

CHINA: A GROWTH ENGINE FOR THE GLOBAL ECONOMY?

- Since the end of 2002, China has been a key growth engine for the global economy, stimulating expansion across the entire Asian region. Chinese imports are the main driving force behind world trade. At the same time, Chinese exports have continued to gain market share at the expense of the industrialised countries and certain emerging ones too.
- Growth in the Chinese economy was extremely strong at the end of 2003, but should slow down in 2004 if, as we expect, the authorities manage to engineer a “soft landing”. The pattern of demand is set to shift: after an excessively rapid rise in 2003, investment should tail off, but consumer spending should accelerate, while exports will once again grow very sharply. Imports should revert to a more sustainable growth rate, but this means that one of the pillars of the world economy will weaken.
- The impact of China’s emergence as a leading economic power varies according to the type of country. The impact is positive for countries that export basic materials and, currently, for Asian NICs whose economies are already tightly enmeshed with the Chinese economy. However, the impact is negative for emerging countries with low wage costs. All the developed countries, and particularly the US, are affected by the faster pace of relocation in their industries. However, Japan and, to a lesser extent, Germany have more than made up for this drawback by being the main beneficiaries of the investment boom in China.

THE EMERGENCE OF CHINA: AN UNPRECEDENTED PHENOMENON

As a key feature of the last few years, China’s emergence has been both impressive and fascinating. It stems from a combination of three factors: the already significant size of the Chinese economy, the speed with which it is growing, and the extraordinary untapped growth potential in a country with a population of 1.3bn, whose productivity per head is currently very low. Sheer size and the speed of change – these are what make China’s emergence a genuinely unprecedented phenomenon. The catalyst for this change was China’s entry into the WTO on December 11, 2001, with an agreed transition period ending in 2004 or 2006 for most products, or 2010 in certain exceptional cases. At the same time, the steady removal of import quotas on textiles and clothing between now and end-2004 is also playing a positive part.

Unlike the other Asian countries (Japan, then South Korea, Taiwan, Singapore, Thailand, etc.), whose growth since the end of the war has resembled a “flying geese pattern”¹, China, which has a virtually inexhaustible labour pool, will remain competitive in labour-intensive markets for many years, while focusing more and more on high value-added products. In one sense, China itself, with its different regions, forms a massive “flying geese formation”, even though the pole position in the flight (high-tech manufacturing) has largely yet to be established.

While China’s growth potential for the medium to longer term is genuinely huge, realising this potential depends on a number of factors. Our purpose in this report is not to examine the potential long-term scenarios for China, of which there are clearly many, but to focus on short-term developments. Three issues seem to be of key importance:

❖ How efficiently resources are allocated. China’s rate of investment is extremely high (almost 47% of GDP in 2003). But, as the astronomically high levels of non-performing loans on the banks’ balance sheets demonstrate, the overall return on investment has

proved low over time, which is bound to put a brake on growth. A significant proportion of this investment capital is wasted, as currently reflected by China’s high level of implicit public debt². Investment decisions can only be rationalised if a genuine market economy is put in place. This would mainly involve cleaning up and deregulating the financial sector, as well as privatising most state-owned enterprises.

❖ How growth is managed with respect to infrastructures, environmental protection, energy supplies, and, obviously, the acceptability of these changes to the Chinese people, who face a widening inequality gap and currently have minimal welfare cover.

❖ How China fits into the world economy, which must be acceptable to its partners, otherwise they could raise protectionist barriers against the country. China looks set to become the “world’s workshop” for labour-intensive products, as an increasingly small proportion of these goods will be manufactured in high labour-cost countries. Over time, these products will become more sophisticated. This pattern of development, which is characteristic of globalisation, can be an overall “win-win” game, subject to two provisos: 1) economies that are seeing some of their industries relocate should be flexible enough to develop alternative industries that are more productive (the problem here being the speed of change); and 2) trade flows should balance out over time. So, the rapid growth in Chinese exports should be accompanied by a sharp rise in the value of Chinese imports of goods and services. It would be inconceivable for China to dominate the world economy in the long run, and accumulate debts from the rest of the world. For this adjustment, the Chinese market needs to be opened up (as agreed when the country joined the WTO), while China’s capital flows must be completely liberalised and the country should move towards a sufficiently flexible exchange rate.

¹ In each of these countries in turn, we have seen manufacturing gradually move upscale. Low value-added manufacturing activities have been abandoned by a more advanced developing country, to be subsequently taken over by a ‘later starter’. Hence the image of a flying geese formation. Japan is now in pole position, followed by the NICs, then the ASEAN countries, and lastly countries like Vietnam. Interestingly, these economies are catching up faster and faster.

² In December 2003, two of the big four state banks – the Bank of China and the China Construction Bank – received a \$45bn injection of public funds taken from China’s foreign reserves. As a result of this massive capital injection, part of CCB’s share capital is likely to be floated on the Hong Kong stock exchange over the next few years. This transaction should also strengthen CCB’s capital base. This injection of public funds comes in the wake of \$202bn of public support to the banking industry since 1998. It should be followed by other large injections given the scale of the banks’ non-performing loans. But, aside from their much-needed recapitalisation, the banks must change their criteria for granting loans (i.e. no more “political” loans, more effective credit risk assessment, which implies more transparent corporate accounting, and deregulation of interest rates). In this way, the banks will be able to accurately evaluate their counterparty risk.

AN EXCEPTIONALLY BUOYANT ECONOMY IN 2003-04³

Very strong growth verging on overheating

Because of its size and rapid expansion, China's economy makes a significant contribution to world growth. China is already the world's second economic power based on exchange rates that give purchasing power parity for a basket of goods and services that are representative of domestic production (GDP at PPP). It ranks No.6 on the basis of current exchange rates (i.e. between France and Italy). In addition, the Chinese economy is currently expanding extremely fast. After year-on-year growth of 'only' 6.7% in the second quarter, due to the Sars epidemic, the economy rebounded by 9.6% in the third quarter before accelerating by 9.9% in the fourth quarter. As a result, average annual growth was 9.1% in 2003, according to official estimates, which may slightly underestimate the actual trend, in this case, due to changes in the various economic indicators. In 2004⁴, growth may drop back to 8.5%, assuming the authorities manage to apply the brakes and engineer a "soft landing" for the economy. Otherwise, there is a significant risk of inflationary pressures, major manufacturing overcapacity in many industries, property bubbles in specific areas, and, to cap all this, a build-up in unrecoverable bank loans. Physical limitations on growth are also emerging (e.g. electricity supplies and transport infrastructures). This would lead to a "boom and bust" scenario that would be economically and socially destabilising.

One sign that the economy is starting to overheat has been the rise in consumer prices, which reached 3.2% year-on-year at end-2003, although this admittedly reflected a sharp increase in food prices caused by poor harvests.

Perhaps more significant is the change in wholesale prices tracked by the Central Bank (the People's Bank of China, or PBOC), which showed a marked acceleration at the end of the year. The year-on-year price increase went from 2.2% in September 2003 to 5.5% in November⁵ and 6.7% in January 2004. These price rises are particularly significant as they are occurring at the upstream end of the production process: in December the twelve-month price increase was 10.9% for basic materials, 6.5% for semi-finished goods, and 4.1% for finished products. There were very wide disparities between the price increases recorded for different products, with strong rises for basic materials (metals, coal, coke, and cotton) and decreases for cars (down 9.1%) and household durables (down 3 to 5%). Many companies are hit by spiralling raw material costs, while increasingly harsh competitive pressures are putting a squeeze on their selling prices. The negative impact on margins is slightly cushioned by the rapid growth in sales volumes.

China accounted for between one-tenth and one-third of the global economy's growth in 2003, depending on whether we base our estimates on current exchange rates or PPP (purchasing power parity). According to our central scenario, China's contribution in 2004 should be slightly smaller, but still substantial, as US economic growth will make a larger contribution to global growth.

³ See Xuan Tran: *Trying to land softly after a space fly* - Emerging Countries Research, Société Générale (February 2004).

⁴ In any event, the government's target of bringing the growth rate down to 7% in 2004 seems unachievable.

⁵ The 12m rise in producer prices of manufactured goods (which took off more slowly) was 3% in December, after 1.9% in November and 1.2% in October.

TABLE 1: CONTRIBUTION TO WORLD GDP GROWTH

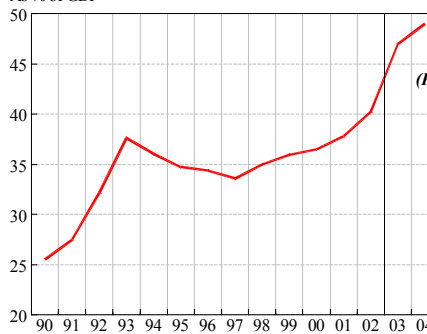
	GDP (current exch. rates)			GDP (PPP rates)		
	% in 2002	Contribution		% in 2002	Contribution	
		2003	2004		2003	2004
World	100.0	2 ¾	3 ½	100.0	3 ½	4 ¼
US	32.3	1.0	1.5	20.8	0.7	0.9
Euro zone	20.5	0.1	0.3	15.5	0.1	0.2
Japan	12.3	0.3	0.2	7.1	0.1	0.1
China	3.8	0.3	0.3	12.4	1.1	1.1

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... driven by a spectacular boom in investment...

Various factors combined to produce the spectacular boom in investment (by value : a 27% rise) witnessed in China in 2003: 1) a more relaxed monetary policy in 2002; 2) an expansionary public-sector policy, notably at the regional level; and 3) the opportunities created by China's entry into the WTO, both in terms of the domestic market and exports from China, which generated a substantial flow of direct foreign investment (DFI)⁶. Foreign investment inflows went from \$38.4bn in 2000 to \$44.2bn in 2001, \$52.7bn in 2002, and \$53.5bn in 2003, when they were temporarily dampened by the Sars epidemic (almost 4% of GDP)⁷. In addition to these factors, there was market speculation surrounding the yuan's revaluation – now seen as a "one way bet"⁸ – and the higher yield obtainable on yuan investments compared to dollar investments. This led to massive inflows of "hot money", in spite of the controls over capital movements (excluding current transactions).

CHINA : INVESTMENT DRIVEN BY DOMESTIC DEMAND
As % of GDP



Source : EIU

In the first eleven months of 2003, fixed investment in industry (around 35% of the total) rose by 43.8%. Capital expenditure in the metal industries doubled, while many sectors recorded increases of over 60% (non-ferrous metals, chemicals, textile industry, light industry, and machinery). Compared to these growth rates, the increases posted by the electronics and energy industries look modest (up 19.6% and 17.4%, respectively). Investment in the service sector (almost 62% of the total) rose by 23.8% over this period, driven by investment in property and public services.

⁶ Following China's entry into the WTO, the regime governing direct foreign investment has been relaxed (companies can be set up with 100% foreign capital and without having to prove that they use advanced technology; joint ventures are no longer required to re-export part of their production or to use a specified percentage of locally-sourced supplies)

⁷ Although direct foreign investment (DFI) into China is growing sharply, direct investment by industrialised countries is still modest. In 2002, it amounted to less than 1% of America's total DFI (to which we should add some of America's DFI into Hong Kong, which amounted to 1.7% of the total) and 4.9% for Japan (0.6% for DFI into Hong Kong).

⁸Judging by the forward market's twelve-month rate, by mid-February 2004 the market was expecting the yuan to appreciate by 6% against the dollar within a year. There was also a drop in foreign-currency savings deposits (down 1.9% year-on-year in October 2003), whereas yuan-denominated deposits have grown rapidly.

However, the transport and telecommunications sectors saw a rise of only 5.2%. Understandably, the Chinese authorities are trying to prevent the build-up of surplus capacity in certain basic industries (aluminium, cement and steel), as well as in some transformation industries such as car manufacturing. The authorities have two weapons they can use: 1) government control over investments, in an economy which is still highly regulated and dominated by state-owned enterprises. However, the central authorities are losing their grip due to increased regional autonomy; and 2) the PBOC, which has tried to rein in lending. After tightening the lending terms for luxury homes in June 2003 and increasing the statutory reserve rate on deposits (from 6% to 7%), the central bank asked the banks in February 2004 to limit the increase in their lending to 16% this year, compared to 21% last year. This target will probably be exceeded if there are still massive flows of "hot money" coming into the country (in spite of the PBOC's efforts to sterilise their impact). It is becoming increasingly difficult to control lending volumes due to the sheer size of the big four public banks and the growing role played by other financial institutions. And the PBOC probably has no intention of raising interest rates in the near future. This would have two drawbacks: it would accelerate inflows of speculative capital, and, secondly, it would indiscriminately penalise all sectors of the economy and put too much of a dampener on growth, which in turn would exacerbate social problems.



What is certain is that China's exchange rate regime is at the top of the authorities' agenda (see *Summary*, page 3), owing to a combination of outside pressures (the Boca Raton G7 meeting and protectionist threats from the US, where job relocations in manufacturing are a key theme in this year's presidential election) and, most importantly, internal pressures.

Consumer spending should partly take over the running from investment

The domestic Chinese market is a two-tier one. There are significant income gaps both between towns and the countryside, and between urban households themselves. In 2002, the average disposable income of the rural population was \$300 (about 830m people) compared to \$930 for city-dwellers. In towns, the richest 10% enjoy an average disposable income of \$2,300, which is eight times higher than the figure for the poorest 10%. So, in 'purchasing power parity' terms, the average disposable income of the 50m wealthiest citizens in 2002 was close to \$11,200, compared to \$12,900 for the Portuguese, \$17,000 for the French, and \$27,400 for Americans.

The Chinese have high take-up rates for certain consumer

durables (e.g. televisions, fridges and bicycles), but the rate is still low for various other products (cars, video recorders and computers). So, market potential is very large: in 2002, China sold 1.2m cars, ranking it the fifth largest car market in the world, and in 2003 it topped the 2m mark. Another example is mobile phones, where the number of new subscribers is growing at a dizzying rate, increasing by 55m in 2003 to a total of 260m.

Consumer spending is rising rapidly. It was up 6% in 2003, in spite of the impact of Sars, and is set to accelerate further in 2004. In November 2003, retail sales volumes rose 9.7%, bringing the growth rate for the first eleven months of the year to 8.9%.

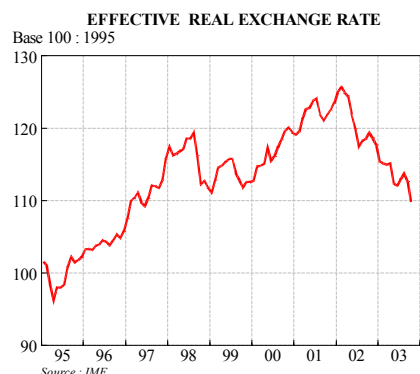
Consumption is being underpinned by falling prices for consumer durables, substantial gains in purchasing power (the rural population is currently benefiting from sharp price increases in agricultural products), and very robust growth in consumer lending. In addition, inflationary pressures could encourage Chinese consumers, who have large cash savings, to spend more.

An outstanding foreign trade performance

Since spring 2002, China's foreign trade performance has been outstanding, though this was temporarily interrupted in spring 2003 by the Sars epidemic. In January 2004, the sharp drop in trade was partly due to the week-long holiday for the Chinese lunar New Year, but also the knock-on effects of the three-point reduction in the VAT rebate on exports, which came into effect on January 1. Anticipating the cut in the rebate, exporters naturally increased their international sales at the end of 2003.



Aside from this hiccup, exports should remain strong in 2004, as China benefits from a favourable combination of factors: 1) strong growth in the US and a slow recovery in Europe; 2) buoyant trends in new-technology sectors; 3) the after-effects of the 2002-03 investment boom (and particularly direct foreign investment); 4) the ongoing impact of joining the WTO, particularly in the textile sector (see below); and 5) a significant depreciation in the yuan's effective exchange rate.



On the import side, the trend should be slightly less robust than in 2003, due to the slowdown in investment. Nonetheless, Chinese imports should still contribute one-seventh of the growth in world imports anticipated in 2004, after contributing more than a quarter of this growth in 2003. So, although growth in Chinese imports may slow down this year, their contribution to global imports continues to increase.

TABLE 2: CONTRIBUTION TO GROWTH IN GLOBAL IMPORTS

	Imports (current exch. rates)		
	% in 2002	Contribution	
		2003	2004
World	100.0	5 %	7 %
US	18.1	0.7	1.2
Euro zone	28.2	0.4	1.3
Japan	5.1	0.2	0.2
China	4.4	1.4	1.0

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IMPACT OF CHINA⁹ ON THE REST OF THE WORLD: WINNERS AND LOSERS

Currently, the impact of China's emergence as an economic force on the world stage varies considerably, depending on the type of country. The impact is positive for countries that produce raw materials, for Asian countries that are already part of the "Asian integrated circuit" and for developed countries that manufacture capital goods. Conversely, the impact is damaging (at least in the short term) for countries taking in low-priced Chinese exports, i.e. mainly the US, which is facing massive job losses in manufacturing and relocations.

Over time, however, the impact will change substantially. The message from economists is unambiguous: globalisation is a "win-win" game¹⁰. However, the various economies need to know how to adapt quickly enough to the new competitive landscape. So, given the circumstances, there may well be both winners and losers, even in the medium to longer term (and without even taking into account the costs of adapting). While countries producing basic materials can only be winners, emerging countries that have so far benefited from relocation trends are likely to be severely affected (e.g. Mexico, and Asian textile-producing countries). Countries in the "Asian integrated circuit" and developed countries will face a two-fold problem: 1) the ongoing relocation of labour-intensive industries, and 2) the fact that Chinese goods in many sectors are moving upscale, a process that will be helped by the technology transfer that China is benefiting from, and the calibre of its university graduates. Also, in the perhaps-not-too distant future, highly competitive Chinese companies will gain a foothold in international markets (household durables, electronics and semiconductors, and cars). Against this, however, the investment effort that China needs to make and modernisation of the western part of the country are long-haul tasks, while the rise in the population's purchasing power will be accompanied by strong growth in consumer spending and increasingly sophisticated demand.

Raw material producers stand to gain the most

Driven by the growth in industrial output (up 17% in 2003) and the spread of durable goods, Chinese demand for raw materials and energy has been rising very sharply since mid-2002, up by around 50% between 2002 and 2003 to \$37.8bn (see Table 8, page 12).

Chinese imports have clearly contributed to the surge in prices of

industrial raw materials seen at the end of 2003 and in early 2004 (32% rise in the cost of mineral raw materials between September 2003 and mid February, according to *The Economist's* index).

According to IEA estimates published in February 2004, China's demand for oil in 2003 was 5.5 million barrels a day (mb/d), compared to 20mb/d for the US and 5.4mb/d for Japan. Chinese demand was up sharply, rising by 11% (an increase of 0.5mb/d), which represented a third of the overall 1.50mb/d increase in world oil demand last year. This stronger-than-expected increase in demand helped OPEC control the oil market and keep oil prices at a higher-than-anticipated level (\$28.8/b for Brent in 2003 versus \$25.1/b in 2002 and over \$30/b since the start of the year). In 2004, after an exceptional year, growth in Chinese oil demand should slow down: it is expected to increase by 0.34mb/d, which is about one quarter of the anticipated 1.44mb/d increase in global oil demand this year. At the same time, local oil production has been stagnating for several years at 3.4mb/d. This means that China's demand for oil from the world market is growing very rapidly and explains why the Chinese authorities are anxious to secure their foreign supplies.

In agriculture, China does not have any competitive advantages in the production of foodstuffs requiring large areas of arable land, such as cereals (with the exception of rice). Furthermore, the country's arable land is shrinking in tandem with urbanisation, while the Chinese diet is becoming more varied. In the medium term, as a result of China joining the WTO, food imports will benefit from the reduction in import tariffs from 22% to 15%, which was completed in January 2004. Furthermore, special measures are in place to encourage imports of certain products considered as strategic (the TRQ system¹¹).

The "Asian integrated circuit"

The NICs and Japan make extensive use of China as an assembly platform for their products (clothing, leather goods, toys, chemical products and, of increasing importance, electronic goods). Relocations and outsourcing have boosted imports, as a large portion of the components used in Chinese assembly plants come from parent companies outside the country. According to Lemoine (2003)¹², imports for assembly accounted for 41% of total Chinese imports in 2002 (vs 59% for foreign subsidiaries), while exports after assembly represented 55% of total exports (80% for foreign companies alone). Furthermore, relocation trends have boosted Chinese exports by re-importing products into the country of origin, or, most importantly, by providing a platform for shipping goods to North America and Europe. Thus, the "Asian integrated circuit" generates substantial goods flows and forges closer manufacturing ties between China and other countries in the region, as illustrated in Table 3.

TABLE 3: TRADE WITH CHINA AND HONG KONG

As % of GDP (2002)	Singapore	Malaysia	Taiwan	South Korea	Japan
Imports	13.5	9.0	3.5	4.0	1.61
Exports	21.1	11.1	14.4	7.1	1.65

Sources: IMF, CEIC

⁹ Given Hong Kong's role as a hub for trade between China and the rest of the world, it is more appropriate to treat the China/Hong Kong bloc as a combined entity when looking at bilateral trade for each individual country. For example, \$90bn of the \$95bn in exports from Hong Kong to China in 2003 comprised re-exports of products from third countries.

¹⁰ The recent controversy following the comments made by Gregory Mankiw (Chairman of the Council of Economic Advisers) on the benefits of relocation (rightly portrayed as an integral part of trade) has highlighted the clashing viewpoints of economists (globalisation creates wealth by allowing a more effective overall use of resources) and politicians, who are concerned about the short-term social impact.

¹¹ Tariff-Rate Quotas: under the bilateral agreement signed between the US and the People's Republic of China, certain agricultural products (wheat, maize, rice, soybean oil and cotton) will benefit from extremely low tariffs on quotas (1% for all the products listed above, apart from soybean oil where the tariff is 9%). These quotas have been steadily increased up to this year (in millions of tonnes: from 7.3m to 9.3m for wheat; from 4.5m to 7.2m for maize; from 2.66m to 5.32m for rice (quota was not fully met); from 2.5m to 3.6m for soybean oil; and from 0.743m to 0.894m for cotton).

¹² Françoise Lemoine (2003): "L'économie Chinoise," Édition La Découverte, Collection Repères.

The importance of the electronics industry for trade relations between Asian countries, and the impact of the "Asian integrated circuit" are illustrated by: 1) the proportion of electrical and electronics equipment in South Korean and Japanese exports to the China/Hong Kong bloc (15% and 31% respectively); and 2) the geographical breakdown of China's foreign trade in electronics goods, with the NICs and Japan running substantial surpluses, while the US, UK, Germany, and France all have large bilateral deficits (see Table 6, page 12).

So, largely due to replacement effects, the market shares of Japan and other Asian countries are shrinking in America, while those of China and Hong Kong are expanding¹³.

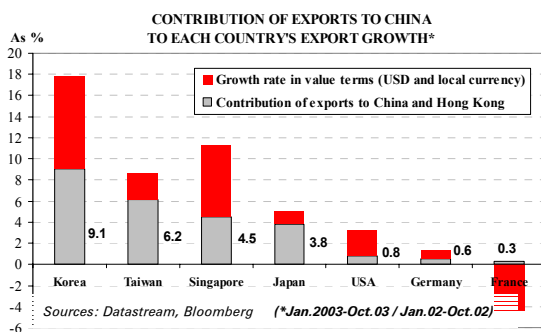
TABLE 4: BREAKDOWN OF US IMPORTS BY REGION OF ORIGIN

%	1995	2000	2002	Jan-Sep. 03
Japan	16.6	12.0	10.5	9.4
China + Hong Kong	7.5	9.2	11.6	12.4
Other Asia*	16.6	15.0	13.8	13.2
Total Asia	40.7	36.2	35.9	35.0
Canada	19.5	18.8	18.0	18.0
Mexico	8.3	11.2	11.6	11.0
Euro zone	13.0	13.5	14.9	14.8
Other	18.4	20.3	19.7	21.2
Total	100	100	100	100

Source: Census Bureau

*Covers Bangladesh, Indonesia, South Korea, Malaysia, the Philippines, Taiwan, Thailand, Vietnam, Singapore, Pakistan and India.

In 2003, the NICs and Japan benefited fully from the "Asian integrated circuit" at a time when the electronics sector was staging a rapid recovery and domestic demand in China was extremely strong. Their trade with the China/Hong Kong bloc has been a major factor behind the recovery in their exports, driving up the region's growth.



With Chinese products gradually but inexorably moving upscale (the country will enjoy a wage cost advantage for many years), other countries in the region will be increasingly pushed towards the back of the "flying geese formation" as China rapidly eats into their market share. Japan and South Korea will be spared this fate for the time being. Under these circumstances, there are only two possible strategic choices: to upgrade products or to adopt a niche strategy.

A harmful effect on low labour-cost countries

Emerging countries specialising in the manufacture of labour-intensive goods are starting to be hit by growing competition from China, due to the reassignment of existing production plants or the establishment of new plants in China.

¹³ In 2003, Canada and the euro zone managed to maintain the value of their market shares due to the price effects caused by the appreciation of their currencies against the dollar. "Other countries" (unidentified) mainly increased their market shares as a result of the increased US oil bill.

As a result of joining the WTO¹⁴, China's clothing exports should continue to grow. The *US International Trade Commission* estimates that the share of Chinese clothing exports in the global market will increase by 6% owing to the lifting of restrictions.

In the US, China is the leading exporter (13.65% of US clothing imports versus 4.65% in 1995). The second largest exporter, Mexico, is already losing market share, a negative trend that is also affecting other poor countries like Bangladesh, whose market share has fallen from 3.30% in 2001 to 2.95% in 2003. Only Vietnam, which has established itself as a significant exporter over the past two years, is clearly gaining market share, from 0.08% to 4.16% over 2001-03.

Against this, China is having to increase its imports of fabrics used in the highly labour-intensive business of clothes manufacturing (and notably synthetic textiles, whose manufacture is highly capital-intensive). This trend reflects the relative strengths of each country in different aspects of production.

A contrasting impact on industrialised countries¹⁵ for now

Very robust growth in imports from China

As a result of the strong growth in Chinese exports, imports by industrialised countries from China and Hong Kong are growing very fast (in value terms), increasing by 20% in the US in 2003; by 12-16% in euro terms in Germany, the UK, and France in the first nine months of 2003¹⁶; and by 7% in dollar terms in Japan.

The penetration rate of Chinese goods (as measured by the share of imports from China and Hong Kong as a percentage of the importing country's GDP) still varies considerably from one country to another (see Tables 9-13, pages 12-13). For the five countries considered here, it ranges from less than 0.9% to over 1.6% of GDP. Not surprisingly, the penetration rate is the lowest for European countries that are furthest from China. However, as a reflection of its historic links, the UK seems more receptive to products from China and Hong Kong than Germany and, above all, France.

Conversely, this penetration rate is highest for Japan due to its geographic proximity and the fact that the country is part of the "Asian integrated circuit" discussed earlier. Japanese companies also play a significant part in the relocation of production to China and in re-imports of finished goods to meet the demands of their domestic market. The yen's 'breakeven point' stands at around one dollar to 200 yen.

The US is a noteworthy case, pointing as it does to future developments. Chinese goods have particularly high penetration rates in America and are taking off rapidly. As a result, American consumers benefit from low-cost goods that are mainly distributed by major retailers, particularly Wal-Mart stores. American imports from emerging Asian countries (a quarter of total US imports) and from China in particular (an eighth of imports) have therefore played a major role in keeping import prices down recently, despite the decline in the dollar's effective exchange rate.

¹⁴ The Agreement on Textiles and Clothing (ATC), which succeeded the Multifibre Agreements set export quotas for textiles and clothing. The Uruguay Trade Round Agreement has gradually liberalised these quotas to the benefit of WTO member countries and the process should be completed at end-2004.

¹⁵ In this report, we have looked at the five largest OECD countries (US, Japan, Germany, UK, and France). The common term "industrialised country" used here seems less and less appropriate for countries that are undergoing deindustrialisation at varying rates.

¹⁶ Given the dollar's sharp depreciation against the euro, volume growth was probably much higher, even though exporters increased their margins.

However, the breakdown of products imported from China is very similar from one industrialised country to another. More than a third of these imports are cut-price, labour-intensive goods (clothing, toys and furniture), where China enjoys a long-term competitive advantage.

At the same time, the proportion of electrical and electronics equipment is also significant, reflecting the nature of the assembly plants. These goods account for around 15% of Chinese imports for all countries combined. The increase in the share of high value-added products (such as optical instruments) in American imports illustrates how China is gradually moving towards more upscale products (see Table 7).

Exports into China currently just as strong

Exports from the industrialised countries into China and Hong Kong rose rapidly in 2003, by between 14% and 20%. There were several factors behind this:

❖ First, China's entry into the WTO has made exporting to this country easier as import tariffs have gradually fallen (see Table 5, page 12) and import quotas have been lowered. Between 2001 and 2007-10, import tariffs on manufactured products should drop from an average of 13.5%¹⁷ to less than 7%. Furthermore, China's commitment to respecting intellectual property rights should have a positive impact in several areas (software, patents, artistic productions and luxury goods)¹⁸.

❖ Secondly, Chinese imports from the most developed countries are being stimulated by the sharp growth in Chinese domestic demand for infrastructures and capital goods, together with rising living standards (as we have mentioned, a significant proportion of the urban population now has purchasing power on a par with certain industrialised countries).

❖ Lastly, since Chinese exports have a high import content due to assembly operations and, more generally, the use of semi-finished products, the rise in Chinese exports is reflected in imports (notably electronic components, chemicals and fabrics).

Clearly the "winners" among China's trade partners over the longer term will be those who produce: 1) capital goods (with Japan and Germany in pole position); 2) high-tech goods, where China still lags far behind (aeronautics for the US and Europe; and electronic components, particularly the most sophisticated, such as microprocessors, where the US has a virtual monopoly); 3) primary foodstuffs (the US in particular) and industrial raw materials; and 4) luxury goods associated with a specific area of expertise, for which a new customer base is emerging and where France is already well-placed (parallels can be drawn here with tourism in the service sector).

The automotive sector is a prime example of the growth pattern we can expect in other sectors. When it joined the WTO, China agreed to substantially reduce its import tariffs in this sector (see Table 5, page 12). However, despite these reductions, there will still be significant custom duties on imports of assembled cars (25-28%), while duties on components will be much lower. Although tariff reductions and quota liberalisation obviously benefit imports of assembled cars, only luxury car manufacturers (principally the German auto companies) are likely to enjoy a long-term advantage. This explains why the world's leading car

¹⁷ In preparation for joining the WTO, China had already reduced its import tariffs significantly during the 1990s, notably for manufactured goods, for which average tariffs fell from 46.5% in 1992 to 25% in 1995 and 13.5% at end-2001, when the country joined the WTO.

¹⁸ According to the International Intellectual Property Alliance, piracy is extremely common in China: apparently, in 2002, more than 90% of royalty-earning products sold in the Chinese market were counterfeit. For instance, there are factories mass producing CDs and DVDs, some of which are even exported. The luxury goods industry and book publishing are also affected by this problem.

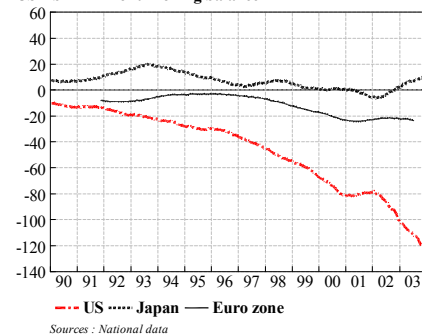
manufacturers are scrambling to enter the Chinese market (albeit through compulsory joint ventures) and are planning significant capacity extensions.

The market boom witnessed in 2003, which was mainly fuelled by the growth in consumer lending and cheaper vehicles, gave a considerable boost to countries that were highly specialised in this industry and already well established in the Chinese market. The main beneficiaries were Japan and Germany, while France and the UK lost ground.

Gradually, the Chinese automobile sector is set to streamline and consolidate, while the local content of vehicles should increase in tandem with this process. Here, as for other sectors, there are two main questions worth asking. Firstly, when will China move from importing car components for assembly to being a major car exporter? And, secondly, when will we see the emergence of Chinese manufacturers that have acquired the necessary expertise through joint ventures?

Bilateral trade balances heading in different directions

TRADE BALANCE WITH CHINA AND HONG KONG
USD bn - 12-month rolling balance



Looking at bilateral trade balances, three trends stand out: 1) the huge US trade deficit, which is widening (deficit of almost \$130bn with China in 2003, or a quarter of the entire US trade deficit). This deficit amounts to \$120bn if we add Hong Kong, with a coverage rate of only 25%; 2) a balance, or even a surplus in 2003, for Japan; 3) a significant trade deficit for the euro zone (coverage rate of 60% for the first nine months of 2003, which has recently started deteriorating). However, this amounts to only one sixth of the US deficit.

Current trends should continue in 2004. In particular, investment by American companies is set to recover (notably in new technologies) and, conversely, domestic demand in China should slow down. The deficits recorded by the US and EMU countries with the China/Hong Kong bloc should continue to widen.

However, we should not focus exclusively on bilateral trade balances: the nature of international trade means that it should be viewed as a whole. The Chinese trade surplus, although large, amounts to only \$25bn. As we have seen with the US, the growth in imports from China is, to some extent, a substitute for imports from other emerging countries, and even Japan.

Nonetheless, industrialised countries are faced with a fundamental question: how to guarantee full employment for their labour forces, despite experiencing very strong and prolonged competitive pressures in a growing number of sectors? Especially as these pressures are speeding up the relocation of former industries and putting a downward squeeze on prices over the long term. The US, Japan and EU have yet to find a satisfactory response to this dilemma.

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TABLE 5 : PROGRESSIVE DECREASE OF INDUSTRIAL TARIFFS IN CHINA

As %	1995	2001	2007-2010
Processed food	20.1	26.2	9.9
Beverages & tobacco	137.2	43.2	15.6
Extractive industries	3.4	1.0	0.6
Textiles	56.0	21.6	8.9
Apparel	76.1	23.7	14.9
Light manufactures	32.3	12.3	8.4
Petrochemicals	20.2	12.8	7.1
Metals	17.4	8.9	5.7
Automotive sector	123.1	28.9	13.8
Automotive vehicles		70.0	25/28
Electronics	24.4	10.3	2.3
Other manufacturing goods	22.0	12.9	6.6
Total manufacturing goods	25.3	13.5	6.9

Source : World Bank

TABLE 6 : CHINA'S EXTERNAL EXCHANGES OF ELECTRONICS (USD BN, 2001)

Imports		Exports	
Total Imports	46.47	Total Exports	66.02
Japan	11.32	US	23.07
US	7.57	Japan	9.25
South Korea	4.90	Germany	4.55
Taiwan	4.27	South Korea	2.61
Malaysia	2.62	France	2.25
Germany	1.72	Singapore	1.81
Hong Kong	1.54	UK	1.61
Singapore	1.36	Taiwan	1.53
Thailand	1.28	Malaysia	1.52
The Philippines	1.05	Thailand	1.12
UK	0.69	The Philippines	0.21
France	0.68	Hong Kong	0.03

Source : CHELEM

TABLE 7 : BREAKDOWN OF US IMPORTS BY SECTORS

As % of the US total imports	JAPAN				CHINA + HONG KONG				OTHER ASIA*				TOTAL ASIA			
	1990	1995	2002	2003***	1990	1995	2002	2003***	1990**	1995	2002	2003***	1990**	1995	2002	2003***
Electric and electronic equipment	32.9	25.6	13.1	12.3	5.8	8.7	17.0	17.9	27.8	33.3	28.0	28.3	66.6	67.6	58.1	58.6
Machinery	30.4	27.2	15.4	14.9	2.0	3.5	12.8	17.0	18.0	26.1	25.3	22.5	50.4	56.8	53.5	54.3
Toys, Games and Sporting Goods	29.4	10.6	10.6	4.1	28.4	52.2	68.4	77.1	26.9	19.3	7.3	7.2	84.6	82.1	86.2	88.3
Apparel and clothing accessories knitted or crocheted	0.4	0.1	0.5	0.6	31.9	24.3	16.4	16.1	38.3	32.3	26.0	27.3	70.6	56.7	42.9	44.0
Apparel and clothing accessories not knitted/ crocheted	0.7	0.2	0.1	0.1	30.0	24.9	20.8	22.2	33.4	29.9	27.2	26.2	64.1	55.1	48.1	48.5
Furniture	3.2	1.9	0.6	0.6	5.4	19.2	37.7	40.2	33.9	24.0	11.7	11.0	42.6	45.1	50.1	51.8
Automotive vehicles, parts, engine vehicles	38.0	31.2	26.7	25.0	0.1	0.5	1.2	1.4	3.2	3.0	5.3	5.7	41.3	34.7	33.2	32.2
Pearls, precious stones and metals, coins...	1.5	1.2	0.7	0.7	5.4	4.9	7.8	7.6	6.9	16.8	18.7	19.3	13.9	23.0	27.3	27.5
Optical instruments	39.9	35.3	17.1	15.3	3.2	7.5	8.6	8.7	7.0	8.8	8.3	7.9	50.2	51.7	34.0	31.9
Articles of leather	0.4	0.2	0.2	0.2	23.8	49.1	64.2	69.2	53.2	29.5	17.9	13.4	77.4	78.8	82.3	82.8
Footwear	0.1	0.0	0.0	0.0	16.6	49.0	66.9	68.4	48.9	20.0	9.6	9.3	65.5	69.1	76.5	77.7
Total	27.6	23.0	14.7	13.5	6.6	9.5	15.4	17.2	18.7	21.5	18.3	17.8	52.9	54.0	48.4	48.5
Other products	6.5	6.7	4.6	4.2	3.0	4.4	6.2	6.4	7.8	8.8	7.6	7.6	17.2	19.9	18.5	18.2
Total import	18.2	16.6	10.5	9.4	5.0	7.5	11.6	12.4	13.9	16.6	13.8	13.2	37.1	40.7	35.9	35.0

*Covers : Bangladesh, Indonesia, South Korea, Malaysia, The Philippines, Taiwan, Thailand, Vietnam, Singapore, Pakistan and India.

** Except India and Pakistan. ***From January to September. Source : Census Bureau

TABLE 8 : CHINA

IMPORTS (January to December) USD bn				EXPORTS (January to December) USD bn				
			2002	2003 Breakdown (as %)				
Imports from the World	295.30	413.10	100	Exports to the World	325.64	438.47	100	
As % of GDP	23.33	28.16		As % of GDP	25.72	29.89		
Top 10 by products				Top 10 by products				
Electric and electronic equipment	73.3	104.0	25.2	Electric and electronic equipment	65.15	89.04	20.3	
Machinery	52.2	71.6	17.3	Machinery	50.85	83.41	19.0	
Metal products and metallurgy	26.3	39.4	9.5	Fiber and cloths	57.87	73.37	16.7	
Raw materials and fuels	24.5	37.8	9.1	Furniture, toys, sporting goods...	23.34	28.49	6.5	
Chemical products and pharmaceutical products	24.3	31.8	7.7	Metal products and metallurgy	18.92	25.13	5.7	
Precision instruments	14.4	26.2	6.3	Chemical products and pharmaceutical products	14.63	18.54	4.2	
Plastic materials and rubber materials	19.8	24.8	6.0	Footwear and fashion goods	13.41	15.63	3.6	
Fiber and cloths	17.0	19.3	4.7	Aircraft, spacecraft, ships and parts thereof	10.50	15.61	3.6	
Wood and paper products	11.5	17.6	4.3	Precision instruments	9.53	13.12	3.0	
Agricultural products and horticultural products	7.4	8.6	2.1	Mineral raw materials and fuels	9.76	12.73	2.9	
Total "Top 10"	270.7	381.0	92.2	Total "Top 10"	273.96	375.08	85.5	

Source : China Custom Trade

TABLE 9 : US

IMPORTS (January to November) USD bn				EXPORTS (January to November) USD bn				
			2002	2003 Breakdown (as %)				
Imports from the World	1062.36	1150.36	Exports to the World	637.95	661.55			
Imports from China and Hong Kong	122.12	147.36	100.0	Exports to China + Hong Kong	31.50	37.30	100.0	
As % of the US total imports	11.50	12.81		As % of the US total exports	4.94	5.64		
As % of GDP	1.27	1.46		As % of GDP	0.33	0.37		
Top 10 by products				Top 10 by products				
Electric and electronic equipment	22.23	26.05	17.7	Electric and electronic equipment	7.29	8.25	22.1	
Machinery	19.33	28.11	19.1	Machinery	5.61	5.95	15.9	
Toys, Games and Sporting Goods	13.33	15.12	10.3	Vegetal oils and products of their distillation	0.97	2.41	6.5	
Furniture	9.09	10.94	7.4	Aircraft, spacecraft and parts thereof	3.34	2.31	6.2	
Footwear	9.40	9.84	6.7	Optical instruments	1.83	2.28	6.1	
Articles of leather	4.22	4.82	3.3	Plastic articles thereof	1.53	1.86	5.0	
Apparel and clothing accessories knitted or crocheted	4.20	4.74	3.2	Organic chemicals	0.71	1.19	3.2	
Plastics and articles thereof	3.57	4.09	2.8	Iron and steel	0.50	1.10	2.9	
Apparel and clothing accessories not knitted/ crocheted	4.11	5.09	3.5	Copper and articles thereof	0.34	0.62	1.7	
Optical instruments	2.59	3.04	2.1	Cotton fiber and cotton textile	0.17	0.57	1.5	
Total "Top 10"	92.07	111.84	75.9	Total "Top 10"	22.29	26.54	71.2	

Source : Census Bureau

TABLE 10: UK

IMPORTS (January to September) Euro bn				EXPORTS (January to September) Euro bn			
	2002	2003	Breakdown (as %)		2002	2003	Breakdown (as %)
Imports from the World	292.37	270.20		Exports to the World	237.77	209.37	
Imports from China and Hong Kong	14.73	15.46	100.0	Exports to China + Hong Kong	4.69	4.70	100.0
As % of the British total imports	5.04	5.72		As % of the British total exports	1.97	2.25	
As % of GDP	1.18	1.30		As % of GDP	0.38	0.39	
Top 10 by products				Top 10 by products			
Electric and electronic equipment	2.34	2.38	15.4	Machinery	1.22	1.38	29.4
Machinery	2.33	2.11	13.6	Electric and electronic equipment	1.06	0.91	19.3
Toys, Games and Sporting Goods	1.14	1.11	7.2	Optical instruments	0.24	0.23	5.0
Apparel and clothing accessories not knitted/ crocheted	1.43	1.49	9.6	Pearls, precious stones and metals, coins...	0.13	0.18	3.8
Apparel and clothing accessories knitted or crocheted	1.11	0.99	6.4	Special transactions	0.24	0.18	3.9
Pearls, precious stones and metals, coins...	0.42	0.83	5.4	Pharmaceutical products	0.10	0.13	2.8
Furniture	0.74	0.84	5.5	Automotive vehicles, parts, engine vehicles	0.12	0.17	3.5
Plastics and articles thereof	0.51	0.53	3.4	Iron and steal	0.06	0.14	3.1
Articles of leather	0.55	0.50	3.2	Plastics products	0.11	0.13	2.8
Special transactions	0.14	0.58	3.7	Aluminum and articles thereof	0.05	0.10	2.0
Total "Top 10"	10.69	11.35	73.4	Total "Top 10"	3.31	3.55	75.6

Source : UK Custom

TABLE 11 : JAPAN

IMPORTS (January to November)- USD bn				EXPORTS (January to November)- USD bn			
	2002	2003	Breakdown (as %)		2002	2003	Breakdown (as %)
Imports from the World	306.74	347.43		Exports to the World	379.79	425.98	
Imports from China and Hong Kong	57.54	69.56	100.0	Exports to China + Hong Kong	58.96	78.25	100.0
As % of Japan total imports	18.76	20.02		As % of the Japanese exports	15.52	18.37	
As % of GDP	1.61	1.63		As % of GDP	1.65	1.83	
Top 10 by products				Top 10 by products			
Electric and electronic equipment	9.45	11.65	16.7	Electric and electronic equipment	17.54	24.34	31.1
Machinery	6.94	10.49	15.1	Machinery	10.91	15.44	19.7
Apparel and clothing accessories not knitted/ crocheted	6.95	7.69	11.1	Optical instruments	3.54	5.19	6.6
Apparel and clothing accessories knitted or crocheted	5.21	6.06	8.7	Iron and steal	3.15	4.02	5.1
Optical instruments	1.58	2.19	3.1	Special transactions	2.67	3.65	4.7
Toys, Games and Sporting Goods	1.83	2.09	3.0	Plastics and articles thereof	3.05	3.65	4.7
Mineral raw materials and fuels	1.82	2.30	3.3	Automotive vehicles, parts, engine vehicles	2.91	4.20	5.4
Preparations of Meat, Fish, Crustaceans Etc	1.56	1.49	2.1	Organic chemicals	2.17	2.85	3.6
Furniture	1.49	1.80	2.6	Manmade Filaments, Including Yarns & Woven Fabrics	0.83	0.91	1.2
Footwear	1.82	1.93	2.8	Articles of iron or steel	0.91	0.89	1.1
Total "Top 10"	38.66	47.70	68.6	Total "Top 10"	47.68	65.14	83.3

Source : Japanese Ministry of Finance

TABLE 12 : FRANCE

IMPORTS (January to September) Euro bn				EXPORTS (January to September) Euro bn			
	2002	2003	Breakdown (as %)		2002	2003	Breakdown (as %)
Imports from the World	242.99	237.91		Exports to the World	241.17	232.94	
Imports from China and Hong Kong	8.78	9.99	100.0	Exports to China + Hong Kong	4.26	4.97	100.0
As % of France total imports	3.61	4.20		As % of the French exports	1.77	2.13	
As % of GDP	0.77	0.86		As % of GDP	0.37	0.43	
Top 10 by products				Top 10 by products			
Electric and electronic equipment	1.57	1.97	19.7	Electric and electronic equipment	1.08	1.05	21.2
Machinery	1.26	1.71	17.1	Aircraft, spacecraft and parts thereof	0.25	0.95	19.1
Apparel and clothing accessories not knitted/ crocheted	0.80	0.87	8.7	Machinery	0.81	0.77	15.5
Toys, Games and Sporting Goods	0.71	0.76	7.6	Articles of leather	0.21	0.18	3.7
Apparel and clothing accessories knitted or crocheted	0.48	0.49	4.9	Optical instruments	0.14	0.16	3.2
Footwear	0.39	0.45	4.5	Automotive vehicles, parts, engine vehicles	0.15	0.21	4.1
Articles of leather	0.49	0.47	4.7	Plastics and articles thereof	0.12	0.12	2.4
Optical instruments	0.43	0.48	4.8	Organic chemicals	0.09	0.11	2.1
Furniture	0.27	0.33	3.3	Beverages, spirits and vinegar	0.09	0.08	1.6
Plastics and articles thereof	0.32	0.31	3.1	Cosmetic products and perfumes	0.10	0.10	2.0
Total "Top 10"	6.72	7.82	78.3	Total "Top 10"	3.05	3.72	75.0

Sources French Custom

TABLE 13 : GERMANY

IMPORTS (January - September) Euro bn				EXPORTS (January to September) Euro bn			
Produits	2002	2003	Breakdown (as %)	Produits	2002	2003	Breakdown (as %)
Imports from the World	383.14	392.34		Exports to the World	482.41	490.35	
Imports from China and Hong Kong	14.99	17.16	100	Exports to China + Hong Kong	13.73	16.45	100.0
As % of Germany total imports	3.91	4.37		As % of the German exports	2.85	3.35	
As % of GDP	0.95	1.07		As % of GDP	0.87	1.03	
Top 10 by products				Top 10 by products			
Electric and electronic equipment	3.81	4.70	27.4	Machinery	4.66	5.82	35.4
Machinery	2.46	2.80	16.3	Electric and electronic equipment	2.48	2.67	16.3
Apparel and clothing accessories not knitted/ crocheted	1.26	1.30	7.6	Automotive vehicles, parts, engine vehicles	1.73	2.60	15.8
Toys, Games and Sporting Goods	0.79	1.19	6.9	Optical instruments	0.72	0.88	5.4
Apparel and clothing accessories knitted or crocheted	0.64	0.67	3.9	Aircraft, spacecraft and parts thereof	0.47	0.41	2.5
Optical instruments	0.75	0.73	4.2	Plastics and articles thereof	0.43	0.56	3.4
Furniture	0.47	0.61	3.5	Articles of iron or steel	0.26	0.31	1.9
Articles of leather	0.55	0.53	3.1	Iron and steal	0.26	0.39	2.4
Footwear	0.27	0.29	1.7	Pearls, precious stones and metals, coins...	0.10	0.14	0.9
Plastics and articles thereof	0.37	0.39	2.3	Tanning extracts, pigments	0.20	0.21	1.3
Total "Top 10"	11.36	13.19	76.9	Total "Top 10"	11.32	13.99	85.1

Source : Eurostat