China's Growing Economic Influence in East Asia after WTO

China's accession to the World Trade Organization on Dec. 11, 2001, together with the 1997 Asian financial crisis and Japan's decade-long economic slump, have begun to change East Asia's economic landscape. China will play a key role in determining the outcome of those changes if for no other reasons than its sheer size and speed of economic expansion.

In dollar terms, China's economy is about 10 percent of the United States' economy, 20 percent of Japan's. However, after adjusting for differences in cost of living (purchasing power parity adjustments), China's economy is more than half as large as the United States', surpassing Japan to become the world's second largest economy. It grew 7.3 percent in 2001 and an average 9.1 percent annually between 1980 and 2000. China expects its economy to grow at an annual rate of 6 to 7 percent over the next 10 years.

This projected growth will require further openness of trade and investment as well as continuing economic reforms. In joining the WTO, China agreed to lower its average tariff from 16.7 percent in 2000 to 10 percent in 2005 and reduce the number of items under import license and quota from approximately 300 to zero in the next five years. China is also liberalizing foreign investment in banking, insurance, financial services, wholesale/retail trade and telecommunications. All these industries have been under tight governmental control until recently.

Southeast Asia

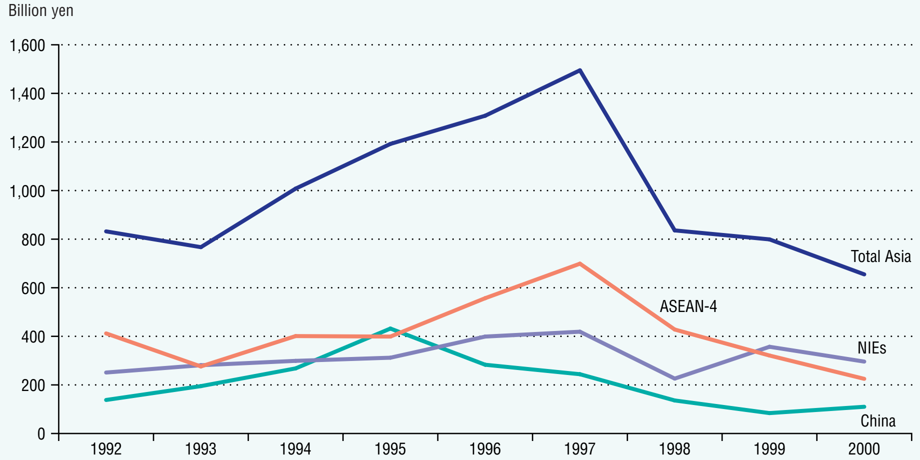
These initiatives have altered regional investment patterns, particularly those of the Association of Southeastern Asian Nations (ASEAN).[1] In 2000, China (including Hong Kong) received 80 percent of total foreign direct investment into the major East Asian countries (excluding Japan), up from 62 percent in 1995. In contrast, major ASEAN countries received only 9 percent of the total in 2000, down from 33 percent in 1995.

Three factors can explain this turn of events. First, the 1997 Asian crisis negatively impacted local business environments in ASEAN economies. Second, Japan failed to continue investing in the region due to its own financial problems (*Chart 1*). Third, improved business opportunities in China during the past two decades, consummated by the WTO accession, are attracting foreign investment away from ASEAN.

Meanwhile, China's trade with ASEAN has increased rapidly, and most ASEAN countries now have a trade surplus with China (*Table 1*). This trade is generally intra-industry. The devaluation of some

Chart 1

Japanese Direct Investment in Asia



NOTES: ASEAN-4 includes Indonesia, Malaysia, Philippines and Thailand. NIEs (newly industrialized economies) include Hong Kong, Korea, Singapore and Taiwan.

SOURCE: Ministry of Finance, Japan.

Table 1

Japan and China's Share in East Asian Countries' Exports

	Exports to Japan (percent)			Exports to China (percent)		
	1990	1995	2000	1990	1995	2000
Korea	18.6	13.6	11.1	5.6	15.3	17.8
Singapore	8.7	7.8	7.5	8.0	10.7	11.8
Indonesia	42.5	27.0	23.2	5.7	7.5	7.0
Malaysia	15.3	12.5	13.0	5.3	7.9	7.6
Philippines	19.8	15.8	14.6	4.8	5.9	6.7
Thailand	17.2	16.6	15.7	5.7	8.0	9.6

NOTE: Exports to China includes Hong Kong.

SOURCE: "Directions of Trade," International Monetary Fund.

ASEAN currencies in conjunction with China's fixed exchange rate helped expand ASEAN exports. As China becomes more willing to open its agricultural market, closer trade relations are more likely. Last November, ASEAN and China called for developing a free trade area over the next 10 years. The enhancement of the ASEAN–China trade relationship contrasts sharply to the weakening trade ties between ASEAN and Japan (*Table 1*).

Taiwan

Another change in the economic landscape, gradual but assured, is taking place between Taiwan and mainland China. Despite Taiwan's internal political turmoil and the cross-strait tension, Taiwan and mainland China are beginning to integrate economically. Taiwan's export dependence on mainland China reached 17 percent in 2000 (24 percent if counting Hong Kong). The trade is highly unbalanced, as Taiwan accumulated a $172 billion surplus between 1987 and 2001. Between 1991 and 2000, 39 percent of Taiwan's overseas investment went to mainland China. On the other hand, 7 percent of mainland China's contracted foreign direct investment came from Taiwan.

Cross-strait trade and investment have been hampered by the Taiwanese government's "patience over haste" policy toward mainland China. However, the two sides' consecutive WTO accessions and Taiwan's recent lift of a ban on direct trade and investment will eventually enhance these ties. As Taiwan's export-oriented economy now suffers from the global high-tech slowdown and Japan's stagnation, Taiwanese entrepreneurs are increasingly looking for capital outlets, production bases and export markets in mainland China.

South Korea

As one of the more technically advanced economies in East Asia, South Korea's response to China's accession to the WTO has been mixed, especially among government and business leaders. Korea established formal trade relations with China only 10 years ago. Now China (including Hong Kong) is already Korea's second largest export market following the United States (*Table 1*). Major Korean chaebols, or conglomerates, such as Samsung and SK have aggressive plans to increase their investment in China. However, many Koreans fear that, in the near future, China will catch up to Korea's technology in semiconductors, shipbuilding, steel and electronics, thus encroaching on Korea's world market shares.

Given this concern, a free trade agreement between Korea and Japan—not China—may be more likely as a way to keep Korea's export-oriented economy afloat. The industrial structures of Korea and Japan are complementary. Both countries have such heavily protected agricultural sectors that the agricultural price differences between them are much smaller than the price differences would be compared with China or the major ASEAN producers.

Regardless of what may transpire, China's influence on Korea's economy will more than likely increase, considering the speed at which the two economies have integrated over the past 10 years.

Japan

Although China's economic integration with its neighbors has grown substantially, Japan, possessing the largest economy in the region, has yet to invest aggressively in China. Japan's direct investment in China has lagged behind its investment in other parts of Asia (*Chart 1*). Japanese companies have been very cautious about transferring technology to China. Meanwhile, Japan has a significant trade deficit with China.

The trade relationship has experienced conflict. Last year Japan threatened to use antidumping measures against Chinese agricultural products. China retaliated with a temporary 100 percent tariff increase on some Japanese products, including automobiles. The two sides finally compromised to avoid a trade war.

The recent depreciation of the Japanese yen has inflamed the debate as each country complains that the other is deliberately undervaluing its currency.

Despite its problems, Japan seems to be persisting in its efforts to maintain regional economic dominance. Nevertheless, ASEAN's trade and investment ties with Japan are loosening (*Chart 1, Table 1*). Japan's trade with ASEAN has traditionally been tied closely to investments. ASEAN countries in practice have served as low-tech manufacturing units for Japan. Importing Japanese capital and intermediate goods and exporting final goods primarily to the United States and Europe have resulted routinely in trade deficits with Japan. Recently this imbalance has eased because Japan's domestic financial difficulties have caused it to invest less in the region and because the ASEAN currencies have been devalued, discouraging imports and encouraging exports.

To reinforce its ties with the region, Japan signed a free trade agreement with Singapore in January 2002. However, it seems unlikely that Japan's relationship with Singapore can be easily extended to other ASEAN countries. Because Japan is highly protective of its agricultural sector, the agreement excluded any reference to agricultural products. Singapore's agricultural sector is negligible, so Japan was able to bypass the agricultural issue. This will not be so easy when negotiating future free trade agreements with other ASEAN countries. These countries have much larger agricultural sectors than Singapore, making it more difficult to keep Japan's domestic agricultural market closed.

Since the Asian financial crisis, East Asia is changing. It is achieving marked economic cooperation and integration. The path of change is still uncertain, though, and will be influenced by political factors as well as economic conditions. Whatever developments occur, China is likely to have increasing economic influence in the region.

—Jahyeong Koo
Dong Fu

Koo is an economist and Fu is an assistant economist in the Research Department of the Federal Reserve Bank of Dallas.

Note

[1] The founding members of ASEAN are Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei, Vietnam, Laos, Myanmar and Cambodia joined later.