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EXECUTIVE SUMMARY

Is China developing so fast that it threatens to dominate completely regional manufacturing, even high technology manufacturing, undermining developing and developed East Asian economies' economic prospects? This report seeks to answer this question by examining the major restructuring underway in regional economies' trade flows China appears to be causing, drawing implications for regional economic prospects and Australian business. This report finds China's industrial rise is a positive sum game for the region and Australia; overall, all economies appear to be gaining. However, some economies like Australia are gaining more than others that are constrained by rigid policies and weak markets. This is because the comparative advantage of China, Australia and other regional economies is dynamic. Firms, markets and economic policies must be flexible and open to remain winners in this rapidly evolving environment.

China's strong growth and large economy is causing rapid changes in production patterns and trade flows within East Asia and between the region and third markets. These changes not only are affecting regional economies but also could significantly influence Australian exporters, most of whom supply industrial inputs to China and other East Asian economies.

This report firstly examines recent production and export growth patterns, assessing concerns China's expanding exports of assembled high technology products could damage middle and high income East Asian economies by making redundant many advanced industrial plants. It also examines concerns China's rapidly expanding production of more traditional labour intensive manufactures is damaging economic prospects in developing South East Asian economies.

China already is, or is fast becoming, the region's largest exporter of many products, from fully assembled high technology products to traditional labour intensive manufactures. At first glance, human capital and technology abundant economies such as Taiwan, the Republic of Korea and Singapore seem to confront rising Chinese competition in markets for some of their high technology exports. Labour abundant economies in South East Asia also appear to face increased competition in world export markets for clothing, footwear, toys, consumer electrical goods and other labour intensive products.

However, detailed analyses of regional trade flows over the past decade this report undertakes shows China's continuing industrial expansion is not damaging but benefiting other regional economies. China is more closely integrating into mutually beneficial regional production chains, stimulating regional trade growth. In more advanced regional economies, exports of advanced components and capital equipment to China and elsewhere are more than compensating for losses in labour intensive manufacturing sectors. In developing regional economies, China's industrial expansion certainly is challenging competing regional industries, encouraging them to specialise and adjust but, overall, competing sectors are still expanding strongly. Furthermore, China's expanding imports, including of advanced components, capital equipment and raw materials, are generating lucrative new markets

for East Asian and Australian exporters. Nevertheless, the study highlights the fact that policy settings need to promote flexibility and resource mobility within regional economies to maximise benefits from China's expansion.

As a major raw material supplier and a smaller but still significant exporter of advanced manufactures and services to China, Australia already is benefiting significantly from China's rapid growth. Furthermore, as other East Asian economies appear to be adjusting successfully to the rise of China's industry, Australia also should retain and expand its traditional markets in these economies. This detailed understanding of how East Asian economies are adjusting to the rise of Chinese industry aims to assist Australian businesses anticipate and benefit from these major emerging market trends.

Regional Hollowing Out Concerns Unfounded

This report's analysis indicates concerns of widespread hollowing out are unwarranted. It shows China's core competitiveness still lies largely in labour intensive production. To produce more technologically advanced products, it mainly assembles imported components from developed East Asian economies. Most developed East Asian economies continue to expand their exports of more technologically advanced products. They also are responding to China's efficiency in labour intensive manufacturing by contracting exports in these industries and expanding exports from more capital and human capital intensive industries where they retain relative strength. By developing new markets and maintaining old ones most developing East Asian economies are achieving strong export growth even in sectors where they compete with China.

While China's more high technology exports appear to be expanding into sectors other East Asian economies supply, closer examination indicates a key driver in this apparent trade convergence is the internationalisation of production chains. Export similarity analysis using gross export data appears to show China's export profile gradually is becoming more similar to the export profiles of many developed East Asian economies in recent years. However, export similarity analysis undertaken using net (export minus import) data shows China's overall export specialisation is not becoming more similar to those of most other East Asian economies. This is because rather than taking over the whole production process for computers, televisions and other electronic products, China is becoming more embedded in regional production chains producing these products. These chains typically take advantage of the strengths of different regional economies to produce the range of required components and assemble completed products. They often involve industrialised Japan, the ROK and Taiwan producing sophisticated components and shipping them to low cost China and South East Asia for assembly into final consumer goods. Once trade flows associated with these integrated production chains are factored in to analyses of regional net trade flows, no overall trend emerges of Chinese exports encroaching on its neighbours' export markets.

In addition, China is becoming an increasingly important market for other East Asian economies and Australia through their increasing trade complementarity. China's expanding industries are providing all East Asian economies with rapidly expanding markets for raw material, component and capital

equipment exports. Australia's exports to China are growing rapidly, particularly raw materials and energy. Regional economies with more established consumer bases, such as Japan, Hong Kong, Singapore and Australia, also are benefiting from cost competitive Chinese consumer good exports.

Chinese Manufacturing Expands

Sectoral analysis of Chinese trade flows confirms significant restructuring and some movement up the value chain is underway in Chinese manufacturing. China maintains a strong competitive edge in labour intensive products like clothing, footwear and toys and rapidly is becoming a more competitive office machine assembler. Over the last five years China also has reduced its comparative trade weakness in more capital intensive industries like non-office machinery and synthetic textiles while its comparative strength in traditional labour intensive products like clothing and footwear is waning. However, China now relies more on imports for human capital intensive products like integrated circuits and energy imports like crude oil.

Strongly Complementary Japan Consolidates Advanced Manufacturing

Japan faces moderate competition from Chinese exports but is responding by moving out of the labour intensive sectors where China is more competitive. Japan is facing increasing competition from Chinese exports in about a quarter of its net export sectors by value. In two thirds of these sectors, mainly labour intensive industries like assembled computers, Japan's net exports are declining. Japan continues to expand its net exports of the other third of export categories, which includes more advanced products like video and digital cameras, mobile phones and motorcycles. Another quarter of Japanese net exports by value, including integrated circuits and steel, complement Chinese net imports and this complementarity is increasing. Around a quarter of Japanese net imports, such as clothing, are complementary with Chinese net exports. Japan retains a strong specialisation in capital and human capital intensive products including non-office machinery and passenger vehicles, and an equally strong reliance on imports for primary commodities like crude oil and meat and labour intensive goods such as clothing.

ROK Expands Exports Regardless of Chinese Competition

The Republic of Korea, ROK, faces competition from Chinese net exports in about half of its export sectors but continues to expand exports of these products regardless, at a similar rate as China. For example, ROK net exports of mobile phones, digital and video cameras, computers and computer parts continue to expand strongly in the face of China's expansion in similar industries. The mutually advantageous intra-industry component and finished product trade between China and the ROK probably explains part of the ROK's success. Another quarter of the ROK's net exports by value, including plastics in primary forms and steel complement Chinese import demand. Hence, the ROK is integrating its industry effectively with China, with few apparent negative impacts in competing sectors and strong growth in clearly complementary sectors.

Taiwan Restructures to Adjust to Strong Competition

Taiwan also faces strong competition from China, competing with Chinese exports in well over half its net export sectors by value. In a majority of these competing sectors, including clothing and fully assembled computers, Taiwan is reducing its net exports but it continues to expand its net exports of other products, such as computer parts. About a quarter of Taiwan's total net exports by value, including synthetic textiles and electronics components, are complementary with Chinese net import demand. By specialising in its comparative strengths, such as computer parts and products China demands, like textiles and steel, Taiwanese industry has continued to expand its exports strongly.

Hong Kong's Entrepot Role Strongly Evident

As Hong Kong is a major re-exporter of Chinese goods, with local firms adding some value to many of these re-exports as they pass through Hong Kong, even analysing net trade flows between Hong Kong and China appears to show the two economies have very similar net export profiles. However, only 9 per cent of Hong Kong's workforce now is in manufacturing; most of its workforce is in service industries, many of which also service China. Meanwhile, 20 per cent of Hong Kong's net merchandise exports complement Chinese net import needs and around a third of Chinese net exports match Hong Kong's net import requirements. While goods trade data analysis provides only a partial picture, the close integration of the two economies is clear. Hence, China's growth should provide Hong Kong strong long term prospects.

Indonesian Resources Complement Chinese Growth

While China is a competitor in almost half of Indonesia's net export markets, mainly for labour intensive manufactures, overall Indonesia is expanding its net exports strongly in these competing sectors. So long as Indonesia retains flexible labour markets and its financial system can recover sufficiently to finance new investment in sectors competing with China, this competition could promote Indonesian efficiency and product specialisation. With its strength in primary commodity exports, Indonesia also is well placed to benefit from Chinese industry's expanding demand for inputs.

Malaysia Boosts Exports despite Chinese Competition

Malaysia, like Indonesia, relies heavily on resource and labour intensive manufactured exports, but has significantly more overlapping export sectors with China than Indonesia. Almost two thirds' Malaysia's net exports compete with China's, including a wide range of electronics. In the past six years, despite strong Chinese net export growth in these markets, Malaysia significantly increased its exports in the majority of these competing sectors. Hence, Chinese competition does not appear to be damaging Malaysia's manufacturing export sector and could well be strengthening it. Although its complementarity with China currently is lower than that of most other regional economies, Malaysia also is benefiting from China's increased demand for resources and components.

The Philippines Benefiting from Complementarity

The Philippines appears to be adjusting successfully to changing international demand and Chinese competition, increasing its net exports in a majority of sectors where it competes with China. However, China may present a low and declining competitive challenge to the Philippines' net exports in part because the Philippines is not a strong exporter of the labour intensive products economies at a similar level of development usually rely on. Nevertheless, the Philippines is highly complementary with China's net import demand, particularly in electronic components, which should assist its future export growth.

Singapore Goes High Tech, Strongly Complementary

As one of the region's most developed economies, Singapore has a strong technological edge over China; it continues to move rapidly out of more labour intensive sectors where China is strong, focusing on higher technology exports. This ongoing restructuring is increasing Singapore's trade complementarity with China. Like other developed East Asian economies and Australia, Singapore is well placed to take advantage of China's growth by exploiting its complementarities, including by exporting components and capital goods and accessing China's low cost exports to supply its mature consumer market.

Thailand Faces Toughest Competition: Continued Reform Important

Of all East Asian economies, Thailand has the most similar net export profile to China's and faces competition from China in the great majority, 70 per cent, of its net export sectors. Competitive pressure from expanding Chinese exports appears to be pressing many Thai industries to either become more efficient or move into more specialised markets. Thailand's complementarity with China is the lowest in the region but is growing rapidly. Provided the Thai economy can restructure flexibly it should gain from this competition; however, if Thai economic reform programs were to stall, Chinese competition could prove a serious challenge.

China's Economy Could Surpass Japan's by 2030

Over the next few decades, if China's reforms stay on track its economy could expand until it approaches the size of Germany in 2010 and rivals Japan by 2030. As its income per capita expands, China already is moving gradually up the value chain and producing an increasingly wide range of goods. However, it is unlikely to become a competitive net exporter of human capital intensive products like high technology components or capital intensive industrial goods for some decades. China's huge, low cost but on average low skill workforce means its relative strength, and hence its trade specialisation should remain in labour intensive exports for some decades.

Positive Implications for Australia and the Whole Region

Due to its complementary trade specialisation and role as a major input supplier to Chinese industry, Australia should continue to profit from Chinese economic expansion. In other East Asian economies, China's industrial expansion is stimulating restructuring that should help boost industrial efficiency and growth; this also should promote Australian exports to the region. However, destinations of some Australian exports will continue to shift as developed regional economies move out of labour and resource intensive industries to more human capital intensive industries.

Vastly different Australian and Chinese economic endowments and strengths mean Australia faces relatively little competition from China in export markets and strongly complements China as a trading partner. As a net exporter of many products China demands, particularly minerals, energy and agricultural commodities, Australia is well placed to benefit from its rapid growth. Australia also is a large net importer of goods China supplies to world markets, including a wide variety of more labour intensive consumer goods. This strong trading partnership will continue to generate considerable benefits for Australia and China.

Over time, as China's raw material requirements continue to increase and other economies restructure into more human capital and less raw material intensive goods and services, some Australian exports will shift from other East Asian economies to China. Economic Analytical Unit commissioned modelling results indicate Chinese demand for many major Australian exports, including copper and natural gas, should continue to grow strongly in the next decade. Resource exports to maturing developed economies like Japan are likely to grow more slowly and in some cases may fall. In the case of coal, Australia's largest export to the region, while its exports to East Asia will continue to rise in absolute terms, its share in total East Asian coal consumption could fall if China's coal industry satisfies more Chinese and regional coal demand.

As China continues to grow, its rapid economic development and on-going integration into regional production chains should benefit the rest of East Asia and Australia. To date, East Asian economies appear to have been sufficiently flexible to restructure and maintain competitiveness to meet the challenge of China's industrial rise. However, developing South East Asian economies require ongoing reforms to ensure they maintain market flexibility so they remain competitive with Chinese exports and capture rapidly growing export opportunities in China. Chinese industries' growing appetite for resources, components and capital goods expands total regional demand and provides significant opportunities for regional economies to gain from increased specialisation, ensuring benefits for Australia and its East Asian trading partners. Hence, China's industrial rise is a major boon for the region, providing a strong engine of growth, but the most flexible economies will reap the greatest benefits in the significant industrial restructuring now underway.