

TRADE

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RESEARCH POLICY BRIEF NO. 3

**Overview of PRC
in East Asian Trade**

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ADBI RESEARCH POLICY BRIEF NO. 3
TRADE AND PRC POST-WTO

Overview of People's Republic of China in East Asian Trade

Based on ADB Institute Research Paper 44, *An Overview of PRC's Emergence and East Asian Trade Patterns to 2020* (David Roland-Holst, October 2002)

www.adbi.org/PDF/wp/rp44.pdf

Post-WTO: Opportunity or Competition

PRC's economic emergence over the last two decades, and in particular its recent WTO accession initiative, portend a dramatically changed landscape of East Asian trade. This has aroused concern around the region, where PRC's success as an exporter poses a threat to other economies that rely on external demand as an essential source of growth. At the same time, the early stage of PRC's development understates the opportunities its internal market will ultimately offer exporters, particularly in East Asia. The resulting bias in perceptions could undermine multilateralism and retard the dramatic historical progress of regional trade and economic growth.

Our research reveals a more complex picture of PRC's emergence, however, one that presents as many opportunities as threats to East Asian policy makers. In this first of three studies, we forecast the evolution of East Asian trade patterns under a variety of alternative policy scenarios.

Market Openings for Region

PRC will be East Asia's largest trading nation by the year 2020, and its growth over the intervening period will dramatically change the regional economy. Contrary to the view that Chinese exports will stifle competitiveness and growth among its neighbors, we find that PRC's expansion, particularly when accelerated by its WTO initiative, will open unprecedented market opportunities for East Asian exporters. Indeed, while PRC will become the region's largest exporter only in 2010, it will be the largest East Asian importer by 2005.

During these two decades of sustained and dynamic growth, PRC will develop a structural trade surplus with the western OECD economies, and a deficit of about the same magnitude with East Asia. In other words, most of the net benefits of PRC's export successes will ultimately accrue to its regional neighbors. This fact reveals the mercantilist fallacy of the PRC as threat argument, and our results further indicate that the spillover effects of PRC growth and trade expansion will far outweigh any trade diversion effects

on the rest of East Asia. Although there is not necessarily a link between the regional components of current and capital account balances, the Chinese “surplus transfer” phenomenon is likely to have significant implications for regional capital markets.

Optimal Policy Response by East Asia

Along similar lines, the growth of PRC’s internal market will accelerate other East Asian export and income growth and create historic opportunities for regional investors. To capture these opportunities, the economies of the region, individually and perhaps collectively, will need to re-examine their domestic and external policies toward capital allocation.

On both the current and capital accounts, the optimal response to PRC’s WTO initiative is neither protectionism nor passivity. Provided East Asian economies do not isolate themselves from the process of PRC trade liberalization, the net effect of PRC’s growth will be hugely positive, as Chinese absorption emerges to dominate regional demand. Failure to adapt to more open multilateralism will undermine competitiveness, leading to lower domestic productivity growth and crowding out from export markets.

Unilateralism vs. Regionalism

PRC’s situation in the East Asian trading region appears to be unique in several important respects. Because of the sheer size and growth momentum of this economy, it apparently is in a position to “go it alone” on the path to globalization, i.e. most of its own benefits from multilateralism can be captured by unilateral liberalization. This fact not only strengthens its resolve to follow that path, but limits any incentive to be drawn into regional agreements.

At the same time, a large part of the benefits to other East Asian economies arise from PRC’s initiative, whether or not it is unilateral, but the regional incidence of these benefits may depend upon bilateral relations with PRC itself. Our results indicate that significant trade diversion can

occur among regional exporters, at the expense of those countries who opt out of either a free trade agreement (FTA) including PRC or unilateral trade liberalization.

Incentives for Regional Negotiations

Because of the complex incentives governing its situation, PRC possesses two carrots and one stick in regional negotiations. The carrots are access to its own domestic market and, by joining PRC in an FTA, greater market access to the rest of the world (a “PRC bandwagon” effect). The stick, obviously, is one of the carrots, used instead as a club: trade diversion arising from direct export competition by PRC and its partners. Clearly, a mercantile or export-only PRC perspective is too simplistic, but this country still holds a special position in the regional negotiating environment, and other East Asian economies must take due account of this fact.

Trade Partner of Japan

Even under status quo policy assumptions, PRC is forecast to be Japan’s largest trading partner by 2020. In terms of both exports and imports, PRC will become Japan’s largest bilateral partner. Japan will also be PRC’s largest individual source of imports. For these reasons, the previous policy conclusions are of special relevance to Japan.

Global Forecasting Model Results

In this study, a global forecasting model was used to examine the economic emergence of PRC in the East Asian region. The projections reported in the paper extend to 2020.

The model’s results indicate that, over the next two decades, PRC will develop a large and sustained trade surplus with western OECD economies, but a nearly equal and sustained deficit with East Asia. Looked at this way,

it is apparent that a large part of the economic benefits of PRC competitiveness, namely most of its current account surplus, will ultimately be distributed across the East Asian region. This final incidence of these benefits will of course depend upon the ability of individual regional economies to identify and capture opportunities in PRC itself. Thus PRC poses not a threat, but an opportunity to its neighbors, but the opportunity comes in the form of a challenge to re-orient production and marketing capacity to a new market of unprecedented potential. Japan and other dynamic Asian exporters have met this challenge before in western markets, and the stakes are high enough in the present context to justify a second effort.

Trade Liberalization Scenarios

In addition to the baseline forecasts, we examined a variety of trade liberalization scenarios for East Asia with reference to PRC's WTO accession. In particular, we compared unilateral PRC liberalization with an example of East Asian regionalism (ASEAN Free Trade Area or AFTA plus PRC) and one Global Trade Liberalization scenario (GTL) that abolishes all tariffs. Our results are consistent with some conventional intuition and in other ways indicate the complexity of the regional negotiating environment.

As intuition would dictate, we find that GTL yields the greatest and most widespread benefits, both for the region and the rest of the world. The regional arrangement, AFTA plus PRC, is beneficial to all members and expands their trade within the region and with the rest of the world, but induces significant trade diversion away from nonmembers. Despite these problems, however, ASEAN's ability to leverage PRC growth would make this arrangement quite attractive to them.

PRC's role in all three scenarios is a unique one, however, and appears to be governed by complex incentives. First, it is apparent from the PRC WTO scenario that PRC is apparently in a position to "go it alone" with trade liberalization. In other words, the gains from unilateralism are for

PRC comparable to those of the AFTA or GTL, and no other economy in the region appears to have this characteristic. Moreover, PRC gains much less in relative terms than either ASEAN in the AFTA or the rest of East Asia under GTL. The reason for this is that PRC can get most of the export benefits by eliminating its own protection, while a large part of the benefit to East Asia comes from PRC market access.

PRC's Participation in Region

PRC may have other reservations about regionalism that limit its willingness to take detours from the path to globalization. In particular, our results indicate that PRC might experience adverse terms of trade effects by diverting its trade into smaller trade zones delineated by East Asian regional preferences. Beyond this, it appears that most regional arrangements would reinforce PRC's neo-mercantilist position vis-à-vis economies outside the region. In each scenario, PRC is estimated to increase ex-Asian exports more than it increases ex-Asian imports, while doing the opposite for East Asia.

These two issues could make it difficult to recruit PRC into East Asian regional agreements, yet our results indicate its membership would be essential to the gains realized by other members. Barring PRC's participation, most regional pacts would yield only small benefits and members would probably be better off going directly toward the goal of GTL. Thus PRC's current orientation, GTL as reflected in its assertive WTO commitments, is the primary goal for this country and, subject to that, may ultimately be the best route for other East Asian economies.

Role of Empirical Analysis

The most salient lesson drawn from this preliminary overview, however, may be the essential role that detailed empirical analysis can play in support of strategic trade policy. It is obvious from the complexity of influences giving rise to our results that policy makers relying on economic theory,

intuition, or rules of thumb alone are unlikely to adequately foresee the consequences of their actions.

Not only are the magnitudes of induced adjustments difficult to ascertain because of the scope of indirect effects, but qualitative outcomes often directly contradict intuition or the predictions of highly simplified models, leading to the opposite results from the intended ones. Fortunately, models and data of the kind used here are by now well established research tools. They can already be applied to a large universe of issues to better elucidate the economic consequences of policy before it is implemented.

Future Research

The present work will be extended in two important directions in the second and third stages of this study. Using the same global forecasting model, a second monograph will examine the complex regional negotiating environment, comparing a wider spectrum of alternative regional trade arrangements. With this work, we hope to better elucidate the bargaining positions of the regional economies and the potential gains they might realize from a variety of intermediate steps toward globalization. A third and final paper will undertake a much more detailed analysis of PRC's regional comparative advantage. Using multi-digit ISIC information on trade patterns and factor utilization, we will attempt to focus on the real trade-offs and structural adjustments that can be expected to ensue from more intense regional trade competition.

ASIAN POLICY FORUM RECOMMENDATIONS (continued from back cover)

same time, it is also very important to prevent private monopolies from emerging as a result of substantial ownership diversification of SOCBs. With these considerations in mind, **Proposal 5 an entry strategy should be structured to encourage reputable foreign participation**, as a means of introducing better risk management skills and a credit culture to the domestic financial sector.

Our risk-based approach flags the **need for caution in opening the capital account**. Given the current status of core institutions, further capital account opening, particularly for short-term, foreign currency denominated international capital movements, should *not* be on the short-run policy agenda for the PRC, and should be phased in according to progress made in institutional capacity building. **Proposal 6 Ill-prepared capital account opening can exacerbate both maturity and currency mismatches**, thereby increasing the possibility of twin financial crises (i.e., difficulty in simultaneously achieving international liquidity coupled with domestic banking crises). Such mismatches were the crux of the problem behind the Asian capital account crisis of 1997–1998.

However, policymakers must also be aware that domestic banking and financial services liberalization (particularly via accelerated foreign bank entry, within the context of increasingly globalized financial markets and rapid financial products innovation) will speed up de facto capital account opening. This phenomenon underscores the need to accelerate the establishment of **sound core institutions that would mitigate and better manage these “double mismatches and twin crises”**.

Finally, when freer international capital flows are allowed, a more flexible exchange rate regime should be introduced to cope with the so-called “trilemma problem” (i.e., free capital flows, independent monetary policy, and a fixed exchange rate), to keep counter-inflationary monetary policy independent of swings in the overall balance of payments strongly influenced by volatile capital flows. However, given the shallow and narrow nature of financial markets in the PRC, large capital flows could translate into excessive volatility of its exchange rate and domestic asset prices, thereby undermining the stable development of trade and foreign direct investment.

Hence, **Proposal 7 a midway exchange rate regime between a free float and hard peg is proposed**. Furthermore, because of the possibility of severe twin crises driven by currency depreciation and balance sheet deterioration over very short time spans, regional lender of last resort facilities should also be established with the help of the PRC’s active participation to prevent the collapse of exchange rates in the event of a capital account crisis.

Bottom Line These seven-point policy recommendations could contribute to establishing a **new coherent policy nexus for the PRC**, consisting of:

- a strong banking system,
- robust core institutions, together with
- a flexible midway exchange rate regime combined with regional lender of last resort facilities, as well as
- sustainable macroeconomic policies, in a **new era of domestic and external financial liberalization after the PRC’s accession to the World Trade Organization**.

**Synopsis of Asian Policy Forum Report on
“Seven-Point Policy Proposals for Sequencing PRC’s
Domestic and External Financial Liberalization” October 2002**
www.adbi.org/apf_main.html

Proposal 1 gives top priority to restoring banking sector solvency through **prompt resolution of large non-performing loans (NPLs)** in the state-owned commercial banks (SOCBs), which in turn requires substantial restructuring of large state-owned enterprises (SOEs).

In order to stop ever increasing NPLs under semi-autonomous management with state ownership and to promote market-based risk management, rational incentive structures must be established through substantial **ownership diversification** and, hence, **clearer property rights** **Proposal 2**.

Such fundamental changes in the ownership of SOCBs and SOEs could be effectively implemented **Proposal 3** owing to the very large accumulation of private savings and strong entrepreneurship, due to the PRC’s successful dual-track strategy for reform over the past quarter century. There would, nonetheless, still be serious implications for fiscal sustainability, because recapitalization of the banks and establishing a minimum social safety net (e.g., unemployment insurance and pensions) will require large fiscal commitments. To avoid monetization of the public debt, **central banks should be given independence from state interference**. Likewise, the **independence of financial supervisory agencies** should be guaranteed to enforce effective legal, judicial, and prudential regulations over financial institutions.

These first three points should enable the PRC authorities to effectively address the new risks entailed by domestic and external financial liberalization. Financial liberalization expands lenders’ and borrowers’ opportunities, as well as their resources, for taking excessive risks, particularly when coupled with an expansionary macroeconomic environment. **Proposal 4** **Managing excessive risk-taking behavior**, induced by such new incentives, necessitates new institution building, which generally tends to advance with a lag. **Domestic financial liberalization of interest rates** should, therefore, **be sequenced** from lending to deposit rates and from long-term to short-term maturities in order to avoid reducing franchise values of banks abruptly over a short period that might otherwise induce banks to take excessive risks. A carefully phased approach would thus provide banks with sufficient time to develop new profit-making opportunities compatible with their capabilities of managing such new risks.

Relaxing domestic entry requirements for banking and other financial service industries would create a large number of new banks and also non-bank financial institutions. This runs the risk of both excessive risk-taking activities among these new institutions and intensified competition, impairing banks’ franchise values, thereby inducing them to take excessive risks and raising systemic risk. At the

(cont. inside back cover)