

# The Economic Rise of China: Threat or Opportunity?

by Nicholas R. Lardy

Rapid long-term economic growth, a quickly expanding share of global trade, and record-breaking foreign direct investment inflows all justify describing China as a rising economic power. Americans view China's rise variously as a threat to jobs in the United States or as a market of unprecedented potential. Some manufacturers and labor unions believe that a large portion of the more than two million factory jobs lost in the United States during the past two years can be blamed on the rapidly rising bilateral trade deficit that the United States has with China. Others focus on China as the fastest-growing large U.S. export market and see substantial opportunities.

Is China's economic rise a threat or an opportunity to American firms, workers, and consumers? Does the rising U.S. bilateral trade deficit with China suggest that China's market is closed? Or does it suggest that China's openness with respect to inward foreign direct investment means that China is now supplying the United States and other advanced industrial countries with goods that previously were produced elsewhere, primarily in emerging Asia? Would trade protection in the United States likely preserve many jobs or simply deprive American consumers of lower-cost goods produced in China?

## ■ China's Economic Prospects: Growing and Growing

China's gross domestic product last year was more than eight times that of 1978, the year when Deng Xiaoping launched the country's economic reform program. The long-term rate of growth has been about 9 percent, the fastest of any country on the globe during the two-decade-

plus period. China's expansion has been particularly impressive recently, when it maintained its growth even in the face of a global growth recession in 2001 and an anemic recovery in 2002. China's economy is now so large that it is beginning to serve as an engine of growth not only in Asia, but even globally. In 2002, for example, the expansion of the Chinese economy in absolute terms was more than 10 times that of Japan. And globally, China, which accounts for only one-twenty-fifth of world output, accounted for one-sixth of global expansion last year.

China's external trade has expanded even more rapidly than its economy, reflecting a substantial increase in openness over the past two decades. In 1977 China accounted for only 0.6 percent of world trade, a share that by 2000 had sextupled to 3.7 percent, in the process catapulting China to become the world's seventh-largest global trading economy. China's trade performance continued to be very strong in 2001, when global trade shrank for the first time since 1982, and in 2002 when global trade recovered weakly. China alone accounted for one-quarter of the expansion of world trade last year.

China's inflows of foreign direct investment are a third indicator of its economic rise. China signaled its intention to open its economy to foreign investment when it passed a joint venture law in 1979 and created several special economic zones on the southeast coast in 1980. Initially the inflows were modest, a few hundred million dollars a year. But by the early 1990s, this trickle had increased to a flood of more than \$25 billion. Even in 2001 and 2002, when global flows of foreign direct investment fell by about a half and

**China's economy is opening up to the outside world. This worries those who fear that country's huge pool of low-cost labor will drain jobs from U.S. shores, and less expensive goods will spark trade problems. The author points out that not only does China's untapped market present huge opportunities for U.S. businesses that would surely outweigh any loss of jobs, but the sort of jobs that would move to China left the U.S. a long time ago. And with respect to fair trading practices, China has made much progress.**

a third, respectively, inflows into China continued to expand, reaching \$52.7 billion last year, making China the world's number-one destination for foreign direct investment.

But China's outstanding economic performance over the past two decades is no guarantee of its future success. China's leadership faces profound challenges as it seeks to sustain rapid economic growth and deliver rising living standards to its population. It must further cut tariff levels and eliminate most nontariff barriers in order to meet its schedule of commitments to the World Trade Organization. This process will open up the economy to even more foreign competition and stimulate further structural changes that, at least in the short run, will add to unemployment and potentially social unrest as well. China's leadership must also grapple with income inequality, which on virtually every identifiable dimension has increased dramatically since reform began. A third major challenge is environmental deterioration, which, according to

the World Bank, is generating substantial excess mortality and morbidity. Finally, China faces the challenge of continuing to reform its financial sector, particularly its fragile banking system. The major state-owned banks remain insufficiently capitalized and suffer from poor risk management. Despite pressures from the government to commercialize their lending operations, China's largest state-owned banks, which dominate the financial landscape, remain burdened with high levels of nonperforming loans. Their profitability levels, extremely low by international standards, to date have impeded the more rapid write-off of nonperforming loans and the achievement of levels of bank capital that meet domestic and international standards.

While this short list of economic challenges could easily be increased, China's growth prospects nonetheless remain strong. In large part, this is because of the cumulative effect of more than two decades of economic reform. Most importantly, the process of gradual price liberalization has proceeded so far that markets now set the prices of almost all commodities. Equally important, reforms have dramatically increased competition, not just in manufacturing but in construction and much of the service sector as well. The pervasiveness of market-determined prices and competitive markets has improved the efficiency of resource allocation. Finally, the rates of savings and investment remain among the highest in the world.

The role of the external sector in increasing competition in the domestic market is especially important, and all too frequently underestimated. Even before China entered the World Trade Organization, it had cut tariffs by almost three-quarters compared to their peak levels of the 1980s. In addition, several nontariff barriers were largely phased out over the same period. At their peak, quotas and licenses, for example, restricted almost half of all commodities listed in China's tariff schedule. But by the time China came into the World Trade Organization in 2001, only 4 percent of all commodities were so restricted. Trading rights have also been liberalized so that the government's ability to limit imports by assigning exclusive rights to import specific commodities to a single or small number of state-owned trading companies has been very substantially reduced.

Finally, while it has been little noticed, foreign firms operating in China are adding substantially to competition in the domestic market. Foreign firms account for more than a quarter of the output of manufactured goods. While it is true that many foreign firms use China as an export platform, about three-fifths of foreign-produced output is actually sold on the domestic market. From the point of view of local firms, the competition added to the market from the availability of these goods is every bit as real as if the goods were imported. In 2002 the value of domestic sales of foreign affiliates was almost as great as the value of imports.

As a result of the increase in competition in the domestic market, China's state-owned sector has undergone a substantial restructuring in recent years. Employment is down by about two-thirds from its peak, the excessive rate of inventory accumulation has been reduced, and profitability has turned up for the first time in 20 years. It is true that the restructuring process is far from over. But the view that China's WTO commitments will cause increasing unemployment and concomitant social unrest fails to take into account that restructuring was well under way even prior to the time China entered the World Trade Organization.

### ■ Implications for the United States

The implications of China's rise as a major economic power for the United States are more difficult to judge. Those who believe China represents a challenge point to the large and growing bilateral deficit in trade with China as evidence that the Chinese domestic market remains closed. Further, they point to the large buildup of official holdings of foreign exchange in China as evidence that the authorities are preventing an appreciation of their currency, which tends to make their products more competitive. The U.S. bilateral deficit with China now far surpasses that with Japan.

But the suggestion that China has replaced Japan as our most common source of trade disagreements seems somewhat misguided. At the time Japan had its record-setting surplus in its trade with the United States it also had a massive global trade surplus. By contrast, China's global trade surplus in recent years has been relatively small. In addition, China has a deficit on its services

account and in its foreign income account, so that its current account, a better reflection of its overall trade balance, is relatively small, only about 1.5 percent of its gross domestic product.

Far from being a closed economy, China for the past decade or so has been the fastest-growing large export market for U.S. companies. Just last year, for example, U.S. sales of aircraft to China soared 42 percent to \$3.1 billion, sales of integrated circuits rose 38 percent to reach \$1.2 billion, and chemical fertilizer sales rose 58 percent to reach \$650 million.

China has the largest surplus of any country in its bilateral trade with the United States, not because its own market is closed, but largely because it has emerged as a major global production base for labor-intensive manufactured goods. Global exports of foreign-invested companies in China have grown from US\$300 million in 1985, when they comprised only 1 percent of China's total exports, to US\$170 billion in 2002, when they comprised over 50 percent of China's total exports. Most of foreign direct investment in China originates in Hong Kong, Taiwan, and Korea. As a result of rising real wages and appreciation of their domestic currencies, firms in these economies became less competitive in labor-intensive manufacturing beginning in the mid-1980s. To survive, these firms in these economies in the second half of the decade began to move their production off shore, first to Southeast Asia and later increasingly to China. China subsequently rapidly displaced the exports of other Asian economies in third-country markets such as the United States. For example, China displaced Taiwan and Korea as the major supplier of footwear to the U.S. market. It also displaced Hong Kong, Taiwan, and Korea as the major supply sources of toys, games, and sporting goods. This displacement began in the mid-1980s and was largely completed by the end of the 1990s.

A similar transformation has been under way for some time in some consumer electronics products and appears to be under way in information technology hardware, a category that includes personal computers, notebook computers, monitors, scanners, personal digital assistants, PC servers, and so forth.

Globally, information technology hardware is a \$300 billion industry, a large portion of which is produced in Asia. The most notable development in the last decade has been the migration of production capacity from elsewhere in Asia, particularly from Taiwan, to China. As a result, China's production of information technology hardware soared in the second half of the 1990s. By 2000, China actually displaced Taiwan to become the world's third-largest producer of information technology hardware, after only the United States and Japan, and last year China displaced Japan to rank number two globally. Taiwanese firms alone accounted for almost two-thirds of the mainland's \$32 billion output of computers and related equipment in 2002.

In the United States, imports of information technology products from China are increasingly displacing products previously made elsewhere in Asia. For example, the share of U.S. computer imports originating in Japan, Singapore, and Taiwan in the early 1990s was almost 70 percent but has now fallen to well under 40 percent. On the other hand, the share originating from China has increased from nil in the early 1990s to almost 15 percent.

But the mainland's production of information technology hardware is based on the import of high-valued-added parts and components, almost all of which originate within Asia. The production of liquid crystal display monitors in China, for example, now is based largely on liquid crystal modules imported from Taiwan, South Korea, or Japan. Thus, even as China displaces other Asian sources of supply of finished goods in third-country markets, it is emerging as a huge market for high-value-added parts and components produced mostly in Asia. The result is a pattern of triangular trade. China imports huge quantities of parts, components, and electronic assemblies from other Asian countries, in the process running very large bilateral deficits. China's deficit with Taiwan last year was \$31.5 billion. And China runs a surplus in its trade with countries like the United States that have a large number of consumers of these electronic products. But overall, its resulting global trade surplus is relatively small.

## ■ **China: An Opportunity for the United States, a Challenge for Asia**

China's rise presents opportunities and challenges for the global economy. China's rapidly expanding trade volume has become a major engine of growth in the Asian region, largely because of the imported capital goods and parts and components used in export processing. And it has become an increasingly important market for U.S. firms as well.

On the other hand, China represents a significant challenge for producers of labor-intensive manufactured goods. Many, particularly in Asia, have adjusted by investing directly in China, with a resulting loss of employment at home. Taiwan and South Korea face the challenge of continuing to move up the technology ladder into the production of more technologically sophisticated, more capital-intensive goods. Although China is displacing some production in the U.S. market, the challenge is substantially less. Production of footwear, toys, and sporting goods largely moved out of the United States to other locations in Asia before it then migrated to China. The U.S. economy adjusted to the loss of these jobs years ago. The story is similar with respect to most information technology hardware, most of which has not been produced in the United States in significant quantity for quite some time.

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