

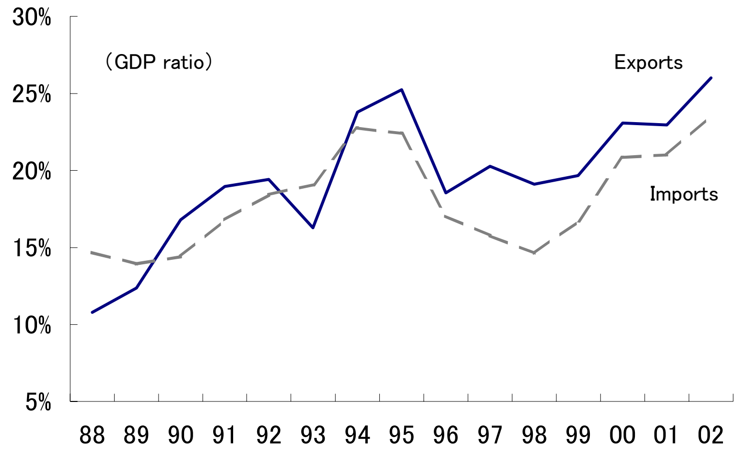
2. China's WTO Accession and Ambition to be Factory to the World

(1) Strong Dependence on Exports and FDI

The growth of China's economy during the economic reform era has been driven by inflows of foreign direct investment, which has increased export production capacity, spurring further investment in a virtuous cycle.

Similar to other successful export-oriented Asian economies, China's structure of trade is characterized by the development of processing trade, wherein raw materials and intermediate goods are imported, and finished products are exported. Thus both exports and imports have a strong tendency to expand, and dependence on trade (exports plus imports as a proportion of GDP) has consistently risen except for a period in the late 1990s (Figure 2). In 2001, the trade dependence of 44% was not conspicuously high among Asian economies with a comparable economic structure, but high compared to similar large continental economies (Figure 3). The fact that the ratio of industrial exports is over 90% attests to the success of the export industry.

Figure 2 China's Exports and Imports



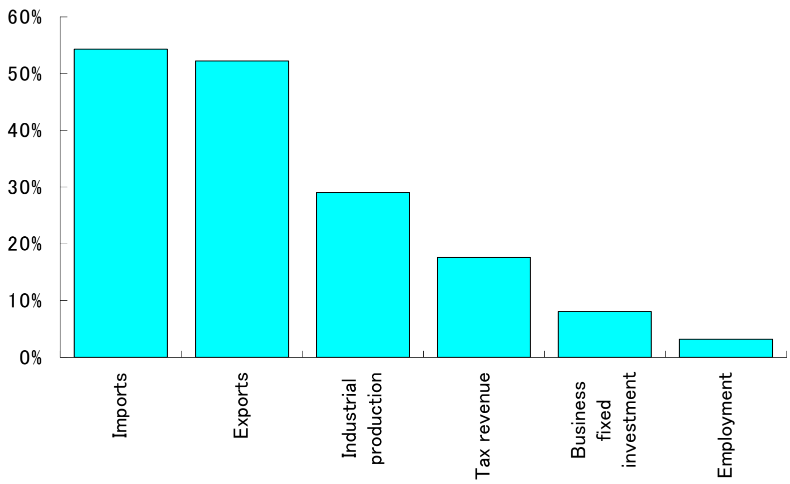
Sources: *China Statistical Yearbook*; and *China Customs Statistics*.

Figure 3　Dependence on Trade and FDI—Large Continental Economies

	Population (bil.)	Area (mil. sq. km)	Trade ratio	Inward FDI (as GDP ratio)
China	1.285	9.600	44.0%	30.9%
India	1.017	3.287	20.2%	3.7%
U.S.	0.284	9.628	18.9%	10.5%
Brazil	0.172	8.510	22.6%	31.0%
Russia	0.144	17.070	52.3%	8.6%
Japan	0.127	0.370	18.2%	1.0%

Note: Trade dependence = (Exports + Imports) / GDP. Inward FDI (stock) data is as of 1999, based on UN data. For Russia, fuel products account for 54.7% of exports.
Sources: IMF, *International Financial Statistics*; UNCTAD, *World Investment Report 2002*.

Figure 4　Presence of Foreign Capital in China



Source: *China Statistical Yearbook*.

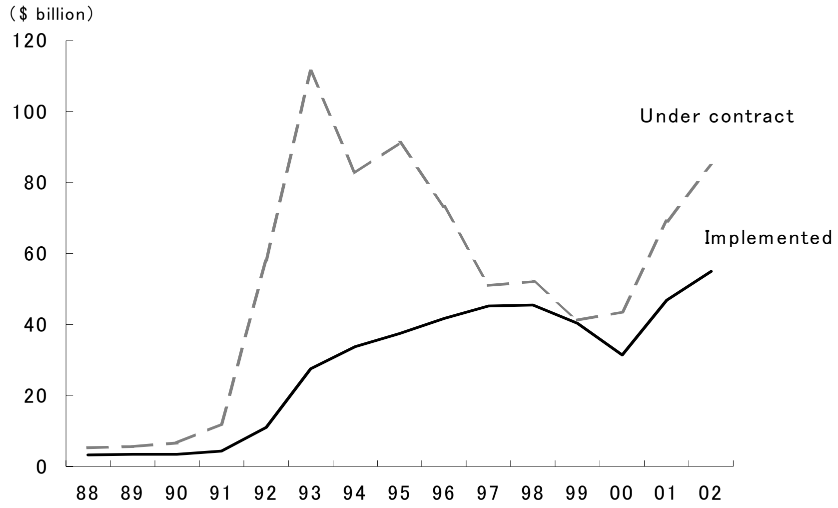
Direct investment has been critical not only to fund growth but to introduce new technologies and enhance competitiveness. Foreign companies represent a large part of trade and production, accounting for over 50% of exports and imports and approximately 30% of production (Figure 4). While restrictions on capital transactions limit the direct effects of cross-border short-term capital and portfolio investment, foreign demand and the activities of foreign companies have already impacted the economy on a significant scale.

As for cumulative FDI by region, from the introduction of economic reform in 1979 to 2002, Hong Kong and Macao rank first with 47.0% of the total, followed by the U.S. (9.0%), Japan (8.2%), and Taiwan. Thus alongside ethnic Chinese capital, Japanese companies are playing a leading role in the export industry.

(2) Inward FDI Grows for Second Straight Year

Recent characteristics of FDI—Foreign direct investment began trending downward in the late 1990s as a result of the currency crisis and reform of state-owned enterprises, becoming a drag on growth from 1998 (Figure 5). However, from 2001, a slowdown in large cross-border M&As caused FDI growth to turn negative elsewhere but not in China, where FDI implemented in 2002 reached $55.01 billion ($84.75 billion contracted; 4.4% and 6.8% of GDP respectively), surpassing the U.S. as the world's top destination for foreign direct investment.

Figure 5 Inward FDI to China



Source: *China Statistical Yearbook*, other.

From 2001, FDI has grown due to the expanding operations of multinational corporations, transfer of production among component suppliers for electrical and IT equipment, and growth in service industries. In the price competitive electrical and IT equipment industries, FDI growth has benefited from the growing concentration of manufacturers of finished products and components, and availability of cheap and abundant skilled labor.

By region, investment continues to concentrate in South China centered around Guangdong and Fujian, where much of the foreign capital has arrived since reforms began, and the coastal area of East China (Shanghai, Jiangsu, and Zhejiang). In particular, since 2001, investment has increasingly concentrated in East China, which accounts for 44.7% of the total contracted amount in 2002. South China has grown into a major export center with a large concentration of electrical, toy, watch, and textile companies due to its access to infrastructure in neighboring Hong Kong, as well as to outsourcing systems for processing. Meanwhile, East China is bolstering its position as a center for hi-tech industries as Japanese and Taiwanese manufacturers invest heavily to boost production capacity for semiconductors and electronic components. Another characteristic of companies entering

East China is their keen interest in the size of the potential domestic market. This interest can be attributed to the region's central location within China, sizable market due to the relatively high income level, and position as a domestic financial center as a result of its advanced financial liberalization.

Expectations generated by China's WTO accession in December 2001 regarding market opening and improvement in the investment environment have greatly affected direct investment from 2001 onward. China is obligated to comply with WTO rules by abolishing high import tariffs, non-tariff barriers, and restrictions aimed at foreign companies regarding operations, location, and customers. The comprehensive revision of domestic laws and establishment of fair dispute resolution procedures will greatly improve the investment environment for foreign companies. China has pledged to gradually implement these measures over the first five years of membership, and progress will be followed with keen interest due to their importance in influencing direct investment trends (Figure 6). The first year ending in December 2002 saw the implementation of investment laws, tariff cuts, and reduction in managed import categories. The U.S. Trade Representative's Office commented that while such measures are encouraging signs, further efforts are needed regarding the administration of laws and regulations, alleviation of regional disparities, and market opening measures for agricultural products and services.

Figure 6 Summary of Protocol and WP Report

General	Transparency, law & administration	Establish a transparent, unified, fair and rational regulatory system
	Adherence to market principles	Reduce price intervention
	Full non-discrimination	Abolish foreign discrimination in purchase of goods & services
Improve trade related systems & market access	Improve trade related systems	Liberalize rights to trade (in 3 years)
		Abolish import quotas (by 2005)
		Reduce investment restrictions, enhance intellectual property protection
		Enhance standards & certification systems
	Tariff cuts	Reduce average tariff rate from 17.5% (1998) to 9.8% (2010)
	Services liberalization	Reduce foreign capital restrictions in distribution, retail, telecom, construction
Transitional measures (by other members)	Transitional safeguards	Safeguards against surge in Chinese imports (for 12 years)
	Safeguards against China's textiles	Until 2008
	Anti-dumping/countervailing tariffs	Special treatment regarding price comparisons and subsidies (for 15 years)
	Transitional review	WTO General Council to inspect China's implementation of WTO obligations

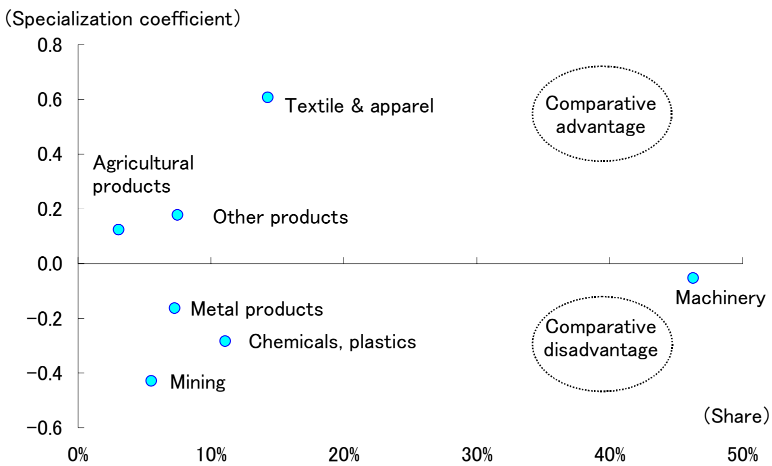
Source: Ministry of Economy, Trade and Industry.

(3) China's Growing Presence in World Trade

The inflow of FDI has added momentum to China's growing presence in world trade. In 2001, China ranked sixth in world trade and had a 4% market share (imports plus exports as a percentage of total world trade). From 2002, China's trade has been growing at over 20%, outpacing the growth rate of world trade by far, driven by electrical machinery and IT equipment, which account for 40% of exports and 50% of imports.

While China's presence is growing in the global division of functions, its composition of trade reveals an uneven performance as factory to the world. Figure 7 shows the share of various product categories in China's trade value and their respective specialization coefficients. To calculate the specialization coefficient of a category, we divided net exports (exports – imports) by trade value (exports + imports). A value from zero to 1 indicates a comparative advantage, while a value from zero to –1 indicates a comparative disadvantage; the advantage or disadvantage is greatest at 1 and –1 respectively. China's textiles & apparel industry has a high comparative advantage, and miscellaneous products (toys, leather products, etc.) are also competitive. While machinery and equipment represent a large trade value due to the development of trade of processed products, the specialization coefficient is negative because of the dependence on imports of components and capital goods; a trade deficit exists for this category. Chemicals and plastics, steel and other metal products are comparative disadvantage, technology and capital intensive areas are not internationally competitive.

Figure 7 Product Categories by Share of Trade Value and Specialization Coefficient (2002)



Source: *China Customs Statistics*.

It is important to note that China's WTO accession affects industries differently based on the state of comparative advantage and competitive mechanisms. Industries that have enjoyed a comparative advantage in the past—textiles & apparel, miscellaneous products, and assembly and processing of electrical and IT equipment—reap benefits from market opening through lower raw material costs and greater access to export markets, and thus expected to enjoy growth momentum. On the other hand, capital and technology-intensive manufacturing industries, which have received generous protection alongside agriculture and non-manufacturing industries (information & communications, finance, distribution, etc.), will experience consolidation and increased unemployment.

Despite the inevitable adjustment costs associated with WTO accession, benefits such as a more stable export environment and promotion of direct investment give China the opportunity to strengthen its industrial base if it can improve its resource allocation and economic efficiency. This in turn would enhance China's chances of becoming factory to the world across a broad range of areas.

3. Issues Confronting a Large, Continental, Emerging Economy in Transition

(1) Growing Need for Structural Reform

China's transition to a market economy has been deliberate and gradual, in contrast to the radical approach taken in Russia and Central and Eastern Europe. The gradual approach is characterized by the aversion of sudden reforms accompanied by the reallocation of capital stock (privatization), and experimenting with reforms and market opening measures in specified regions and companies before applying them broadly.

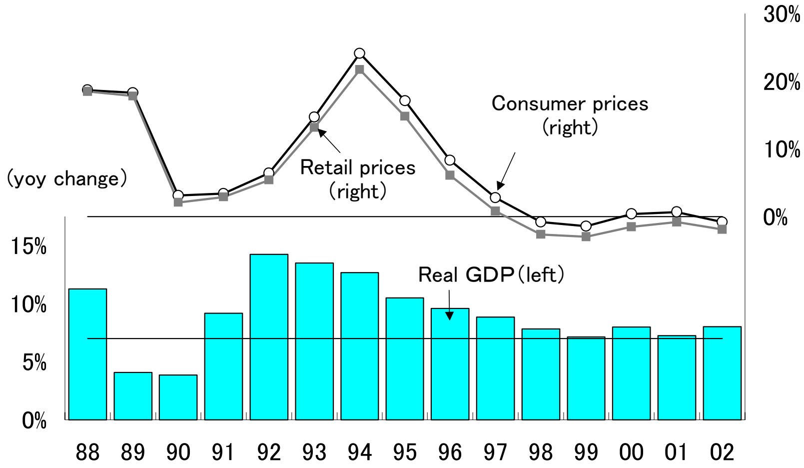
This gradual approach to reform has already produced astonishing results in export industries with the help of direct investment. Meanwhile, however, the reform of state-owned companies is being postponed even as they continue to deteriorate, and disparities between coastal areas (where foreign capital has concentrated) and inland and agricultural areas continue to grow.

Since 1998, China's economy has achieved a growth rate of over 7% on the strength of exports and direct investment, with support from policy measures. This growth has sustained the society's stability by absorbing a new labor force exceeding 10 million persons each year. At the same time, however, domestic private demand growth has grown sluggish, and prices have declined (Figure 8).

The deflation has occurred against the backdrop of an inflow of surplus labor from rural areas into cities, which has suppressed wages with respect to labor productivity, and tariff cuts following WTO accession, which have driven down import prices.[2] Also, unbalanced growth has generated a gap between supply and demand.

[2] The average tariff rate fell from 15.3% in 2001 to 12% in 2002, and 11% in 2003.

Figure 8 China's Real GDP Growth Rate and Inflation Rate



Source: *China Statistical Yearbook*.

On the demand side, deflation is exacerbated by the restrained consumption growth in light of employment anxiety centered around the troubled state enterprise sector, and anxiety of higher costs following medical and social security system reforms. Another factor is the growing income gap between rural and urban areas even as absolute rural incomes remain low. On the supply side, factors include excess production capacity mainly among state-owned companies, and the mismatch between product supply and demand.[3]

While state-owned companies and rural areas account for a declining weight in production and income allocation over the years, their weight of employment and population remain high. Thus if the growing disparity between urban and rural areas continued to be ignored, there is a risk that the foundation for stable growth will be lost.

The step-by-step increase in competitive pressure over the five-year period after WTO accession is another reason for urgent structural reform. This is because conforming to WTO rules to ensure fair competition among state-owned companies, non-state-owned companies, and foreign companies means abolishing the protective regulations and subsidies enjoyed by state-owned companies. The benefits of WTO accession will be felt by export industries in the East, while state-owned companies and farms concentrated in the Central and Western regions will incur heavy costs. Thus regional disparities are likely to become even more pronounced (Figure 9).

[3] According to a survey by the State Economic and Trade Commission, 513 of 600 product categories surveyed (85.5%) are in excess supply; most are agricultural byproducts, apparel, and home appliances.

Figure 9 Characteristics of China's Economy by Region (2001)

		Coastal	of which South	of which East	Central	Western	National
Basic indicators	Population distribution	41.6%	13.3%	10.7%	35.3%	23.1%	100.0%
	GDP distribution	59.6%	16.6%	19.9%	26.9%	13.6%	100.0%
	Per capita GDP (national = 100)	143.3	124.9	185.4	76.0	58.7	100.0
Industrial structure	Weight of agricultural sector	11.4%	13.7%	8.8%	18.7%	20.1%	15.2%
Ratio of state-owned cos.	Weight of state-owned cos. in urban employment	45.8%	42.3%	39.4%	55.7%	59.3%	51.5%
	Weight of state-owned cos. in fixed investment	40.6%	37.8%	39.3%	53.0%	55.1%	47.3%
Progress in market opening	Distribution of FDI by region	84.7%	35.5%	25.4%	10.5%	4.8%	100.0%
	Distribution of exports by region	91.2%	42.3%	30.3%	5.9%	2.9%	100.0%
	Ratio of foreign companies in exports	53.6%	56.1%	49.3%	16.1%	10.0%	50.1%

Notes: South coastal area is the total of Guangdong, Fujian, Hainan and Guangxi. East coastal area is the total of Shanghai, Jiangsu, and Zhejiang.
Source: *China Statistical Yearbook 2002*.

The situation described above highlights the urgent need to promote reform of state-owned companies, encourage private sector growth, and alleviate regional income disparities by boosting low income levels. The reform of state-owned companies is intimately tied to the bad loan problem of state-owned commercial banks, and also raises two fiscal problems: unemployment generated by state-owned companies must be dealt with, and social functions once performed by state-owned companies such as housing, health care, and education must be transferred. The financial system needs to be revised to promote growth in the private sector, while income reallocation functions must be strengthened to alleviate regional disparities.

(2) Monetary and Financial Reform

In the era of economic reform, the primary objectives of monetary and financial reform have been: (1) to secure funds for growth by mobilizing domestic savings and introducing foreign capital, (2) to establish methods of macroeconomic control through monetary policy, and (3) to build mechanisms for the effective utilization and efficient allocation of funds through the banking system.

During this time, despite efforts to build financial institutions, create new markets, develop the legal system, and open up markets, progress toward the three objectives has been varied. The goal of securing growth funds has been highly successful thanks to a savings rate of over 40% and successful introduction of foreign capital. However, the other two goals have not been achieved.

Banking reform—In addition to four state-owned commercial banks, China's financial system consists of policy banks, other commercial banks, and non-bank financial institutions. With the creation of policy banks in 1994 to separate policy-related loans from state-owned commercial banks, the establishment of private banks, and the expansion of business areas accessible to foreign-affiliated financial institutions, the market share of the four major state-owned banks has decreased, but still remains at over 60%.

The most critical issue for financial reform is the accumulated bad loans of state-owned commercial banks. Bad loans can broadly be classified into policy-related loans made prior to the creation of policy banks, and loans made by banks at their own discretion. A major cause of bad loans—the lack of separation between loan operations and fiscal administration, and cronyism at the provincial government level—was corrected by separating out policy related loan operations and establishing the Commercial Banking Law (July 1995). To improve the balance sheets of banks, 270 billion renminbi (RMB) in special government bonds were issued to boost bank equity (August 1998), and the central government also set up asset management companies (AMC) at the four major banks in 1999 to dispose of non-performing policy related loans. At the end of 2000, the four banks had transferred a total of 1.4 trillion RMB in bad loans. And at the end of 2002, the AMCs had sold or auctioned off properties held as collateral worth 301.4 billion RMB, and recovered 101.3 billion RMB, for a recovery rate of 33.6% and cash recovery rate of 22.4%.

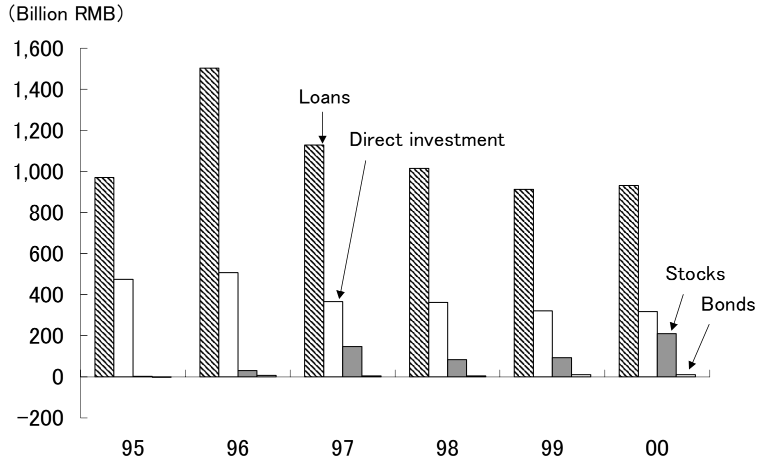
Despite progress in alleviating financially distressed state-owned commercial banks, the ratio of bad loans remains high even by official count at 23.9% (June 2002). Moreover, most of the loans held by state-owned commercial banks have been made to state-owned companies, effectively restricting financing opportunities for growth companies while encouraging excess investment in non-profitable state-owned companies. Thus capital is not being effectively allocated.

The weakness of state-owned commercial banks as financial intermediaries poses another problem—the effects of monetary policy are hindered. In addition to the disposal of existing bad loans, state-owned commercial banks need to improve their risk management methods, improve their ability to efficiently allocate funds. Since these problems are being addressed together with the problem of state-owned companies, more time is needed for their resolution.

Given this situation, it is important that other financial intermediaries be rapidly enhanced and expanded. In particular, domestic private companies and individual proprietorships urgently need financial institutions and credit guarantee systems to be able to absorb the surplus labor shed by state-owned companies.

Reform of capital markets—Since China's financial system primarily involves indirect financing, the role of capital markets is relatively small. With borrowing playing a major role in corporate financing, while the role of equity markets has grown over the years, equity financing remains less than the inflow of direct investment. Bond markets are centered around government bonds and financial bonds, and the issuance of corporate bonds is limited (Figure 10). There is also a need to enhance the limited capital markets from the perspective of reforming state-owned companies, banks, and the fiscal structure.

Figure 10　Composition of Corporate Financing



Source: People's Bank of China, *Quarterly Statistics*.

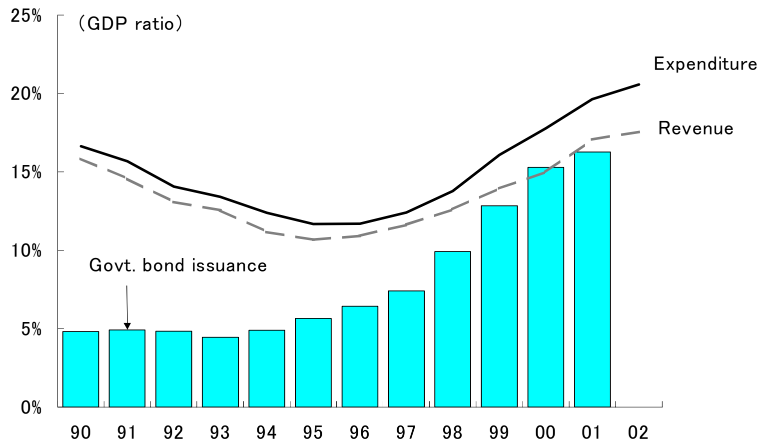
As of 2000, over 1,000 companies had been listed on the equity market. In 2001, the total market valuation had surpassed that of Hong Kong, becoming second in Asia only to Japan. But of the total market valuation, which amounts to approximately 50% of GDP, only about 30% of the shares actually circulate in the market; the rest are non-floating shares of state-owned companies. The equity market is still in a developmental stage, and confronts problems such as an abundance of speculative individual investors, absence of rational institutional investors, large proportion of ailing companies among the listed companies, lack of accounting standards, and inadequate disclosure. From the perspective of promoting reform of state-owned companies and enhancing financing alternatives for the non-state-owned sector, further development of the market is needed. Efforts are being made to improve the financial soundness of equity markets by revising listing standards and bolstering market supervision.

The bond market, as already noted earlier, consists mainly of government bonds and financial bonds, with the corporate bond market being limited in size. As will be discussed below, the recent surge in government bond issuance has heightened the need to develop the secondary market. The development of a comprehensive system is also vital from the perspective of diversifying financing alternatives for companies.

(3) Fiscal Reform

Since 1998, China has fully supported economic growth with a low interest rate policy and fiscal spending, but with the effect of monetary policy reaching its limit, the burden on fiscal policy is large. While the 1994 tax reform has increased revenue growth, the fiscal deficit has continued to grow each year due to economic stimulus packages and spending on large projects such as the Western development strategy begun in March 2000 (Figure 11).[4]

Figure 11 China's Fiscal Condition



Source: *China Statistical Yearbook*.

A total of 660 billion RMB was issued in government construction bonds from 1998 to 2002. Government bond issuance amounted to only 16.3% of GDP at the end of 2001, which is a sustainable level even if we consider problems such as the state's cost of disposing of non-recoverable debt of state-owned companies after transfer to the AMCs, and the underfunded status of the social security system. However, fiscal structural reform will need to be steadily pursued to achieve critical priorities such as the accelerated reform of state-owned companies, enhancement of the social security system for the aging society in the future, and strengthening of income transfer functions to alleviate regional income disparities.

As for the tax system, issues that need to be addressed include reform of the individual and corporate income tax systems, enhancement of the tax collection system, clarification of roles, authority, and revenue sources between the central and provincial governments, and

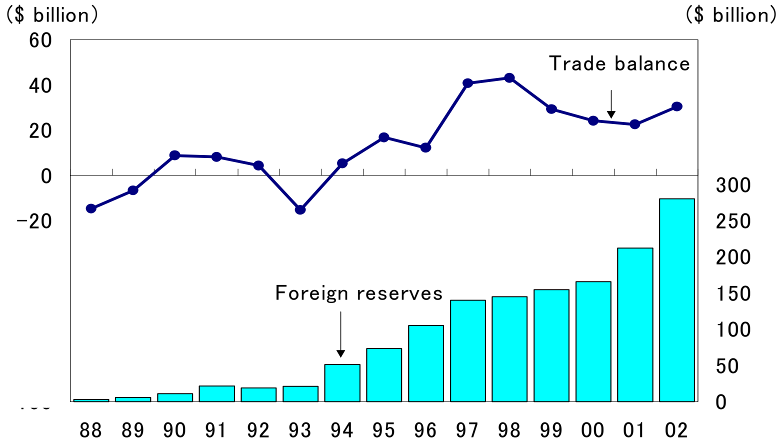
[4] The 1994 reform implemented a nationwide tax sharing system that categorizes tax revenue into state, provincial, and common revenue components. Common revenue is allocated between the central and provincial governments at a fixed ratio. Spending categories are also clarified between central and provincial governments. The reform replaced the fiscal contracting system of 1984, and increased the central government's declining revenue, but worsened the fiscal condition of provincial governments.

strengthening of the income transfer system.[5]

4. Conclusion

The current debate regarding China's growing foreign presence is often accompanied by calls to revalue the RMB. Foreign currency reserves ballooned to $286.4 billion at the end of 2002 due to a large surplus in the overall balance (from sustained trade surpluses and growth in direct investment), while the central bank (People's Bank of China) also bought excess dollars to maintain the dollar rate (Figure 12).

Figure 12 China's Trade Balance and Foreign Reserves



Sources: *China Customs Statistics*; *China Statistical Yearbook*; other.

Proponents of currency revaluation cite the balance of payments situation, and the fact that following a 33% cut in the official rate on January 1, 1994, the dollar rate has effectively been pegged at 8.3 RMB, with a fluctuation range of 0.3% from the previous day's rate.[6] The exchange rate has thus not been adjusted to reflect productivity growth and differences in inflation rates.

Putting aside the complex debate on the issue of calculating fair currency value and the disparity with the actual value, the policy options available to Chinese authorities make it unlikely that the currency will be revalued in the near future.[7] As already seen, a high

[5] Since the individual income tax comprises a small part of tax revenue, issues include the revision of tax categories and progressive tax rates. The corporate income tax 's heavy dependence on state-owned companies needs to be corrected. Foreign companies are particularly interested in the revision of preferential tax measures accompanying conformance to WTO rules.
[6] To achieve consistency between the dual market rate and official rate, the official rate was reduced.
[7] Fair value calculation of the RMB is discussed in Akama, Mifune and Noro (2002), and Hirose and Morifuji (Cabinet Office, 2003).

growth rate must be sustained to absorb the surplus labor from state-owned companies and the rural sector, as well as to reduce the relative size of the bad loan problem and alleviate the fiscal imbalance. Market opening in goods and services to 2006, as stipulated by the conditions of WTO accession, will increasingly affect the balance of payments structure and fair exchange rate level. As long as the preconditions for deregulating capital transactions and implementing a variable exchange rate system are not achieved—including a sound and strong financial system, regulatory oversight, corporate governance, and accounting system—the central government is apt to limit deregulation of capital transactions, and prioritize currency stability to boost exports and direct investment.

From China's perspective, Japan is the largest source of imports. In fact, imports grew 25% in 2002 led by electronic components and capital goods that are unavailable domestically. According to the World Bank, next to China itself, the greatest benefactor of China's WTO accession is Japan. Japan thus should not exaggerate the threat or instability of China's economy, but rather closely watch the progress of structural reform, and use China's economic development as a springboard for Japan's own transition to a new industrial structure.

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