China is promising amidst growing risks

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Without a doubt, China is making waves. Nations that underestimate China's economic prowess would do so at their own peril. In 2002, China's exports to the US exceeded that of Japan for the first time since 1949. China has also emerged as the biggest exporter to Japan. What's more, China is riding high on many counts, including FDI inflows, GDP growth, BOP surplus and international reserves. In 2002, total exports of China surged to US$322 billion, while foreign investment inflows exceeded US$52 billion. From Japan alone roughly 23,000 Japanese companies have invested in China. For nearly a decade, China has been the second largest recipient of FDI next to the United States.

China has every reason to be confident of itself. China continues to register the fastest growth rates in its exports and gross domestic product (GDP). It has registered a whopping 9.9 per cent year-on-year GDP growth in the first quarter this year, its fastest growth since 1998, driven largely by exports and investments. China's entry into the World Trade Organization (WTO) in December 2001 has provided a shot in the arm for its economy. Projections show that China will overtake Japan as the largest economy in East Asia before long and become a US$10 trillion economy second only to the United States by the middle of this century. In fact, China is already the second largest economy in the world in purchasing power parity (PPP) terms since 2000.

China is so confident that it could proactively propose a Free Trade Area arrangement with the Association of South East Asian Nations (ASEAN). It even appears that China is more willing and more ready than ASEAN is for its own ASEAN Free Trade Area (AFTA). China has expressed its readiness to accept tariff cuts that are in line with the AFTA provisions. China is also game for the removal of non-tariff measures such as licensing requirements and quantitative restrictions.

China is so gung-ho about the regional trading arrangement with ASEAN that some ASEAN countries can't help suspecting that this would benefit China more than ASEAN. What is important is that the proposed ASEAN-China FTA is a positive-sum game where all will gain and no one will lose. This notwithstanding, the fact remains that the gains may well be unevenly distributed not only between ASEAN and China but also among the ASEAN countries which are highly heterogeneous. Countries that will gain most from all this are those with economies that are complementary to China. In any case, China cannot possibly have comparative or competitive advantage in every product or activity. Even countries with production structures similar to China's will still be able to specialise and compete.

The main advantage of an ASEAN-China FTA for ASEAN is that it will make South-East Asia again attractive for foreign direct investment (FDI). What made China so attractive for foreign investors is the huge domestic market of 1.3 billion people. Low labour costs are also an important consideration for FDI flows into China, but there are signs that labour costs cannot continue to be as low as before. Already some levelling of wages is taking place between Hong Kong and Shanghai. Besides, labour costs account for only a portion of the total costs. Other costs, including transaction cost, transportation costs and telecommunication costs are higher in China. A combined ASEAN-China market will therefore make it advantageous for foreign investors to locate some of their offshore production units in South-East Asia, as the ASEAN-China FTA would allow them to have direct access to China's lucrative market from ASEAN.

Be all that as it may, all indications are that China may have been over-rated. China has been drawing in more investments than it can really absorb. Many investors in China are yet to make any money. Many have discovered that it is not easy to do business in China. The chances are that China will experience what may be termed "investment indigestion". Besides, there are other problems facing China that will make foreign investors increasingly cautious, if not nervous, about investing in the country.

A major concern now is deflation, which would impact negatively not only on China's economy but also on others' as well. Domestic companies are increasing production, at the cost of receding profit margins, in an effort to gain market shares. Increased volume is seen as a solution to the problem of declining profit margins, notwithstanding the fact that it contributes to growing inventories, declining prices and diminishing mark-ups. According to China's central bank, 86 per cent of manufactured products is in oversupply. For example, statistics show that, in the first 10 months of 2002, China could sell only 58 per cent of the 24 million units of air-conditioners produced in the country. A somewhat similar overproduction of microwave ovens has driven the unit price to one-fourth of what it was a few years ago. Likewise, the price of a 29-inch colour television set has dropped to less than one-third of the price in 1997.

Oversupply has led to price wars and falling corporate profits. Yet banks are ever willing to lend, based not on cash-flow analysis but on collateral, where big companies are considered creditworthy. Self-correcting mechanisms that would bring about a balance between supply and demand does not work in China because China is not a full-blown market economy by any measure. In the absence of an effective bankruptcy law, banks are understandably hesitant to seek liquidation for the fear of losing their assets. Thus, banks continue to finance weak companies. This means that pressure is building and an implosion seems almost certain. Official figures have put non-performing loans at 23 per cent of total assets, while independent analysts think it is closer to 40 per cent.

While deflation eats into the profitability of companies that compete within China, it has rendered China's exports internationally competitive. Hence the rush to export. No wonder China could garner a trade surplus of about US$100 billion last year. All these mean that China will be an ardent supporter of free trade. It is through trade channels that China will be exporting its deflation, knocking out rivals everywhere. China's foreign exchange regime makes it worse, as its currency is pegged to the US dollar, which has been depreciating against the Euro and yen. One would expect China's export surpluses to translate into a stronger renminbi, which is not happening on account of the currency peg. It is estimated that renminbi is undervalued by as much as 20 per cent. China has no intention of allowing its currency to appreciate by de-pegging it, as undervalued currency under the peg system complements and reinforces its export drive, which it badly needs to remain in the growth trajectory. This is worrisome not only to Europe and Japan but also to most ASEAN countries.

As oversupply piles up and domestic prices nosedive, China would turn increasingly to the regional and global markets. China's external sector, which accounts for 44 per cent of GDP, is considered too large for a continental economy. The chances are that it will grow even bigger. In fact, companies that are making profits in China are those producing for the external market. Many that produce for the domestic market are facing dwindling profit margins. It is therefore hardly surprising that China would want to expand its external linkages not only through the WTO but also through regional initiatives such as the ASEAN-China FTA.

It cannot be denied that China presents both challenges and opportunities. As mentioned, countries that will gain most are those, whose economies are complementary to, not competing with, China. Seen in these terms, the gains to ASEAN countries in the ASEAN-China FTA context would be very uneven. Countries that have a lot to fear are those with resource and factor endowments similar to that of China, while countries that avoid a collision course with China, by focussing on activities that are complementary to what China does, will be able to ride on China's coat tails.

In any case, ASEAN countries will find that China will affect their economies one way or another. If China is beset with domestic problems of sorts, such as banking crisis, corporate failures or currency turmoil, there is no way for ASEAN countries to insulate themselves from the fallout. The proposed ASEAN-China FTA would draw ASEAN countries even closer to China, thereby raising the risk factor even further for ASEAN members. It then follows that ASEAN countries need to worry about China with weak economic fundamentals rather than China with strong economic muscles.

In the final analysis, it is certain that China will lose its growth momentum, if it fails to bring about serious, not half-hearted, economic reforms. But, then, the risk is that meaningful reforms are likely to trigger political changes through social strife. Herein lies the tough dilemma for China's ruling elites.

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