

China's Real Exchange Rate and Implications for East Asian Regional Trade and Investment Flows

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Introduction

China's accession to the WTO is a watershed event, for the global economy generally and for East Asia in particular.

Initial reactions of regional partners, who perceive China as a strong export competitor and magnet for FDI, have been somewhat defensive.

This research reveals a more complex picture of China's emergence, one that may present as many opportunities as threats to East Asian policy makers.

Introduction

Three issues are of particular relevance in this context:

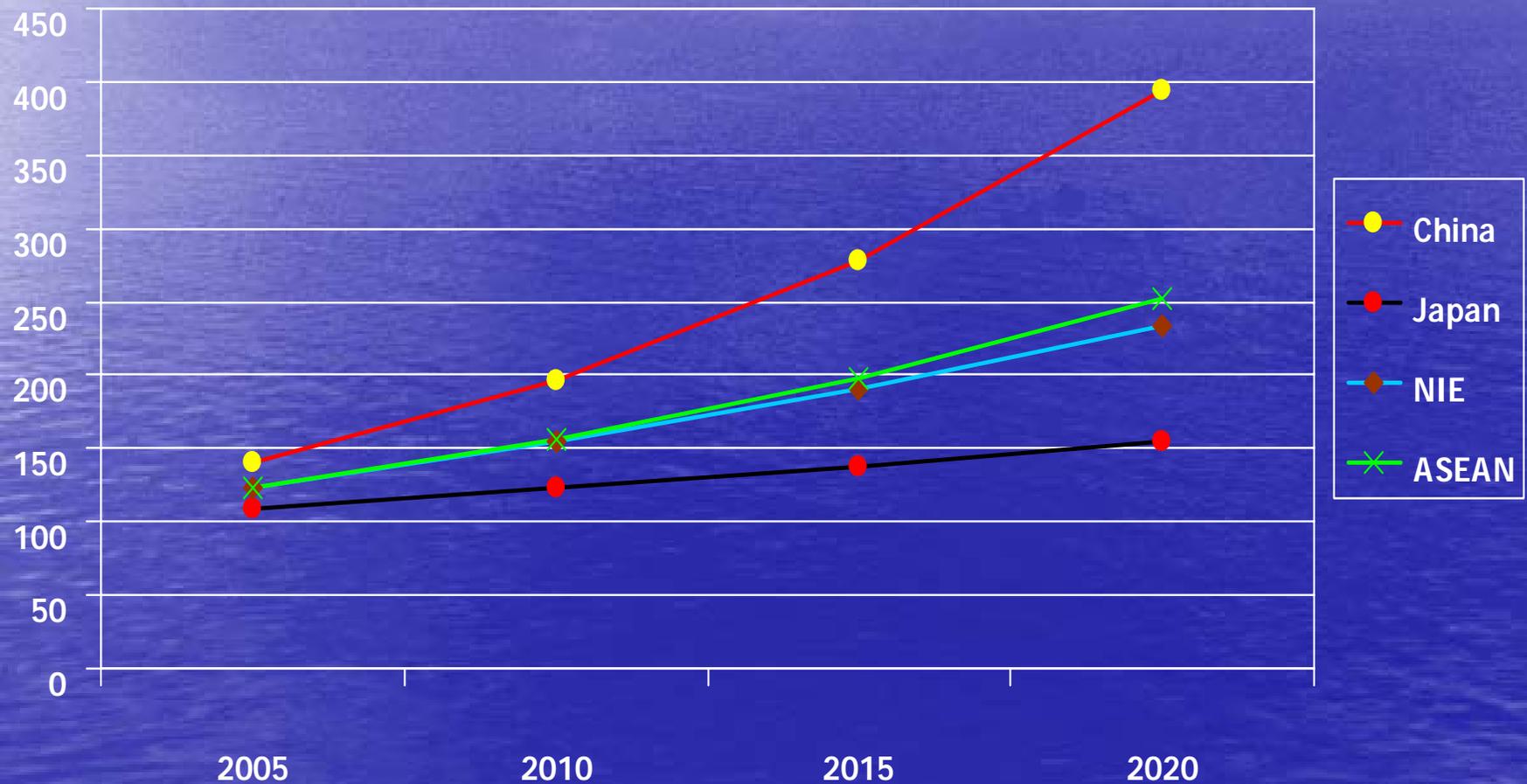
1. It will stiffen export competition in a broad spectrum of products, particularly in extra-regional markets.
2. The growth of China's economy will make it the region's largest importer, and this absorption will create unprecedented opportunities for regional exporters.
3. In the baseline growth trends, emergent imbalances portend real exchange rate adjustments that could alter regional trade and growth patterns.

I. China's Emergence and the Asian Trade Triangle

Regional economic projections to 2020. Baseline GDP growth scenarios are evaluated with a dynamic global CGE model.

Baseline Real GDP Growth Rates

(Normalized to 100 in 2000)



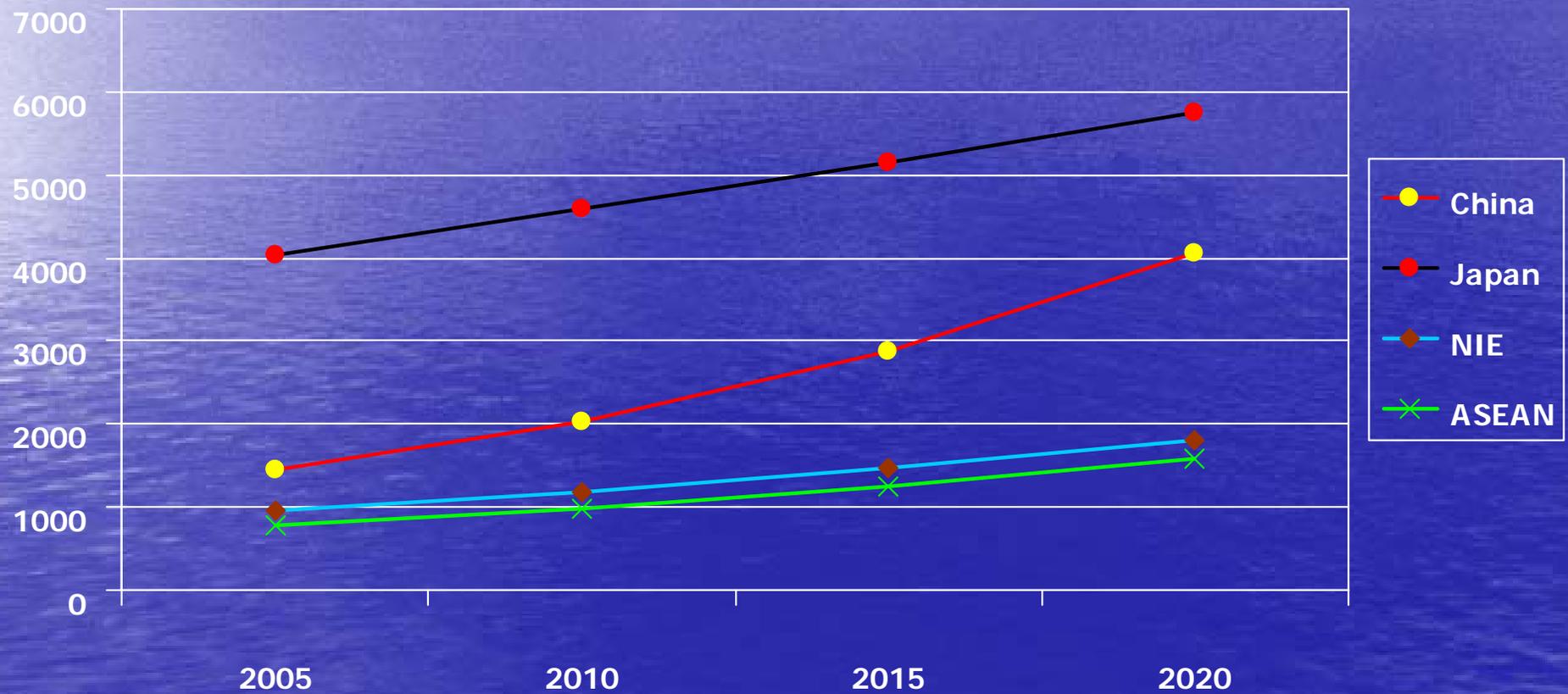
Sources: DRI, WB, Oxford Econometrics

October 15, 2004

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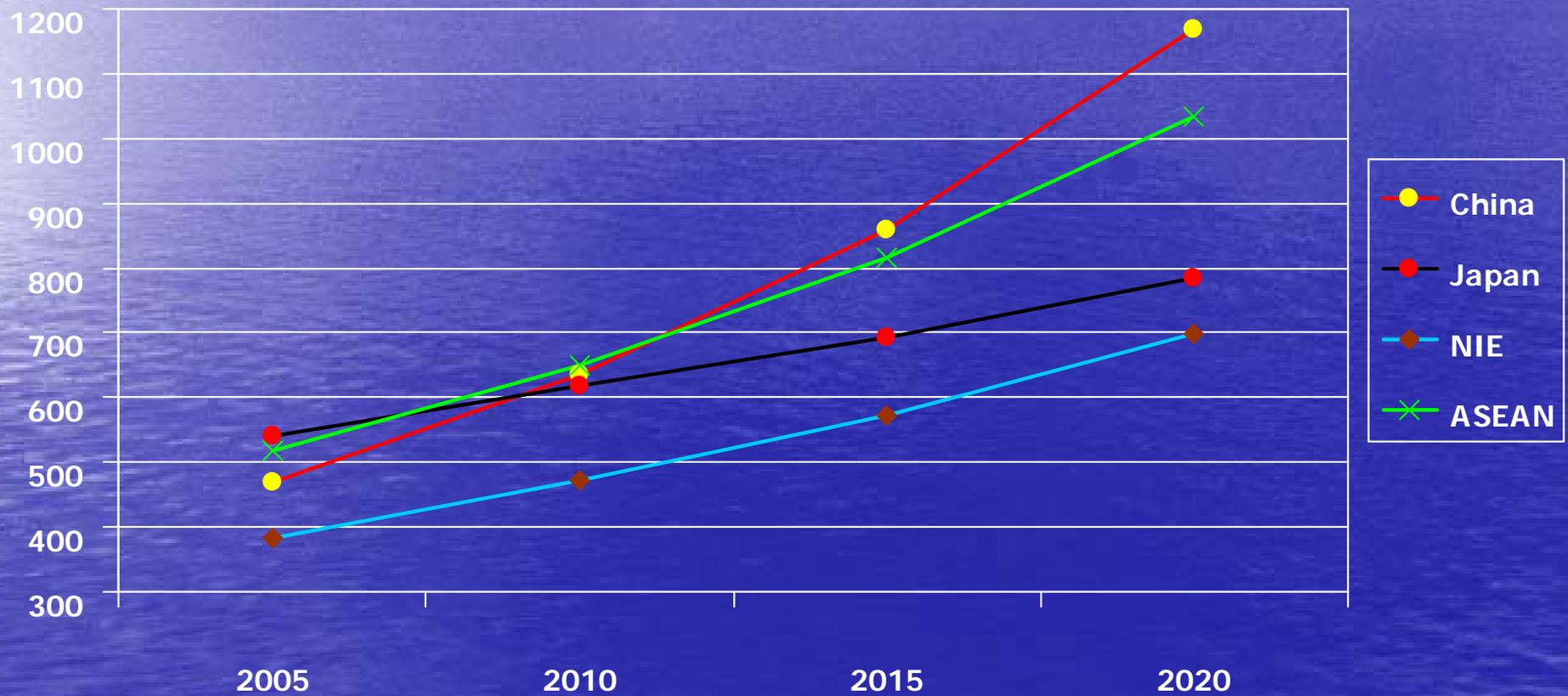
Real GDP

(billions of 2000 USD)



Real Exports

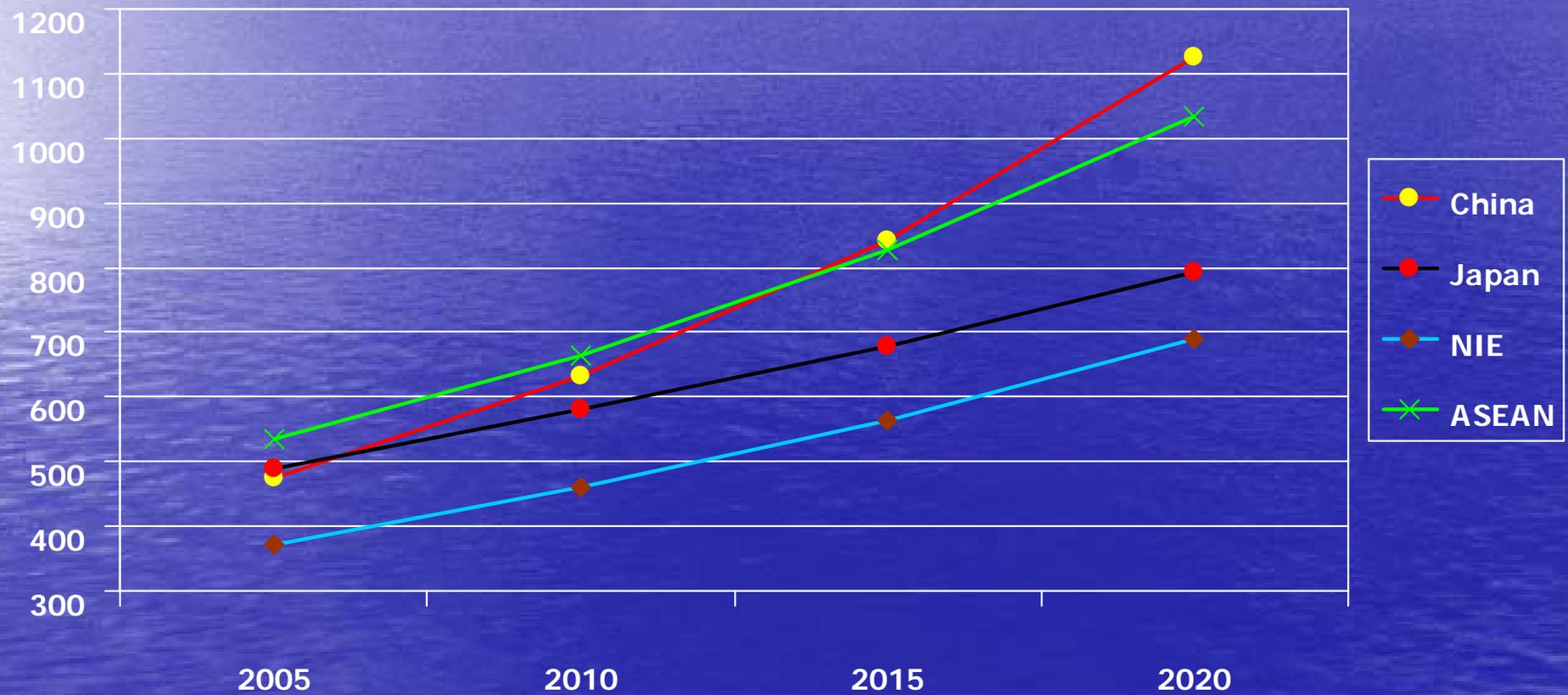
(billions of 2000 USD)



Source: Author's estimates.

Real Imports

(billions of 2000 USD)



Source: Author's estimates.

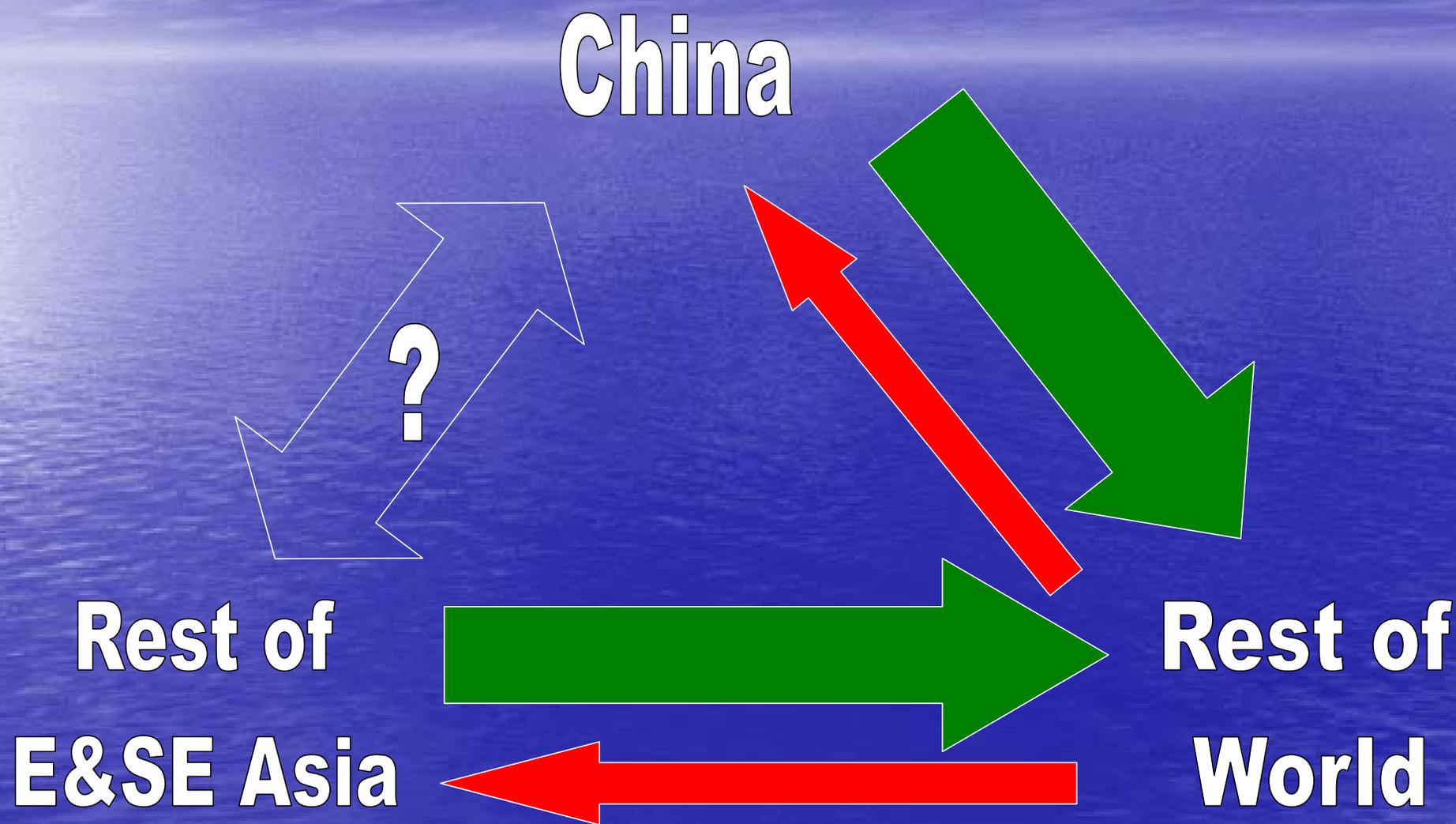
The Asian Trade Triangle

These forecasts indicate the emergence of a systematic pattern of triangular trade between China, the Rest of East and Southeast Asia, and the Rest of the World

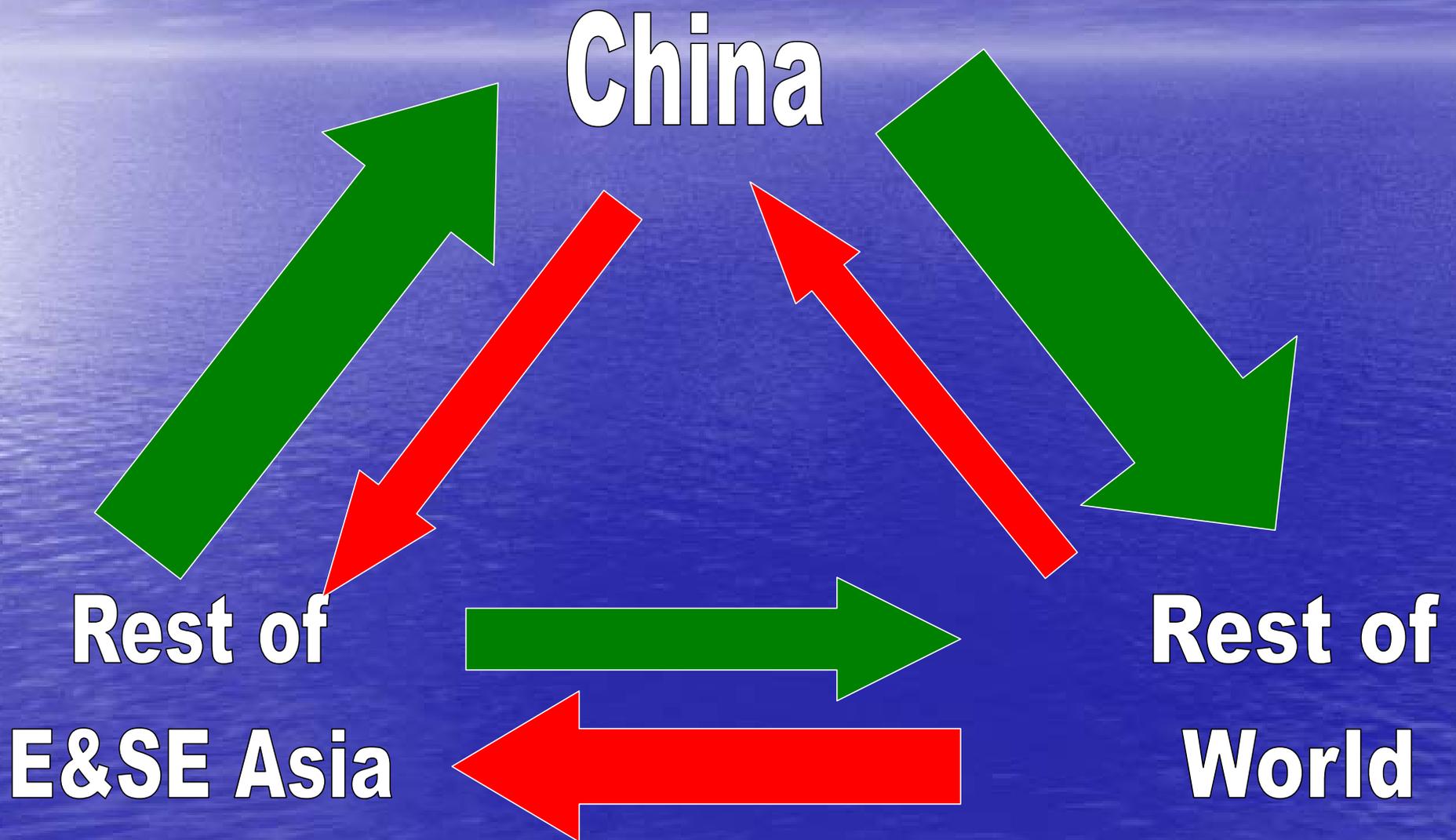
This Trade Triangle reveals that China's export expansion offers significant growth leverage to its neighbors.

Chinese absorption will emerge to dominate regional demand. Provided Asian economies do not isolate themselves from this process, the net effect of China's growth can be hugely positive.

Trade Triangle 2000



Trade Triangle 2020



II. Regional Strategic Scenarios

How can regional economies best respond to China's global initiative?

A variety of alternative regional arrangements were examined empirically. All include the first scenario.

1. **CNWTO**: China joins WTO, status quo elsewhere
2. **AFTA**: ASEAN Free Trade Area
3. **AFTAPC**: AFTA plus China
4. **NEAFTA**: Northeast Asian Free Trade Area
- China, Japan, and Korea
5. **ASEAN+3**: ASEAN, China, Japan, and Korea
6. **PAC3**: Pacific Trilateralism - China, Japan, USA
7. **GTL**: Global Trade Liberalization

East Asian Regionalism and China

China is in a relatively unique position. This country can apparently “go it alone” to globalization. It also possesses two carrots and one stick in regional negotiations:

- Carrots: Access to domestic market and the “bandwagon” effect, selling into China’s export growth.
- Stick: Denial of access.

However, this strategic leverage appears to be limited for two reasons:

- Chinese imports are essential to its export capacity
- WTO standards will not sustain exclusion

Regionalism and Globalism

East and Southeast Asia can capture most of the absolute export growth expected from full globalization by just forming ASEAN+3.

Thus, head-to-head export global competition is less important than leveraging opportunities presented by East Asia's fastest growing internal market.

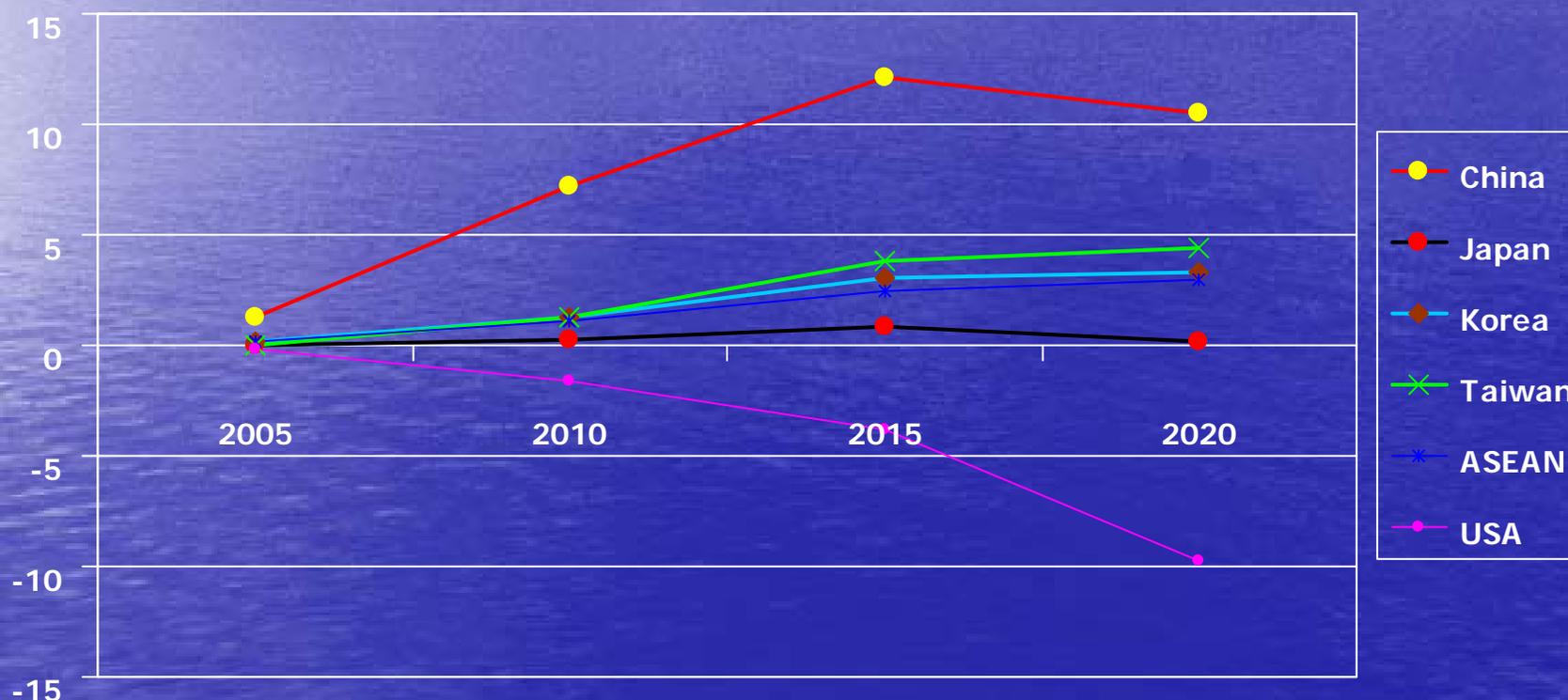
The best strategy for East and Southeast Asia is to pursue globalism through more comprehensive regionalism.

III. Implications of Real Exchange Rate Appreciation

To consider the implications of greater RMB flexibility, we examine a scenario where the regional economies maintain constant ratios of net foreign saving to real GDP.

The adjusting variable in this case is the domestic GDP price index, a proxy for the real exchange rate.

Real Exchange Rate Adjustments



Percent change from WTO trend. Positive values indicate appreciation.

Real Exchange Rate Adjustments

	2005	2010	2015	2020
China	1.29	7.23	12.09	10.52
Japan	.00	.26	.88	.14
Korea	.13	1.28	3.04	3.27
Taiwan	-.01	1.28	3.85	4.43
ASEAN	.15	1.10	2.45	2.93
USA	-.21	-1.62	-3.78	-9.78

China's adjustment is moderated by high levels of prior import dependence.

The US assumes nearly half the adjustment burden because of unsustainable imbalances.

Trade Adjustments

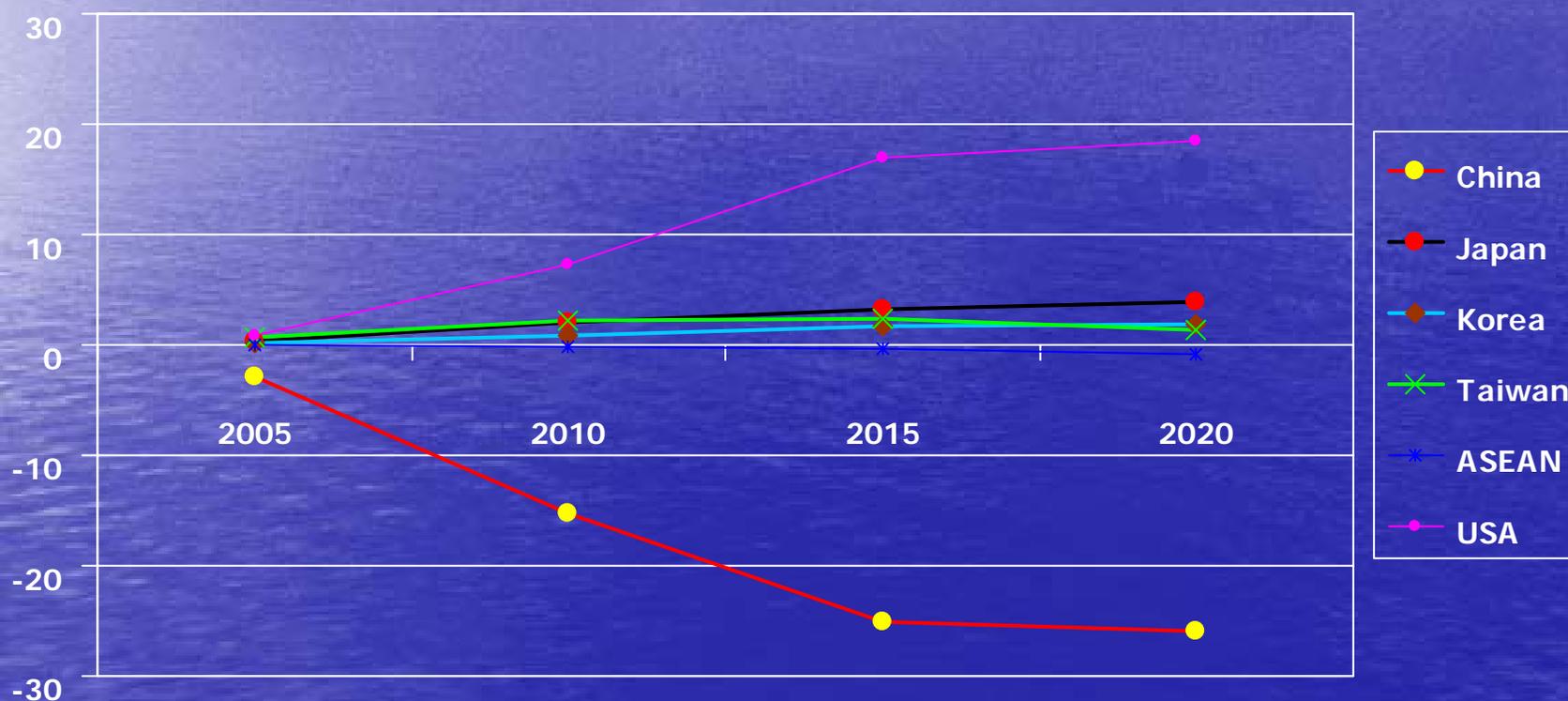
Exports

- ❖ Chinese exports are adversely affected with respect to the WTO scenario, but still rise above baseline values.
- ❖ Other Asian total exports grow only modestly.
- ❖ US exports expand significantly.

Imports

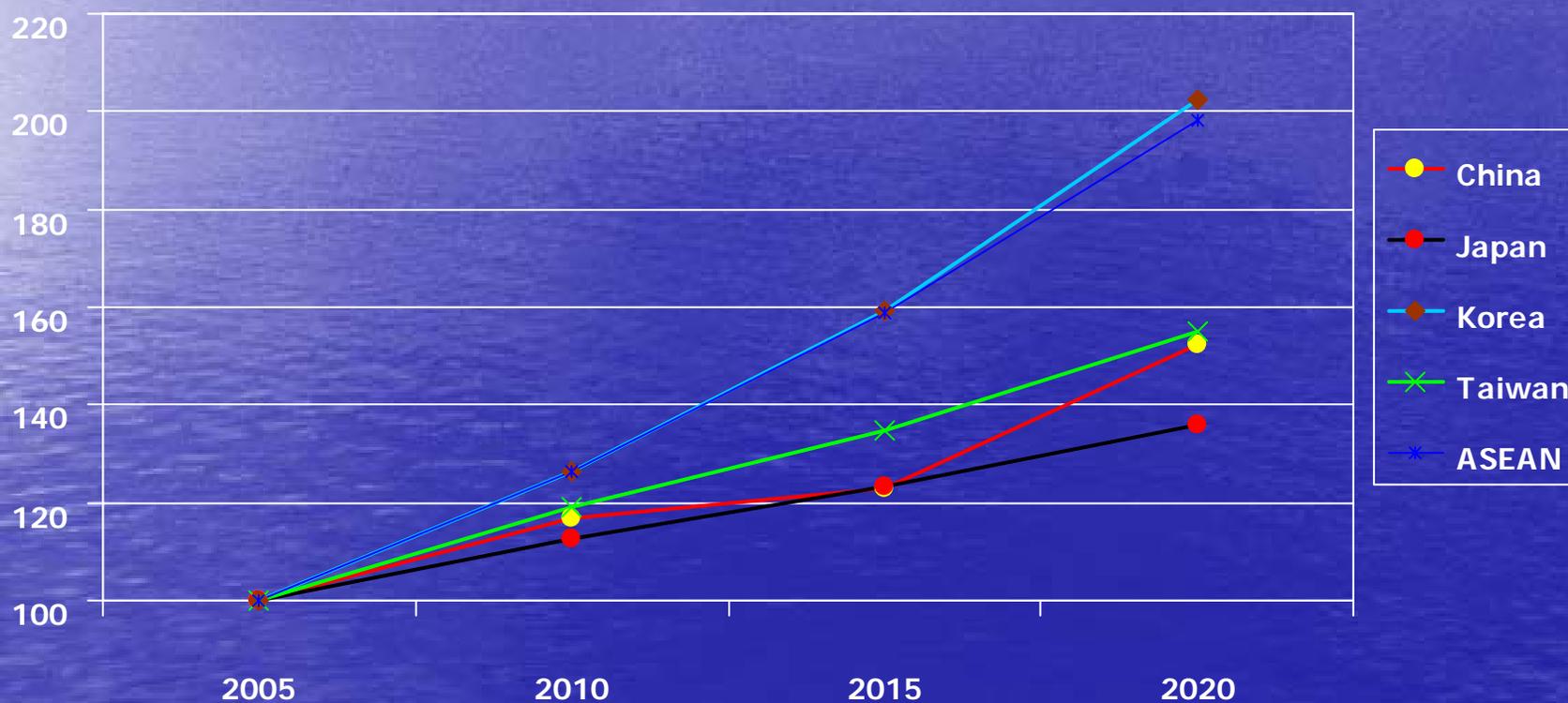
- ❖ As intuition would dictate, China and the US change places, with other East Asia in the middle.
- ❖ Trend Chinese imports rise much more significantly than exports, however.

Real Export Adjustments



Percentage change with respect to WTO scenario.

Export Trends



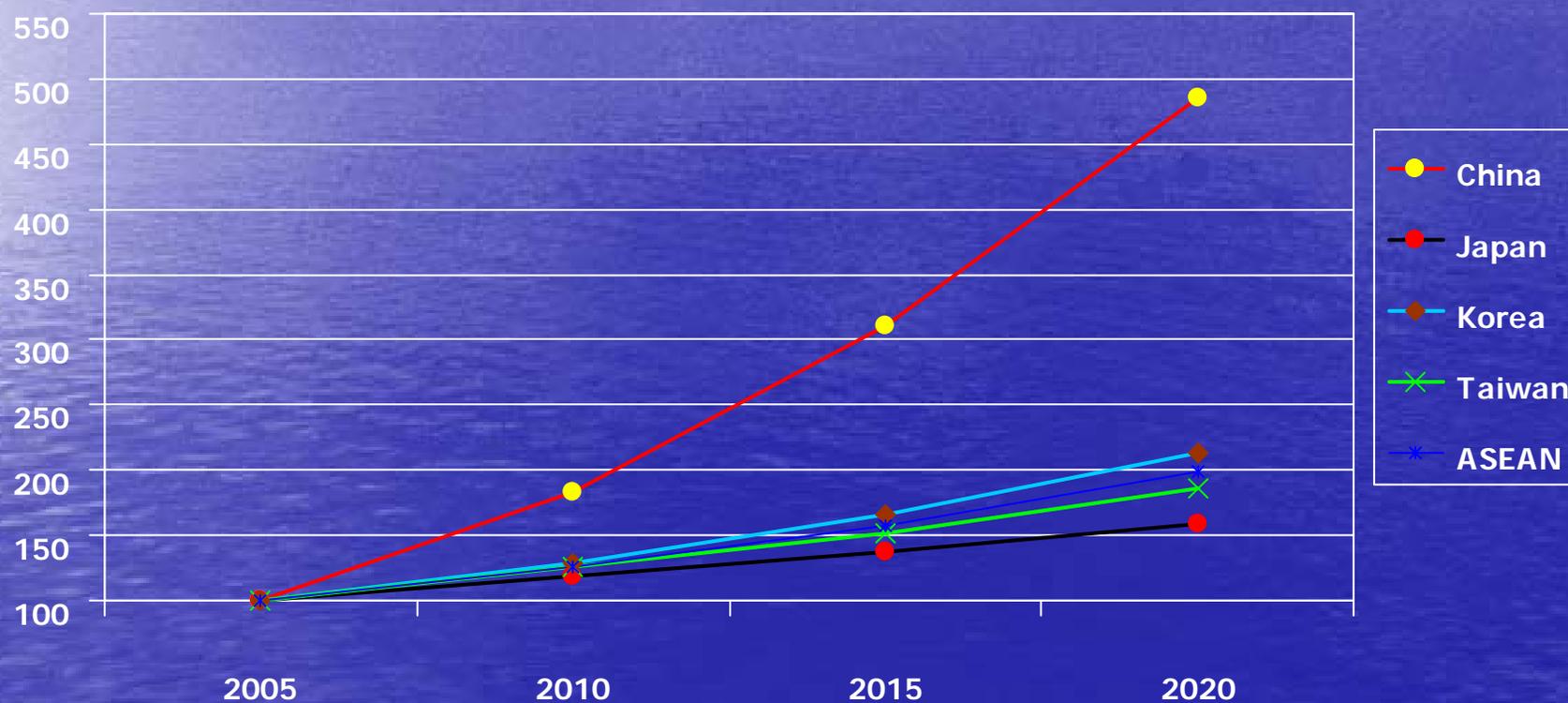
Indexed to 2005 Exports = 100

Real Import Adjustments



Percentage change with respect to WTO scenario.

Import Trends



Indexed to 2005 Imports = 100

Trade Composition

Beneath the veneer of macro shifts, dramatic patterns of trade diversion emerge, both between countries and within sectors

Salient trends:

1. Massive export switching to China.
2. China's import dependence accelerates across a wide spectrum of products, but especially energy and food.

East Asian Export Switching

<u>Exporter</u>	<u>Importer</u>					Total
	China	Japan	Korea	Taiwan	ASEAN	
China		-25	-25	-29	-26	-26
Japan	25		0	-4	-1	4
Korea	18	-5		-9	-7	2
Taiwan	14	-10	-10		-10	1
ASEAN	21	-4	-2	-8	-4	-1
Total	25	-1	3	-2	2	2

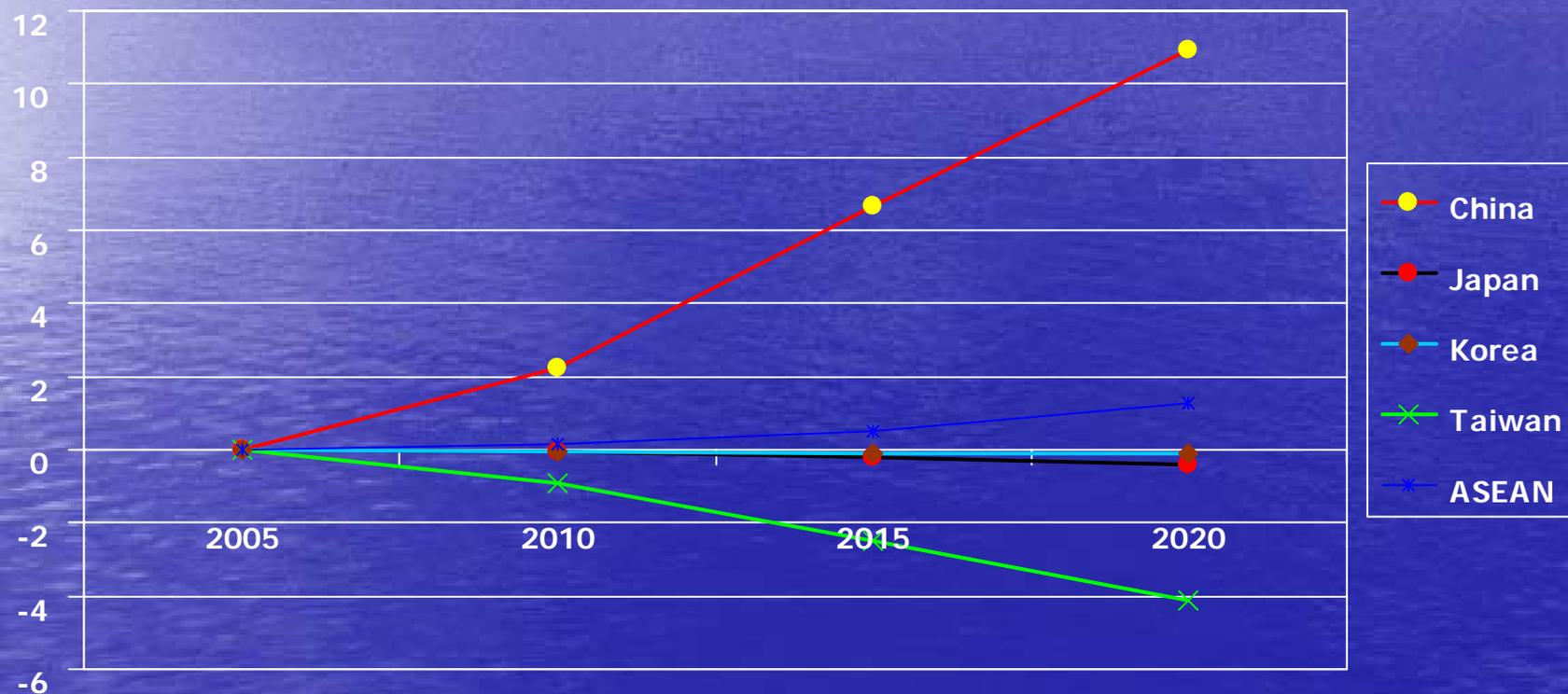
Domestic Growth

Contrary to neo-mercantile or other protectionist arguments, China's real economic growth accelerates.

The main reasons for this are:

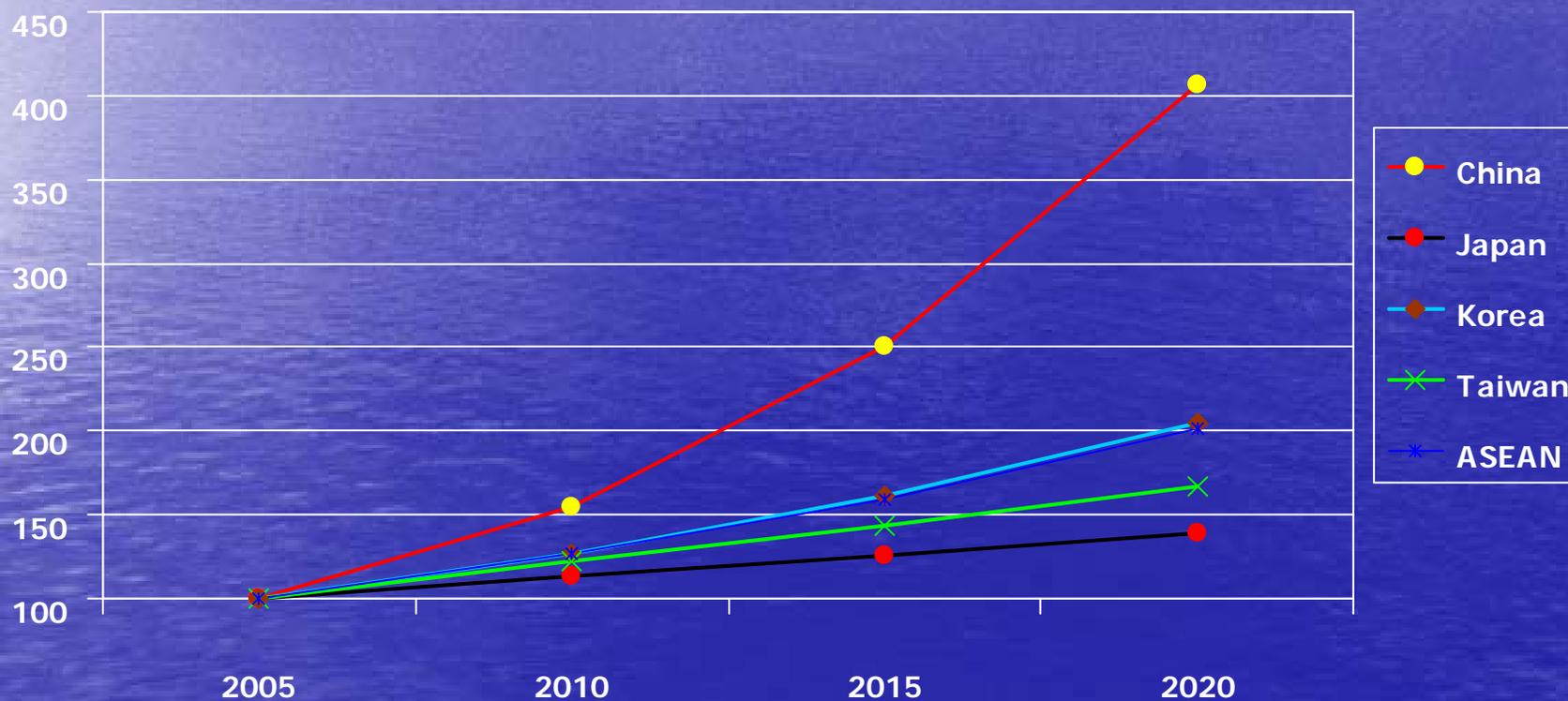
1. Increased domestic purchasing power (overcoming import constraints).
2. Accelerated domestic capital accumulation (FDI/GDP rises sharply).
3. Induced internal market expansion.

Real GDP Change



Percentage change with respect to WTO scenario.

Real GDP Trends



Indexed to 2005 = 100

Capital Market Implications

Obviously, the current account adjustments will be reflected on the capital account.

These shifts are notoriously difficult to generalize, yet a few observations might be relevant.

China's Capital Account I

Under the assumed closure, foreign savings are constrained by real GDP and the trade surplus is falling.

This means FDI is increasing in both absolute and relative terms, with two main effects:

1. Rising average quality of domestic investment and asset holding
2. Accelerated domestic capital accumulation and (discounted) technology transfer.

China's Capital Account II

As FDI accelerates and China's aggregate terms of trade deteriorate, an extensive sectoral rotation will be set in motion.

This can be very beneficial to development of the internal market, but there are risks:

1. Reverse Dutch disease – disengagement from external competitive discipline.
2. Labor intensity – the net employment characteristics of this rotation will be very important (services vs. real estate).

Capital Account III

Other basic adjustments:

- ❖ Incumbent Chinese assets are more valuable.
- ❖ FDI depreciates.
- ❖ Repatriated profits appreciate.
- ❖ Chinese wages escalate regionally.

Labor Markets I

Full employment was assumed across all scenarios.

Clearly, compositional features of actual employment will determine whether or not the implied economic potential is realized.

For the region, detailed analysis of sectoral adjustments is needed to assess this question.

For China, elastic supplies of unskilled workers are probably less of an issue than recruitment of skilled labor.

Labor Markets in China

❖ How high?

- Skilled labor demand may be rising faster than supply. This trend is being accelerated by FDI, for which skilled labor appears to be a complement.
- What exactly is the capacity of formal and informal education/innovation to deliver higher productivity?

❖ How long?

- Demographic transition and rising dependency
- The only way out is ever-increasing labor productivity

❖ How wide?

- Migratory pressure will continue as the opportunity cost of labor in the rural sector declines monotonically
- Actual migration must continue to be demand-driven
- Regional growth rates will increasingly determine aggregate growth (median vs. average growth)

Regional Issues

On the current account, China tempering its export competitiveness and accelerating absorption looks good to regional neighbors.

However, we are sure to see intensified competition for primary products and intermediate goods.

This will squeeze regional balance sheets and lead to a general shift from export competition to competition for imports.

RER appreciation will help China here, but intensify the underlying regional (and global) problem.

Expect to see all of the following:

- Resource seeking integration/partnerships
- Upstream FDI
- Value added shifting/transfer pricing

Conclusions

Overall trends in East Asian regional growth:

1. China will be the largest trading economy in East Asia by about 2010.

China will be the region's largest exporter by about 2010, but it's largest importer by 2005.

The latter situation presents an unprecedented opportunity for neighboring economies.

Conclusions

2. The growth of China's internal market will accelerate other East Asian export growth significantly and create historic opportunities for regional investors.

Provided East Asian economies do not isolate themselves from the process of Chinese trade liberalization, the net effect of China's growth will be hugely positive, as Chinese absorption emerges to dominate regional demand.

Conclusions

3. An East Asian Trade Triangle will emerge, where China develops a sustained trade deficit with East Asia and a surplus with Western OECD economies of nearly equal magnitude.

In other words, most of China's trade surplus will ultimately accrue to its regional neighbors. This has profound implications for patterns of both North-South and regional capital accumulation.

Conclusions

4. The Trade Triangle enables China to “deliver globalization” to the region by joining the WTO.

In this sense, East Asia can capture most of the benefits of full globalization by just forming ASEAN+3. The other EA countries should negotiate collectively with China, with an eye toward broader objectives.

Our results indicate that, in the wake of China’s WTO accession, the best strategy for East Asia is to pursue globalism through more comprehensive regionalism.

In the context of exchange rates, China’s emergence as a dominant regional importer may shift Asia’s “strong dollar consensus” to a “strong RMB consensus.” This could have profound implications for regional reserve holdings and the dollar.

Conclusions

- If regional balances over the next two decades were to be stabilized with Real Exchange Rate Appreciation, a complex set of adjustments would ensue. Most of these are consistent with prior intuition, but the magnitudes are important for policy reasons.
5. Aggregate RERs would adjust only moderately (less than 12% for any country considered).

Conclusions

6. China's trade would move in the expected direction,
 1. Export growth slow but remain positive
 2. imports accelerate rapidly
7. Aggregate regional trade would not change in trend, but its composition would shift dramatically with export switching to China.

Conclusions

8. The Chinese economy would experience significant new growth with RER appreciation, mainly due to accelerated expansion of the internal economy.

Conclusions

9. Capital flows across the region can be expected to shift on a sectoral basis.
10. Within China, a significant sectoral rotation of investment can be expected.
11. Inbound FDI will be an increasing percent of net foreign savings
12. Labor market developments are mixed, but must be closely monitored.

Discussion