

CHINA: A WORKSHOP OF THE WORLD AND A MARKET FOR EUROPE

China has become the world's third largest exporter and will doubtless be number one in less than ten years. The recent elimination of textile quotas has opened European and North American markets to Chinese textile products. But machinery, electrical and electronic products actually account for the bulk of Chinese exports. These products stem mainly from factories owned by foreign companies located in China, which import components from Asia, and subsequently export finished products to world markets. This is one source of the asymmetry in trade between China and the United States and Europe, which tends to hide the fact that Europe is a leading supplier of imports for China's domestic market. European companies should be well-placed to meet local demand were growth to be led more by domestic consumption. Such a scenario depends, however, on the evolution of the labour market and on the extent of rural-urban migration.

■ The Shock of Chinese Textiles

The influx of Chinese textiles into us and European markets had been anticipated. One of the major consequences of China's entry into the WTO, at the end of 2001, was that it would benefit from the liberalisation of international trade in textiles, in exchange for opening up its own market. Various simulations indicated that China's clothing exports could double their share of the world market, from 20% to 40%.¹ Furthermore, the protocol on China's accession to the WTO contains a specific, derogation clause allowing partner countries to implement safeguard measures against Chinese textiles, through to 2008, should massive imports disrupt their markets.²

Chinese textile exports have indeed risen much since 2001. The total elimination of import quotas from the 1st January 2005 onwards, as set out in the ATC³, led to a strong influx of Chinese textiles into us and European markets, during the first quarter. Nine product categories have been placed under investigation by the European Union. In seven categories, Chinese gains have occurred at the expense of

other exporters, without causing a strong, overall rise in import quantities (Table 1). However, Chinese competition has translated into a sharp fall in unit values for most products, be they from China or elsewhere. As a result, the euro value of European imports has fallen in eight out of nine categories, often significantly. The European market thus seems to be disrupted more by price falls, than by a rise in import volumes.⁴

Table 1 – Textile imports under investigation by the EU25 (excluding intra-EU trade) - comparisons between 1st quarters of 2004 and 2005

in %	Variation in import volumes		Variation in unit values of		Variation in the euro value of imports	
	from China	from all countries	from China	from all countries	from China	from all countries
T-shirts	164	16	-26	-20	95	-8
Pullovers	534	4	-47	-22	239	-18
Men's trousers	413	4	-16	-20	330	-17
Blouses	186	-11	-24	-11	118	-21
Socks and stockings	183	63	-20	-76	132	-59
Women's overcoats	139	36	-15	-28	104	-2
Brassieres	63	-16	-22	-12	28	-26
Flax yarn	51	19	1	-7	52	11
Flax fabrics	257	5	0	-23	259	-19

Source: <http://europa.eu.int/comm/trade/issues/sectoral/industry/textile/pr280405_en.htm>.

1. R. Avisse & M. Fouquin (2001), "Textiles and Clothing: the End of Discriminatory Protection", *La Lettre du CEPII*, No 198, February; E. Ianochovichina, W. Martin & E. Fukase (2000), "Comparative Study of Trade Liberalisation Regimes: The Case of China's Accession to the WTO", presented at the 3rd annual conference on *Global Economic Analysis*, Melbourne, Australia, June, <www.monash.edu.au/policy/conf/75Martin.pdf>.

2. This has been used by the United States, which has placed restrictions on Chinese textile imports. As regards Europe, an agreement was reached with China on the 10 June 2005, limiting the progression of Chinese imports through to 2008.

3. The Agreement on Textiles and Clothing was reached in 1995, within the WTO framework. It sets out the progressive suppression of quotas, ending with their complete elimination on 1st January 2005.

4. As for third markets, it is probable that European textile exports have been little affected by Chinese competition, which is less prominent in the same product ranges.

The surge of cheap Chinese products has indeed been a shock, threatening the industrial production links which have grown up within the Euro-Mediterranean region. For thirty years, Europe's textile industry has abandoned or relocated numerous activities, first South of the Mediterranean (Turkey and the Maghreb) and subsequently to Eastern Europe. This has allowed it to retain segments in the production chain, especially in upstream stages of production and in high quality products. Consequently, countries bordering the EU were able to increase market shares between 1990 and 2003, while Asia lost shares: the gains made by China did not compensate for the drop in textile and clothing exports from other Asian countries (Table 2).

Table 2 – Sources of textile* imports by the EU-15 (excluding intra-EU trade)

	Market share in 2003, in %	Change in percentage points, 2003/1990
EU-15 periphery	35	+12
Central Europe	16	+10
Mediterranean	18	+2
Asia	30	-6
China	20	+11
Japan and NICs	9	-17
Other	36	-6

*Textiles-clothing-leather.

Source: CEPII, CHELEM-CIN database, authors' calculations.

■ A Global Trading Power

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The worries generated in Europe and the United States by the surge in Chinese clothing exports are largely linked to the impression that they herald an invasion of Chinese goods in all sectors.⁵ China's rise in world trade has indeed been very rapid, with its share in world exports standing at 7% in 2003. It has thus become the world's third largest exporter, behind Germany and the United States, but ahead of Japan. It is probable that China will become the world's leading exporter over the next decade. Chinese exports grew in

Table 3 – Contributions to world growth in exports, 2003/2001

in %	Exports		Imports	
	in dollars	in volume	in dollars	in volume
China	3.9	3.8	3.0	2.9
EU-15 (excl. intra)	4.2	0.8	3.7	0.9
United States	-0.2	-0.2	2.0	2.0
Japan	1.3	1.0	0.7	0.4
Asian NICs	3.9	3.4	2.3	1.7
World	18.4	10.5	18.4	10.5

Source: BACI-CEPII, authors' calculations.

volume terms by an average of 16% per annum, between 1993 and 2003 (source BACI-CEPII). From 2001 to 2003, its exports accounted for more than one third of the volume rise in global exports (Table 3).

The increase in exports has mainly been led by machinery, electrical and electronic products, which totalled 40% of Chinese exports in 2003, compared to 16% in 1990. These products have therefore largely surpassed textiles, whose share fell from 32% in 1990, to 22% in 2003. China's share of world exports exceeds 20% not only in clothing, but also in consumer electronics and household appliances. It stands at 18% for computer equipment and office machinery. This diversification of manufactured exports has been accompanied by a rapid upgrading in their technology content. China now exports approximately 5% of the world's high-tech products, about as much as France.⁶

As a result, China provokes concerns not just among developing countries with which it is in direct competition in labour-intensive goods, but also, increasingly, among developed countries.

To be sure, this is not the first time that the world economy faces the challenge of "absorbing" the arrival of a major exporter: China has followed the path taken by Japan a few decades earlier, though at somewhat greater speed.⁷ China, however, has achieved this trade position at a far earlier stage of economic development. Japan was already an industrialised country at the start of the 1960s: its GDP per capita was higher than the world average and equivalent to about 40% of the United States' (at purchasing power parity). In contrast, China remains a developing country, whose per capita income is only 15% the US level. Chinese agriculture, which still employs 50% of its working population, constitutes a huge reservoir of labour available to industry. It is therefore to be expected that low labour costs will remain the principal source of China's comparative advantage for a long time.

China's commercial strength does not just stem from wage levels, but also from its integration in Asian production systems. Companies from the most advanced economies in the region have integrated China into their production and trade networks, leading to a substantial regional restructuring of industries. They have relocated most of their textile industries to China (first upstream, then downstream), and Chinese exports have substituted those of developed Asian countries, as shown above. In electrical goods and electronics, the relocation of production has taken place in

5. E. Izraelwicz (2005), *Quand la Chine change le monde*, Grasset; Patrick Artus (2005), "La Chine et la théorie du commerce international", Flash, No 2005-193, Ixis.

6. Source: *World Development Indicators*, World Bank.

7. Japan took 20 years (1953 to 1973) to raise its share of world exports from 1.5% to 6.6%, whereas China took only 15 years (1978 to 2003). Japan's share of world exports peaked in 1988 at 9.8%. In 2003, it stood at 6%.

downstream activities of the value-added chain, and Chinese exports come mainly from processing activities, involving imported component parts (Table 4). The division of labour in these sectors means that Asia's advanced economies export less finished products to Europe and the United States, and more and more component parts to their production units in China. The latter, in turn, export finished products (with a high import content) to the rest of the world. The lion's share of China's trade in high-tech products stems from such processing operations, 80% of which are carried out by foreign companies established in China.⁸ Production is now moving upstream in these industries, as has already happened in textiles, as foreign companies are increasingly drawing their sub-contractors to China. That said, the local content in such processing activities is only about 30% on average, and has hardly changed since the end of the 1990s.

Table 4 – The share of processing activities in exports, 2003

<i>in %</i>	Processed exports/total exports	Share of the branch in total manufactured exports
Textiles-clothing	30	21
Electrical machinery and electronics	86	42
Office machinery	96	16
Electrical machinery	63	7
Radios, TVs, communications	87	16
Precision instruments	73	3
Other	40	37
Total manufacturing	57	100

Source: Chinese customs data provided by the ITC, Geneva; authors' calculations.

Western countries provide few intermediate products to these assembly industries, largely because they are geographically remote from China. But they are the main destination for final products. An intrinsic asymmetry therefore exists in China's foreign trade with the United States and Europe, which stems from the relocation of Asian industries to China. Aside processing industries, trade between China and the United States is balanced, and in deficit with the European Union (Table 5). Indeed, Europe is a key supplier of imports to the Chinese internal market.

Table 5 – China's trade balance, by customs regime, in 2003 (in billions of dollars)

	World	Developed Asia*	EU-15	United States	Rest of World
Total	25	-15	19	59	-38
Processing trade	79	11	34	54	-21
Ordinary trade	-53	-26	-15	4	-17

*Japan, South Korea, Hong Kong, Singapore and Taiwan.

Source: Chinese customs data provided by the ITC, Geneva; authors' calculations.

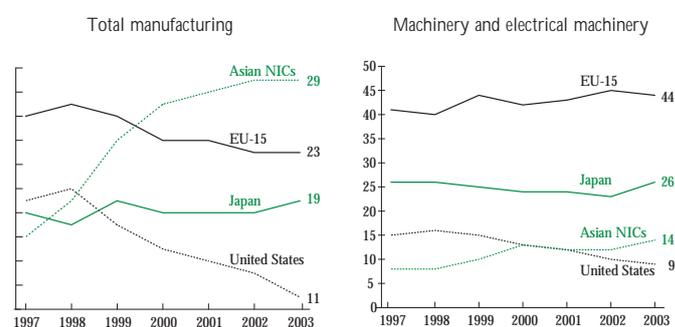
Europe's Strong Position

Since 1997, imports to China's domestic market have grown far faster than imports for processing industries. This has resulted from cuts in tariffs, the reduction of other import barriers, and, more recently, the acceleration of Chinese growth. Such "ordinary" imports accounted for 27% of China's import total in 1997, rising to 44% as of 2002. The level of openness of the domestic market (ordinary imports/GDP) has doubled in the last ten years, up from 10% to 20%.

In 2003, the European Union provided about 23% of these ordinary imports, putting it ahead of Japan, and very clearly ahead of the United States, which has seen its market share fall since the late 1990s (Graph). European suppliers have a strong position in ordinary imports of capital equipment. In the major categories of manufactured products imported for the domestic market, EU suppliers have held on to their lead position in mechanical and electrical machinery (44% in 2003), in vehicles (43%), and in precision instruments (33%). In contrast, under competitive pressure from the Asian Dragons, the EU's share of Chinese imports has fallen strongly in Radios, TVs and communication equipment (down from 50% in 1997 to 11% in 2003).

Consumer products still account for a marginal share of ordinary Chinese imports (only 3% of manufactured imports in 2003). To be sure, living standards have much improved over the last twenty years and 10% of urban households (about 50 million people) now have a domestic purchasing power and consumer habits close to those of western middle classes.⁹ Nevertheless, the number of persons making up the solvent market for imported consumer goods is more limited.

Graph – The origin of "ordinary" imports – in %



Source: Chinese customs data provided by the ITC, Geneva; authors' calculations.

8. See G. Gaulier, F. Lemoine & D. Ünal-Kesenci (2005), "China's Integration in East Asia: Production Sharing, FDI and High-Tech Trade", *CEPII Working Paper*, No 2005-09, June.

9. The per capita earnings of this upper income bracket stood at around Yuan 23000 in 2003, equivalent to Euro 2300 at current exchange rates, and to Euro 4600 at purchasing power parity.

■ Towards More Balanced Growth?

Given China's place in international trade, it is unlikely that its exports can go on expanding at the rate shown over the last three years, without provoking new trade disputes with other actors in the world economy. China's economic policy therefore has little choice but to favour a return to growth which is led more by domestic consumption.

A shift occurred in the composition of Chinese demand, in the ten years from 1993 to 2003, when compared with the previous decade. The contribution of household consumption in GDP growth fell, whereas investment became more important, and net exports turned positive (Table 6). These trends were further accentuated in 2004. GDP growth at 9.5% was spurred by a 20% increase in fixed capital equipment investment. This was double the rise in household consumption, bringing investment almost to 50% of GDP. The trade surplus also expanded in 2004. These trends continued into the first quarter of 2005, with the trade surplus widening strongly.

Table 6 – Contributions to Chinese GDP growth

	Domestic demand	Private consumption	Government spending	GFCF	Net exports
1984-1993	101	46	14	42	-1
1994-2003	90	33	11	45	10
Share of GDP, 2003 in %					
China	94	40	12	43	6
for information: India	101	63	12	26	-1

Source: Asian Development Bank, *Asian Development Outlook*, 2005.

In its annual Development Outlook for 2005, the Asian Development Bank stresses that most other Asian economies have also been unable to implement a growth strategy led by household consumption. Indeed, the latter appears to be the weak link in these economies, with India being an exception. China, however, is an extreme case, with private consumption only accounting for 40% of GDP in 2003. China's weak private consumption has several explanations. Income growth of the rural population, still 70% of the total, has been relatively slow over the last ten years. This is due to poor price trends for agricultural products, the very low level and low rate of increase in wages paid by rural

enterprises, as well as in the wages paid to migrants working in urban enterprises. The income gap between towns and the countryside has widened strongly. Also, though the wages of urban workers have risen, rising unemployment and job insecurity favour precautionary saving.

It may therefore be asked whether prevailing conditions are likely to lead to growth based more on domestic consumption. Rising agricultural prices in 2004 helped to stop the fall in relative rural incomes while tax measures have been implemented to support this trend. More generally, it seems likely that the decline in industrial employment is coming to an end: industrial jobs fell from 98 million to 83 million between 1995 and 2002, with job creation by private local and foreign firms not being sufficient to compensate for cuts in over-manning in the State sector. It is likely that the bulk of these job losses has taken place, and China may well benefit from a more dynamic labour market in the years ahead. Together with improvements in purchasing power and employment, the extension of China's social security system (unemployment insurance and pensions) as well as a shift in public spending away from investment towards social spending (education and health) should support household consumption.

More balanced growth in favour of consumption should in turn help alleviate social tensions. It would also diminish the vulnerability of the Chinese economy to fluctuations in the global business cycle and to international trade disputes. This would be so especially were more balanced growth to be accompanied by rising domestic incomes and prices, which would lead to an appreciation of the yuan's real exchange rate. European companies should be well-placed to meet local demand for goods and services, given their market positioning and investment which are oriented towards China's domestic market. Such a positive scenario, however, depends on the evolution of the labour market and the scale of rural-urban migration during the years to come.

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