China’s Rise and its Impact on the East Asian Economy

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Abstract

This paper examined the future prospects of China’s economic development and its impact on the East Asian Economy and the economic integration of the region. The key issue to China’s economic growth is the contradiction between the socialist political system and a market-based economy. The overall assessment is that China will be able to manage the transformation of the nation into a steadily growing market economy.

We also found that China is the key country forming a triangular trading block which has implemented the international division of labor in the North-East Asian region. China’s rapid export growth and increased market share in the world economy is not a threat but a new opportunity for the East Asian countries. The rise of China will certainly be accompanied by an expansion of a consumer market, which will also broaden business opportunities for East Asian.

Despite the interdependence between East Asian countries, a regional trading bloc embracing East Asia has not been created yet. The future prospects for realizing the vision of a regional free trade agreement in East Asia in the foreseeable future is not bright, either.

Key Words: China’s economic development, Impact on the East Asian economy, Economic integration in the East Asian economy

I. Introduction

At the 2005 Boao Forum for Asia, former Singapore Prime Minister Lee Kwan Yew said “China will continue to develop well into the 21st century and pursue a ‘peaceful rise’ strategy”, implying that China wants political and economical win-win situations with its neighbors in Asia and the world. The rise of China, and the consequences of this growth, has become a key issue in international politics and economics. Lee’s statement emphasizes the bright side, but many people express concerns regarding obstacles facing...
the future of China and the world.

This paper would like to address three areas of concern: 1) Can China continue to rise and, if so, what are the main obstacles to China’s economic growth? Can China resolve these obstacles to maintain their economic growth? 2) What is the impact of China’s rise on the East Asian economy? and 3) Will China’s rise help to produce institutional agreements for regional integration?

II. Future Prospects of China’s Economic Growth

China has achieved remarkable economic success since the country adopted the reform and open door policies (gai-ge, kai-fang) in 1978. The average annual economic growth rate of the past twenty-six years is about 9.4% with the fast growth continuing into the 21st century. Japan and the Newly Industrialized Countries in East Asia have experienced high economic growth in the past but China’s growth is astonishing considering the huge size of its population. China’s growth is accompanied by a fast expansion of foreign trade and investment. China became the third largest trading country in the world in 2004.

Although the per capita income of China is still very low, the Chinese economy as a whole is big enough to have a major influence on the world economy. Based on official exchange rates, China has become the world’s sixth biggest economy. If calculated on purchasing power parity (PPP), China may be the second or third largest in the world. A recent article of The Economist describes how China’s decisions affect workers, companies, financial markets and economies in every part of the world.1

With regard to the future of China, conflicting views are expressed. If China can continue to keep the pace of rapid economic growth in the future, it could catch up with the major economic powers of the world in the near future. Even the possibility that China could challenge the status of the world economic leader, the U.S., before the end of this century, has been mentioned in the press. On the other hand, the problems of China have also been pointed out. The imbalance of development between urban and rural areas (and between coastal and inland regions), environmental problems, energy resource depletion and huge amounts of non-performing loans of the state-owned banks related to the low profitability and inefficiency in the state-owned enterprises were listed as key problems. It is not the intention of this paper to examine all these controversial issues. We want to focus on the contradiction between the politics and economics, which, we think, is a key and fundamental issue in China.

China’s economic development is based on a reform policy which has been led by political leaders and elite groups. In China, the elite groups who have the knowledge and power to initiate, formulate and implement the reform come from the Party- the communist party- members. In other words, it is the communist political system that transformed China into a market economy. The government of China called its system a ‘socialistic market economy’. What is meant by this self-contradicting concept? We once

1 The Economist (2005) pp 65-67.
tried to find out the definition of the socialistic market economy so we read an article explaining its meaning in ‘The People’s Daily’ (RenMinReBao). It was a full-page article, one half of which described the problems of the socialist economy while the other half described the problems of the market economy. The article ends with a simple one sentence conclusion: ‘Therefore, China should adopt a socialistic market economy’. Such ambiguity is a Chinese way of pragmatism and flexibility. It has the advantage of being adaptable to changing environments. Deng Xiao Ping’s ‘black cat, white cat’ statement is well-known for expressing the need to adopt pragmatism and introduce market policies despite the socialist political system.

Even though there is not a clear definition for the Chinese economic system, we can find widely accepted descriptions of the ‘socialistic market economy’. That is to say, the ‘socialistic market economy’ is based on public ownership while approving various kinds of ownership and using the distributive role of the market mechanism; all with the intent of pursuing the public interest. To our understanding, this means that the ‘socialistic market economy’ introduces market mechanisms in most of the economic distribution processes but the Party still has an omnipotent power in controlling the economy.

There can be a trade-off situation in this kind of dual mechanism. The Chinese government can fully control the economy so a one-time economic crisis can be easily overcome. But on the other hand, there can be efficiency and severe socio-economic problems such as income imbalances, rent-seeking behavior and bottleneck of major resources. So, it can be argued that the main challenges for the Chinese economy would not be the pure economic obstacles themselves, but the socio-political problems.

Until now, this pragmatism and ambivalence concerning the political and economic systems has worked well. However, such systems cannot be maintained forever. The influence of the Party acts as a burden on the Chinese economy. The state-run enterprises, in which the party leaders still exercise decision-making powers in business operations, experience huge deficits. It is estimated that about 30% of state owned enterprises run deficits. The debt of the state run enterprises has made the banks and financial institutions very vulnerable. Standard & Poor’s estimates that non-performing loans of Chinese banks amounts to $400-800 billion which is about 30-50% of China’s GDP. It is said that China has become the manufacturing hub of the world. However, it still has an “inheritance” of problems from the planned economy in the financial sector and many other service industries.

The future of China’s economy depends on how the country solves the problems of the system. Ultimately, China should become a capitalist economy and a democratic nation in order to be a truly advanced country. The post-war history of the world has demonstrated that economic prosperity needs a solid market system. The leaders of the state, and the Party in China, seem to be well aware of this fact. However, the people, forming a population of 1.3 billion individuals, may not be ready to acknowledge this necessity or be uncomfortable with the necessary transformation of the society. If the transition is smooth, the chances of China’s rise will be greater.

\[\text{The largest enterprises and banks are state-owned, important resources such as oil, coal etc, are distributed by the government, land is generally owned by the government.}\]
The overall assessment is that the government and people of China have the ability to adapt to a changing environment. China adhered to the WTO in 2001 and made commitments to develop a system that is transparent and consistent with global standards. Also, it has implemented its commitment without many problems. The ‘openness’ of China is substantial considering its huge size. The ratio of trade to GDP of China was 60.4% in 2004 (table 1). The corresponding figure of the U.S. was 18.5%, and Japan 19.9%. Considering that the U.S. and Japan have a much longer experience of international trade and that China has a much larger population, China’s exposure and adaptation to the international system is remarkable. Therefore, our assessment is that China will be met with occasional bumps arising from energy, environment and infrastructure problems, but in the long run it will manage to transform itself into a growing market economy. Such a transformation will be possible provided that any serious attempts to reverse to, or stick to, the Party dominated political system are not made.

In this context, it could be argued that there were meaningful strategic changes observed in the “Communist Party of China (CPC) Central Committee’s Proposal on the Formulation of the 11th Five-Year Plan (2006-2010) for National Economic and Social Development” adopted by the Fifth Plenum of the 16th CPC Central Committee. This will definitely exert major influences on the new practices of China’s economic and social development. The most important change is that the theory “getting rich first”, proposed by Deng Xiaoping, will give way to “common prosperity”, which means that the Chinese government will be more concerned to solve the income gap between the rich and the poor and the growth gap between the developed and underdeveloped regions. Also they will not put priority on the “growth rate” policy but on “sustainable development”. This means that the economic growth itself can not be the primary policy issue but the environmental problems and quality of life could be considered more important. Also, the heavy reliance on foreign investment and resources to secure its economic growth will be changed.

The Chinese government, or the Party, has enough power to control the economy, so the pure economic problems could be managed or resolved successfully. Therefore, it could be suggested that in the near future China can maintain its high economic growth rate. But as we mentioned before, the main obstacle to the Chinese economy is not a pure economic problem but a socio-economic or a political-economic problem which mainly comes from the contradiction between the market economy and the socialistic political system and the inconsistency between the market distribution system and the socially owned production system. This problem cannot be easily solved when the government only pursues economic growth. In this sense, the recent policy changes from “getting rich first” to “common prosperity” and “sustainable growth” could be assessed as positive and meaningful steps to solve the present and potential obstacles to China’s economic growth in the long term.
Table 1. Trade Dependency of Selected Countries

| Country | Population (A) | GDP (B) | Trade Volume (C) | Trade Dependency (C/B) |
|---------|----------------|---------|------------------|------------------------|
| U.S.    | 291,038        | 108,816 | 2,029,654        | 18.5                   |
| Japan   | 127,478        | 43,264  | 854,893          | 19.9                   |
| China   | 1,302,307      | 14,099  | 851,210          | 60.4                   |
| India   | 1,049,549      | 5,990   | 124,483          | 21.6                   |

Unit: population (1,000), GDP($100 million), trade volume($ million)
Source: KITA DB, 2003

Ⅲ. The Impact of China’s Rise on East Asia’s Trade and Investment

The rise of China has had a great impact on the world economy but the greatest impact is on East Asian countries. They have direct links with China in terms of trade and investment so they are sometimes met with head-to-head competition from Chinese products. In light of this fact, two kinds of perceptions of China are prevailing in East Asia: threat and opportunity.

According to the ‘threat’ view, as China becomes the manufacturer of the world, other countries, particularly those in East Asia, will lose their market share and hence their economies will suffer from China’s rise. It seems that products made in China are taking over the export market of East Asian countries. In the U.S. import market, the share of China’s exports increased from 5.4% in 1993 to 13.4% in 2004. The share of Japan’s exports to the U.S. dropped from 18.5% to 8.8% during the same period. The corresponding figure of Taiwanese trade dropped from 4.3% to 2.4% and Singapore from 2.2% to 1.0%. At the early stage of development, China had a competitive advantage in labor-intensive industries such as textiles and garments. However, China also developed skill intensive and some capital-intensive industries later. China exports color TVs and refrigerators to advanced countries as well as to its neighbors in East Asia. China is the leading supplier of textile products and at the same time the largest producer of computers in the world market. Some Korean businessmen worry that even the markets for highly sophisticated information and technology products, such as memory chips and mobile phones, may be taken over by China in a few years.

With regard to foreign direct investment (FDI), the concern is more serious as China is regarded as a ‘black hole’ of foreign capital. The amount of FDI that flowed into China was $52.7 billion and into Hong Kong $13.7 billion in 2002 (table 2). The sum of FDI in China and Hong Kong was about seven times that of Japan ($9.3 billion) and almost twenty times larger than India’s FDI ($3.4 billion). Singapore, Korea and Taiwan, the once promising tiger economies, attracted very small amounts of FDI as compared to China. According to the World Investment Report, about 400 out of 500 fortune companies established affiliates in China. If it is assumed that there are limits of available foreign capital, China’s absorption had the effect of reducing the funds going into the other countries. Attraction to China not only affected the destination of foreign capital but
also the allocation of other resources. Researchers who worked on the Korean economy now study China, and international conferences that used to discuss Japan, or newly industrialized economies, now focus on China.

Table 2. Foreign Direct Investment by Host Country

| Country | amount of FDI ($ million) | share in the world (%) | rank in the world |
|---------|---------------------------|------------------------|-------------------|
| China   | 52,700                    | 8.09                   | 2                 |
| Hong Kong | 13,718                  | 2.11                   | 15                |
| Japan   | 9,326                     | 1.43                   | 18                |
| Singapore | 7,655                    | 1.18                   | 23                |
| India   | 3,449                     | 0.53                   | 28                |
| Korea   | 1,972                     | 0.30                   | 34                |
| Taiwan  | 1,445                     | 0.22                   | 40                |

Source: KITA DB, 2002

With regard to the direct investment flow, the problem of ‘hollowing out’ is often raised. In order to become competitive, Japanese and Korean firms move their production facilities to China. In the 1980s, small scale labor intensive industries, such as textiles, invested in China. In recent years, chaebol (conglomerates) and big companies have built automobile and computer chip factories and R&D facilities in China. As the outflow of investment has increased, the concern of reduced production base and employment in their home countries has also increased. If these concerns were to be realized, the result would be the ‘hollowing-out’ of the economy. This situation adds to the feeling of a threat from the rise of China.

The view that China poses a threat to East Asian economies focuses on the competition and overlooks the interaction between China and its neighbor countries. It implicitly assumes a zero-sum game situation in the world market: China’s increase in exports must be balanced by a decrease in exports of its competitors. In fact, however, the exports of East Asian countries have rapidly grown. Korea exhibited a double-digit export growth rate during the past three years while most East Asian countries outperformed the rest of the world in trade. China is a factor behind the trade expansion of East Asian countries, and NOT contraction, as the threat view perceives. Korea’s exports to China increased by a remarkable 51.0% growth in 2003 and 44.0% in 2004 (table 3). Thailand’s exports to China increased 57.7% in 2003 and 30.7% in 2004. China became the largest trading partner of Korea and of many other countries in East Asia. The intra-regional trade of three Northeast Asian countries (China-Korea-Japan) has grown from 10% in 1980 to 24.1% in 2004.

In the last 15 years, China’s exports have been growing rapidly, which reveals the competitiveness of Chinese manufactured goods and hence China’s growing influential power in the world economy. In this period, if we accept the threat view, the growth rate of exports of East Asian Countries has to have a negative impact caused by the increased market share of Chinese products. But East Asian countries such as Korea, Taiwan and
Singapore also have experienced continuous growth in their exports compared with the other major trading countries (table 4).

| Country | 2000 | 2001 | 2002 | 2003 | 2004 |
|---------|------|------|------|------|------|
| Korea   | 34.7 | 2.9  | 24.6 | 57.5 | 44.3 |
| Japan   | 0.8  | 3.1  | 1.6  | 7.6  | -11.7|
| Singapore | 22.2 | 24.9 | 37.2 | 18.8 | 15.8 |
| Thailand | 51.0 | 38.7 | 48.7 | 57.7 | 27.8 |
| Indonesia | 44.0 | 26.9 | 33.5 | 30.7 | 25.3 |
| World   | 35.8 | 8.2  | 21.2 | 39.9 | 35.8 |

Source: KITA DB, 2000-2004

From 1995 to 2004, in the U.S. market, China’s market share of exported goods has been growing rapidly, but the market share of all of the East Asian Countries has been shrinking (table 5). So, considering the trend of the export market share of the East Asian countries in the U.S. market over time, it could be strongly argued that the negative impact of China’s export growth has been so obvious that the threat view could be easily accepted.

However, in this period, the market share of East Asian countries, such as Korea and Taiwan, has increased, but the market share in the Chinese market of all the Western countries and developed countries such as U.S, Japan, German and France has been consistently decreasing (table 6).

Therefore, there appears to be a trade-off trend in the export market share of the East Asian countries. That is to say, there is a reduced share in the U.S. market but an increased share of the East Asian countries in the Chinese market and an increased market share of China in the U.S. market. It could be supposed that there is a triangular international trade pattern among China and East Asian countries.
Exports to the U.S. and EU markets involve cooperation rather than competition between China and East Asian countries. A triangular trade pattern has emerged between China, more industrialized Asia (e.g. Japan, Taiwan and Korea) and western markets (the U.S. and EU). In many sectors, China is used as an export base by firms from Japan and Korea. Intermediate goods are exported to China and after processing, they are re-exported to the U.S. and EU as finished products. Therefore, China’s increase in its share of the U.S. market may decrease the share of the East Asian exports to the U.S., which is the final destination. However, it has the effect of increasing East Asian exports of intermediate goods to China.

For a more analytical study of the triangular trade pattern among China, East Asian countries and western countries, we separated traded goods into categories such as primary industrial goods, processed industrial goods, capital goods and consumer goods. From this traded goods classification, we can infer several interesting and meaningful characteristics in the triangular trade among China, East Asian countries and the U.S.

First, it could be strongly suggested that an excessively tight division of labor between China and East Asian Countries, such as Japan and Korea, really exists. This is to say that Japan and Korea export industrial supplies, capital goods, parts and accessories

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1 Gaulier, Lemoine and Unal-Kesenci (2005).
2 This has been done by HS 6 digit code to be classified into Broader Economic Classification (BEC) code.

Table 5. The Market Share of Major Trading Countries in the U.S.

|      | 1995 | 2000 | 2004 |
|------|------|------|------|
| China | 6.1  | 8.2  | 13.4 |
| Japan | 16.6 | 12.0 | 8.8  |
| Korea | 3.3  | 3.3  | 3.1  |
| Taiwan| 3.9  | 3.3  | 2.4  |
| Singapore | 2.5 | 1.6  | 1.0  |

Source: KITA DB, 1990-2004

Table 6. The Market Share of Major Trading Countries in China

|      | 1995 | 2000 | 2004 |
|------|------|------|------|
| Japan | 22.0 | 18.4 | 16.8 |
| Korea | 7.8  | 10.3 | 11.1 |
| Taiwan| 11.2 | 11.3 | 11.5 |
| Singapore | 2.6 | 2.2  | 2.5  |
| U.S.  | 12.2 | 9.9  | 8.0  |
| German| 6.1  | 4.6  | 5.4  |
| France| 2.0  | 1.8  | 1.4  |

Source: KITA DB, 1990-2004
while China makes the final consumer goods and then re-exports them to the western market.

Second, in the early periods, processed industrial supplies, which could be used as materials for textiles and clothes, had the largest portion in the traded goods from Japan and Korea to China. But recently, capital goods, and their parts and accessories, had the largest portion. This phenomenon could be explained from the fact that China’s major exportable goods have changed from the simple labor-intensive goods to the more complicated and capital intensive goods (graph 1 and graph 2).

Third, consumer goods are still the biggest portion of China’s exports to the U.S. but this portion has been reduced consistently and the capital goods are replacing the consumer goods rapidly. This phenomenon is also consistent with the fact that Chinese exportable goods are being replaced by capital-intensive goods.

We also can find the same phenomenon from the changing patterns of the major traded goods among China, Korea, Japan and the U.S. (appendix 1).

**Graph 1.** Triangular Trade Pattern with China in 1990

![Graph 1](image1.png)

**Graph 2.** Triangular Trade Pattern with China in 2004

![Graph 2](image2.png)
Table 7. Korea-China Traded Goods Classification Based on BEC Code (%)

| code<sup>1</sup> | Export |              |               |               | Import |              |               |               |
|-----------------|--------|--------------|--------------|--------------|--------|--------------|--------------|--------------|
|                 | 1990   | 1995         | 2000         | 2004         | 1990   | 1995         | 2000         | 2004         |
| 21              | 0.1    | 0.6          | 0.4          | 0.6          | 14.1   | 5.5          | 9.1          | 2.8          |
| 22              | 75.9   | 67.6         | 55.5         | 36.7         | 60.5   | 55.0         | 31.7         | 32.1         |
| 3               | 0.0    | 4.7          | 8.8          | 0.0          | 16.3   | 11.3         | 8.7          | 5.7          |
| 41              | 4.3    | 11.9         | 9.6          | 15.8         | 1.5    | 4.4          | 13.8         | 18.2         |
| 42              | 15.5   | 6.5          | 18.9         | 31.1         | 0.4    | 5.0          | 14.6         | 16.4         |
| 5               | 1.2    | 3.4          | 1.4          | 5.9          | 0.2    | 0.6          | 1.4          | 2.4          |
| 6               | 2.3    | 3.8          | 3.9          | 2.1          | 2.4    | 12.9         | 13.9         | 14.5         |

Table 8. Japan-China Traded Goods Classification Based on BEC Code (%)

| code<sup>1</sup> | Export |              |               |               | Import |              |               |               |
|-----------------|--------|--------------|--------------|--------------|--------|--------------|--------------|--------------|
|                 | 1990   | 1995         | 2000         | 2004         | 1990   | 1995         | 2000         | 2004         |
| 21              | 0.1    | 0.6          | 1.3          | 2.0          | 8.2    | 3.4          | 2.4          | 1.6          |
| 22              | 47.8   | 38.5         | 40.7         | 32.5         | 19.3   | 17.2         | 14.1         | 16.0         |
| 3               | 1.0    | 1.3          | 0.5          | 0.0          | 23.7   | 5.5          | 3.4          | 2.0          |
| 41              | 27.1   | 30.0         | 20.9         | 23.1         | 2.5    | 6.5          | 10.7         | 19.1         |
| 42              | 11.3   | 17.5         | 25.5         | 26.7         | 0.8    | 4.2          | 9.0          | 12.5         |
| 5               | 6.8    | 7.2          | 6.4          | 8.4          | 0.1    | 0.9          | 1.9          | 2.6          |
| 6               | 4.1    | 2.9          | 1.6          | 1.6          | 29.8   | 48.6         | 46.8         | 36.6         |

Table 9. U.S.-China Traded Goods Classification Based on BEC Code (%)

| code<sup>1</sup> | Export |              |               |               | Import |              |               |               |
|-----------------|--------|--------------|--------------|--------------|--------|--------------|--------------|--------------|
|                 | 1990   | 1995         | 2000         | 2004         | 1990   | 1995         | 2000         | 2004         |
| 21              | 23.3   | 26.5         | 11.7         | 15.2         | 1.4    | 0.7          | 0.6          | 0.4          |
| 22              | 19.3   | 16.8         | 21.8         | 22.7         | 12.0   | 11.5         | 12.3         | 11.8         |
| 3               | 0.0    | 0.2          | 0.2          | 0.2          | 4.3    | 0.7          | 0.5          | 0.1          |
| 41              | 14.7   | 19.2         | 21.0         | 18.1         | 8.4    | 15.8         | 19.0         | 28.6         |
| 42              | 10.6   | 12.5         | 19.3         | 19.9         | 1.5    | 4.9          | 7.9          | 9.1          |
| 5               | 19.0   | 12.6         | 12.8         | 9.5          | 0.9    | 2.0          | 3.2          | 3.2          |
| 6               | 2.3    | 2.9          | 4.2          | 3.6          | 67.8   | 62.7         | 55.3         | 45.2         |

<sup>1</sup> 21: primary industrial supplies, 22: processed industrial supplies, 3: fuels and lubricants, 41: capita goods, 42: parts and accessories, 5: transport equipment, parts and accessories, 6: consumer goods.
The problem of the so-called “hollowing-out” is also over estimated. The affiliates of firms from Japan and Korea, which were established in China, operate in close cooperation with their headquarters. The foreign direct investment made by the Japanese and Korean businesses is a means of implementing global business strategies. In many cases, exports from Korea and Japan to China occur through the channel of the home company and its affiliate. A large portion of China’s exports to the world is also manufactured by foreign affiliates. About 57% of China’s $600 billion in exports was produced by foreign invested enterprises in 2004. This production sharing helped to expand intra-industry trade between Northeast Asian countries.

The intra-industry trade ratio of manufacturing sectors between Korea and China was 0.50 in 1998 which expanded to 0.57 in 2004 (table 10). The ratio between Japan and China was 0.46 in 1998 and 0.51 in 2004. Compared to EU countries, the intra-industry trade of Northeast is still at a low level. However, considering the different economic level and structure between Northeast Asian countries, the extent of intra-industry trade seems to be remarkable. The intra-industry trade increases the scale of economy and product specialization and opportunities for deeper economic integration without a massive reallocation of resources.

The intra-industry trade trend could be more clearly analyzed if we divided IIT (intra-industry trade) into vertical IIT and horizontal IIT. Vertical IIT is the intra-industry trade which is in the same statistical group but has a larger price gap resulting in a larger quality gap. So, the vertical IIT is more likely to be driven by differences in factor endowments. On the contrary, horizontal IIT is the intra-industry trade which has few differences in price and product quality. So, the horizontal IIT generally results from the consumer preference variety and product differentiation.

The intra-industry trade between China and East Asian countries, such as Japan, Taiwan and Korea, could be almost composed of vertical IIT (table 11). This means that East Asian countries export higher quality and priced products to China while China exports lower quality and priced products to East Asian countries in the same category of goods.

Considering the many empirical studies that demonstrate how vertical IIT is positively related to FDI⁴, and that Korea has the largest FDI in China, the problem of hollowing-out investment caused by China should be viewed differently. It could be suggested that Korea’s FDI to China is a natural procedure based on the international division of labor. Therefore, it is not harmful to Korea’s economy and, to a certain extent, it could actually enhance the market share in the Chinese market through tight interdependence between the parent companies in Korea and the affiliates in China. It also can give the opportunity for industrial restructuring in Korea.

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⁴ Hu, X, and Y. Ma, “International Intra-Intra Trade of China,” Weltwirtschaftliches Archiv 135(1), 1999, pp.62-81. Kim, C.H., Y.C. Choi and H.C. Shin, “Intra-Industry Trade of Korea: Trends and Determinants, Economic analysis, 6(4), Bank of Korea, 2000, pp.120-163.
The fact that China is becoming the manufacturing hub of the world provides certain service sectors of East Asian countries with the opportunity for business expansion. Korean Airline (KAL) became the world’s leading carrier of freight in 2004.\(^9\) Raw materials, parts and finished goods going into and out of China have contributed to the success of the company. Hanjin Shipping, and other shipping companies of Korea, also relies heavily on freight to and from China. Other service industries including telecommunications, tourism, entertainment and finance will also benefit from the rise of China. Until China’s inefficient service industries fully develop, China’s growing economy and increasing demand require a foreign supply of services. Since service sectors comprise about 70% of economic activities in industrialized economies, China’s demand for services will provide an impetus for their industrialized neighboring countries.

China is known for its manufacturing platform but not widely recognized as a consumer market. However, the country has a population of 1.3 billion people so its purchasing power will increase as the economy develops. U.S. and EU firms paid attention to this consumer market earlier, but East Asian firms that previously focused on production sharing with China also have begun to penetrate into China’s consumer market. ‘Anycall’, a Samsung produced mobile phone, became a popular brand in China and likewise, the sales of Hyundai cars produced in Beijing have increased rapidly. The rise of China will certainly be accompanied by consumption expenditure and

\(^9\) As for passenger statistics that have close relations with the number of a carrier’s national tourists, the company ranks about 10th in the world. The outstanding result of the freight reveals the China effect.
consequently expanded business opportunities for foreign firms as well as Chinese firms.

IV. The Prospect of Institutional Arrangements for Regional Economic Integration in East Asia

The rise of China has the effect of increasing interdependence and deeper economic integration in the region. Actual economic exchanges between the countries in the region, in areas such as trade and investment, increased tremendously and at a pace that will continue in the future as described in the preceding section. According to Summers (1991), it is natural that trading blocs form between countries that have large trade volumes with each other. However, despite growing interdependence in East Asia, the attempts to strengthen institutions for regional cooperation have so far produced limited success. After the Asian financial crisis of Indonesia, Thailand and Korea in 1997, East Asian countries discussed measures to enhance the financial stability of the region. However, the proposal of Japan to set up an Asian Monetary Fund was not realized. East Asian countries agreed on the Chiangmai Initiative, a mechanism to facilitate the currency swap among the Northeast Asia and ASEAN countries. China’s role during the financial crisis was noted for maintaining the value of its currency, the yuan, which helped to stabilize the currencies of other countries in the region.

With regard to the trading agreement, unlike the EU and NAFTA agreements, a regional trading bloc embracing East Asia has not yet been created. Meanwhile, China has agreed to a free trade agreement with ASEAN, and Japan formed separate FTAs with Singapore, the Philippines, Malaysia and Thailand. Korea also signed an FTA with Singapore and is negotiating with ASEAN countries. Korea and Japan began FTA negotiations in 2003. The big question is whether these activities will lead to an East Asian FTA or a Northeast Asian FTA, particularly in view of China’s growing economy and influence in the region.

It is interesting that many government officials and scholars in the region have proposed a bold vision of establishing an East Asian FTA despite the differences of the methods and paths leading to an agreement. At the ASEAN+3 meeting in Brunei in 2000, President Kim Dae-jung of Korea proposed that an East Asian Free Trade Area be established based on the East Asian Vision Group recommendations. Lee (2003) considers three possible scenarios in the establishment of such an FTA. The first path is to accelerate the regional economic integration process through the existing ASEAN+3 framework. The second is a series of bilateral FTAs in the region leading to the formation of an East Asian FTA. The third is the expansion of the path from ongoing negotiations of Korea-Japan to a China-Japan-Korea FTA and finally to an East Asian FTA by combining the AFTA. The third scenario is also suggested by Baldwin (2004). He expects that a domino effect will be triggered in East Asia and that all major nations will eventually be

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10 A free trade agreement between ASEAN members was signed in 1992, but the focus here is the three big Northeast Asian economies of China, Japan, and Korea.

11 Ten Southeast Asian countries and three Northeast Asian countries (China, Korea and Japan) have regular annual meetings.
pulled into a single agreement. Using exclusion indices, he picks the Korea-Japan FTA as the most plausible gravitational force to initiate FTA enlargement in East Asia.

The prospects for realizing the vision of a regional free trade agreement in East Asia in the foreseeable future are extremely dim. The most likely candidate as a trigger to start the domino effect, the Korea-Japan FTA, is at a stalemate: since the last round of negotiations held in December 2004 in Seoul, the delegations have not met for anymore formal negotiation sessions. The separate FTAs of Northeast Asian countries with ASEAN will have little possibility to converge into one regional FTA. Since ASEAN is not a customs union or common market, forming a bloc with ASEAN provided no common ground. And, in fact, FTAs between Northeast Asian countries and ASEAN have different parameters from each other.

In addition to the difficulties and problems of currently negotiated FTAs, there exist fundamental problems for East Asian economic integration. First, strategic alliances and economic alliances differ. In Asia, strategic alliances are traditionally formed along the U.S.-Japan-Korea lines, but the rise of China brought about increasing economic interdependence between China-Korea-Japan (Choi 2004). The governments in East Asia seemed to put higher priority on strategic considerations rather than economic benefits. China’s choice of ASEAN as its first FTA partner reflects the country’s intention to restore friendly relationships with Southeast Asia. Japan, Korea and ASEAN are also influenced by security concerns in pursuing trade agreements with foreign countries.12

Second, the two major economic powers in the region, China and Japan, do not want to form a trading bloc with each other. China is concerned that the superiority of Japanese industrial technology would hamper the development of the Chinese industry if an FTA would be concluded with Japan. Historical animosities also make China hesitant to negotiate an agreement with Japan. The Japanese believe that China’s level of development and openness falls short to conclude a free trade agreement. In fact, some Japanese scholars believe that China still has a socialist economy, and has not yet become a market economy. The cooperative spirit of France and Germany initiated the formation of the EU. In East Asia, however, China and Japan exhibit ‘rivalry’ in regional economic integration activities by competing to form FTAs with other countries in the region.

Third, East Asian countries trade a great deal with the U.S. and the U.S. attitude to an exclusive East Asian trading bloc has not been favorable. Most East Asian countries are heavily dependent on trade with the U.S. Intra-regional trading in East Asia is also indirectly linked to the U.S. since such trade has a final export destination of the U.S. market. The U.S. supported APEC and its trade liberalization plans, but was hesitant to the launch of a formal trading agreement between the Asian countries. With increasing FTA trends around the world, the U.S. attitude seems to be changing. Among some scholars on both sides of the Pacific Ocean, FTA options between the U.S. and Asia are being explored, but not with much enthusiasm.

12 We need to note that Taiwan and North Korea are in the Northeast Asian region which creates tension in international politics. Agreements in the region, including economic ones, inevitably have strategic implications.
Considering the difficulties and problems, regional cooperation in East Asia will take two forms in the short and medium terms. First, the ongoing negotiations and discussions on various bilateral FTAs will be continued. Singapore and Thailand have been, and will continue to be, very active in pursuing bilateral FTAs with countries within and outside the region. FTAs between major economic players such as China, Japan and the U.S. will be unlikely. Korea can take the mediator’s role but it seems to be concerned with domestic opposition to FTAs and will make lukewarm efforts.

Second, economic cooperation can be realized at the sector level, as can the harmonization of standards and regulations at the regional level. Energy sector cooperation and railroad network projects have been discussed and an information network in East Asia has been proposed. In this regard, APEC, the forum for trade promotion and economic and technical cooperation among Asia and Pacific countries, served as a useful tool to formulate and implement specific cooperative programs including an APEC Business Travel Card and digital networking. Economic cooperation and development programs on bilateral or sub-regional basis will be likely to increase as China’s rise continues and events like the 2008 Beijing Olympic Game and 2010 Shanghai Expo are prepared.

In the long term, it is possible that the economic interdependence between Northeast Asian countries, accelerated by the rise of China, will lead to a formal regional trade agreement. This possibility will be influenced by many factors: the economic necessity of an institutional agreement, a change in the strategic alliance, the U.S. policy on East Asia, the development of regionalism in other parts of the world and the future development of the WTO system. Predicting the time horizon of creating a Northeast Asian FTA or an East Asian FTA would not provide any meaningful assistance. With or without a regional agreement, China will likely experience continued economic development producing a tremendous impact on the Asian economy.

V. Conclusion

In this paper, we have examined the future prospects of China’s economic development. Also, we have examined the development’s impact on the East Asian economy and economic integration of the region. China has problems of increasing income disparity, a deteriorating environment and depleting energy resources. The key issue is how to solve the contradiction between the socialist political system and a market-based economy. The overall assessment is that China will be able to manage the transformation of the nation into a steadily growing market economy, although there may be occasional bumps in the road. Some people perceive the rise of China as a threat to the East Asian economy, pointing out that export markets were taken over by Chinese products and that China absorbed so much FDI. In fact, however, exports of most East Asian countries have grown as China rises. China is used as an export base by firms from Japan and Korea: intermediate goods are exported to China and after processing they are re-exported to the U.S. and EU as finished products. The expansion of manufacturing production in China provides service sectors of East Asian countries with the opportunity for business expansion. Although not fully developed yet, China’s growing economy will certainly be
accompanied by the expansion of a consumer market, which will in turn broaden business opportunities for East Asia. Despite the increase in trade and investment, and hence interdependence between East Asian countries, a regional trading bloc embracing East Asia has not yet been created. The future prospects for realizing the vision of a regional free trade agreement in East Asia in the foreseeable future is not bright, either. The ongoing efforts for various bilateral FTAs involving countries within and outside the region will continue. However, the FTAs between major economic players such as China, Japan and the U.S. will not be concluded soon. Economic cooperation at the sector level, and cooperation on project-based development programs, will likely increase as China continues to rise and hosts events such as the Beijing Olympic Games.
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Appendix:

Appendix 1: Korea’s 7 Major Export and Import Goods with China

| Export to China in 1995 | Import from China in 1995 |
|------------------------|--------------------------|
| HS CODE    | BEC CODE | portion | HS CODE    | BEC CODE | portion |
| 271000     | 31       | 4.7%    | 270112     | 31       | 4.3%    |
| 410439     | 22       | 3.6%    | 271000     | 31       | 3.6%    |
| 390210     | 22       | 3.5%    | 720110     | 22       | 3.5%    |
| 550320     | 22       | 3.3%    | 720711     | 22       | 3.3%    |
| 390120     | 22       | 2.5%    | 270900     | 31       | 3.1%    |
| 290250     | 22       | 1.5%    | 551311     | 22       | 2.6%    |

| Export to China in 2004 | Import from China in 2004 |
|------------------------|--------------------------|
| HS CODE    | BEC CODE | portion | HS CODE    | BEC CODE | portion |
| 847330     | 42       | 6.8%    | 270112     | 31       | 4.2%    |
| 852990     | 42       | 6.8%    | 847330     | 42       | 3.2%    |
| 271019     | 32       | 5.0%    | 847160     | 41       | 2.9%    |
| 847160     | 41       | 3.8%    | 760110     | 22       | 2.8%    |
| 901390     | 42       | 3.3%    | 854221     | 42       | 1.9%    |
| 291736     | 22       | 2.9%    | 853120     | 41       | 1.8%    |
| 870899     | 53       | 2.9%    | 854389     | 41       | 1.7%    |

Appendix 2: Japan’s 7 Major Export and Import Goods with China

| Export to China in 1995 | Import from China in 1995 |
|------------------------|--------------------------|
| HS CODE    | BEC CODE | portion | HS CODE    | BEC CODE | portion |
| 852810     | 41       | 2.2%    | 270900     | 31       | 4.3%    |
| 847989     | 41       | 1.8%    | 611010     | 63       | 2.5%    |
| 540760     | 22       | 1.7%    | 160419     | 12       | 2.1%    |
| 847330     | 42       | 1.6%    | 611030     | 62       | 1.7%    |
| 271000     | 31       | 1.3%    | 420292     | 62       | 1.4%    |
| 854211     | 42       | 1.2%    | 020741     | 12       | 1.2%    |

| Export to China in 2004 | Import from China in 2004 |
|------------------------|--------------------------|
| HS CODE    | BEC CODE | portion | HS CODE    | BEC CODE | portion |
| 854221     | 42       | 5.0%    | 847330     | 42       | 3.1%    |
| 847989     | 41       | 3.2%    | 847130     | 41       | 2.6%    |
| 847330     | 42       | 2.8%    | 847160     | 41       | 2.6%    |
| 852990     | 42       | 2.7%    | 847150     | 41       | 2.2%    |
| 901380     | 41       | 1.6%    | 852990     | 42       | 1.8%    |
| 290250     | 22       | 1.5%    | 270112     | 31       | 1.6%    |
| 870323     | 51       | 1.3%    | 611020     | 62       | 1.4%    |
Appendix 3: U.S.’s 7 Major Export and Import Goods with China

| Export to China in 1995 | Import from China in 1995 |
|------------------------|--------------------------|
| HS CODE | BEC CODE | portion | HS CODE | BEC CODE | portion |
| 310000 | 21 | 10.3% | 640399 | 62 | 4.1% |
| 880240 | 52 | 7.4% | 640299 | 62 | 2.8% |
| 520100 | 21 | 7.1% | 950390 | 62 | 2.7% |
| 100590 | 21 | 5.4% | 847330 | 42 | 2.1% |
| 100190 | 11 | 4.3% | 640391 | 62 | 2.0% |
| 150710 | 12 | 2.5% | 950210 | 62 | 1.7% |

| Export to China in 2004 | Import from China in 2004 |
|------------------------|--------------------------|
| HS CODE | BEC CODE | portion | HS CODE | BEC CODE | portion |
| 120100 | 11 | 6.7% | 847160 | 41 | 5.6% |
| 854221 | 42 | 6.1% | 847330 | 42 | 4.4% |
| 880240 | 52 | 4.7% | 847130 | 41 | 3.9% |
| 520100 | 21 | 4.1% | 852520 | 41 | 2.8% |
| 847330 | 42 | 1.6% | 640399 | 62 | 2.5% |
| 847989 | 41 | 1.6% | 852190 | 41 | 1.5% |
| 740400 | 21 | 1.5% | 950390 | 62 | 1.2% |
