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## China and Globalisation

*Since the initiation of economic reforms in 1978 China has become one of the world's fastest growing economies and has emerged as a global economic and trade power. What are the implications for the world economy, in particular for the distribution of income and wealth? How will China contribute to shaping not only the globalised world economy but also the institutions and policies of global governance?*

China's rapid growth over the last two decades has shaken the world. Globalisation, the catchword of the 1990s, has gained its prominence due to the opening of the Second World (i.e. central and eastern Europe and the former Soviet Union) and the rise of new industrial powers in Asia, most prominently China. But it is China's rise that worries the rich world, while competition from the post-communist transition countries worries only western Europe – and perhaps only Germany. China's transition has been more economic than political (in contrast to the Second World). What are the implications for the world economy, in particular for the distribution of income and wealth? How will China contribute to shaping not only the globalised world economy but also the institutions and policies of global governance?

### China as an Engine of Globalisation

China has become the world's economic powerhouse. It may still need years to become the world's largest economy but measured in purchasing power parity (ppp) it already ranks second after the USA. China also accounts for the largest shares of global growth in volume terms. Between 2000 and 2003, the growth of China's share of global GDP (at ppp) and global imports was more than 30%, its share in the worldwide growth in fixed investment even amounted to 60%, the corresponding figure for oil consumption being about 35%.<sup>1</sup> However, the gigantic level of investment points to one problem involved in Chinese growth: its low capital productivity due to a planned allocation of capital geared more to preserving structures than to rapid change.

China's share of world trade increased from about 1% to almost 6% between 1979 (when China started to open up) and 2003. This rise is comparable to the past rise of Japan or other newly industrialising economies in Asia. China's most important trading partners

are its Asian neighbours (including Japan, China's most important trading partner), accounting for between 50% and 60% of its exports and imports, while the EU has a share that ranges between 12% and 16% and the USA accounts for a share of about 20% of exports and 10% of imports. China is importing large quantities of investment goods and raw materials. Its exports stem to a large extent from subsidiaries of multinational enterprises and consist mainly of finished manufactured goods. While in 1990 primary goods still accounted for about one quarter of all merchandise exports, by 2002 these goods represented less than 10%. The strongest increase occurred in the machinery and transport equipment sector, where exports grew from US \$6 billion in 1990 to 127 billion in 2002, while total merchandise exports increased from US \$62 billion to 325 billion.<sup>2</sup>

China's share of global inflows of foreign direct investment was almost 10% in 2003 (US \$53 billion of a world total of US \$560 billion).<sup>3</sup> That made China the world's largest recipient of FDI in 2003.<sup>4</sup> By 2002, China had 200 000 firms that were either foreign affiliates or funded from foreign sources.<sup>5</sup> The major investors were Hong Kong and Macao, the USA, Japan, Korea and Taiwan. For its economic modernisation China has relied more on FDI than other Asian "tigers" such as Japan, Korea and Taiwan. But it is integrating foreign investment in its domestic economy, using it as a partner and a source of competitive pressure to create

<sup>1</sup> This section draws on Pam Woodall: The dragon and the eagle, in: *The Economist*, 2 October 2004.

<sup>2</sup> See World Bank: China. Promoting Growth with Equity. Country Economic Memorandum, Washington 2003, Statistical Appendix, Tables 9 and 10.

<sup>3</sup> Data on China from Mechtild Schrooten: Chinas Integration in die Weltwirtschaft – Chancen und Gefahren, in: *DIW-Wochenbericht* No. 52/2004; and UNCTAD: World Investment Report 2004. The Shift Towards Services, Geneva 2004 ([http://www.unctad.org/en/docs/wir2004\\_en.pdf](http://www.unctad.org/en/docs/wir2004_en.pdf)).

<sup>4</sup> After Luxemburg, which is a special case as a transshipping financial centre; see UNCTAD, op. cit., p. 10 ([http://www.unctad.org/en/docs/wir2004overview\\_en.pdf](http://www.unctad.org/en/docs/wir2004overview_en.pdf)).

<sup>5</sup> See World Bank, op. cit., p. 6, Footnote 5; according to UNCTAD, op. cit. (Annex table A.I.2, p. 274), there were 424 196 foreign affiliates located in China.

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### Measuring China

*Most statistics on China are shaky. Official data and expert estimates vary dramatically. Even basic indicators such as GDP growth rates,<sup>1</sup> employment<sup>2</sup> or foreign trade are open to intensive debate and contradictory estimates, which can vary by more than 100%. Beyond that uncertainty, there is a more basic and much more relevant difference in yardsticks, namely that between exchange rates and purchasing power parities (PPP). Measured in terms of exchange rates, China is a big but not very big economy with a very low per capita income. Measured at ppp, China is already the world's second biggest economy, a fact which has served to reduce the number of its poor substantially. With development and integration into world markets, Chinese and world market prices are slowly converging, thus reducing the big difference between the two yardsticks.*

*But as long as the difference persists, it has huge effects. Low incomes, in particular wages, measured in terms of exchange rates are attractive for foreign investors, but they mean low purchasing power in global markets. The much higher ppp income indicates high real consumption of real goods such as food, clothing and – directly or indirectly – raw materials. It is probably a better indicator for pollution, too.*

<sup>1</sup> See Albert Keidel: Special Report. Truth or Consequences: China's GDP numbers, in: China Economic Quarterly, Vol. 7, No. 1, 2003, pp. 32-40 ([http://www.theceq.com/ceq2003q1\\_sec3\\_01gdp.pdf](http://www.theceq.com/ceq2003q1_sec3_01gdp.pdf)).

<sup>2</sup> Mechthild Schrooten: Chinas Integration in die Weltwirtschaft – Chancen und Gefahren, in: DIW-Wochenbericht No. 52/2004.

a vibrant national modern sector. Recently, that sector has itself started to invest abroad. China's largest computer firm, Lenovo, expressed interest in buying IBM's PC business. By 2003, total Chinese investment abroad amounted to US \$37 billion.<sup>6</sup>

Thus far, migration to and from China has been relatively low. The immigration required to meet the needs of China's booming new industries has largely been from China's own domestic hinterland, plus a limited number of foreigners who work as expatriates. Emigration from China could potentially be huge but is still limited thanks to official restrictions. However, Chinese tourism has become more and more important, particularly in neighbouring countries. It could also become a major source of export revenue for countries such as the USA or Europe, balancing payments made for imports of Chinese manufactured goods.

<sup>6</sup> See Mechthild Schrooten, op. cit., p. 810.

However, it is basically the size of China's population that is increasingly turning globalisation into a Chinese process. China is actually still a very poor country with a per capita income (at ppp) of US \$4 900. But the overwhelming number of about 1.3 billion "capita" makes it the world's second largest economy. The size of its labour force is correspondingly large and still, to a large extent, made up of the right age cohort. China's labour pool is underemployed and marked by a huge surplus. To quote Sandra Polaski of the CEIP, "... if all U.S. jobs were moved to China, there would still be surplus labour in China."<sup>7</sup> If there were a truly global market for labour, China would be its largest supplier, exerting enormous downward pressure on wages and working conditions. Of course, there is no fully integrated world market for labour; but we will deal with these potential threats below.

As long as China, with its huge population and economic potential, was withdrawn from the world, it had very little impact on the course of the global economy and globalisation. To a large extent, the new importance of China reflects a "return to normalcy", if we understand a certain level of economic openness and integration as the normal situation of a country. The world has to, and will continue to have to, adjust to the wide range of opportunities (and risks) that emerge with a more open China. When a fifth of the world population approaches the global average per capita income (which is almost double the current Chinese figure, even at ppp, let alone at exchange rates, which is almost five times as high as the Chinese average), then huge shifts in the global pattern of production and consumption must be anticipated. Germany presently exports almost US \$10 000 per capita per year. If China approached that figure, its exports would amount to about US \$13 trillion (i.e. 150% of present US GDP). The complaints the world is uttering are similar to those heard when Japan or the other Asian "tigers" started to pour out exports. Meanwhile, both sides have adjusted: the old rich by restructuring and/or reducing work; the new industrial powers by raising their incomes to, or even beyond, the level of the other OECD countries. But how long will the adjustment take, in particular in China itself?

### The Globalisation of the Chinese Economy

While the world is concerned about an emerging China, China is changing rapidly, in particular because it has opened up to the world. Formally, that process culminated in China's accession to the WTO in

<sup>7</sup> Sandra Polaski: Job Anxiety Is Real – and It's Global, Carnegie Endowment Policy Brief No. 30, Washington 2004.

2001. The real opening occurred at a dramatic speed. Exports as a share of gross domestic product (GDP) grew from 4% in 1965, 6% in 1980, and 14% in 1989, to 24% in 1994.<sup>8</sup> In spite of that large share, the absolute figures, about US \$300, for exports/capita are still low (3% of the German value!) because of China's low GDP (in particular when measured in terms of exchange rates). Exports and imports as a share of GDP increased from 33% in 1993 to 60% in 2003 (in comparison, Japan's share grew from 14% to 18% during the same period).<sup>9</sup> Gross foreign direct investment increased from 1.2% of GDP in 1990 to 4.9% in 2001.<sup>10</sup>

China still controls inward and outward capital flows, though not completely. On the one hand, it is slowly liberalising its capital account;<sup>11</sup> on the other hand, it cannot prevent capital inflows disguised by transfer pricing and the overbilling of exports or underbilling of imports. This allows China to maintain the present exchange rate *vis-à-vis* the US dollar in spite of a growing stock of foreign exchange reserves that results largely from capital inflows and trade surpluses. But the export surpluses, mainly with the US market, have contributed less to the accumulation of reserves than the capital inflows. Since 1995, trade surpluses have averaged US \$30 billion per year, while in most years FDI inflows have been higher than US \$40 billion. At the same time, China is paying annually between US \$10 and 20 billion in factor income to foreign investors. However, this picture is contested by some experts, who estimate that China's trade surplus is about four times (!) higher than the Chinese statistics indicate. They base their much higher figures on the trade data of China's trading partners.<sup>12</sup> These discrepancies could possibly be explained in part by trade-related activities that disguise capital inflows. The fact that there are large capital flows even without full capital account liberalisation might explain why China is trying to keep its exchange rate as it is and to accumulate a huge stock of foreign exchange. Capital inflows could – under certain circumstances such as political or economic crisis – turn into outflows which would be as hard to control as the former inflows. Without countervailing policies, a capital flight of this

kind could provoke a crisis similar to the Asian crisis of 1997. Given the shakiness of China's financial system, with its huge burden of non-performing loans, such a financial or banking crisis is far from improbable and could interrupt China's growth dramatically.

Exports from China are largely produced by subsidiaries of foreign firms. In 2002, foreign affiliates accounted for about 50% of all Chinese exports (up from 9% in 1989). In high-tech industries, the share was even higher, reaching more than 90% (e.g. mobile phones).<sup>13</sup> The foreign-funded firms are also absorbing a large share of all Chinese imports (5% in 1985; 15% in 1989; 52% in 2000).<sup>14</sup> About half of the overall value of China's foreign trade is thus related to FDI. In 2002, foreign-owned firms produced 28.9% of the gross output value of all industrial enterprises in China (up from 11.7% in 1995).<sup>15</sup> Most of that foreign investment and corresponding export production takes place in the export processing zones that are located in the coastal areas of eastern China. The rapid growth of these exploding urbanised regions in the east has led to a dramatic increase in regional, sectoral and personal income disparities. While the eastern regions have experienced dramatic growth, the rural hinterland, which had been the first and major beneficiary of the market-oriented reforms during the 1980s, has fallen back in relative terms.

Labour has moved from the hinterland to take up new jobs offered by the emerging modern sector, which now employs at least 20 million workers<sup>16</sup> in foreign-owned firms plus additional millions in Chinese firms that are either relatively modern or suppliers of the modern export-oriented sector. While nominal wages are substantially higher in the modern urban sector, real wages are less high because prices in the coastal provinces are also much higher. China has become an economy not only of large and increasing income disparities but also one with price levels and structures that tend to differ greatly in regional terms. While domestically produced simple consumer goods are cheap, international brand-name products cost almost as much as in rich countries. To give a few

<sup>8</sup> Data from World Bank (World Development Reports 1991 and 1996).

<sup>9</sup> Data from Mechtild Schrooten, op. cit.

<sup>10</sup> Data from World Bank: World Development Indicators 2003, p. 310.

<sup>11</sup> See Mechtild Schrooten, op. cit.

<sup>12</sup> See Thomas I. Palley: Trade, Employment and Outsourcing: Some Observations on US-China Economic Relations, presentation given to the France/ILO dialogue on the social dimension of globalization, "The internationalization of employment: A challenge for a fair globalization?" held in Annecy on April 11-12, 2005. Palley estimates China's global trade surplus in 2002 at US \$189.9 billion, compared with Chinese data indicating a figure of US \$45.1 billion.

<sup>13</sup> [http://www.uscc.gov/researchpapers/2000\\_2003/reports/workapp1.htm](http://www.uscc.gov/researchpapers/2000_2003/reports/workapp1.htm).

<sup>14</sup> See Nicholas R. Lardy: Integrating China into the Global Economy, Washington 2002, The Brookings Institution, p. 7.

<sup>15</sup> See World Bank: China. Promoting Growth with Equity. Country Economic Memorandum, Washington 2003, Table 31 (p. 118).

<sup>16</sup> Numbers given at the end of the 1990s indicate 18-20 million workers in foreign-owned firms in Chinese export processing zones ([http://www.ilo.org/public/english/dialogue/govlab/legrel/tc/epz/reports/epzrepor\\_w61/](http://www.ilo.org/public/english/dialogue/govlab/legrel/tc/epz/reports/epzrepor_w61/)); other sources give much lower figures of about 8 million workers (communication by Nicholas Lardy to the authors).

extreme examples which are unlikely to be part of the consumption basket of a typical Chinese worker: a Big Mac has a price in China of US \$1.26 (USA: US \$3.00; Europe: US \$3.75). In Shanghai, a coffee at Starbucks on People's Square or a scoop of ice cream at Häagen-Dazs in the centre costs as much as in Europe, or about the average daily wage of a Chinese manufacturing worker and half the daily wage of an employee in Shanghai, where wages are more than double the Chinese average. The newly rich Chinese upper middle class and foreigners living in or visiting China share consumption patterns that make possible a supply of high-quality goods at correspondingly high prices, including not only consumer goods but also luxury housing.

There is still a substantial labour surplus in agriculture and in state-owned industries that could be moved into modern industries with much higher productivity. Thanks to generous credits from the state banking system, there has been little labour shedding from state-owned enterprises. The new jobs in foreign affiliates or new export-oriented private Chinese firms have mostly been filled by rural workers. But there are still more than 300 million workers in agriculture, many of them working on small subsistence plots with very low productivity. During the first phase of reforms, increasing productivity in agriculture led to the development of rural industries supplying manufactured goods to farmers as well as to substantial construction in rural areas. Later, structural change shifted more to the above-mentioned export-oriented and/or foreign-owned industries. With the trade liberalisation to which China has committed itself by joining the WTO, the low-productivity sectors of agriculture, rural industries and state-owned enterprises are coming under pressure to get rid of their hidden unemployment, i.e. workers who are not really needed to maintain a given level of output.

Recently, the modern enterprises in the coastal areas have had difficulties in finding enough workers to fill all vacancies. As long as the state protects its own overstaffed enterprises (and the level of employment there) and rural jobs offer an acceptable standard of living, a low-wage job at a high-cost location will become less attractive, in particular if it is dirty and dangerous. In agriculture, income depends on productivity and prices. Farmers can earn more by producing fruit and vegetables than by producing grain. China still controls the product mix of its farmers through a variety of formal and informal measures, such as the power of local party leaders. If farmers are allowed to switch from grain to higher valued-added products,

the growth of the rural economy will accelerate. The Chinese government is reluctant to become dependent on grain imports and still insists on maintaining domestic grain production, which, as a consequence, did not decrease during the 1990s, while fruit production tripled.

In employment terms, export production is still the tip of the iceberg. The high value of exports in relation to GDP is a result of the high price of internationally traded goods, which contain a high share of imported inputs (intermediate goods and, through depreciation, modern machinery), while most of the remaining domestic economy, above all agriculture, produces cheap goods and services. That explains the above-mentioned fact that China achieves a share of exports in GDP terms that is comparable to Germany (more than 30%), while having exports per capita of only 3% of the German value. In physical terms, domestic production still vastly exceeds exports or imports. The satisfaction of basic needs depends to an overwhelming extent on that domestic production. It is therefore questionable how far globalisation has contributed to the reduction of poverty in China. Globalisation advocates like to present China as a showcase for their argument that global economic integration benefits the poor.<sup>17</sup>

Actually, inequality has risen in China. Poverty may have declined if we define it as an income of US \$1 or 2 per day at ppp. But that income is less than 10% of the average national per capita income in China. Most poverty measurements assume that poverty starts at an income below 50% of average income, which in China amounts to a poverty threshold of at least US \$5 per day. Measuring income at ppp also touches up the picture, since services account for an unrealistically (because of their higher value and higher share of consumption in rich economies than in poor ones) large part of the basket of goods and services that are used to translate a given amount of national currency from exchange rate parity into ppp.

### Global Repercussions 1: the Rich World

Contrary to the often and loudly voiced concerns about the threat China is posing to employment and prosperity in the rich industrialised countries of the OECD, the actual impact so far has been limited. China might account for a large share of the rich world's export growth, but it is still a small market that has a

<sup>17</sup> The seminal work in this regard is World Bank: *Globalization, growth, and poverty: building an inclusive world economy*, New York 2002. The best critique is by Robert Hunter Wade: *Is Globalization Reducing Poverty and Inequality*, in: *World Development*, Volume 32, Issue 4, 2004, pp. 567-589.

correspondingly small share in the rich world's total exports. That small size of the import market reflects the relatively small size of the total Chinese economy when measured at exchange rates (rank 6 between France and Italy in 2001).<sup>18</sup> Exchange parity actually measures – unlike ppp – the capacity of an economy to buy in the world market. China absorbs less than 2% of the EU's exports and about 3% of US exports. More generally, trade with developing countries has destroyed jobs in rich countries. But these losses in import-competing industries have for the most part been compensated for by gains in other sectors, either exporting ones or domestic services. These gains could have been higher if demand by the developing countries had been less constrained by undervaluation, austerity policies and debt problems.<sup>19</sup>

Similarly, China's share of total FDI has been significantly below 10%. The total number of jobs shifted to China is also small in comparison with total employment in countries of origin. A study submitted to the US-China Economic and Security Review Commission<sup>20</sup> estimated that 99 000 jobs have been relocated from the USA to China (at the same time, the report estimates that 140 000 jobs had shifted to Mexico) in 2004. That is less than 0.1% of the total labour force. The employment effects of trade itself are particularly strong in the USA because of the country's large trade deficit with China. A US study estimates that a net 1.5 million<sup>21</sup> job opportunities were lost between 1989 and 2003 due to trade with China. But even that figure pales in comparison with the total job turnover in

the US economy. As regards Europe and Germany in particular, empirical studies have also detected some very limited effects of job relocation and outsourcing.<sup>22</sup> Outsourcing from Europe in any case tends to shift jobs to eastern Europe rather than to China, although relocation to China has also occurred. The welfare and employment effects of outsourcing depend to a large extent on the adjustment capacity of the rich country concerned, i.e. its capacity to create new jobs in industries such as domestic services or up-market exports. A study by McKinsey has estimated that Germany is losing from outsourcing, while the USA is winning, thanks to its more flexible labour market.<sup>23</sup>

Obviously, it is difficult to determine empirically the net trade- and offshoring-related effects of globalisation on rich countries. Economic theory provides a mixed picture, too. Optimistic advocates of globalisation tend to rely on Ricardo's classic trade theory, which promises welfare gains for all, as all participating economies specialise according to their relative comparative advantages. These welfare gains result from increased productivity and depend on a successful course of structural change within the economies involved, a process which entails substantial adjustment costs (loss of physical and human capital in the declining sectors). Moreover, if demand does not keep pace, growth in productivity will be translated into unemployment. Welfare gains and employment are distributed between the countries involved through the terms of trade, which depend on exchange rates. The devaluing country forgoes welfare gains and has (or is able) to increase employment in order to achieve the same level of consumption. As Paul Samuelson has shown in a recent critique<sup>24</sup> of the Ricardo-based justification of globalisation, in the longer run rich countries will probably lose the welfare or employment gains achieved through specialisation when the developing countries start to produce, at the same level of productivity, the goods they have been importing. Meanwhile, as trade theory (Heckscher Ohlin, Stolper-Samuelson) suggests, trade affects income distribution when countries specialise in products that use domestically abundant production factors. In theory, China specialises in low-skill, labour-intensive activities, while rich countries specialise in high-skill, capital-intensive activities. Subsequently, wages,

<sup>18</sup> See World Bank: World Development Indicators 2003.

<sup>19</sup> See David Kucera, William Milberg: Deindustrialization and Changes in Manufacturing Trade: Factor Content Calculations for 1978 – 1995, in: Review of World Economics, Vol. 139, No. 4, 2003, pp. 601–624.

<sup>20</sup> Kate Bronfenbrenner, Stephanie Luce: The Changing Nature of Corporate Global Restructuring: The Impact of Production Shifts on Jobs in the US, China, and Around the Globe, 2004 ([http://www.uscc.gov/researchpapers/2004/cornell\\_u\\_mass\\_report.pdf](http://www.uscc.gov/researchpapers/2004/cornell_u_mass_report.pdf)).

<sup>21</sup> Resulting from a gross loss of 1.7 million due to imports from China and gross gains due to US exports of 0.2 million jobs; see U.S.-China Trade, 1989-2003: Impact on Jobs and Industries, Nationally and State-by-State, tables: "Effects on Employment of U.S. Trade Deficit with China, by State and Major Industry", prepared for the U.S.-China Economic and Security Review Commission by Robert Scott of the Economic Policy Institute, Washington 2005 ([http://www.uscc.gov/researchpapers/2005/05\\_02\\_07\\_epi\\_wp\\_rscott.pdf](http://www.uscc.gov/researchpapers/2005/05_02_07_epi_wp_rscott.pdf)).

<sup>22</sup> See for Europe Jacob F. Kirkegaard: Offshore Outsourcing – Much Ado about What?, in: CES ifo Forum, Vol. 5, No. 2, 2004, pp. 22–29; and for Germany Ingo Geishecker: Outsourcing and the Demand for Low-Skilled Labour in German Manufacturing: New Evidence, DIW Discussion Papers 313, 2004; and Ingo Geishecker, Holger Görg: Winners and Losers: Fragmentation, Trade and Wages Revisited (Updated Version), DIW Discussion Papers 385, 2004. For a general and balanced view, see Richard B. Freeman: Are Your Wages Set in Beijing?, in: Journal of Economic Perspectives, Vol. 9, No. 3, 1995, pp. 15–32.

<sup>23</sup> See Reiner Clement, Johannes Natrop: Offshoring – Chance oder Bedrohung für den Standort Deutschland? in: Wirtschaftsdienst, Vol. 84, No. 8, 2004, p. 527.

<sup>24</sup> See Paul A. Samuelson: Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization, in: Journal of Economic Perspectives, Vol. 18, No. 3, 2004, pp. 135–146.

in particular of unskilled workers, will decline in rich countries.<sup>25</sup>

Classic trade theory, even as revised by Samuelson, assumes that there is no movement of production factors between countries. The actual process of globalisation is obviously one driven by trade and factor flows. Multinational enterprises rearrange global production networks and value-added chains in a way that minimises costs by locating each production step at the location with the minimum cost (including wages, taxes and other inputs). That process does not necessarily increase productivity, but it does replace higher-cost inputs with lower-cost inputs, in particular high-wage jobs with low-wage jobs.<sup>26</sup> Since the high value-added segments of global production chains are mostly located in rich countries, and given the strong competition between locations with abundant low-skill labour, poor countries hardly benefit at all from this process, and wage dispersion in such locations even tends to increase.<sup>27</sup>

To benefit from China's growth, rich countries must upgrade their labour force and shift it into higher value-added industries. They should also expand service industries that cater to the domestic market and need to be located close to consumers. Another option is the reduction of working time. In particular, the USA, with its high number of hours worked per year per employee (about 20% higher than Europe), could translate some of the welfare gains from trade with China into more leisure time, which in turn would possibly increase demand for domestic services. When China, under severe pressure from the USA and Europe, raised its export tariffs on some textiles in May 2005, it actually chose welfare gains at the expense of employment, while its rich customers wanted to protect employment, even though this implied more expensive imports.

### Global Repercussions 2: the Poor World

In most countries of the poor world China is seen as a direct and fierce competitor. This has largely to do with the fact that developing countries, including China, all fish in the same pond.<sup>28</sup> As far as export activities are concerned, countries in the poor world typically target markets for low-skill and labour-intensive

goods and services – and many exporters are increasingly struggling to beat their Chinese competitors. The most recent example of the competitive pressure coming from China is the world textile market, which, due to the phase-out of the Multifibre Agreement (MFA), has seen a massive expansion of the activities of Chinese textile and apparel exporters.<sup>29</sup>

The competitive pressure is twofold: first, products from Chinese factories meet their rivals from other developing countries in first-world markets, particularly the USA and the EU; second, goods made in China are exported to the developing world, where they substitute for locally made products. Since the reach of Chinese activities has been expanded far beyond neighbouring Asian countries into Africa and Latin America, the latter form of competition has an almost global reach, particularly in some product categories such as toys and textiles. While governments could guard their countries against the second type of competition by means of traditional protective measures, the typical reaction to the first type is downward pressure on wages coupled with an “or else we relocate to China” threat.<sup>30</sup>

A study by Enrique Dussel on the case of Mexico illustrates this “double whammy” effect.<sup>31</sup> The author first looks at Mexico's most important export market – the USA. In 1990, Mexico was the third largest exporter to the USA. Since then, Mexican exporters have benefited from an environment marked by strong US demand and trade liberalisation measures. Despite this positive trend, Mexico was merely able to consolidate its overall position. China, however, started out in the same period from the 12th rank and smoothly moved ahead of Mexico to second place in 2003. It is important to note that the categories of products exported from China and Mexico to the USA largely overlap – with electronics and car parts among the most important items. And despite the fact that Mexican exporters enjoyed tariff advantages thanks to NAFTA, Chinese exporters greatly outperformed their Latin American rivals. As a result, goods from

<sup>25</sup> See Alan V. Deardorff: Developing country growth and developed country response, in: *Journal of International Trade and Economic Development*, Vol. 10, No. 4, 2001, pp. 373-392.

<sup>26</sup> See Michael Dauderstädt: *Standortkonkurrenz, Arbeitsplatzexport und Beschäftigung*, Bonn 2004, FES.

<sup>27</sup> See William Milberg: The changing structure of trade linked to global production systems: What are the policy implications?, in: *International Labour Review*, Vol. 143, No. 1-2, 2004, pp. 45-90.

<sup>28</sup> In countries such as Thailand, Malaysia or Indonesia the value of exports to the USA that are in the same product categories as Chinese exports to the USA accounts for about two thirds; the figure for countries such as Japan or Singapore is 22% and 40% respectively. See *Economist*, 26 March 2005, p. 24.

<sup>29</sup> On the implications for developing countries, particularly Africa, see Mills Soko: *Trade Pact Expiry Weaves Worry for Global Textile Industry*, Pretoria 2005, South African Institute of International Affairs.

<sup>30</sup> For a critical review of the growing engagement between China and Africa, see Chris Alden: *Leveraging the Dragon: Toward “An Africa that can say no”*, 2005, eAfrica.

<sup>31</sup> See Enrique Dussel Peters: *Implications of China's Recent Economic Performance for Mexico*, Berlin 2005, FES.

Mexico are struggling today to hold their share in the US market, while China's climb to the top of the US trade statistics seems to be just a matter of time. Dussel concludes that the Mexican economy has begun to sputter as a result of sluggish export growth and due to competition from China. To make matters worse, Mexico's bilateral trade relations with China reveal a similar pattern. In the period 1993-2003, China's exports to Mexico achieved a whopping annual average growth rate of 37.6%. Of a total of 9.4 billion dollars worth of Chinese exports to Mexico in 2003, two thirds were in the car parts and electronics category.

The big question is: why are Chinese electronics and car parts exporters so much more successful than their counterparts from Mexico? Dussel's study does not provide any quick answers and sees a mix of wage differentials and technological advantages at work. A look at exchange rates reveals, however, that the relative price of the Mexican and Chinese currencies to the US dollar may in fact have accentuated existing real wage differentials. With the RMB undervalued relative to the dollar, the Mexican peso appears to be overvalued and suffering from the Dutch disease phenomenon typical of resource-rich countries.

Apart from the twofold effect exemplified by the case of Mexico, another and less obvious consequence of China's growth is the expansion of Chinese investments into the developing world. Although exact statistics are hard to come by, Chinese firms are certainly on the way to becoming major investors in global markets. Many projects are related to resource exploitation and aim to satisfy China's ever growing appetite for oil, gas and mineral imports.

Is there no way for countries in the poor world to survive direct competition from China? Yes, there is. A case in point is the success of the world's second most populous country. India has built its success on abundant cheap labour, just as China has. But Indian firms, at least in part, have gone into different product categories. Given its big pool of formerly under-utilised semi-skilled and highly skilled labour, India geared its export drive towards tradable services industries and the production of research-intensive goods such as information processing, telephony services, medical services, software development and the production of medicines.

But even if the niche strategy does not work, the picture is not really all that gloomy. It is important to note that resource-rich countries have greatly benefited from China's demand for commodities such as iron ore and copper. Big exporters of these goods

– such as Brazil and South Africa – are currently enjoying huge windfall profits by raising both the prices and the volumes of their commodity exports.

Another, if yet more distant, hope for poor countries wishing to benefit from China's success is the "graduation" of the Chinese economy. Initially, China itself had benefited from the advancement of its Asian frontrunners. In 1987, Hong Kong, South Korea and Taiwan supplied 60% of all US imports of footwear, toys, games and sporting goods. Only twelve years later (1999) it was China that supplied the 60%, partly because Korean and Taiwanese firms "offshored" their low-skill production to China.<sup>32</sup> The question, however, is how soon China will hand over the baton to its followers. The reason for offshoring is a cycle of increasing labour scarcity, rising real wages and ascent up the value chain. Given China's huge pool of cheap labour, it would, however, seem much too soon to call on China to give the next generation a chance.

Even if the competitive pressure from China on the poor world continues on for the foreseeable future, China is also increasingly seen as a role model. What adds to China's attractiveness, apart from its undoubted success, is the unique policy mix that the Chinese government has been pursuing.<sup>33</sup> Particularly striking is the comparison with Latin America, where during the 1980s and 1990s the recipes of the Washington Consensus were followed and where few of the expectations placed in this model were met. In view of this sobering comparison, governments in Latin America have started to carefully study the Chinese model. They are particularly astonished by the strong role that the Chinese government has played in industrial development as well as by the cautious approach that it has used towards liberalisation and deregulation.

### China and Global Governance

Without any doubt, the days when the Chinese government sat comfortably in the camp of those calling for solidarity with the South and demanding a "New Economic World Order" are over. And yet in the field of economic global policy-making China is still a sleeping giant. It is only when it comes to hard security interests that China – a member of the P5 in the UN Security Council – does not shy away from positioning itself as a member of the "big league".

Some new terminology is a first indicator that change is on the horizon. Senior Chinese leaders have

<sup>32</sup> See Nicolas R. Lardy: *Integrating China into the Global Economy*, Washington 2002, The Brookings Institution, p. 159.

<sup>33</sup> See C.P. Chandrasekhar, Jayati Ghosh: *China's extraordinary export boom*, New Delhi 2005, IDEAS.

replaced the inward-driven “peace and development” paradigm with the more outward-oriented term of “peaceful rise.” One aspect that is not made clear by this new rhetoric is: how fast, and in what direction, will China’s leadership take the country into the global policy arena?

An example of how Chinese leaders are shifting gears is China’s relationship with the WTO. When China joined the WTO in 2001, many observers pointed to domestic considerations, i.e. use of the pressure generated by a rules-based institution such as the WTO to speed up reforms at home.<sup>34</sup> Shortly after it had joined the trade body, the Chinese government surprised many when it joined the G20 – a group of countries led by Brazil, India and South Africa that is pushing for reforms in the agricultural sector. In a similar vein, China has placed a bid to become a shareholder of the Inter-american Development Bank (IDB) – a move that has met with some resistance, particularly from the most powerful stakeholder. China also wants to strengthen its position in other international financial institutions, where the distribution of power has depended on the size of the member states’ GDP, a fact which originally gave poor China little voice (in contrast to the situation at the UN). Despite these moves, China’s approach to global policy-making is still far removed from the megaphone diplomacy of other countries, and it certainly pales in comparison with the level and depth of involvement of countries such as Brazil.

To predict the future direction of China’s activities in the global policy arena, an analysis of China’s interests should be a good guide. First of all, China has a number of offensive and defensive interests, to speak in the parlance of trade policy. On the offensive side, China’s key interest for the foreseeable future will be to push for open markets for its goods and services. Depending on the fate of the WTO – which is struggling to recover from an acute crisis – the attention of Chinese trade policy might shift to regional and bilateral agreements, as other big trading nations have done. On the defensive side, the most important line of defence lies with China’s capital markets. China (rightly) resents the request for full liberalisation of its capital account, and it will continue to resist such requests for quite some time to come. Given its unwillingness to succumb to outside pressure, China has been very reluctant to accept invitations to join forums such as the G8, where there is a great danger that the country might find itself “cornered.”

<sup>34</sup> See Bernd Reddies: China one year after joining the WTO, Beijing 2003, FES.

Less obvious is whether China has the ambition and potential to play the role of an “economic policy hegemon”. When the US government adopted the Washington Consensus approach, it was motivated by a mix of objectives, including the desire to export its own set of values and recipes and to advance the interests of its banks and companies in relevant countries. Joshua Cooper Ramo – an American analyst – sees China emerging as a powerful alternative to the American role model and calls this the “Beijing Consensus”.<sup>35</sup> Where Washington has argued in favour of market orthodoxy and a lean state, Beijing is promoting a pragmatic approach to capitalism coupled with what is known as the developmental state. This approach goes down very well with many countries in the South – if the many delegations from developing countries recently visiting China are any guide. What remains to be seen, however, is how proactively China will play the Beijing Consensus card. Ramo points to what he calls China’s asymmetric use of power and predicts that it will rely on a very indirect form of soft power rather than the arm-twisting approach used by its rival. He may be right. When Chinese officials are asked about their attitude towards “development policy,” a reply that is both often heard and at the same time stunning and convincing is, “If China continues to grow at its current rate and pulls out its whole population of 1.3 billion out of poverty, this would be the substantial contribution to the achievement of the UN Millennium Development Goals!”

In addition, as China moves further up the economic ladder, its interests in global politics will change. From a somewhat cynical perspective, it could be argued that China’s ultimate ambition is to “leap to the big league and leave the rules as they are”. In some areas this might well be the case. Take the issue of investment protection: as China moves away from being a prime recipient of FDI and into the role of one its major sources, it will more willingly support global rules designed to safeguard foreign investors. The same may apply for global environmental policy. In the Kyoto Protocol context, China has traditionally argued for the right of developing countries to pollute on a “per capita basis.” This attitude could change. Not only is China already feeling the pain of environmental degradation, it is also growing increasingly concerned about the rising price of energy, particularly oil. Rather than promoting a relentless surge in global energy consumption, China could soon find

<sup>35</sup> See Joshua Cooper Ramo: The Beijing Consensus, London 2004, The Foreign Policy Centre.

itself in the same camp as Europe – arguing for a global approach to energy efficiency.

### Adjusting to China's Rapid Growth

Given China's size and the success of its economy, there is no doubt that China will incrementally move from the engine room of globalisation into the driver's compartment. Whether it will stay in the camp of those who support a rules-based system of global governance, or opt instead for the "G1 approach," will remain an open question for some time to come. The most powerful members of any club invariably tend to bend the rules. If the rules serve your own interest, you happily comply. If they do not, you claim that it would be "irresponsible" not to act in your own interest.

Quite apart from considerations of global politics, the fundamental economic consequences of the process of globalisation should be kept in mind. In order to shape globalisation in a way that delivers or protects growth and equity, several obstacles have to be overcome.

- While global trade enhances global welfare and raises productivity, global demand must increase at more or less the same pace to maintain current levels of output and employment. Productivity gains can be translated into higher factor incomes, lower prices or lower factor input. For China, reduction of labour input (be it in terms of reduced weekly working hours, longer vacations or early retirement) is still less preferable than higher output, given the country's continuing vast needs. Thus real wages should reflect (increased) productivity. Lower prices are also apt to ensure equity since they benefit all consumers.
- China should not deliberately undervalue its exchange rate. By doing so, it would stand to increase domestic employment, but at the expense of welfare gains. If it is more flexible than its trading partners in shifting labour to the most productive activities, it will be better off improving its terms of trade by holding a higher external value for its currency. At the same time, this would reduce the resistance of its trading partners to China's exports, in particular on the part of those that are faced with greater difficulties in adjusting. However, China must weigh these benefits against the benefits which result from a slight undervaluation, namely the capacity to lower interest rates.
- To avoid a race to the bottom as regards wages, it would be good if the reservation wage in China increased. That reservation wage depends on the income which potential workers could get from other

activities such as jobs in state-owned enterprises or in agriculture or other firms oriented towards the domestic market. The more local rural economies flourish, the less people will be inclined to move to the coastal regions and seek low-wage jobs there. To that end, China should loosen its restrictive agricultural policy and allow more flexibility within the rural economy. By not restricting the production shift from grain to fruit and vegetables, China could increase rural productivity and incomes. A supply guarantee by other grain producers (or at least a guarantee that grain exports would not be used as a weapon, as former US administrations threatened) would encourage such a Chinese policy.

Rapid growth in China would alleviate many problematic effects of its integration into the global economy. A growing China would absorb its own labour supply, thus driving up wages and leading to a real appreciation of its currency. Such a development would ease competitive pressure, in particular on other low-wage countries, and increase demand for imports from the rest of the world, which in turn would create more jobs there. But there is another side to that coin: the growing demand for raw materials as well as growing pollution, including higher emissions of greenhouse gases. "China now consumes 40% of the world's cement, a third of its coal and a quarter of its steel."<sup>36</sup> This above-average demand (compared to China's share of world GDP, or even population) will not last forever, as it mirrors the need to build up a modern infrastructure, including transport, plant and housing. More developed countries are already saturated with steel and concrete, and they have subsequently changed their patterns of demand and production from heavy industry to services. But China's huge appetite for raw materials will probably continue for decades, and it is already a burden on its relations with other countries, in particular with Japan and some other Asian neighbours.<sup>37</sup> Rising global demand for natural resources may be good news for their producers/owners, but it will sharpen the competition between importers, who have to earn the money to buy raw materials by selling manufactured goods. Besides some East Asian countries, it is above all resource-poor, high-wage Europe that is bound to see its terms of trade decline. But even such a development – if it materialises – would call primarily for a European agenda of ecological modernisation which creates new jobs by economising on energy and natural resources.

<sup>36</sup> The Economist, 7 May 2005, p. 77.

<sup>37</sup> See The Economist, 26 March 2005, pp. 23-25.