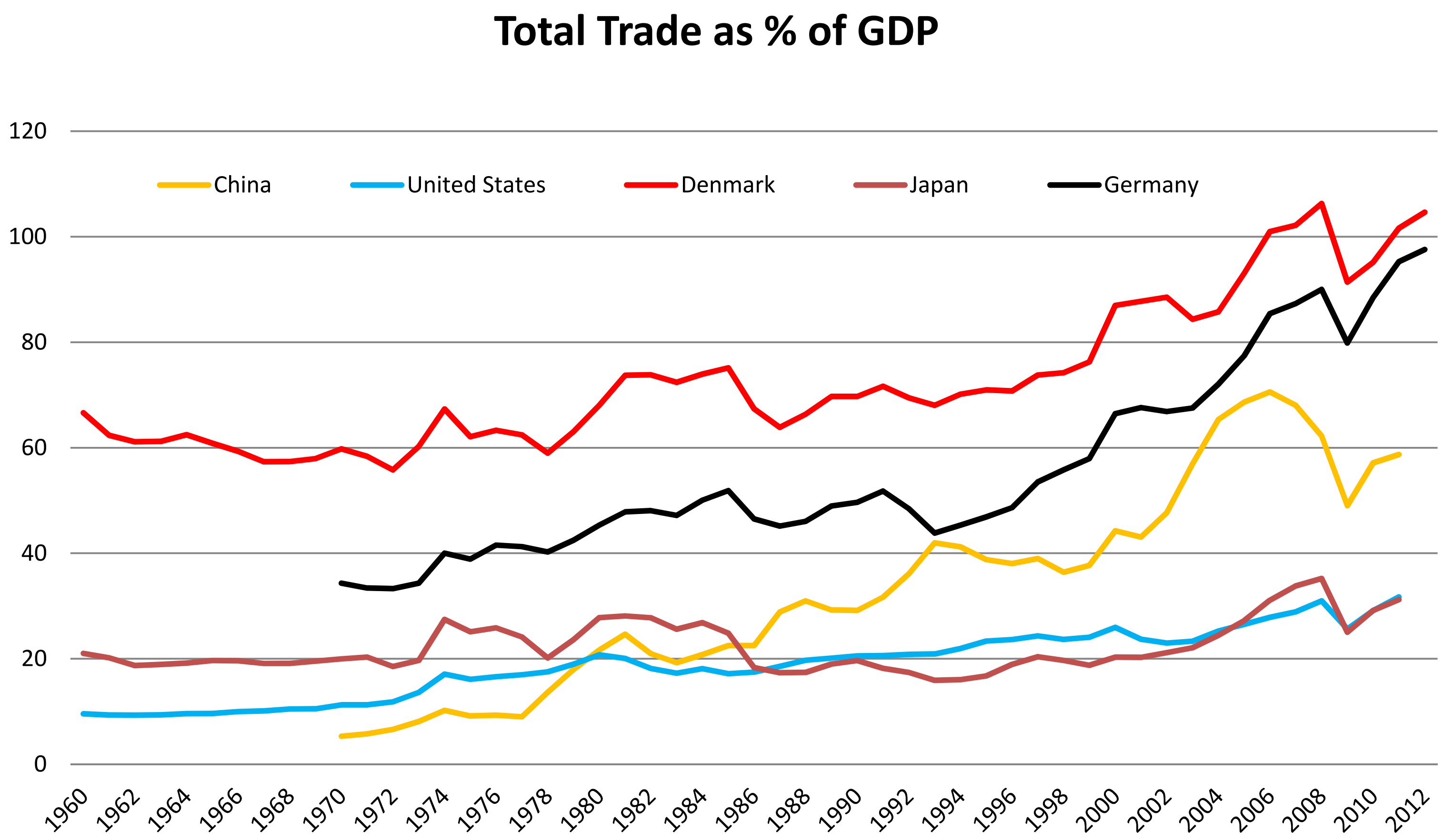
What's Happening

- Major policy annoucements from China's 3rd Plenum (of 18th Party Congress):
  - allowing the market economy to play "decisive" role in the allocation of resources was a basic theme
  - to establish a national security council that brings together the country's top security officials
  - further relaxation of "one-child policy"

- Lack of details, more policy elaborations expected in coming weeks

How trade-dependent is China?

Traditional Measure: trade dependency ratio



Note: Trade includes both exports and imports;   Source: World Development Indicators

Problem with traditional measure

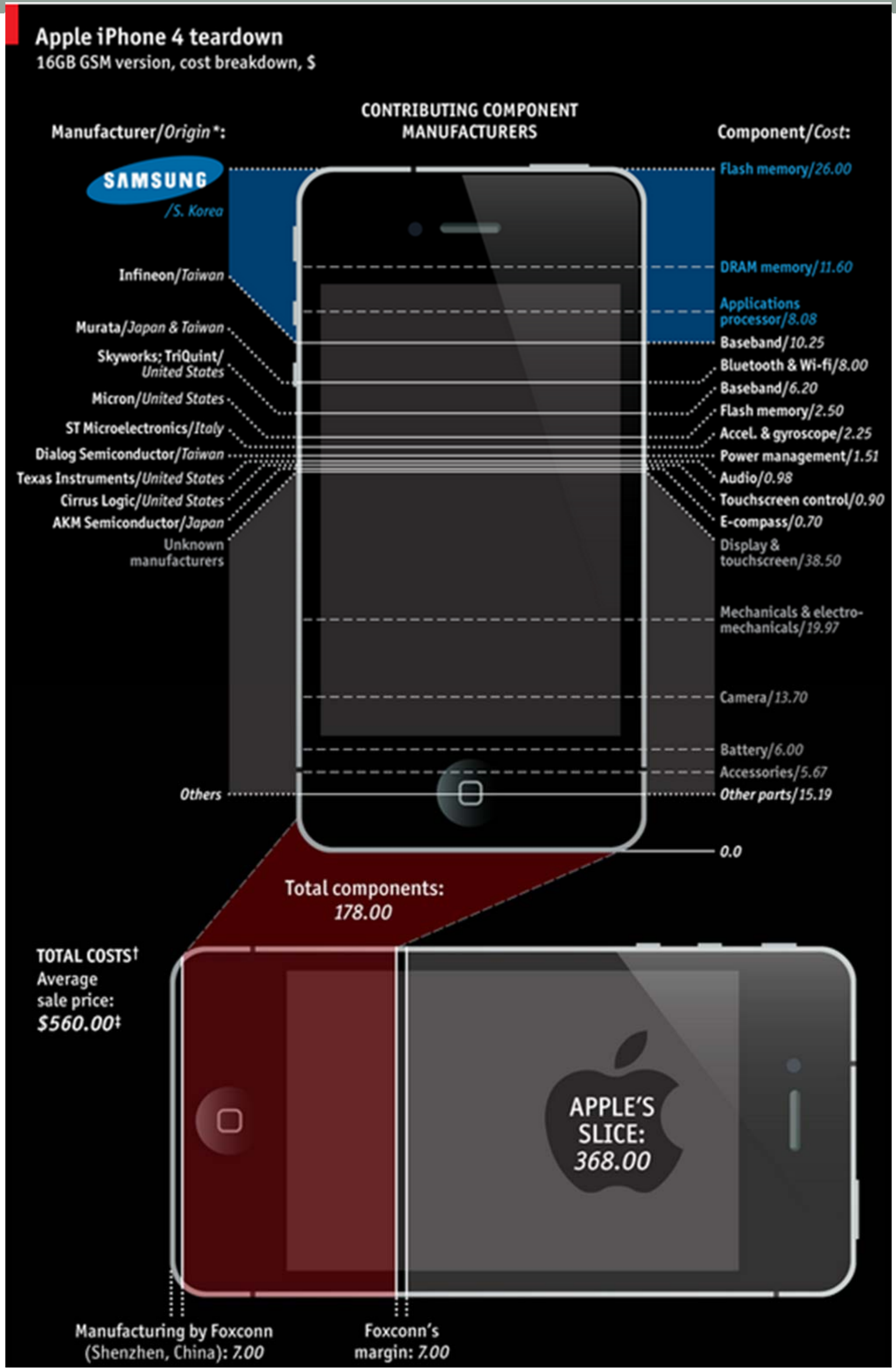
- Trade, or sum of both exports and imports, counts the total value of goods and services, incl. the value of intermediate goods/services

- Yet, GDP is a measure of value-added. So trade dependency ratio basically compares apple with oranges.

- When a country engages in processing trade, like China, trade/GDP ratio tends to exaggerate its trade dependency:
  - Imports used mainly as intermediate goods for further processing in China will be counted as part of Chinese export value as if there were produced in China. In fact, these imports were manufactured elsewhere (e.g., iPhone components);
  - The value-added portion of China's export value should be the total export value minus the value of imported intermediates

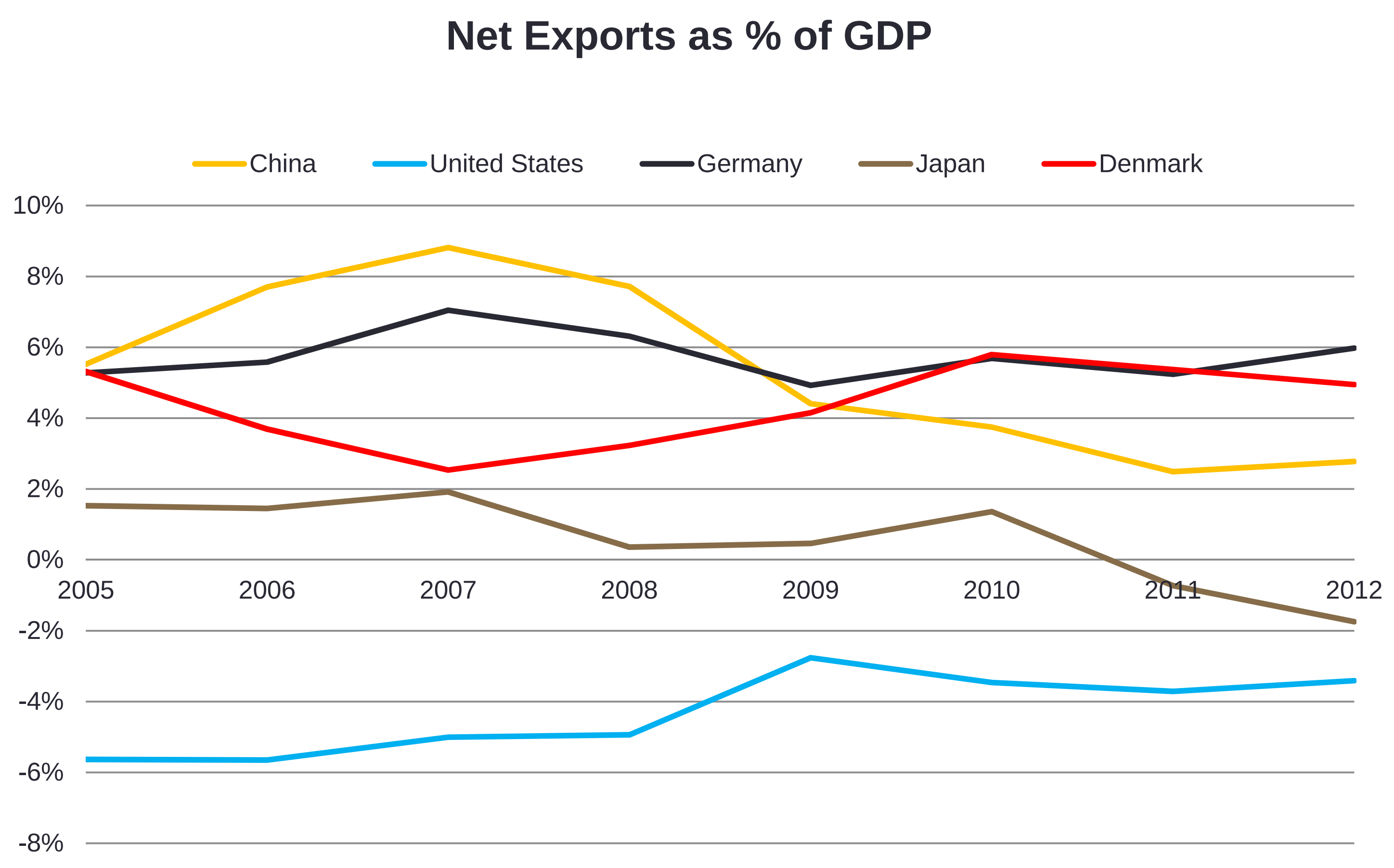
- With trade-dependency ratio, the higher the share of processing trade, the greater exaggeration of the importance of trade to an economy

iPhone economy



A better measure: net exports

Y = C + I + G + <u>NX</u>



Lots of activities, why small contribution?

Y = C + I + G + NX

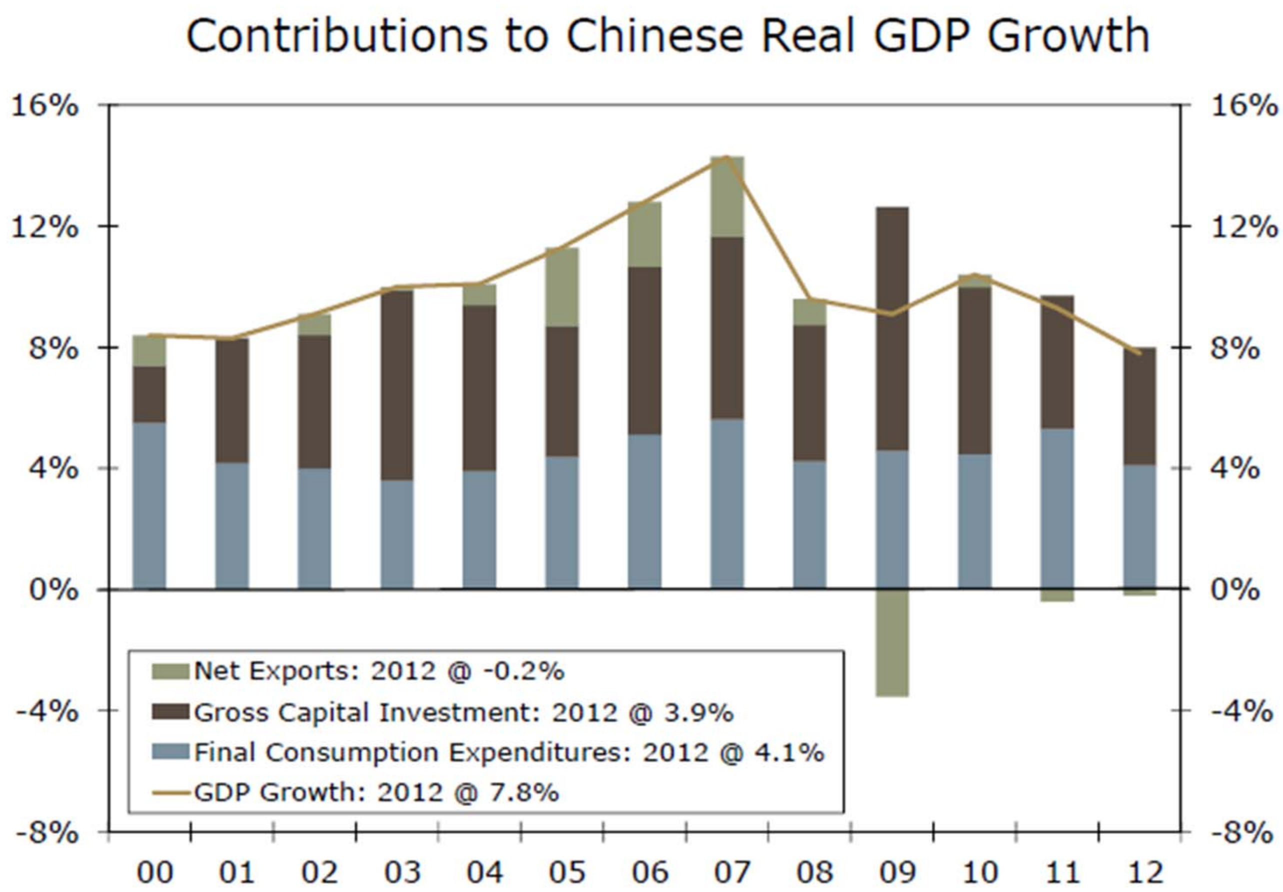
- China's total trade is around 65% of its GDP, yet the contribution to its GDP, in terms of net exports (NX) to GDP raito, is much smaller

- Again, this is closely related to China's processing trade regime:
  - Processing trade means China needs to import a lot of intermediate inputs for manufacturing processing
  - In China's case, the volume for both exports and imports tend to be very large
  - But only the **domestic content** of exports goes into GDP calculation

- In other words, one should really pay attention to the "value-added" portion of exports

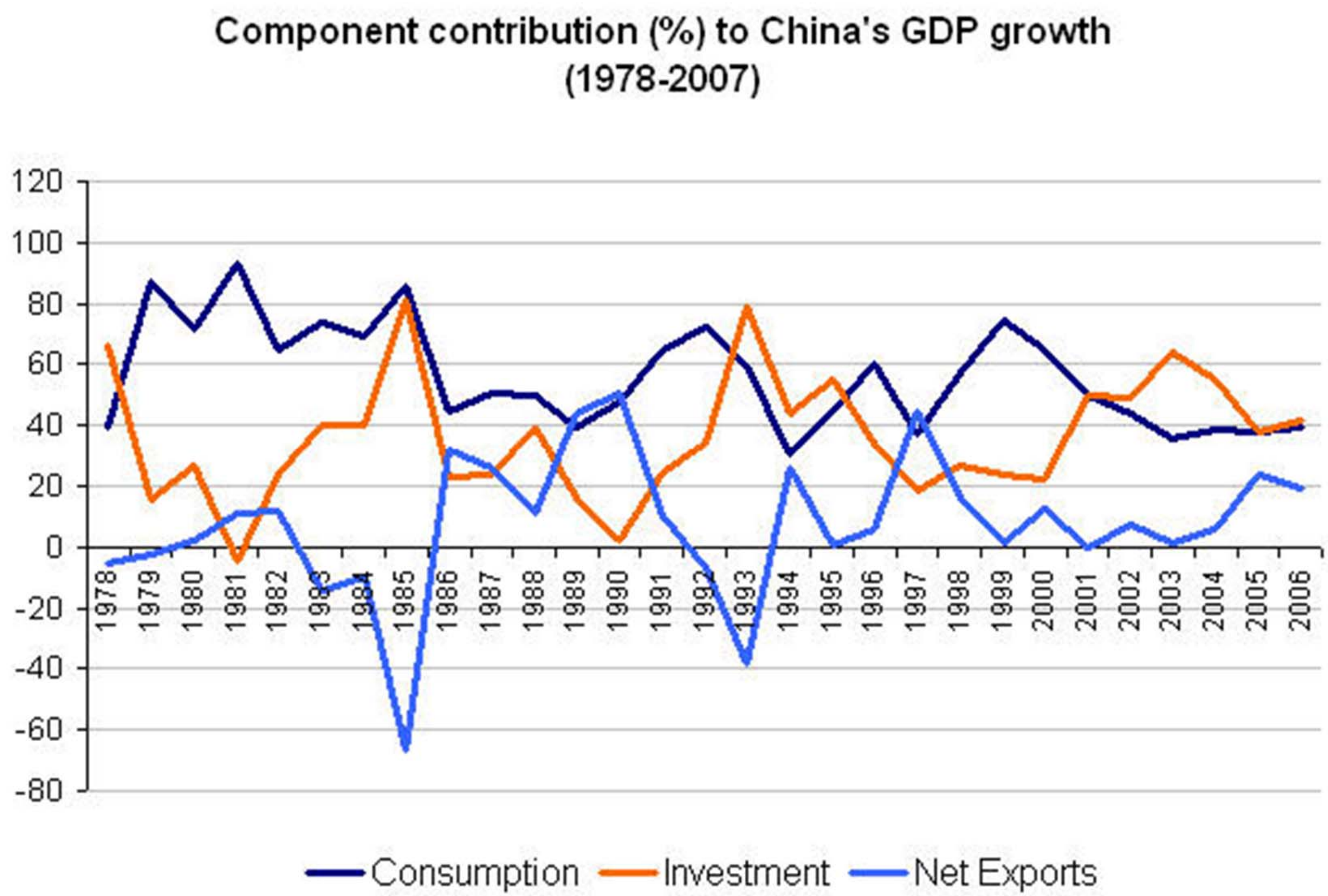
What's export's real share of GDP?

Trade's contribution to China's GDP growth



Source: IHS Global Insight, Bloomberg LP, CEIC and Wells Fargo Securities, LLC

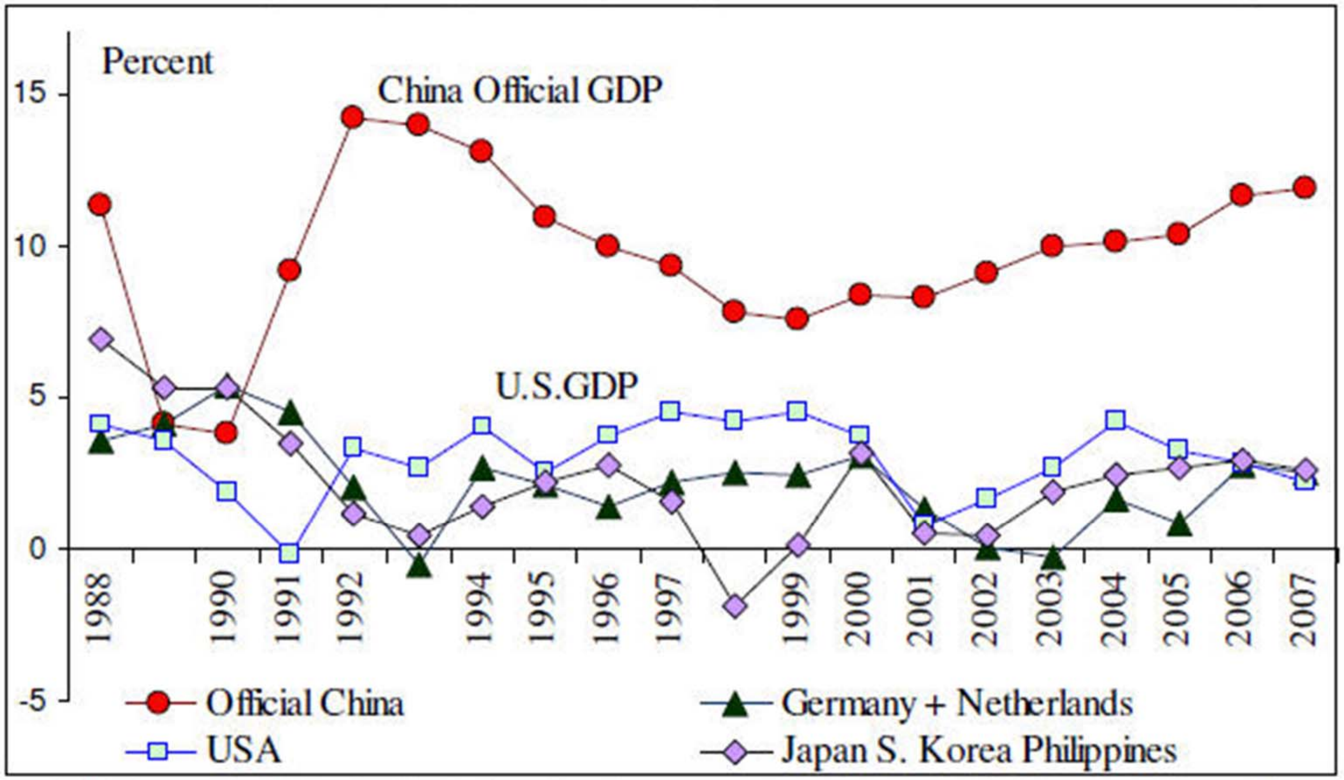
Trade's contribution to China's GDP growth: longer time span



China and US: Not much correlation

Figure 1. Chinese GDP Growth Independence from U.S. GDP Fluctuations

European and non-China East Asian economies often shift with U.S. GDP fluctuations—sometimes lagged or interrupted, as during the Asian Financial Crisis. But China's GDP growth has surged when the U.S. economy slumped—just the opposite pattern from that for other U.S. trade partners.



Sources: IMF *International Financial Statistics* various issues, respective country statistical bureau web sites, China National Bureau of Statistics, and author's calculations.

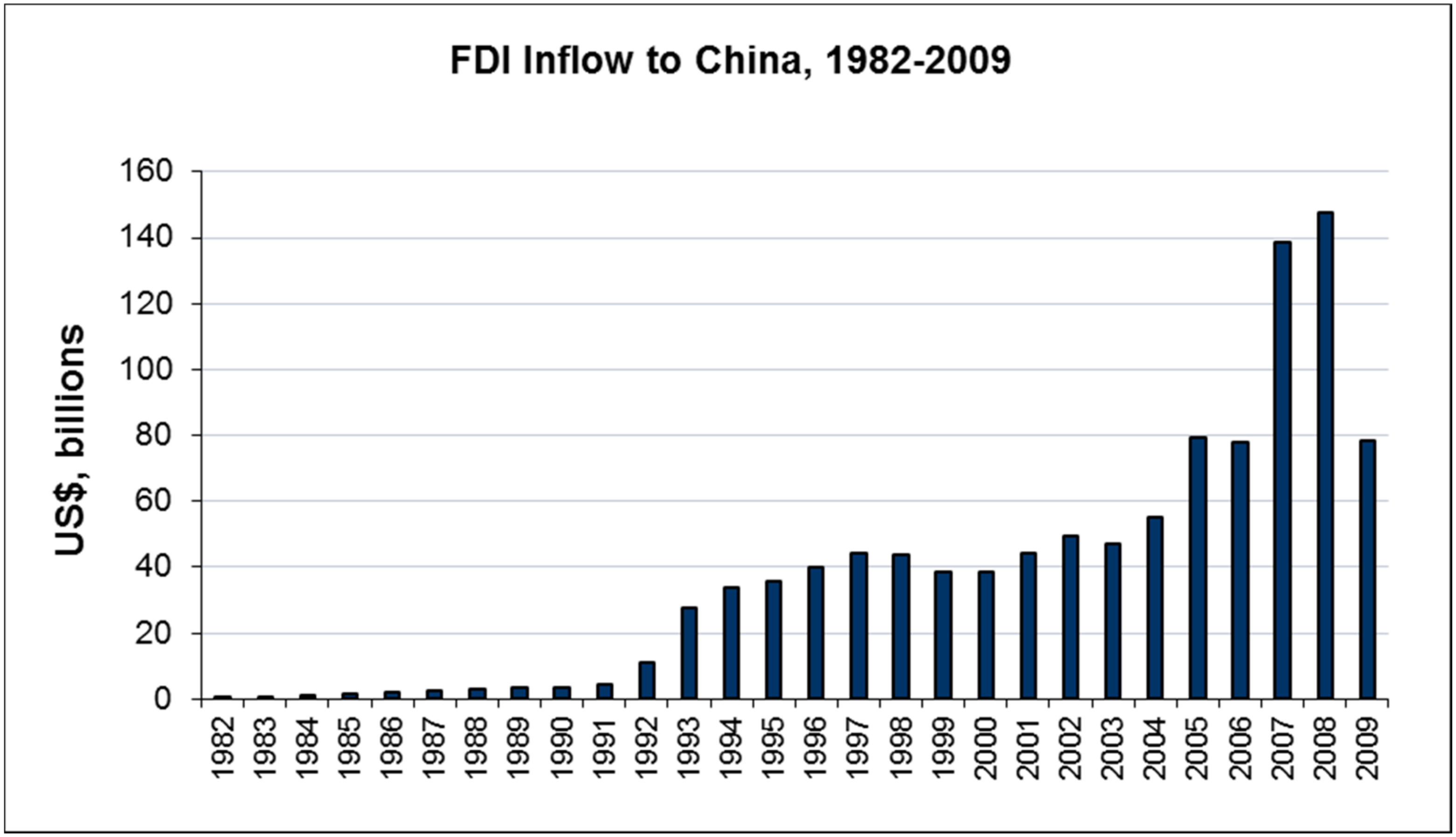
Recommended

Read more, “Is China’s export-driven economy a great exaggeration?” at:

1. http://pauldeng.com/teaching/chinaecon/readings/Is%20China%20export%20led%20-Jon%20Anderson,%20UBS.pdf
2. http://www.economist.com/node/10429271

Foreign Direct Investments in China

Evolution of China's FDI Inflows



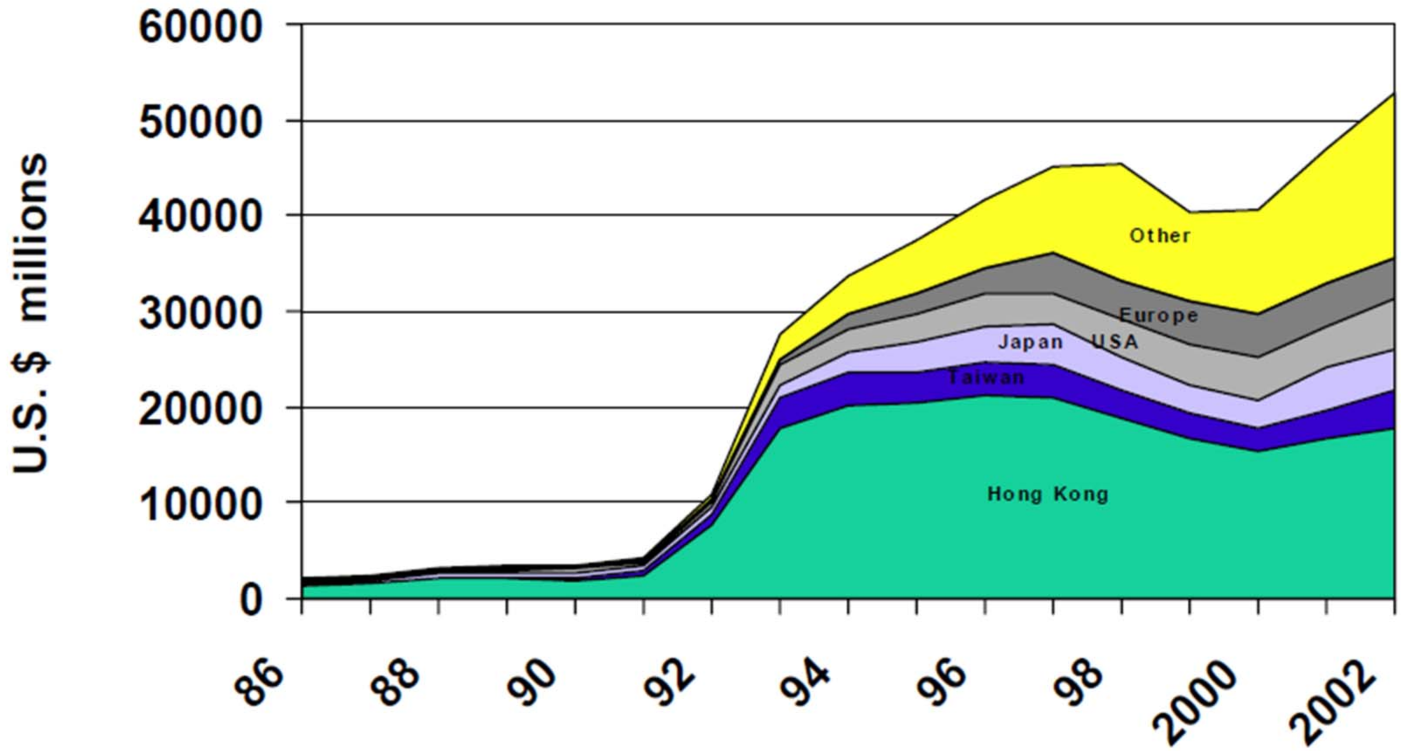
Three Distinctive Characteristics of China's FDIs

1. FDI has been the predominant form in China, vis-à-vis short-term capital flows, such as foreign portfolio investments and bank loans

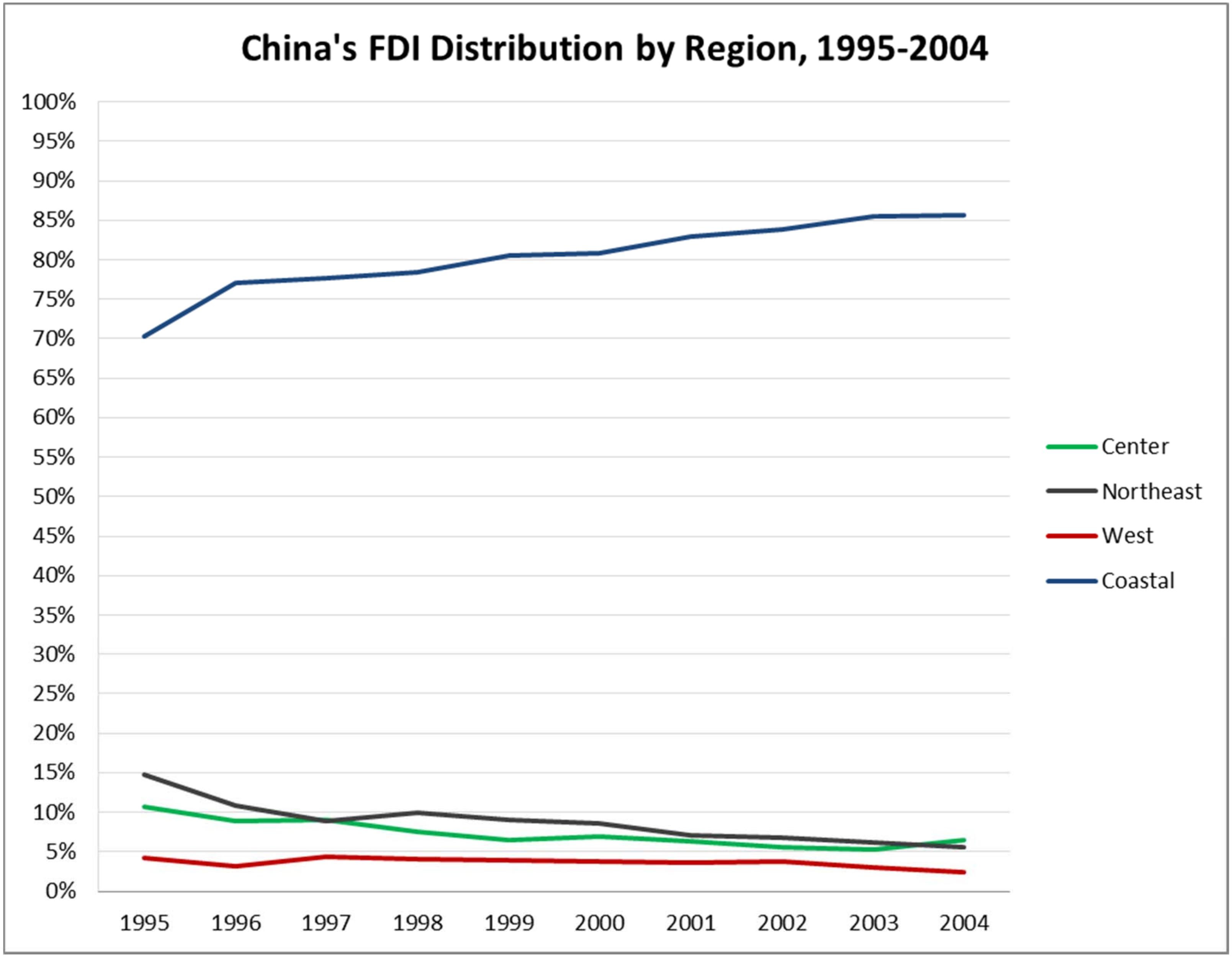
2. Most FDIs concentrated in manufacturing sectors (**70%**) of the total in 2004), as opposed to services and resource extraction sectors, which is typical in other developing countries

3. FDI inflows have predominantly come from East Asian economies, especially Hong Kong and Taiwan

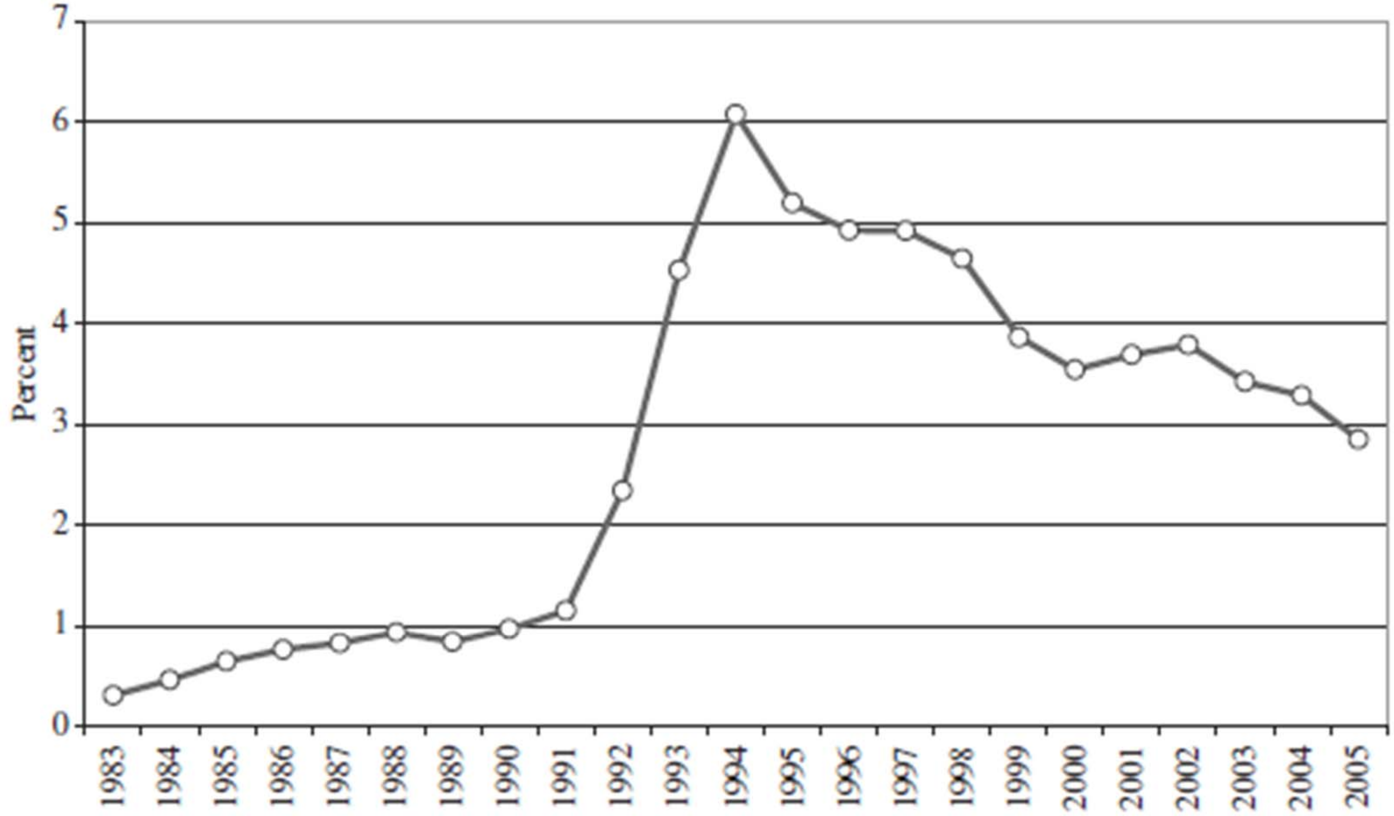
Source Countries of China's FDI Inflows



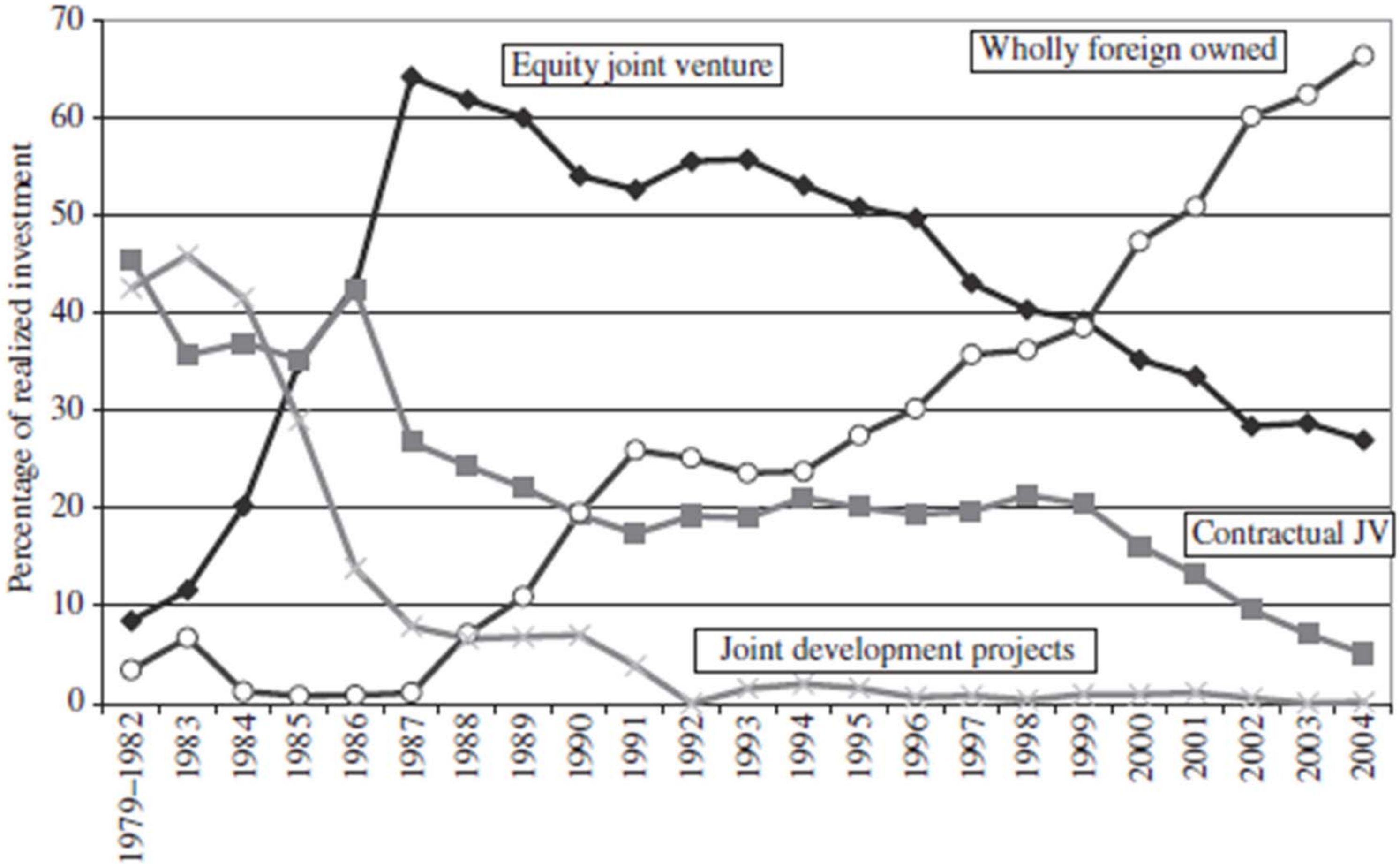
Source: Ministry of Foreign Trade and Economic Cooperation, Ministry of Commerce, People's Republic of China


China's FDI Distribution by Region, 1995-2004
100%
95%
90%
85%
80%
75%
70%
65%
60%
55%
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
Center
Northeast
West
Coastal

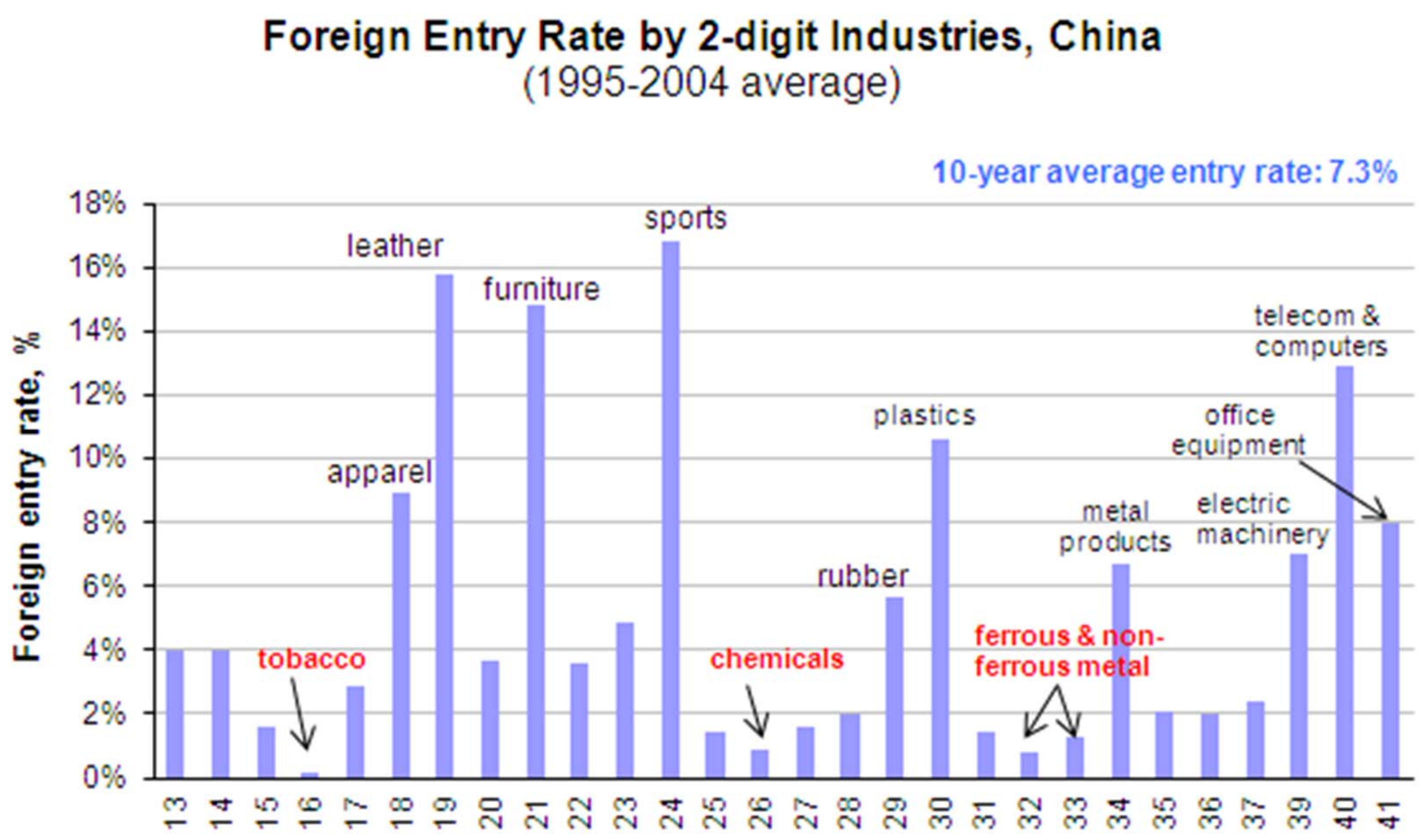
FDI as a Share of China's GDP



Modes of FDIs



FDI Inflows by Industry



Source: Deng (2009)

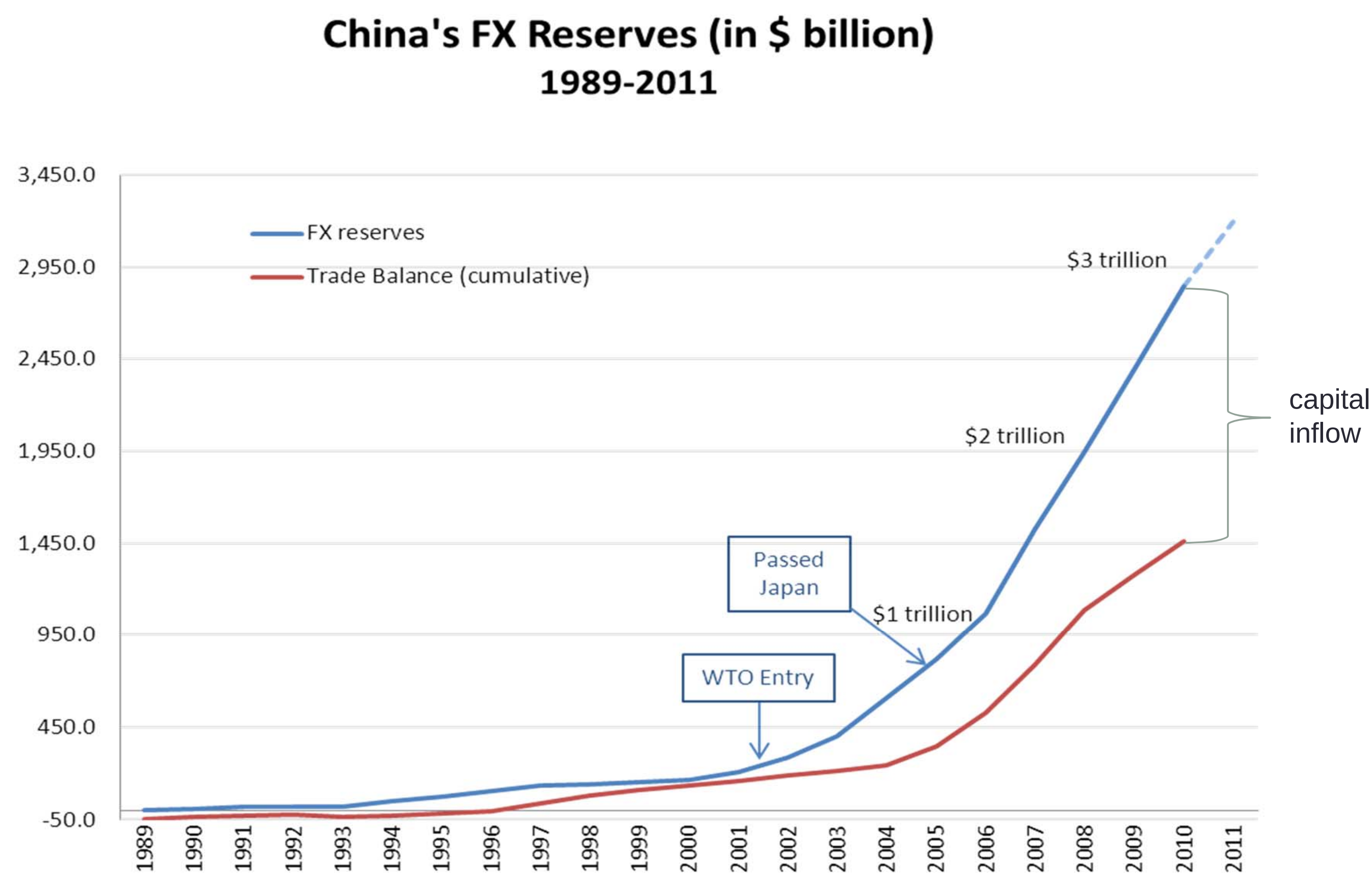
Why did foreign capital flow into China?

- **China's low wage**: a tiny fraction of that in developed economies
    - Until 2010, only 10% of the US average wage

- Chinese government offered very **attractive corporate tax rates:**
    - Domestic firms pay 33%, incl. 30% national income tax + 3% local
    - Foreign firms in SEZs only pay 15%
    - If related to technology or strategic area, only pay 10%
    - Note that starting from 2008, the preferred tax treatment to foreign investors has been gradually phased out, putting foreign and domestic firms on equal footing

- The potential of China's fast economic growth and its **very large domestic market**

The Evolution of China's FX Reserves

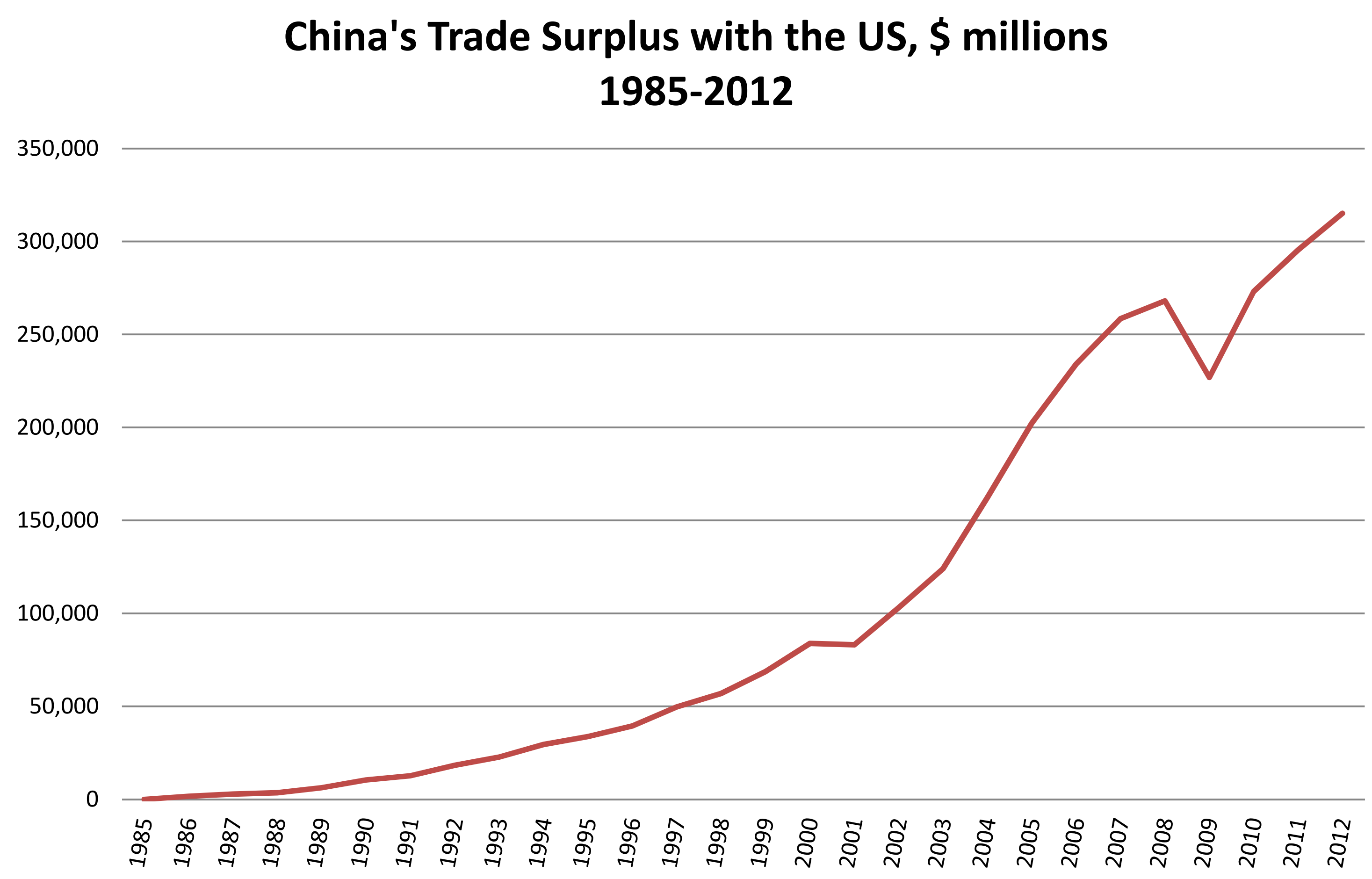


How FDI and China’s growth are related

- Large FDI flowed into China despite China’s weak institutions, such as insufficient protection of intellectual property rights
- FDI has helped China build a robust and strong manufacturing sector
- The interactions of domestic firms with foreign firms provided China with positive spillovers in areas like technology and management skills
- Foreign firms both pay taxes and employ local labor force. A strong manufacturing sector also bring additional jobs to service sector.
- The higher wage offered by foreign-invested firms also provided incentives for people to improve their skills through higher education, increasing China’s endowment in human capital

China and the Global Imbalance

China runs a big trade surplus with the US



How to think about global imbalance

- ***Global imbalance*** here refers to the phenomenon that the US tends to run huge trade deficits, while emerging economies, like China, and a couple of developed countries (Japan and Germany), tend to run huge trade surplus

- Because the US dollar serves as world's reserve currency, the US essentially becomes *“the importer of the last resort”*
  - The reserve currency status increases the world's demand for US dollar
  - In order to “earn” US dollar, foreign countries need to either run trade surplus with the US or attract inflow of foreign capital

- Like UK in 19th century and early 20th century, both reserve-currency countries tended to run huge trade deficits – this is not by accident!!

How to think about global imbalance?

Global imbalance is also closely related to saving-investment behavior of a country

The relationship between CA (current account, or trade surplus, or net exports) and S, saving:

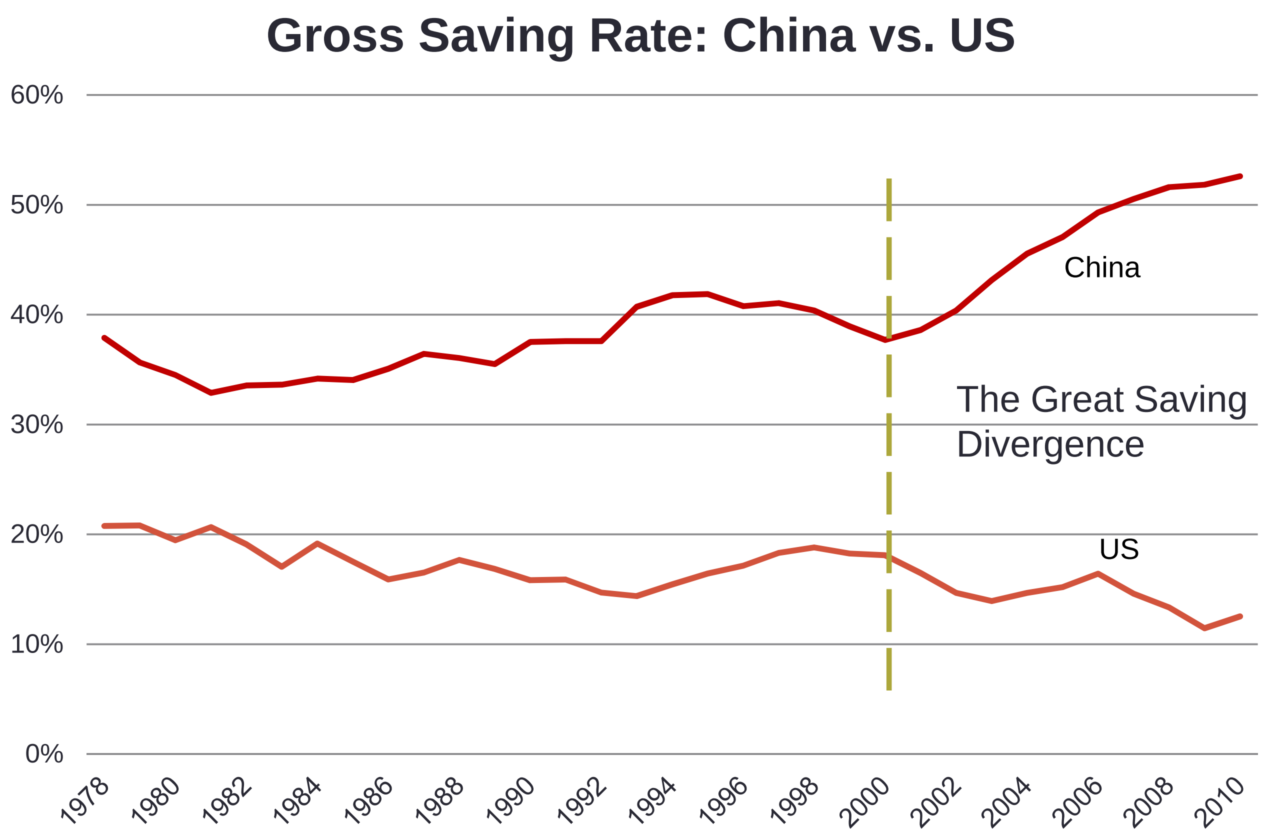
$$CA = NX = Y - (C+G+I), \text{ and } \; S=Y-C-G$$

$$\Rightarrow \boxed{CA = S - I},$$

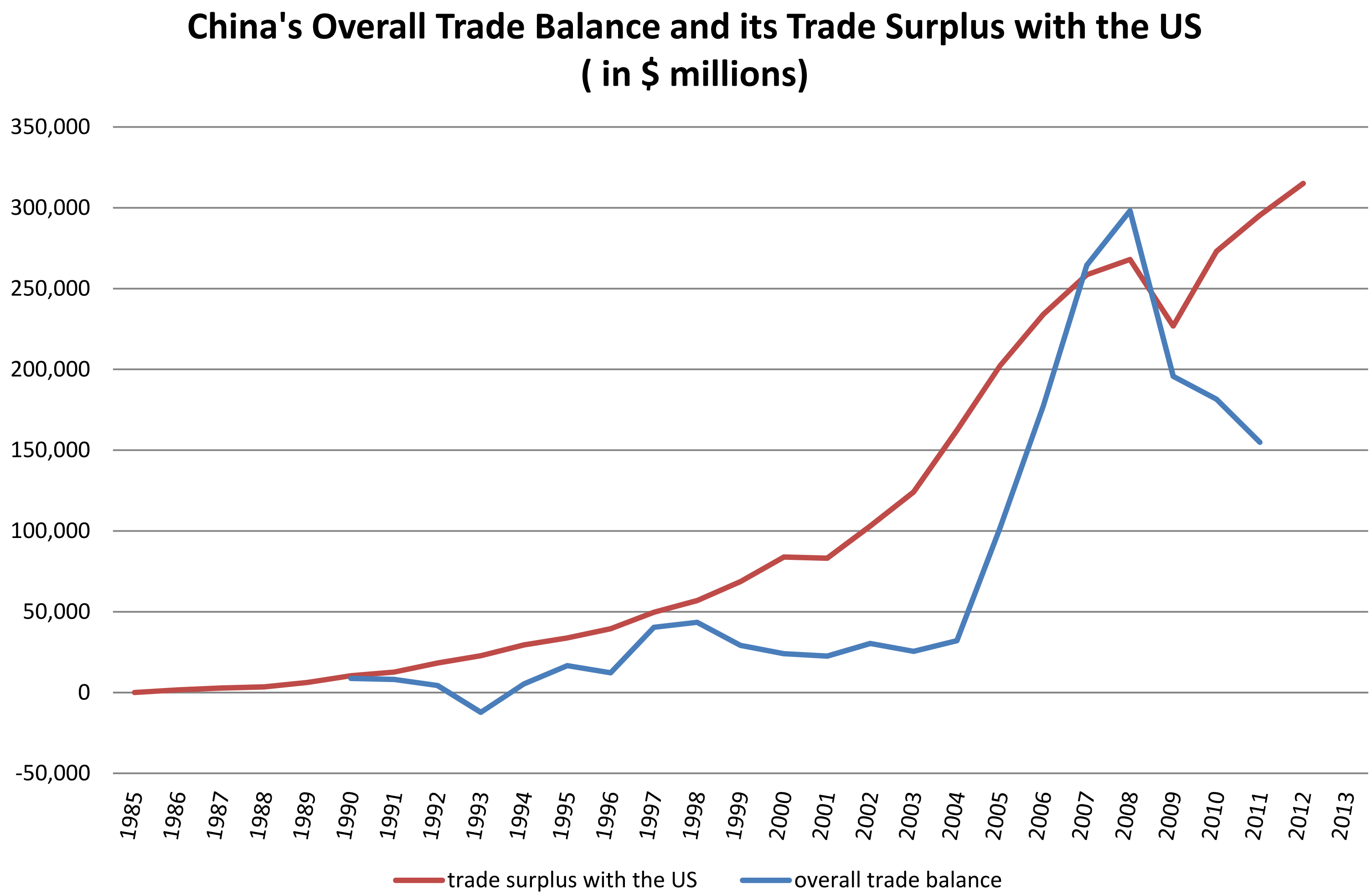
which says, ceteris paribus, when saving increases, a country's trade surplus tends to rise (the case for China); when saving decreases, the country's trade surplus tends to fall (the case for the US).

How to think about global imbalance?

The heavy borrowing fueled US consumption, decreased savings



Despite a huge trade surplus with the US, China's overall trade balance looks very different



How to make sense

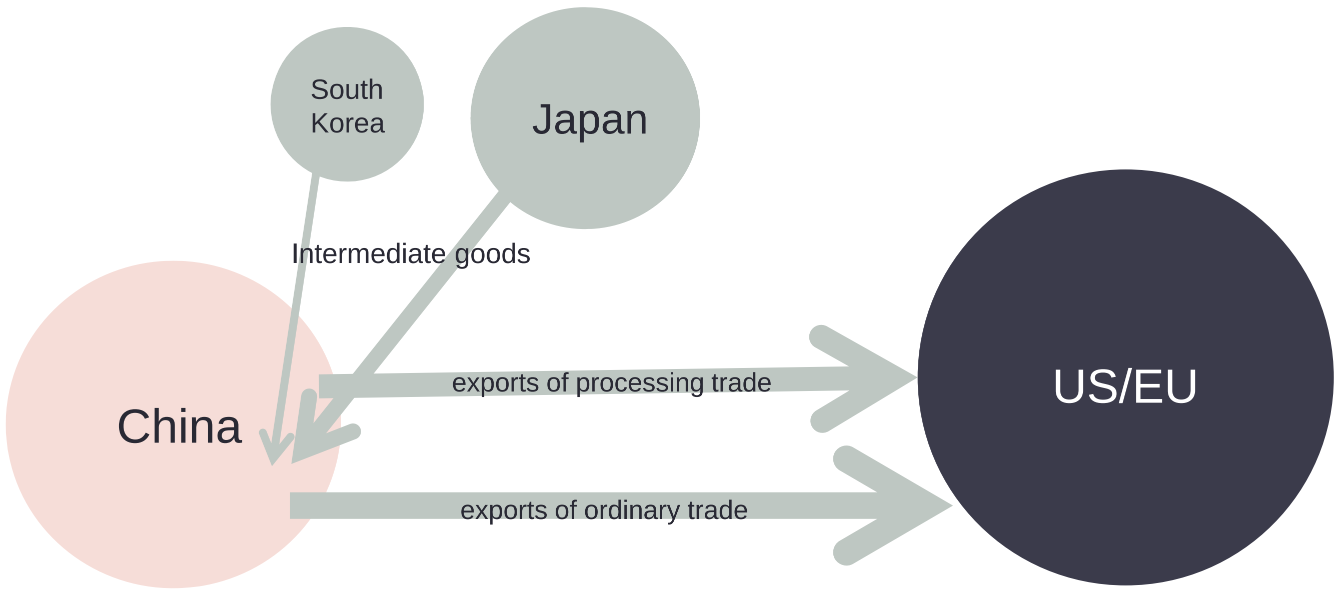
- Because of the nature of global supply chain, trade surplus has largely become concentrated to a few countries
  - For example, Japanese firms regularly move intermediate goods and assemble them in China and then export to the US
  - This results in China's big trade surplus with the US, yet China runs a trade deficit with Japan

- Again, over 50% of Chinese exports are processing trade, and most foreign firms doing processing trade come from East Asian countries

- These economies, incl. Japan, S. Korea, and Taiwan, are essentially "hiding" behind China, running an *indirect* trade surplus with the US

- In other words, the problem of trade deficits with the US has been shifted to China – China got all the blame and political tension

The nature of global supply chain and the mis-conception on global imbalance



Next Time

We will summarize what China has done right and done wrong