Emerging Countries in the World Economy: New Competitors and New Markets

Policy Statement
T5 Group

The integration of China and the countries of the former Soviet Bloc into the world economy has been a major issue of international relations for over a decade. China, in particular, has achieved dramatic growth in incomes and has emerged as a major participant in many markets. The process has accelerated and taken on increased importance with the membership of China in the World Trade Organization (WTO) and the accession of ten Central and Eastern European (CEE) countries to the Europe Union. The changes have created considerable anxiety in other countries where many perceive a growing competitive threat to their jobs and living standards. The anxiety is particularly strong in Japan and the United States, which have large and growing economic linkages with China. Europe has been more focused on the problems of merging the CEE countries into an expanded European Union, but competition from China is also felt as a threat in a number of sectors.

In this report, we offer our perspective on several of the issues that surround the expanding role of China in the global economy and the accession of the CEE countries to the EU. While both are part of a common pattern of increased economic integration, the goals of the CEE accession are much more ambitious than the effort to make China a full partner in the system of global trade and finance. Their membership in the EU will require the elimination of all controls on the cross-border movement of products, labor, and financial capital, as well as membership in the

European Monetary Union (EMU). This is far beyond the economic integration being contemplated for China. But China is much more significant for the world economy, and even EU countries are increasing their relationships with China.

We first want to emphasize that China and the CEE countries are being integrated into a global trading system that is itself changing in important respects. In the following sections, we discuss first the changing structure of global trade and the development of global production networks, which involve the fragmentation of production processes that were formerly concentrated in single countries. China is only one of many emerging economies that are participating in that process. The section also underscores the dual influence of the emerging economies as rapidly growing new markets as well as new sources of production. Finally, it emphasizes the need for adequate policies in the high-income economies to promote the evolution of their own industrial structures. Section two addresses some of the issues that arise with respect to the entry of CEE countries into the European Union. The final section is focused on China's expanding role in the world economy, particularly the contentious issue of its exchange rate policy.

The Integration of Emerging Countries into the Global Trading System

The reduction of protectionist polices was a driving force behind the re-emergence of global trading networks in the half century after World War II. However, the liberalization of cross-border relationships is now interacting with a range of technological innovations and institutional changes to promote the formation of global production networks (GPNs). These GPNs involve cross-border exchanges in parts and components (and, increasingly, services), which may be produced in different countries and assembled in still another. Since the 1980s, increasing codification of knowledge, standardization of interfaces and flexible manufacturing technologies have led firms to fragment previously integrated plants into networks of suppliers. Globalization of these production networks has been made possible by innovations in transportation and communications, reduced trade barriers and the liberalization of foreign direct investment by developing countries.

Multinational firms have led the way in developing both *internal* networks of subsidiaries that stretch across national boundaries and *external* networks of contractors and allied companies. These production networks are geographically widespread and allow the participants to concentrate on their own core areas of comparative advantage. Their importance is evident in the rapid growth of both intra-firm and intra-industry trade.

The fragmentation of the production process has provided a major channel for integrating China and other emerging economies into the global economy. China's abundant supplies of low-cost labor have attracted large volumes of foreign direct investment, which served to speed its integration into the global networks. It has thus become a key actor in the assembly of manufactured products, drawing on components that are often produced in other parts of East Asia. Global production networks have also been important to the CEE countries where they are particularly evident in the automotive industry, as well as parts of electronics.

American firms have been particularly quick to expand the use of GPNs. The modular structure is well suited to the production of electronic products, and by outsourcing the production to contract manufacturers in Asia, U. S. firms have been able to focus on product design and marketing. In contrast, Japanese firms have traditionally emphasized a more integrated structure of product development and manufacture that made them reluctant to outsource the labor-intensive components in the sectors in which they held strong competitive advantages. Moreover, their greater commitment to employment in Japan has slowed the process of transferring production abroad. In recent years, however, they too have begun to transfer production to neighboring low-income countries, particularly China, and to focus their own efforts on high value-added products and key components. European firms are not major electronic producers; and since they are further from Asia, they are not as integrated into the region's production. European companies have, however, increased their reliance on the production of component parts in CEE countries.

The rapid pace at which the global realignment of production is occurring has created significant adjustment problems in the high-income countries. Difficulties in retraining workers and moving them into higher skilled jobs have created a political backlash that is unduly focused on the costs, displaced workers, while ignoring the benefits of better allocation of resources and growing export markets. It is important to recognize that China and the other emerging countries have expanded their own imports at a pace that matches the growth of their exports. Some of the political problems are the result of the highly distorted trade situation of the largest economy, the United States. It has a large trade deficit with every significant economy in the world, not just with the emerging countries.

The technological changes that are driving the evolution of the global production system will strengthen in future years. The high-income countries need to focus greater effort on the restructuring of their own economies to take advantage of the new areas of comparative advantage. They should avoid the temptation to erect barriers to the fuller inclusion of the emerging countries.

Integrating the Central European Countries into the European Union

The European Union has made a major commitment to expand its membership to include most of the CEE countries that were formerly members of the Soviet Bloc. Ten countries will become members of the EU in May 2004 (Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia). They are required to adopt full capital account convertibility at that time. However, there will be a delay of at least two years in their adoption of the Euro, and some restrictions on emigration and trade in services will exist at the beginning. The accession countries are not required to join the new exchange rate mechanism (ERM II) immediately, but most are expected to do so as part of the process of satisfying the Maastricht criteria for inclusion in the European Monetary Union (EMU).

Concerns have been raised that the adoption of a fixed exchange rate regime is incompatible with the convergence of living standards and productivity between the old and new members. At present, productivity in the tradable goods sector of the accession countries is only about half that of the EU. Thus, a rapid increase in productivity and wage rates is anticipated as they converge to the EU average. However, to the extent that these productivity gains cannot be matched in the non-tradable sectors, such as services, where the cross-national productivity differences are much smaller, price inflation is expected to be higher in the non-tradable sector. While the difference in productivity growth between the tradable and non-tradable sectors (Balassa-Samuelson effect) was large in the 1990s, its magnitude has lessened in recent years and is no longer a primary explanation for the high rate of inflation in accession countries.

This means the ten New Member States can act to curb inflation without inducing barriers to the adjustment of relative prices. In line with a moderation of price increases an exchange rate regime can be introduced that is directed towards a stable link to the Euro. Participation in the EMU is to be delayed for a two-year period, during which the New Member States will have to prove their convergence under the ERM II rules.

The delay in entry to the EMU serves no real value, however, and raises the risk of speculative attack against the currencies of these small economies during the period that they follow the rules of ERM II. This is particularly likely if the requirement to maintain the exchange rate within a very narrow band of ± 2.25 % of the central rate is used as a strict criterion for the fulfillment of convergence. Thus, we believe that the two-year period of compliance with the exchange rate target should be eliminated so as to allow countries that have already achieved price stability and meet the other budget and financial criteria to enter the EMU on an accelerated time table. Thus, the Czech Republic would be a candidate for early admission to the EMU, while others with higher inflation rates will require more time.

Rapid integration into the EU is important to the CEE countries because their trade performance is extremely dominated by the relationship with the EU. Trade with non-EU countries has fallen off severely since the early 1990s. And even in the area of EU trade, the positive performance is dominated by the expansion of exports of the machinery and transport sectors; and the shares of exports devoted to other manufacturing industries have all declined. The trade in machinery is also very reflective of their inclusion in regional production networks, since most of the exports are in component parts rather than finished goods. A deepening of their economic relationship with the EU offers the best opportunity for near-term growth. To the extent that they enter the EMU at a below-equilibrium exchange rate, their strong competitive position will speed up the convergence of incomes without the risk of protracted high unemployment as in East Germany.

China's Exchange Rate and Sustainable Growth

We believe that the current discussion of China's role in the international economy, and in particular the related issues of its trade balance and exchange rate, suffers from considerable confusion. First, while China has a large bilateral trade surplus with the United States, it has substantial trade deficit with other countries in Asia, and its overall trade balance has been consistently in the range of 0-2 percent of GDP. In this regard, the unusual country is the United States, which has large trade deficits with everyone, not just China. The rapid growth of China's exports has been matched by an equal expansion of its imports.

Second, measured on a multilateral trade-weighted basis, the Chinese real exchange rate has been essentially constant since the consolidation of the exchange rate system in 1994, and the adoption of a single fixed nominal rate tied to the U.S. dollar. It has also been consistent with a small, but stable current account surplus over the past decade.

Third, China's small current account surplus is fully compatible with its internal macroeconomic situation, which is marked by an extraordinarily high rate of domestic saving that is more than adequate to finance domestic investment. As a result, China has no need or capability to absorb large net inflows of foreign financial capital. Additional inflows, as would result from a current account deficit, run the substantial risk of generating an asset market bubble in China comparable to that which affected other Asian economies in the mid-1990s.

We conclude that, while the RMB might be undervalued on the basis of purchasing power parity (PPP), the current exchange rate is appropriate from the more relevant macroeconomic perspective. A current account surplus of 1-2 percent of GDP is fully consistent with China's high saving and a rate of domestic investment that may already be in excess of a sustainable rate. In that circumstance, a revaluation of the exchange rate runs the risk of destabilizing the Chinese economy.

Instead, China's problem is an excess inflow of financial capital that results from the combination of the small current account surplus and a large inflow of foreign direct investment. It needs to find a means of redirecting or recycling those funds back into international markets. Prior to 2002, a large portion of the inflows were offset by unrecorded outflows (errors and omissions in the balance of payments) and by allowing onshore foreign exchange deposits and loans within the domestic banking system. The remainder was purchased by the central bank and recycled back into international bond markets, principally U.S. government securities.

However, with speculation about a possible revaluation of RMB, no one wants to hold foreign exchange. As a result, a flood of foreign currency claims is being presented to the central bank for conversion into yuan. Since the conversions are largely financed by money-creation, there is a concern about the potential for inflation.

With open capital markets, the pressures of foreign financial inflows could be balanced by an equal magnitude of outflows from Chinese citizens seeking to diversify their investments. However, there is widespread agreement that China cannot allow free cross-border financial flows until it has progressed further in establishing a strong and competitive domestic financial system. Thus, it needs a means of managing the inflows during the interval before it can make the transition to full capital account convertibility.

There are a variety of measures that could be taken to ameliorate these financial problems. While China desires the expertise and market access that accompanies foreign direct investment, it could remove the requirement that those investments be financed abroad, thereby reducing the magnitude of financial inflows. In addition, it could move toward capital account convertibility on an incremental basis of allowing limited capital outflows by resident firms and individuals.

Third, it currently encourages newly privatized or restructured firms to seek financing in international markets. This is done to obtain a foreign imprimatur for its internal system of commercial law, corporate governance, and accounting, but it comes at the cost of exacerbating the excess net inflow of foreign exchange.

Fourth, while we do not believe that the RMB is significantly undervalued, it certainly does not need to follow the U.S. dollar in its decline against other currencies. China could maintain many of the advantages of a fixed exchange rate regime by moving its peg to a market basket of major currencies. This would divert much of the current critic ism of its exchange rate regime.

Finally, China does not play a major role in the current preoccupation with global deflation. Its export capability is largely built around the relatively simple processing of imports for re-export. As such, we find that China's export prices are dominated by the cost of imports, with a relatively small role for domestic value added. The implication is that a currency revaluation would have a relatively small effect on export prices because it would also lead to reduced prices of the imported components. On the contrary, a rapidly growing Chinese economy is a force for higher global prices through its impact on the demand for a range of basic commodities.