China's Leap Forward and East Asia – Threat Theory and Risk Theory –

By Watanabe Toshio

China's Foreign Capital-Dependent Growth

With the turning point yielded by China becoming a member of the World Trade Organization (WTO) at the end of last year, there has been a recent shift in the "China as economic power" theory to the "China as economic threat" theory. In fact, seen from Japan, where the severe economic recession has become a constant, China has been astonishing, demonstrating outstanding results on all indicators including, of course, the economic growth rate and rate of trade growth, as well as the supply of workers and technicians and market size. Looking at the media coverage just over the last year, the entire tone is that all of China is abuzz and moving forward, mowing down Japan and its neighbors with its momentum. Many people seem to be gripped by a sense that not only large Japanese corporations but even small and medium-sized enterprises will not make business profits unless they attempt to enter China. In this paper, I will assert that the "China as threat" theory is an unreasonable argument, while maintaining, on the other hand, that we must be more sensitive to the so-called "China-risk."

China's economic growth is spectacular. Nevertheless, it is foreign-affiliated companies that have been driving this high growth. Foreign-affiliated companies account for 30% of industrial production and 50% of industrial exports. The percentages for telecommunications equipment are 50% and 70%, respectively. China's economy is heavily dependent on foreign capital, and its dependence is even greater than other East Asian countries. China has continued to take great strides forward with the large-scale entry of companies from neighboring East Asian countries.

Why has East Asia been expanding investment in China? The inclusion of China in a company's international division of labor is the result of rational decisions aimed at contributing to the maximization of a company's profits. The accumulation of the rational decisions of countless numbers of East Asian companies on the micro level is the cumulative expansion of investment in China. Under these conditions, Chinese production and exports are large, and it is a logical contradiction to diagnose this as the "China threat."

Through its membership in the WTO, China will increase its dependence on foreign companies, and this trend is likely to become a constant. We must consider that China's economic development, which is dependent on foreign investment, will reinforce and amplify the East Asian division of labor.

To reiterate, the central force in bringing about the development of the Chinese economic giant is foreign companies. Why do foreign companies choose China as the best place for investment and concentrate investment there? What about the case of Japanese companies?

The Value Chain and Corporate Entry into China

Many Japanese companies entered East Asia in the period of appreciation in the value of the yen after the Plaza Accord of 1985, and made the expansion of local production and imports from there commonplace. Further, since the Asian economic crisis in the summer of 1997, it has become very disadvantageous in price terms for Japanese-affiliated companies in East Asia to procure components and intermediate products from Japan. Therefore, moves have been made to increase the proportion of procurement from the country where a company is located and neighboring East Asian countries.

These moves were initially a response to the crisis. Recently, however, they have gone beyond a simple response to crisis and have been shifting toward a more proactive strategy to subsume East Asia within the global logistics of individual companies.

The activities of an industry incorporate a value chain that runs from 1) research and development (R&D) and planning and design through 2) the production and procurement of components and intermediate products and 3) assembly and processing and finally to 4) marketing. In other words, the value chain extends from upstream sectors through midstream to downstream sectors. The highest added value sectors (per employee) in this process are the upstream and downstream sectors while the midstream sector provides the lowest added value. This tendency is pronounced in the information and telecommunications equipment industry, in which technological progress is particularly rapid.

East Asian countries have to survive in a world of intense competition to lower prices by even one yen or one cent per unit. In other words, we have entered an era of global mega-competition. Japanese companies are also finally trying to spin off companies for each value chain function, cutting *keiretsu* group subcontracting ties and choosing the path of transferring production and procurement centers to East Asian countries. It is the coastal regions of south and east China that have emerged as the most advantageous centers for offshore production and procurement.

The choice to concentrate the production and procurement of components and intermediate products and the assembly and processing sector, or the midstream sectors of the value chain process, in low cost countries is the

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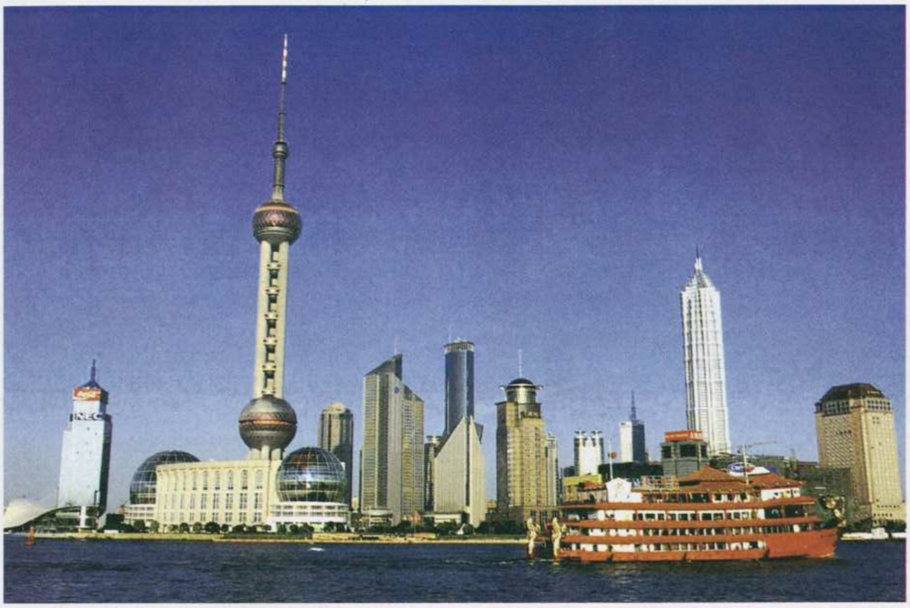

Shanghai, the center of the East China region, where foreign investment is rapidly increasing after China's WTO accession

consequence of rational decisions by companies. This is because, when a company can transfer midstream sector production centers to low cost countries overseas and specialize in the downstream and upstream sectors itself, this enables the whole company to maximize its added value and consequently its earnings and profits.

Currently, the best production center for the manufacturing sector, including production of components and assembly and processing, is the coastal region of China. Companies can easily hire painstaking workers and science and engineering university graduates at low cost, infrastructure is also developed as well, and more significant than anything else, the scope for freedom of activity by foreign-affiliated companies has been increased by WTO membership.

To repeat, for companies to survive in an era of extremely severe, global price competition, they have to split the value chain into each of its functions and replace sectors that can be produced at low cost with overseas production.

The foremost characteristic of Japanese-style manufacturing industry is the presence of a major assembly and processing corporation at the core surrounded by numerous small and medium-sized subcontracting companies making up a "full set" from upstream to downstream sectors. This was the source of Japan's powerful industrial competitive strength. However, approaching an era of global price competition, even Japanese companies have been finally reconsidering their traditional keiretsu group subcontracting ties and have started offshore production and procurement in midstream sectors.

Each technology has a life cycle of creation, growth, maturity and decline. Today, when the pace of technological progress has accelerated, technologies are created and grow at high speed and the speed at which they mature and decline is also rapid. The shortening of the technology cycle is marked. Companies must aim to shift production and procurement centers for mature and declining sectors to low cost countries while they need to develop more sophisticated technology themselves and commercialize it.

China has benefited enormously from the shift in production and procurement centers. China is in the doubly advantageous position of obtaining the benefits of the introduction of technology and capital imports not only from top runners such as Japan, but also from second runners such as neighboring Hong Kong and Taiwan.

The telecommunications equipment industry, which is a very high growth industry in China, is typical. Strongly characteristic of recent years has been the fact that Hong Kong and Taiwanese companies in this industry have congregated in the south China region (Zhu Jiang Delta) followed by the east China region (Chang Jiang Delta), creating the world's leading industrial clusters in these two regions. The amount of production of the telecommunications equipment industry in China roughly rivals that in Taiwan proper. It is estimated that Taiwanese companies account for approximately 70% of China's telecommunications equipment production.

China's membership of the WTO has been a turning point in the acceleration of investment in China by foreign companies. China's WTO membership is set to expand opportunities for trade and investment in China by neighboring East Asian countries. Tariff rates will be lowered and non-tariff barriers, such as import quotas, the import license system and foreign exchange restrictions, are likely to be reduced. More advantageous conditions for companies entering China are being set up, including the relaxation and abolition of local procurement and export obligations that were previously imposed on companies moving into China, as well as the protection of intellectual property, and thus investment in China is poised for promotion. Openness is naturally making progress in the manufacturing industry, but is also moving ahead in the service sector as well, including telecommunications, finance, insurance and distribution, meaning that the scope of sectors for investment in China will expand.

Expansion of the East Asian Intra-regional Division of Labor

I will now turn away from China to take a broader look at trends over the

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Rural poverty is a serious problem in China (Shanxi Province)

last 20 years in the East Asian region as a whole. This shows that East Asia has created a strong development mechanism as an entire region and that China is also becoming deeply incorporated into this mechanism. East Asia is not a region where China alone stands out for sustained growth.

I will refer to East Asia as the region including the Newly Industrializing Economies (NIEs) countries (South Korea, Taiwan, Hong Kong and Singapore), the Association of South-East Asian Nations (ASEAN) countries (10 countries including Thailand, Malaysia, Indonesia and the Philippines) and China.

The region that has demonstrated exceptionally large growth as an export partner for East Asia over the last 20 years is none other than East Asia. While the level of intra-regional export dependence was 23% in 1980, this figure was 40% in 2000. Looking at import partners by region, East Asia has the biggest level of dependence on East Asia. This is despite experiencing the severe economic crisis in the summer of 1997.

East Asia's biggest market is now East Asia itself in exports and imports, and the presence of both Japan and the United States has declined. East Asian products circulate within the East Asian region. In other words, an "intra-regional circulation mechanism" for products has been formed in East Asia.

An East Asian intra-regional circulation mechanism has also emerged in investment funds. Since 1990, the biggest investors in ASEAN countries have been countries within the region. Looking at the cumulative total of foreign direct investment (FDI) in ASEAN countries between 1990 and 2000, the NIEs countries are on top, followed by Japan. Moreover, the figure for NIEs countries is probably underestimated, and may in fact be considerably higher.

Hong Kong, Taiwan and Singapore are NIEs where overseas Chinese reside. NIEs Chinese together with overseas Chinese in ASEAN countries lead "*bang*," which are human networks of mutual aid and cooperation for people who share the same homeland. Investment funds move freely in the conduits of the bang, and it is difficult to assess these funds statistically. It is certain that NIEs investment in ASEAN countries is an underestimate.

China began receiving FDI in 1992. Classification of the FDI that China has received and actually used since then up through 2000 by investing country shows that the proportion accounted for by NIEs Chinese is about 70%. This indicates that China has been incorporated into the East Asian intra-regional circulation mechanism. This may be called the "Asianization" of the Chinese economy.

The biggest regional trade partner for East Asia is East Asia, and the biggest provider of investment funds for East Asia is also East Asia. The influence of extra-regional powers such as the United States and Japan has gradually diminished. An independent, rather than subordinate, and powerful, rather than weak, mechanism has come into being on the stage of the East Asian region. This is how Asia is "Asianizing." The "Asianization" of China is likely to contribute to the further deepening of East Asia's "intra-regional self-circulation mechanism."

The "China Risk"

Meanwhile, we need to be sensitive to the "China risk." As I described earlier, the expansion of trade and investment opportunities for companies from neighboring East Asian countries as well as Japanese, European and U.S. companies that accompanies China's WTO membership means that China will be drawn into the vortex of global competition across all industrial sectors, and will be exposed to the pressure of mega-competition. An increase in the pressure of competition will bring about a shake-up of inefficient manufacturing companies, such as state-owned enterprises, convert subsistence agriculture into commercial agriculture and change the pattern of resource distribution. Changes in the pattern of resource distribution will promote improvements in the productivity of the entire Chinese economy and are likely to set China on the course of becoming a major economic power.

However, this is a long-term development issue, and many problems will arise in the short and medium terms until China has these results in hand. If it fails to manage these problems, they have the potential to plunge the country into chaos. There are a number of possibilities for chaos, but I will discuss two. The first one is the problem of the generation of unemployment accompanying the reform of state-owned enterprises. The second one concerns the damage that the lowering of tariff rates and the reduction and abolition of protective policies will cause in agriculture.

I will start by looking at the first problem. The reform of state-owned enterprises is still the most difficult challenge facing China. The final move in the reform of state-owned enterprises is the introduction of a joint stock system. It will probably be a long time before China's stock market develops and the joint stock system for state-owned enterprises becomes commonplace. If the development of joint stock companies makes progress, a substantial number of unemployed people will be generated by state-owned enterprises with surplus labor. Even at the current time before the adoption of a joint stock system, restructuring of the labor force is already becoming essential.

"Cull the large and abandon the small" is the key phrase for the reform of state-owned enterprises in China today. To reorganize all state-owned enterprises, large companies are to be integrated into a small number and small companies are to be abandoned.

Strategic state-owned enterprises that already have a high market share in such areas as electricity, petrochemicals, steel, home electrical appliances and hi-tech industry are being selected, and reform efforts will be concentrated on them. They are the focus of preferential conditions that include the conversion of the debts of strategic companies to state investment, the provision of low interest finance for technology reconstruction investment, the provision of financial support to encourage joint ventures and the implementation of a main bank system.

Unlike the situation at strategic firms, reorganization, including bankruptcy, sale of assets and mergers, is needed for small and medium-sized state-owned enterprises that are difficult to reform. In other words, companies other than strategic firms are being left in the shake-up brought about by the stormy seas of the market.

"Cull the large and abandon the small" is creating large numbers of unemployed people and generating layoffs. In China, where there is no social safety net provision such as unemployment insurance, health insurance or national pension, there is a great danger that unemployment and layoffs will lead to social instability. Due to its WTO membership, China has to accelerate the reform of state-owned enterprises, but, at the same time, this acceleration comes at the risk of inviting social and political instability.

Another factor that troubles today's China is rural poverty. Without fertile arable land, the productivity of small-scale agriculture with surplus labor is low. Due to WTO membership, this agricultural sector cannot avoid the lowering of tariffs as well as the adoption of liberalization and deregulation measures such as the abolition of import quotas and the import license system, agricultural subsidies and export subsidies. Chinese agriculture, which has low productivity when compared with international standards, will be washed away by the waves of global mega-competition, as a result of its WTO membership. The latent surplus labor force will emerge and could possibly create a considerable number of rural unemployed. The loss of employment opportunities will decrease rural incomes and is likely to increase the disparity in incomes between urban and rural households.

This will create supply pressure on the cities from the rural labor force. In addition to the unemployment and layoffs created by the reform of state-owned enterprises, the labor force that flows out from the countryside will swell the ranks of the unemployed. This has the potential to lead to social and political instability, unless employment opportunities can be provided. The capacity of the Party and the government to rule is likely to be thoroughly tested.

In sum, there is no doubt that China's membership of the WTO will have a positive impact in terms of shaking up inefficient state-owned enterprises and small-scale agriculture, thus improving the efficiency of the entire economy. Nevertheless, considerable risks are unavoidable in the short to medium-term before China can harvest these beneficial fruits of WTO membership.

How to Prepare for the "China Risk"

As I pointed out at the beginning of this paper, the entry into China by the manufacturing sector is an unavoidable requirement in an era of intense price competition in the situation of globalization and the current rapid advance of technological progress. However, while China is a "high return" country, it is also a "high risk" country. Efforts to maximize returns and minimize risk cannot fail to grasp this.

Methods of risk avoidance for investment in China must be thoroughly studied at the time of entry. The natural response for large companies is probably to incorporate China into their production and procurement network connecting the whole of East Asia and to construct a system such that the network itself will continue to function even if the risk in China does materialize.

For small and medium-sized enterprises, it is vital to look into methods that involve collaboration with Chinese in Hong Kong, Taiwan and South East Asia – with Chinese partners building the business front while the company itself controls the overall business, rather than developing solo businesses in the unfamiliar Chinese environment. Japanese companies need to be ready to meet the challenges of doing business in China. JJTI

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