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The Role of China in Regional South-South Trade in the Asia-Pacific: Prospects for Industrialization of the Low-Income Countries

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CONTENTS

NOTE

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1 Introduction

WE have shown elsewhere (Shafaeddin, 2010) that the theoretical literature on the rationale for South-South trade is not satisfactory. The neo-liberals argue against South-South trade, regarding it as inefficient. They argue that North-South trade according to the principle of static comparative cost advantage and free flow of international trade would involve higher gains. The opponents of the neo-liberals have not come up with a strong theoretical rationale in favour of South-South trade. Amid this backdrop, we have provided an alternative theoretical framework and the rationale for South-South trade as a vehicle for industrialization and development. Our argument is based on a combination of four building blocks: extension of the "vent for surplus" theory; dynamic comparative cost advantage; scarcity of resources needed for industrialization and development; and proactive industrial policy for collective division of labour and specialization through industrial collaboration (Shafaeddin, 2010).

In the light of the above-mentioned framework, in this study we analyze the merits and shortcomings of China's[1] regional trade with its partners in the East, South and South-East Asian (ESSEA) region, particularly low-income countries. Further, we suggest ways in which the role of China as a growth "pole" of industrialization and development can be enhanced through industrial collaboration among low-income countries – which currently benefit less than others from the dynamics of the Chinese economy as a "hub" – complemented by adjustment assistance by China and the newly industrializing economies (NIEs). In addition, refuting the "decoupling" thesis – that is, that East Asian countries are decoupled from the business

cycle in developed countries – we suggest the need for technological cooperation among countries which are involved in production sharing in order to upgrade their industrial structure and reduce their vulnerability to dependence on China as a "hub" and on third markets in developed countries.

In Chapter 2 we refer briefly to the dynamism of the Chinese economy as a market and source of supply for South-South trade in the ESSEA region, mainly through production sharing, and particularly in electrical and electronic products. We show, however, that China's trade relationship with the countries of the region reveals three main shortcomings as far as industrialization and development of these countries is concerned. First, China's trade in these products is concentrated in trade with the first-tier NIEs and, to some extent, with the second-tier NIEs. The low-income countries of the region have benefited little from the dynamism of the Chinese market. Second, China's main partner countries in the region have become vulnerable to the risks of dependence on the Chinese market as a hub, because of its exposure to external shocks and vulnerability to changes in the economic situation in developed countries. Third, there has not been sufficient technological development by the second-tier NIEs to prepare themselves for longer-term changes in the Chinese economy as their market for parts and components (P&C). To deepen their industrialization they need to upgrade their technological capabilities.

Chapter 3 is devoted to a discussion on decoupling and vulnerability of East Asian countries to global business cycles and other short- and long-run risks related to changes in China's development strategy. In Chapter 4, policies for integration of low-income countries and upgrading of other ESSEA countries through regional cooperation are discussed. The last chapter concludes the study.

2 China as a Regional Industrial "Pole"

China's economic dynamism and trade performance

SINCE the early 1980s China has been the fastest-growing economy in terms of GDP, manufacturing value added (MVA), fixed capital formation and international trade, particularly in manufactured goods (Table 1). As a result, it accounts for a significant share of global merchandise trade in various products (both exports and imports), except foods (Table 2). When Hong Kong is included, in 2008, China became the largest global exporter and the second largest importer, after the USA. It also accounts for nearly a quarter of exports and over one-fifth of imports of developing countries (Table 2).

Trade in manufactured goods has been the most dynamic element of China's trade with the ESSEA region (Table 3). Nevertheless, on the whole China has been more of a market for the exports of ESSEA than a source of supply for their imports (Table 4). Instead, the USA and Europe, in particular, have been the most dynamic markets for China's exports. Such a pattern of trade is influenced mainly by trade in information technology (IT) products and by the role of China as a "hub" in the international trade of the ESSEA region (see below).

Note that China's imports from members of various trade blocs in the ESSEA region have increased faster than their intra-bloc trade (Table 4). As a result, the importance of China not only as a source of supply of imports but also as a market for exports of various trade blocs has increased significantly

(Table 5). Such a development implies that factors other than preferential trade agreements must have been at work in the expansion of regional trade in general and the regional trade of China with the ESSEA countries in particular. Compare, for example, the data on China's trade with SAARC (South Asian Association for Regional Cooperation) and intra-trade within SAARC. China has had trade agreements with ASEAN (Association of South-East Asian Nations) and APTA (Asia-Pacific Trade Agreement) since 2002 and 2001, respectively, but not with SAARC. Yet, imports of China from SAARC have grown two times faster than the intra-bloc trade of SAARC (Table 4). Further, the exceptionally high rate of growth of the intra-bloc trade of APTA is due to the involvement of China in the grouping; China accounted for over half of the intra-bloc trade of members of APTA in 2008 (Table 5).

Structure of China's imports

Tables 6 and 7 provide a breakdown of China's imports from the main trade blocs in the ESSEA region (ASEAN and SAARC). Table 6 also shows the data for India (which is a SAARC member state) as a separate item because of its size. The tables indicate, first of all, that manufactured goods, particularly SITC 7 items (i.e., capital goods), and minerals and metals have been the most dynamic imports of China from ESSEA.

Secondly, when India is excluded from SAARC, other members of the regional group (all are low-income countries) benefit little from the dynamism of China's market. In fact, India alone accounts for about 76 per cent and 99 per cent of China's imports of manufactured goods and SITC 7 products from SAARC respectively. The remaining countries, excluding Pakistan, account for only over 2 per cent of Chinese imports of these products from SAARC (Table 7). Similar tendencies are observed in the case of low-income country members of ASEAN (Table 7). Therefore, it appears that the level of development and the degree of industrialization, and thus the supply capabilities, of the partner countries are important factors in the expansion of imports of China from countries of the region.

Table 1: **Annual average trade growth of China and developing countries, 1995-2008**

Region	Non-fuel				Non-fuel (SITC 0 to 8 less 3)	Fuel (SITC 3)	Total (SITC 0 to 9)
	Food (SITC 0 + 1 + 22 + 4)	Raw materials		Manufactures (SITC 5 to 8 less 68)			
		Agriculture (SITC 2 - 22 - 27 - 28)	Minerals (SITC 27 + 28 + 68)				
Exports							
1. China	9.3	7.1	19.4	21.5	20.7	14.2	20.5
2. Developing Asia including China	7.2	6.4	15.1	11.9	11.8	15.5	12.4
3. Developing countries excluding China	7.0	6.0	14.0	8.8	9.1	15.9	10.6
4. Developing countries including China	7.2	6.1	14.4	11.5	11.2	15.9	12.1
5. World	6.4	4.7	11.9	8.4	8.3	16.1	9.2
Imports							
1. China	14.8	16.0	29.3	18.9	19.3	30.2	20.2
2. Developing Asia including China	7.5	7.4	16.9	10.0	10.2	18.9	11.1
3. Developing countries excluding China	6.6	3.6	12.2	8.1	8.2	16.9	9.1
4. Developing countries including China	7.3	6.8	16.2	9.6	9.7	18.2	10.6
5. World	6.5	4.1	11.8	8.4	8.3	16.4	9.2

Note: "SITC" refers to the Standard International Trade Classification of goods.
Source: Calculated by the author based on UNCTAD (2009) and UNCTAD *Handbook of Statistics* database.

Table 2: **Percentage share of China in world trade, 2008**

Region	Non-fuel				Non-fuel (SITC 0 to 8 less 3)	Fuel (SITC 3)	Total (SITC 0 to 9)	Non-fuel (SITC 0 to 8 less 3)
	Food (SITC 0 + 1 + 22 + 4)	Raw materials		Manufactures (SITC 5 to 8 less 68)				
		Agriculture (SITC 2 - 22 - 27 - 28)	Minerals (SITC 27 + 28 + 68)					
	(% of world trade)							Value ($billion)
	Exports							
Share in world:								
1. China	3.3	28	3.6	12.7	10.6	1.2	9.0	1,399
2. Developing Asia including China	18.1	21.3	17.6	31.2	28.8	34.8	29.8	3,809
3. Developing countries excluding China	32.3	30.6	36.2	23.0	24.8	53.8	29.6	3,289
4. Developing countries including China	35.6	33.4	39.8	35.7	35.4	55.0	38.7	4,688
Share in developing countries:								
5. Share of China in developing Asia	18.0	13.3	20.3	40.7	36.7	3.5	30.3	
6. Share of China in developing countries	9.2	8.5	8.9	35.5	29.8	2.2	23.3	
World: values at end year ($billion)	1,101	225	660	10,467	13,243	2,636	15,879	
	Imports							
Share in world:								
1. China	4.3	15.9	18.8	7.0	7.2	6.0	7.0	963
2. Developing Asia including China	20.4	34.5	39.9	25.6	26.1	27.9	26.4	3,475
3. Developing countries excluding China	28.1	26.2	26.5	27.5	27.6	28.8	27.8	3,671
4. Developing countries including China	32.4	42.0	45.3	34.5	34.8	34.8	34.8	4,634
Share in developing countries:								
5. Share of China in developing Asia	21.2	46.0	47.2	27.2	27.7	21.5	26.6	
6. Share of China in developing countries	13.3	37.7	41.5	20.2	20.8	17.2	20.2	
World: values at end year ($billion)	1,147	235	737	10,487	13,323	2,822	16,145	

Source: Calculated by the author based on UNCTAD (2009) and UNCTAD *Handbook of Statistics* database.

Table 3: **Direction of trade of China, 1995-2008**

	Exports			Imports		
	Share (%)		Average annual growth in value (%)	Share (%)		Average annual growth in value (%)
	1995	2008	95-08	1995	2008	95-08
Developed countries:	52.3	51.8	19.1	54.9	35	14.2
Europe	14.2	21.4	23.1	16.5	10.9	14.7
USA	16.6	18.6	20.2	12.2	6.7	13.1
Japan	19.1	8.2	11.7	21.9	12.4	13.3
Others	2.4	3.7	23.2	4.3	5	19.8
Developing countries:	46.3	43.8	18.7	38.7	53.8	21.5
of which ESSEA	40.5	31.3	16.9	33.9	38	19.5
Others*	1.4	4.4	30.2	3.8	3.1	16.6
Statistical error, unspecified				2.6	8.1	
Total	100	100	—	100	100	—
Mimeo: Value ($billion)	149	1,469	19.3	132	1,197	18.4

Note: *Transitional economies and Oceania.
Source: Based on UNCTAD (2009), Table 2.1.

Table 4: **Annual average growth rate of exports of various Asian trade blocs, 1990-2008 (%)**

Exporter	Destination (importer)					
	ASEAN	SAARC	APTA	Total (ASEAN, SAARC, APTA)	China	Developing economies excl. China
China	21.08	22.48	17.95	16.8	-	16.46
ASEAN	12.2	14.2	18.3	13.5	24.1	12.3
SAARC	15.3	15.9	14.1	15.8	31.8	16.3
APTA	16.4	17.2	24.1	20.7	33.1	14.5
Total (ASEAN, SAARC, APTA)	13.46	15.84	20.71	14.47	21.92	11.93
Developing economies excluding China	11.3	11.9	15.6	13.7	17.5	10.8

Source: Calculated by the author based on UN COMTRADE database.

Table 5: **Matrix of trade of China with various economic groups in ESSEA, 1995-2008 (%)**

Exporter		Destination (importer)					
		ASEAN	**SAARC**	**APTA**	**Total (ASEAN, SAARC, APTA)**	**China**	**Developing economies excl. China**
China	1995	7.0	1.7	5.6	12.2		46.3
	2008	7.8	3.1	7.5	15.8		43.8
ASEAN	1995	24.4	2.2	7.6	28.2	2.7	43.8
	2008	25.4	4.1	17.4	43.1	9.6	50.0
SAARC	1995	6.4	4.7	6.4	12.2	1.0	32.6
	2008	7.5	6.3	15.9	25.8	9.2	45.9
APTA	1995	9.8	2.1	6.8	15.6	3.0	41.1
	2008	8.6	3.2	11.7	20.8	5.3	42.8
Total (ASEAN, SAARC, APTA)	1995	16.0	2.2	6.9	23.4	3.0	43.1
	2008	13.9	3.6	13.5	28.0	7.4	45.2
Developing economies excluding China	1995	11.2	1.9	10.4	21.1	6.5	33.6
	2008	10.3	2.8	19.5	30.4	13.8	36.2

Source: Based on UNCTAD (2009).

Finally, two main SITC items, mainly electrical and electronic products, account for the bulk of China's imports of manufactured goods from countries from which manufactured goods constitute the bulk of China's imports. Such trade patterns make these countries vulnerable to the business cycle in third markets, i.e., markets of developed countries, as will be explained shortly.

Nature of production sharing and its role in East Asian trade

Production sharing is a form of industrial collaboration and intra-industry trade whereby various parts and components (P&C) of a product are produced in different countries, crossing borders to another country for assembly. The intensity of such a vertical production chain depends on the nature of the product involved, which in turn depends positively on the following factors: technical divisibility of the product, factor intensity of its process of production, technical complexity of each process and the

Table 6: **Imports of China from ASEAN and SAARC, 1995-2009 ($million)**

	Total	Non-fuel	Manufactures			Ores and metals	Agricultural raw materials	Food	Two main SITC items*
			Total (SITC 5 to 8 less 68)	SITC 7	Others (light manufactures)				
ASEAN									
Total value (2009)	106,713.9	93,574.5	74,932.5	56,226.5	8,466.1	5,350.6	4,944.5	8,214	40,560 (SITC 776 and 752)
Share in non-fuel (2009) (%)	114	100	80.1	60.1	9	5.7	5.3	8.8	43.3 (54.1)
Growth rate (1995-2009) (%)	23	24	27	32	14	30	16	16	47.5
SAARC									
Total value (2009)	15,199	15,095.6	4,685.4	718.8	2,783.2	9,254.7	628.3	506.5	1,443.8 (SITC 651 and 667)
Share in non-fuel (2009) (%)	100.6	100	31	4.8	18.4	61.3	4.2	3.4	9.6 (30.8)
Growth rate (1995-2009) (%)	28.8	29	20.9	39.7	16.3	41.4	30.8	10	5.3
India									
Total value (2009)	13,714.3	13,619	3,551	709.8	1,716.5	9,106.7	508.9	431.8	284.5 (SITC 512 and 682)
Share in non-fuel (2009) (%)	100.6	100	26.1	5.2	12.6	66.8	3.7	3.2	2.1 (8)
Share of India in imports of China from SAARC	90.2	90.2	75.7	98.7	61.6	98.4	81	85.2	

Note: *Figures in brackets are shares of the items in China's imports of manufactured goods from the region/country.
Source: Calculated by the author based on UN COMTRADE database.

Table 7: **Imports of China from individual countries, 2009**

Country	Value ($million)		Shares of individual countries in China's imports of various product groups from the relevant regional trading group				% of two main products in China's imports of manufactured goods from the country	
	Total	Non-fuel	Non-fuel	Total manufactures	SITC 7	Others (light manufactures)	Share (%)	SITC
ASEAN:								
Malaysia	32,330.7	29,718	31.7	32.9	37.2	20.4	70.5	776, 752
Thailand	24,896.9	23,715.9	25.3	26.6	25.4	27.3	50.5	776, 752
Singapore	17,798.6	14,868	15.9	18.8	15.3	24.5	34.5	776, 752
Philippines	11,946.6	11,894.3	12.7	14.1	17.4	6	70.5	776, 752
Indonesia	13,663.8	9,395.8	10	4.8	3	11.1	17.2	776, 752
Vietnam	4,746.7	2,989.1	3.2	2.4	1.5	9.4	15.2	764, 776
Myanmar	646.1	588.6	0.6	0.13	0.01	1.1	0.8	764, 621
Laos	367.3	365.8	0.4	6.2	nil	0.02	nil	682
Cambodia	36.4	36.4	0.03	0.02	nil	0.4	nil	
Brunei	282	1.9	nil	nil	0	nil	nil	
Total			**100**	**100**	**100**	**100**		
SAARC:								
India	13,714.3	13,619	90.2	75.8	98.7	61.6	82	682, 512
Pakistan	1,260.2	1,260.2	8.3	21.9	0.07	35.2	14.7	583, 512
Bangladesh	140.7	140.7	0.9	1.6	0.12	2.24	16.1	512, 611
Sri Lanka	70.2	70.1	0.5	0.63	1.04	0.68	2.5	512, 611
Nepal	5.3	5.3	nil	0.1	nil	0.15	1.4	611, 741
Maldives	0.1	0.1	nil	0.003	nil	nil	nil	
Bhutan	0.05	0.05	nil	nil	nil	0	nil	
Total			**100**	**100**	**100**	**100**		

Source: Calculated by the author based on UN COMTRADE database.

Table 8: **Importance of trade in P&C in trade in manufactured goods**

	Exports		Imports	
	1992/93	**2005/06**	**1992/93**	**2005/06**
Share of P&C in global manufacture trade (%):				
Total	18.9	22.3	19	22.3
SITC 7	36.6	40.7	36.6	40.7
ICT products	50.5	55.5	51.2	55.5
Share of P&C in PRC's trade in ICT products (%)	26.2	38.3	62.7	81.3
Share of ICT products in global trade in P&C (%)			42.92	52.70
Share of various groups and PRC in global trade in P&C (%):				
Developing countries	23.8	46.1	30.3	48.4
East Asia	30.1	40.6	24.4	38.1
Developing East Asia	14.4	30.6	21.2	34.1
PRC	1.1	10.9	2.4	11.5
Share of P&C in PRC's trade with (%):				
World		17.5		39.3
Developing East Asia		30.6		44.7
ASEAN		35		47.1
ASEAN 3*		28.7		39.1

Note: * Malaysia, Singapore and Thailand
Source: Based on Athukorala and Menon (2010), Tables 1, 2, 3 and 4.

value-to-weight ratio of the product (Lall and Albaladejo, 2004). SITC 7 items, particularly information and communication technology (ICT) and automobile products, have many of these characteristics. For example, for three SITC 7 items, P&C accounted for 56.5 per cent of their world exports, 80.8 per cent of exports of East Asia and 82.5 per cent of exports of China. These items include: office machines and data processing products (SITC 75), telecommunications and sound recording equipment (SITC 76) and electrical machinery, etc. (SITC 77) (Athukorala and Menon, 2010: Table 5).

Production sharing is facilitated by the liberalization of trade and foreign direct investment (FDI), the reduction of transaction costs due to reduced costs of transportation and communication (Arndt, 2002), and the involvement of transnational corporations (TNCs) as a source of technology

and a marketing channel. Meanwhile, a country's capacity to get involved in production sharing also depends on the capabilities of its domestic firms and its availability of skills, transport and communication infrastructure, institutions, and the necessary back-up services (Lall and Albaladejo, 2004) – all of which are lacking in low-income countries – and political stability as well as capability in governance (Pitigala, 2009).

Trade in P&C has been a dynamic source of global trade in manufactured goods, particularly in ICT products (Table 8). Accordingly, from 1992 to 2006, over 57 per cent of global growth in ICT products originated from P&C as against about 24 per cent for manufactured goods as a whole, 43 per cent for SITC 7 products, 10.4 per cent for electrical machinery and 6.7 per cent for light manufactured goods (SITC 8) (Athukorala and Menon, 2010: Table 1). As a result, the share of ICT products in global trade in P&C has increased from nearly 43 per cent in 1992/93 to 52.7 per cent in 2005/06 (loc. cit.).

The sharp increase in intra-regional trade in the East Asian region has been also largely due to the expansion of intra-industry trade, particularly in skill-, capital- and/or technology-intensive goods such as electronic products and other machinery and transport equipment (SITC 7) (Ng and Yeats, 2003). As countries develop and industrialize, the prospects for regional trade increase. In particular, China has increasingly expanded its share of global and regional trade in P&C (Table 8).

The role of China in regional production sharing

China is regarded in the literature as the leading country in terms of deepening of vertical intra-industry trade specialization (i.e., production sharing), and as the engine of export growth of the East Asian region (e.g., Kiyota et al., 2006; Lall and Albaladejo, 2004; Haltmaier et al., 2007). Apart from Japan, China has been the biggest importer of P&C of SITC 7 products, particularly electrical and electronic products, in the region as well as the most important exporter of related finished goods. Trade in P&C, particularly

electrical and electronic P&C, has been one of the most dynamic elements of China's trade in manufactured goods in general, including its regional trade with ESSEA (Pizarro and Shafaeddin, 2010). China has also become a net exporter of P&C. For example, according to one estimate, in 2005, trade in P&C accounted for about 30 per cent of China's total exports and 41 per cent of its exports of machinery and equipment (Haltmaier et al., 2007: Table 2). Trade in the 10 main items of P&C (mostly electrical and electronic goods) expanded even faster than that in total P&C (Pizarro and Shafaeddin, 2010).

Data on the regional trade of China in P&C and their corresponding finished products for SITC 7 items are exhibited in Table 9, in which the countries/regions are ranked according to the value of imports of P&C in 2009. The data also include total trade of China with ESSEA. There is a separate item on total trade with ESSEA excluding Hong Kong (Special Administrative Region (SAR), China) because of Hong Kong's special position as a major re-exporter of the related products imported from China and the discrepancies between the data reported by China and Hong Kong as exporter and importer, respectively. Such discrepancies cannot be explained by transport costs alone.

According to the table, China is not only a large market but also a net importer of P&C and finished products from ESSEA when Hong Kong is excluded. Yet it is a net exporter to the rest of the world, particularly for finished products. Therefore, it acts as an export hub (bridge) for the ESSEA region; in 2009, some 43 per cent of its imports of P&C originated from ESSEA while over 64 per cent of its finished products were exported to other countries (5.5 per cent to Japan and 58.8 per cent mainly to the USA and Europe) (Table 9). When Hong Kong is excluded the latter figure increases to 72.7 per cent.

Table 9: **China's trade in main parts and components and their corresponding finished products for main SITC 7 items, 2009 (value: $million)**

Country	Parts and components					Corresponding finished products				
	Imports		Exports		Balance	Imports		Exports		Balance
	Value	Share	Value	Share	Value	Value	Share	Value	Share	Value
Rep. of Korea	11,908.0	16.80	7,610	5.9	-4,298	27,658	15.3	13,462	4.7	-14,196
Taiwan Province	8,259.7	11.65	3,600.0	2.79	-4,659.7	32,782	18.1	5,256	1.8	-27,526
ASEAN 4	7,623	10.75	6,607	5.12	-1,016	43,607	24.1	10,612	3.7	-32,992
Rest of ASEAN	1,851.4	2.61	4,093.5	3.17	2,242.1	5,710	3.2	10,955	3.9	5,245
Hong Kong (SAR)	1,347.3	1.90	40,240.5	31.21	38,893.2	2,446	1.4	54,151	19	51,705
India	125.3	0.18	2,588.1	2.01	2,462.8	99	0.1	5,737	2	5,638
SAARC excl. India	0.9	0.00	477.2	0.37	476.3	7	0	1,515	0.5	1,508
Total above	31,115.7	43.90	65,217.4	50.58	34,101.7	112,310	62	101,527	35.7	-10,783
Total excl. Hong Kong	29,768.4	42	24,976.4	19.37	-4,792	109,864	60.6	47,376	16.7	-62,488
Japan	20,688.6	29.19	10,747.9	8.34	-9,940.7	24,586	13.6	15,574	5.5	-9,012
Others	19,079.5	26.92	52,981.5	41.09	33,902	44,238	24.4	167,249	58.8	122,957
Total world	70,883	100	128,949	100	58,066	181,134	100	284,249	100	103,115
Total world excl. HK	69,537.3	98.1	88,708.5	68.7	19,172.8	178,688	98.6	230,146	81	51,458

List of parts and components: SITC 7169, 759, 7649, 77129, 772, 77689, 784, 7929, 7139, 78539.
List of corresponding finished products: SITC 7169, 751&752, 764-7649, 771-77129, 776-77689, 722&781, 785-78539, 792-7929.
Source: Calculated by the author based on UN COMTRADE database.

Lack of integration of low-income countries

Not all developing countries of the region have benefited from the dynamism of the Chinese market to the same extent. Three groups can be distinguished in order of their importance as providers and markets for the selected products. The first group includes the Republic of Korea and Taiwan (Province of China). China's trade balance with these economies is significantly negative for both P&C as well as finished products. They are major regional suppliers to China of sophisticated P&C and finished consumer goods and capital equipment.

The second group consists of four ASEAN members: Indonesia, Malaysia, Singapore and Thailand (ASEAN 4). China is also a net importer of both P&C and finished products from these countries. Nevertheless, as far as finished products are concerned, the figure is heavily influenced by imports from Singapore. Otherwise, China is a net exporter of finished goods to the other countries.

The third group consists mostly of other ASEAN countries and members of SAARC. China's imports from the rest of ASEAN and members of SAARC are insignificant except for the Philippines and, to some extent, Vietnam. The Philippines has become an increasingly important exporter of electronic products since the late 1980s because of the involvement of Japanese and United States TNCs. Three characteristics of the country have attracted FDI: its proximity to other East Asian countries involved in the production network; ease of regional transport due to its vast coastal areas; and its low-wage and skilled manpower. Japan and the United States have been its main markets, but its exports of high-tech products to China have also increased significantly, from 1.3 per cent of its total exports in 2000 to 13 per cent in 2005 (Haltmaier et al., 2007: 32-36). In 2009, imports of seven main electrical and electronic products accounted for over 79 per cent of China's imports from the Philippines, out of which two products (SITC 776 and 752) accounted for 63 per cent.

3 Vulnerability of ESSEA Countries, or Decoupling?

THE ESSEA countries which depend on the production sharing system dominated by China face a couple of short/medium- and long-run risks.

Short/medium-run risks

One short/medium-term risk facing them is related to their exposure to the global business cycle, directly and through the "hub", by means of a fall in demand for finished ICT products of China in developed-country markets. It is a myth to believe that China (and East Asia) is decoupling from the developed countries as argued by some (Anderson, 2007; *The Economist*, 2007; Bergsten, 2008). In fact, the linkages have intensified. Generally speaking, in 2005 over 61 per cent of China's processing exports were destined for member states of the developed-country Organization for Economic Cooperation and Development (OECD), out of which the USA and the EU-19 accounted for 31.1 per cent and 25 per cent, respectively (Ma et al., 2009: Table 2). The business cycle correlations of East Asian countries with China as well as developed countries have increased considerably, as shown in Table 10. The only exception is the correlation of East Asia's direct trade (excluding China) with the G7 leading developed countries. The correlation between growth in East Asia's inter-regional exports and the USA's non-oil imports increased from -0.01 during the 1990s to 0.83 during 2000-August 2009 (Kim et al., 2010: 8).

Similarly, growth rates of China's exports to the G3 (USA, EU and Japan) are "highly correlated with those of the PRC [People's Republic of

Table 10: **Business cycle correlation of East Asian[a] countries**

	Pre-(1997/98) crisis[b]	**Post-crisis[c]**
Business cycle correlation with PRC:		
East Asia excluding PRC	-0.379	0.549
G7	-0.304	0.580
USA	0.490	0.517
Japan	-0.633	0.477
Inter-regional business cycle correlation:		
East Asia-G7	0.084	0.611
East Asia-USA	0.233	0.715
East Asia excluding PRC-G7	0.619	0.537
East Asia excluding PRC-USA	-0.345	0.724

Notes:
a: PRC, Hong Kong (SAR), Taiwan (Province of China), Indonesia, Rep. of Korea, Malaysia, the Philippines, Singapore and Thailand.
b: 1990Q1-1996Q4.
c: 2000Q1-2007Q2.
Source: Kim et al. (2009: 37).

China] imports from the rest of East Asia" (Kim et al., 2010: 10). In other words, not only is China itself exposed to the business cycle in developed countries, but Asian exporters of P&C are as well, via their exposure through China. Hence, East Asian countries and the US/European economies are "recoupling" rather than decoupling (Kim et al., 2009). The argument that the economies are decoupling from developed countries is based on an erroneous methodology of analysis in which the GDP growth rates of China and developed countries, rather than their deviation from the trend growth rates, are compared (Wälti, 2009).

Another source of short-term risk is related to the interdependence of these countries as the correlation of business cycles between economies across the East Asian region has also increased considerably since the mid-1980s (Zebregs, 2004: 14; Kim et al., 2009).[2] Bottlenecks in the production of an item of P&C in one country or an economic shock in one country may be transmitted to another country through the production sharing network, leading to a slowdown in growth of other exporting countries.

Yet a further source of risk arises from the exchange rate system in China. The Chinese currency is fixed and pegged to the US dollar within a band. A switch to a floating exchange rate would create instability in exports of P&C to China (Thorbecke, 2008). Recently, the band has been widened and pressure has been exerted on China to revalue its currency or to switch from a fixed exchange rate system to a floating one. In the former case, the appreciation of the currency would make Chinese exports more expensive, reducing its demand for imports of P&C. At the same time, however, P&C imports would become cheaper. The net effect on China's exports, and thus its demand for P&C, which is a derived demand, is not clear and will depend on the import intensity of exports and the pass-through of the import price of P&C (Athukorala and Menon, 2010 and Jongwanich, 2010). In East Asia, where the importance of P&C in international trade has increased from 20 per cent in 1992 to about 41 per cent in 2008 (Kim et al., 2010: 9), the link between exports and exchange rates has weakened. P&C are less sensitive to changes in exchange rates. Meanwhile, it is also argued that devaluation by other East Asian countries does not necessarily affect China's exports (Liao et al., 2010). This is because the complementarity effects of China's exports (through imports of P&C) with most exporters of P&C are greater than their competitive effects with their exports of final products. Thus, China would benefit from cheaper imports of P&C, which accounted for nearly 29 per cent of its total imports from developing East Asian countries in 2005/06 (Athukorala and Menon, 2010). In East Asia, "world demand, FDI and production capacity have increased in importance in determining exports" (Jongwanich, 2010).

Long-run risks

The long-run risks facing China's regional trading partners are related to a slowdown in China's imports of P&C from ESSEA due to two different reasons: the substitution of domestically produced P&C for imports, and a shift from export-led growth to consumption-led growth, or a combination of both.

China has been increasing its capabilities in production of P&C and expanding domestic value added in assembly operations, particularly in ICT products (electrical and electronic items) and other items under the SITC 7 group which are the main source of production sharing (Pizarro and Shafaeddin, 2010). As a result, its imports of P&C decelerated from an annual average growth rate of about 44 per cent during 1992/93-2001/02 to 35.3 per cent during the 2001/02-2004/05 period despite acceleration of its exports of manufactured goods (Pizarro and Shafaeddin, 2010: Table 4). It has been improving its revealed comparative advantage in production and export of P&C (ibid.: Table 4 and Gallagher and Shafaeddin, 2010). In 2005-09, China's imports of P&C for production of SITC 7 items declined in absolute terms, while their exports expanded rapidly; thus the balance of total trade in these products has improved by over five times (Table 11).

So far, China's imports of P&C from the ESSEA region have been increasing both as a share of its total imports of P&C and in absolute terms – although the pace of the latter has been slow.[3] Furthermore, the country's exports of finished products to the world as a whole expanded faster than its exports to the ESSEA region. Hence, the role of China as a "hub" in the region has been increasing. Nevertheless, as China's exports of P&C to ESSEA are increasing faster than its imports from the region, whether Hong Kong is included or not (Table 11), it is very likely that its role as a "hub" may become gradually less important in the future (Gallagher and Shafaeddin, 2010).

Shift to consumption-led growth

Another reason China's imports of P&C from ESSEA may slow down is due to a shift in the Chinese economy to consumption-led growth. One reason for the possible shift is the development of protectionism in the importing developed countries, particularly the USA with its growing trade imbalance with China (Akyüz, 2010; Kiyota et al., 2006). If China wishes its export growth to continue at the rate of 20 to 30 per cent a year, one has to take

Table 11: **China's trade in P&C and their corresponding finished products for SITC 7, 2005-09 ($million)**

	P&C			Finished products		
	2005 (1)	2009 (2)	Ratio (3)=(2)/(1)	2005 (4)	2009 (5)	Ratio (6)=(5)/(4)
Total world						
Exports	97,502	128,949	1.32	199,486	284,249	1.42
Imports	86,185	70,883	0.82	172,618	181,134	1.05
Exports (X)-Imports (M)	11,317	58,066	5.1	26,868	103,115	3.84
(X-M)/M (%)	13.1	81.9	6.25	15.3	56.9	3.7
Total world excluding Hong Kong						
Exports	67,611	88,708.5	1.31	156,375	230,146	1.47
Imports	84,459	69,537.3	0.82	170,770	178,688	1.05
X-M	-16,848	19,172.8	na	-14,395	51,458	na
(X-M)/M (%)	-19.9	27.6	na	-8.4	28.8	na
ESSEA						
Exports	49,327	65,217.4	1.32	72,592	101,527	1.40
Imports	29,535	31,115.7	1.05	94,343	112,310	1.19
X-M	19,792	34,101.7	1.72	-21,751	-10,783	0.49
(X-M)/M(%)	67	109.5	1.63	-23.1	-9.6	0.42
ESSEA excluding Hong Kong						
Exports	19,436	24,976.4	1.28	29,481	47,376	1.6
Imports	27,809	29,768	1.07	92,495	109,864	1.18
X-M	-8,368	-4,791.6	0.57	-63,014	-62,488	0.99
(X-M)/M (%)	-30	-16	0.53	-68.1	-56.8	0.83
Source: Calculated by the author based on UN COMTRADE database.						

this risk seriously. Such rates of export growth at a low base are not a cause for concern for the developed countries, but at a high base it is a different matter. Currently China's exports exceed $1.4 trillion. Hence, the risk of protectionism should not be underestimated.

An optimistic appraisal of China's strength reflected in its massive trade surplus underestimates its structural vulnerabilities (Fischer, 2010). China's "massive rerouting of East Asian centred international production networks" entailed development of trade deficits with East Asian countries and trade surpluses with the USA and EU (ibid.). The large volume of imports of

developed countries from China makes China vulnerable to the risk of a tendency towards protectionism in the importing countries. If so, Chinese imports of P&C from the ESSEA region will be adversely affected.

A shift from export-led to consumption-led growth may entail less import intensity as production of consumer goods for the domestic market is less import-intensive than production of ICT products for the export market (Akyüz, 2010; Lall, 2004; Humphrey and Schmitz, 2006).

Currently, the export/GDP, savings/GDP and investment/GDP ratios of China are relatively high in comparison with those of the other ESSEA countries and they have been rising in recent years (Prasad, 2009). By contrast, its consumption/GDP ratio is lower, its wage/GDP ratio has not been keeping pace with labour productivity, and there is inequality in income and consumption between its rural population and city dwellers. In fact, there are indications that a shift from export-led growth to consumption-led growth will also improve the distribution of income in favour of the lower-income strata through wages. According to an empirical study by Xing (2010: 1), "China's export share of GDP has a positive effect on the enlargement of the upper half distribution." Thus there is some scope for a structural shift towards consumption-led growth. The related risk is, however, somewhat overstated. The experience of industrialized countries demonstrates that as countries industrialize, intra-industry trade in differentiated consumer goods as well as investment products also increases. During 1996-2008, the share of P&C imports in total imports of China declined (from about 35 per cent to 25 per cent), but the share of final products in its imports changed little. More importantly, during the same period, the share of final goods in imports from East and South-East Asia increased considerably – from about 35 per cent to 55 per cent (Kim et al., 2010: 14-15). Therefore any shift to consumption-led growth would also lead to further increases in China's imports of these goods from the ESSEA region. It is also very likely that for a given growth rate of GDP, imports of raw materials and foods will also be accelerated.

4 The Future of Regional Trade: The Questionable Role of the Market

NEITHER the integration of lower-income countries nor the technological upgrading of the second-tier NIEs is feasible through the operation of market forces alone. There is a need for policy initiatives by the governments of the region, particularly in the case of the low-income countries.

There is a misconception about the role of the market in the expansion of regional trade in East Asia as it is believed that such an expansion has been market-driven (Kawai and Wignaraja, 2007). We have shown elsewhere that the bulk of intra-regional trade in East Asia takes place through intra-firm trade, and that such trade was mostly policy-driven, resulting from changes in the FDI policies of the governments of Japan and the East Asian countries, particularly after the Plaza Accord of 1985 and active participation of Japanese firms. Japanese firms purchased the bulk of their inputs of goods and services from the local markets and local firms. By contrast, the US firms involved produced mostly for export to the United States. At the same time, the governments concerned built up the production capabilities of their local firms, developed their infrastructure and utilities, and provided the facilities for necessary back-up services. China also adopted similar policies, with the difference being that initially, inward FDI originated largely from ethnic Chinese investors – mainly Hong Kong, Taiwan and Singapore (Shafaeddin, 2008: 36-37 and the sources reported therein). Between 70 and 80 per cent of China's cumulative inward FDI during 1990-2002 originated from Hong Kong and Taiwan, depending on whether one uses China or these two territories as reporting trade partner (ibid.: 37).

Although the pattern of expansion of regional trade and industrialization in East Asia resembles the "flying geese" model (Akamatsu, 1961; Kasahara, 2004), the geese did not fly automatically, either in Japan or at the regional level in East Asia. Various government policies played an important role in the development of domestic capabilities in Japan and East Asian NIEs (Fan and Watanabe, 2006; Lall, 2004; Gallagher and Shafaeddin, 2010). The trickle-down effects of the process have also reached the second-tier NIEs, although it has not had sufficient impact on their technological development. Moreover, the low-income countries of the region were not a part of the "flying geese" process.

As China upgrades its industrial structure, will it exit some low-technology-intensive industries to create opportunities for low-income countries of the region? Although China has been improving its revealed comparative advantage in production and export of technology-intensive products, it still remains, and will remain for the foreseeable future, a massive exporter of labour-intensive products.

Moreover, currently, under new global economic conditions governed by market forces and liberalization, the space available to the low-income countries to follow similar policies adopted by the NIEs to enhance the capabilities of their local firms is limited. Hence, it is not clear whether the geese could easily fly over these economies to facilitate their industrialization through trickle-down effects of the dynamism of the Chinese economy. Neither is it clear whether market forces alone could induce technological upgrading of the second-tier NIEs.

Policy implications for the future of industrialization in the ESSEA region

What sort of policy measures are required to enhance the positive impact of China's South-South regional trade on the industrialization and development of the low-income countries and the exporters of P&C? In both cases, there is a need for some adjustment in the production and export structure of

the countries concerned. Such adjustment requires proactive policies by the governments.

Industrial collaboration among low-income countries

In order to benefit from the dynamism of the Chinese economy as well as the ESSEA region as a whole, the low-income countries need to expand their industrial supply capabilities. But, such expansion is faced with scarcity problems, including the scarcity of finance, skills, infrastructure, organization and entrepreneurship. Further, regional investors do not favour low-income countries, as outward FDI by the NIEs flows mainly to China and the ASEAN 4 (Isoga and Shibanuma, 2000). The low-income countries need to mitigate their scarcity problem through industrial collaboration among themselves, with some adjustment assistance by China and, possibly, the NIEs (see Shafaeddin, 2010).

Industrial collaboration can be facilitated by regional FDI from countries like China and the NIEs as it will be beneficial to the host country as well as to the investing countries since they are market seekers. The processing of raw materials before exporting to China is one possibility, but it is not the only one. India's investment cooperation with Nepal and Sri Lanka for production of manufactured goods is an example (Wishwanath, 2007: 2).

Industrial collaboration is necessary but not sufficient. In addition to the need for industrial policy at the country level (Shafaeddin, 2005), arrangements have to be made for the division of labour in required back-up services, export credit, information and the development of the necessary infrastructure, training and skills development, and business cooperation through chambers of commerce.

Cooperation among the countries concerned necessitates political will, harmonization of rules of origin as well as external assistance. Often, there are political problems in securing agreements among the countries for industrial collaboration. Each country may have its own individual interest

as against the common interest of the group. Fostering appreciation by the partners of the ultimate benefits of such arrangements for individual countries requires dialogue and the dissemination of information and knowledge. External financial and technical assistance is also needed to overcome the scarcity of financial and other resources: it is in the interest of China itself to provide such assistance. If China is faced with obstacles in expanding its markets in developed countries, it may be interested in expanding its regional market in ESSEA. Such expansion in low-income countries requires expansion of their effective demand, which is, in turn, a function of their level of development and industrialization.

Technological collaboration

The countries which rely on exports of P&C to China need, *inter alia*, to adjust their production/export structure by upgrading their technological and skill capabilities in order to reduce their vulnerabilities. One option is to emphasize production for the domestic market rather than for export. Recently, in a shift from the International Monetary Fund (IMF)'s traditional stance of propagating export-led growth, the IMF Managing Director recommended that "Asia, which has until now relied heavily on exports for economic growth, needed to boost domestic investment and consumption" (Yoo and Cheon, 2010). Such adjustment will also help the expansion of exports of differentiated products to China even if this country shifts to consumption-led growth.

Technological development requires, *inter alia*, research and development (R&D), skill development, etc. Regional cooperation can help the countries concerned to attain their growth objective through division of labour and specialization in R&D and development of skills. The lack of skills and financial and technical resources prevents countries in the group from undertaking research in a large number of areas individually. Large countries, such as China and India, are in a better position to do so. For example, India has succeeded to some extent in the particular case of pharmaceutical and software industries; so has China in ICT. Nevertheless, even for these

countries their R&D/GDP ratios are far below those of developed countries (Gallagher and Shafaeddin, 2010). Therefore, the division of labour and specialization in technology development could help all countries of the group in advancing their technological capabilities. Attempts have been made by ASEAN and China to cooperate in research on ICT activities, for which they have envisaged the establishment of an R&D centre for telecommunications equipment. Such initiatives need further extension.

There are a number of other areas in which China and other countries of the ESSEA region can cooperate. One is coordination of their policies for intensifying the technological spillover of FDI. Another is cooperation on financial issues to reduce the risks of financial crisis. Having experienced the financial crisis of 1997/98, the East Asian countries have increased their currency reserves and developed the Chiang Mai Initiative, a network of bilateral financial swap arrangements among ASEAN+3 countries (ASEAN, China, Japan and South Korea) (for details, see Shafaeddin, 2008). Nevertheless, there are areas in which they can further expand their cooperation. One can mention a few: "stronger regional cooperation in monitoring and regulating financial markets";[4] formulation of modalities of capital controls in the region; establishment of a regional South Bank; and development of strategic energy reserves (Shafaeddin, 2008).

5 Concluding Remarks

BASED on our proposed framework for South-South cooperation (Shafaeddin, 2010), in this paper we have looked into the implications of the dynamics of the Chinese economy for the expansion of South-South trade within the ESSEA region, shed some light on the merits and risks of such trade, and proposed some changes in the strategies of the ESSEA countries in the future.

More specifically, it was shown that China has been a dynamic market and source of supply for South-South regional trade in ESSEA, mainly through production sharing and particularly in electrical and electronic products. Nevertheless, the trade relations of China with the countries of the ESSEA region reveal three main shortcomings as far as the impact on the industrialization and development of these countries is concerned. Firstly, China's trade in these products has been concentrated on trade with the first-tier NIEs and, to some extent, the second-tier NIEs. While low-income countries of the region have acted as a market for China's exports, they have benefited little from the dynamism of the Chinese market.

Secondly, through production sharing, China's regional partners have become vulnerable to the risks of dependence on the Chinese market as a hub, because of the latter's exposure to external shocks and vulnerability to the business cycle in the developed-country markets for its exports of the related finished products. For example, in 2009, China's imports of two items of P&C (SITC 776 and 752) from Malaysia amounted to over $17

billion (70.5 per cent of imports of manufactured goods from this country), accounting for about 17 per cent of its total imports.

Thirdly, there has not been sufficient technological development by China's trade partners which are involved in regional production sharing. They are also vulnerable to longer-run changes in Chinese trade and development strategies. To deepen their industrialization they need to upgrade their technological capabilities.

Regional trade agreements and market forces have not alone been responsible for the expansion of South-South trade in the region; trade agreements are necessary, but they are not sufficient. Demand and supply dynamism as well as policies of governments and transnational corporations have been among the important contributory factors. In particular, low industrial and skills capabilities have prevented lower-income countries from getting involved in the rapid expansion of production sharing. Similarly, in the future, neither the integration of lower-income countries nor the technological upgrading of the second-tier NIEs is feasible through the operation of market forces alone. There is a need for proactive policy initiatives by the governments for regional cooperation.

As the low-income countries have a similar production and export structure, they have little prospects for expanding intra-regional trade. Such an expansion is to be policy-driven. It can be achieved through industrial collaboration among themselves for building up their supply capacity. There is also a need for cooperation, coordination and harmonization of their development and industrial policies with a view to achieving dynamic comparative advantage. Further, it is also in the interests of China, and other "market seekers" (NIEs), to provide them with adjustment assistance in building up their supply capacity, skills, training facilities, back-up services, etc.

Another area for enhanced cooperation is R&D and technological capacity building by China and the second-tier NIEs for upgrading their industrial structure. The idea is to develop complementarity through the division of labour and specialization in different products and industries. Through specialization and division of labour by means of industrial collaboration and/or cooperation in R&D, developing countries can overcome scarcity in complementary factors of production, and benefit from larger markets and scale economies. Instead of trade leading to division of labour and specialization, division of labour and specialization, in accordance with the principle of dynamic comparative advantage, is to lead to trade. The expansion of supply capabilities and South-South trade could, in turn, reduce the risk of dependence on markets of developed countries and improve the ESSEA economies' bargaining position in multilateral forums as well as in their bilateral trade relations with the developed countries.

Endnotes

1. "China" and "People's Republic of China" (PRC) are used interchangeably in this paper.

2. According to Kim et al. (2009), intra-regional correlation of East Asian countries increased from zero during the 1990s to 0.448 during 2000-August 2009. When China is excluded, the respective figures are 0.007 and 0.446.

3. This is despite the fact that its share in total imports from ESSEA has declined as mentioned before.

4. "Emerging East Asian bond markets resilient, but risks loom, says ADB report", Asian Development Bank press release, 22 November 2007, available at http://www.adb.org/media.

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