

## IV. REGIONAL INTEGRATION AND THE ROLE OF CHINA FOR REGIONAL PROSPERITY

*China's rapid and sustained economic expansion over the last three decades has been without precedent, lifting hundreds of millions from poverty at home and providing an increasingly stronger engine of growth globally. The country's rise has provided a strong boost to the process of regional integration, with a rapid increase in intraregional trade—including for commodities and final products—and capital flows. As China's wages are rising, there may in time be room for relocation of production toward other East Asian countries, although this process will take quite some time. Chinese investment in the region and beyond is rising steadily, and China's prominence in global affairs suggests regional issues will receive a global audience. There are substantial risks, however, stemming from China's exceptionally diversified output and export mix—much like the U.S.—that is in direct competition with countries in East Asia in foreign markets.*

### *Regional integration is becoming a key driver of regional growth*

**Deeper regional integration will provide a further impetus to growth in East Asia and the Pacific.** This boost will be especially timely given the likelihood that growth in high-income economies will be subdued after the global economic crisis. As barriers to the movement of goods, services, capital, and labor within the region are reduced further, countries that have integrated spectacularly with the world will integrate further among themselves, facilitating specialization and economies of scale and scope. The regional market for goods and services will provide opportunities that so far have been less than fully realized.

**And regional integration will allow East Asia to benefit from China's dynamism.** Fewer barriers between countries within the region will allow for stronger links with China. Over the last decade, trade in goods—both for final consumption and for further processing—with China has been growing faster for most countries in the region than with the rest of the world. Deeper regional integration should facilitate stronger trade in services, thus adding a powerful impetus to the development of the countries' higher-value-added service sector that has thus far lagged behind manufacturers at home—and the service sectors in other large emerging markets, including India. Allowing for a larger role for the service sectors will lead to gains in others sectors domestically and abroad and help support rebalancing efforts in some East Asian economies, most importantly in China.

**Market-driven integration will support efforts to strengthen institutions and arrangements for more comprehensive regional economic cooperation.** ASEAN (including its manifestations as ASEAN+3, ASEAN+6, and the East Asia Summit) has taken the lead in Southeast Asia, starting with the ASEAN Free Trade Area (AFTA) established in 1993. This was followed by ASEAN's commitment to create a single ASEAN Economic Community by 2015 and the free trade agreement between ASEAN on the one hand and China and India on the other. A dialogue under the Asia-Pacific Economic Cooperation (APEC) is also well-advanced.

**Further impetus to financial integration—a part of the integration of services—and the strengthening of the region's financial safety net has been provided by the Chiang Mai Initiative Multilateralization (CMIM).** This is an arrangement among the ASEAN+3 that came into effect in March 2010. The CMIM converted the system of bilateral swap arrangements between the individual ASEAN countries on one side and China, Korea, and Japan on the other and the \$2 billion swap arrangements between the ASEAN countries (ASA) into a single \$120 billion multilateral swap arrangement for balance of payments support. The maximum amount available for each country

to draw on is a multiple of its original contribution, ranging from \$11.2 billion for Indonesia, Malaysia, Singapore, and Thailand to \$0.2 billion for Lao PDR.

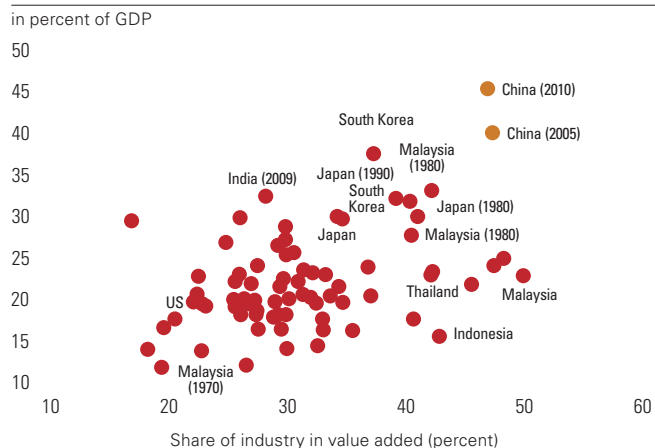
### *China's global and regional role surged since 1978*

Over the last three decades, China's sustained rapid growth and outward-oriented economic policy have helped to transform the country, the region, and the world. Real GDP growth in China averaged 10 percent a year during 1978–2010. In 2010, China became the world's second largest economy, representing about 9.5 percent of global GDP at market exchange rates. Regional production networks in East Asia grew substantially in the last few decades and are largely centered on China. As a result, China is now the world's largest exporter, second largest importer, and the focus for manufacturing activity in many sectors.

China's strong growth and export orientation are the result of many external and domestic factors. A supportive global environment for much of this period including the structural shift to more globalized forms of industrial production has been critically important. China's accession to the WTO in 2001, and associated changes in tariffs and other policies were especially crucial for deepening its global links, as has been the country's gradual opening up to foreign investment.<sup>10</sup> Domestically, growth has been spurred by phased landmark economic reforms and by an impressive deepening of domestic market integration both through policy reforms and improvements in infrastructure and logistics.<sup>11</sup>

China's growth has been investment-oriented and industry-led. So far, the investment rate has been higher in China than in almost any other country, and the production structure is geared heavily towards industry (Figure 49).

**Figure 49.** China's rise has depended more than elsewhere on high investment



Sources: World Development Indicators, NBS (for China) and staff estimates.

This pattern of growth has served the economy well in many respects but has also contributed to some imbalances. The emphasis on capital deepening and industry in China has accentuated the gap that existed for a long time between productivity and wage growth. Thus, the share of wage income in GDP declined and along with it fell the share of consumption. This pattern of growth has limited the absorption of surplus agricultural labor and contributed to rising rural-urban income inequality. It has also been particularly intensive in energy and natural resources and has been tough on the environment.

While successful in several regards, government policies have accentuated these imbalances. Policies have encouraged saving and investment, with government spending for a long time geared towards investment in physical

<sup>10</sup> The liberalization brought about by WTO accession was substantial. The average tariff rate was reduced from 43.2 percent in 1992 to around 9.8 percent in 2009.

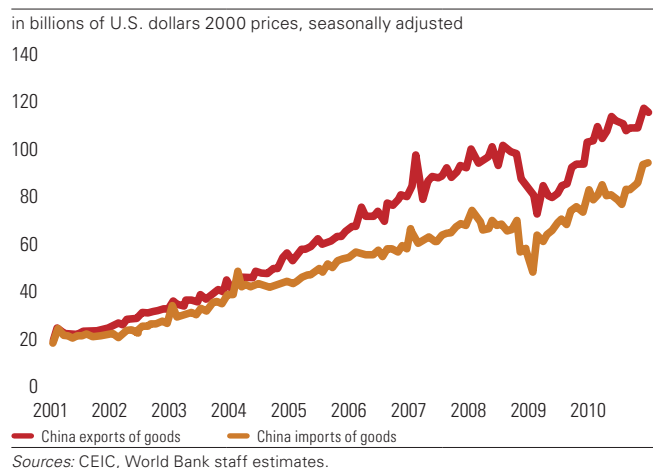
<sup>11</sup> For more discussion of factors behind China's past performance, see Vincelette et al. (2011).

infrastructure more than in health and education, and were initially tilted towards richer, coastal areas. Industrialization and exports were promoted via easy access to cheap credit for large industrial firms, the under-pricing of key inputs—notably energy, natural resources, land, and the environment—and exchange rate policy. Meanwhile, service development received less attention.

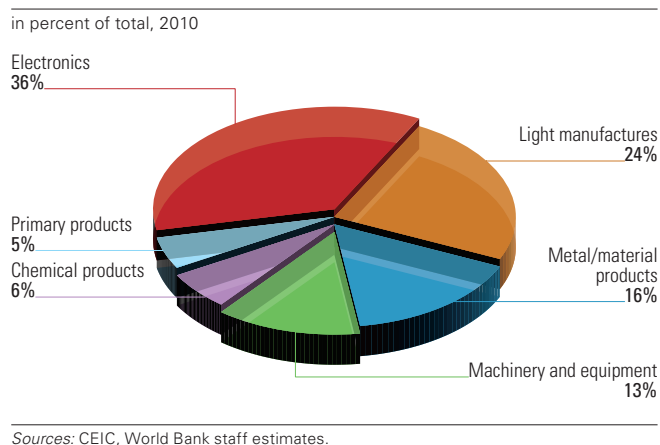
**This growth model, and the resulting imbalances, also strongly influenced how China’s economy interacted and affected the rest of the world.** This interaction occurred in three main dimensions that involved China as a large and growing producer and exporter of manufactures, a diversified importer of commodities, intermediate inputs, and final goods, and, during the last decade, as a large net saver.<sup>12</sup> We look at each of these dimensions in turn.

**China’s exports have grown dramatically, turning the country into the world’s largest exporter.** Since 1978, exports have increased 163 times in nominal U.S. dollar terms, or 17.2 percent a year on average. Since 2000, exports have risen 5.3 times in real terms (Figure 50).

**Figure 50.** China’s trade has risen dramatically



**Figure 51.** Exports are dominated by manufactures



**As China has become a dominant global production center in many industries, manufactures comprise around 95 percent of its exports (Figure 51).** In 2010, China’s exports of manufactures were equally split between “processing” and “non-processing” activities, with electronics and light manufactures together accounting for over 60 percent of all exports.<sup>13</sup> These are the products of which China is a significant net exporter. The important role of processing trade reflects China’s emergence as a central player in many global and regional production chains, including in textiles and apparel, automobiles, and electronics.<sup>14</sup> The productivity gains allowed by this dynamic and flexible form of production have helped to keep Chinese producers competitive despite headwinds from the post-2005 currency appreciation, large increases in real wages, and the global economic crisis.

<sup>12</sup> In contrast, China has so far had much less impact on the world as a service exporter and as a source of outward FDI. This is gradually changing but from a low base.

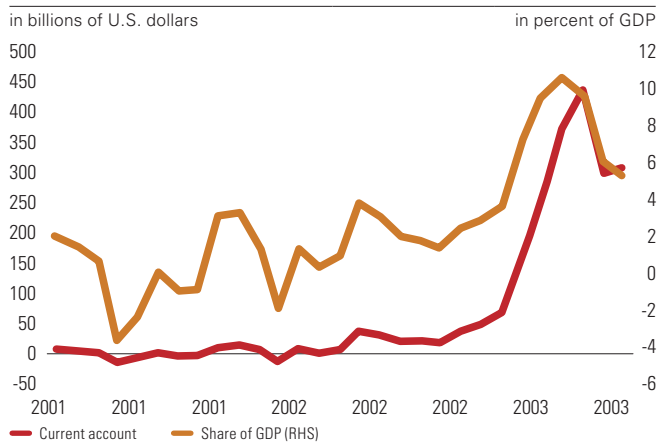
<sup>13</sup> “Processing” trade refers to exports that are processed/assembled, often along the coast and under a specific customs regime, using a large share of imports.

<sup>14</sup> For more on the growth of the processing trade in China, see Zeng (2011).

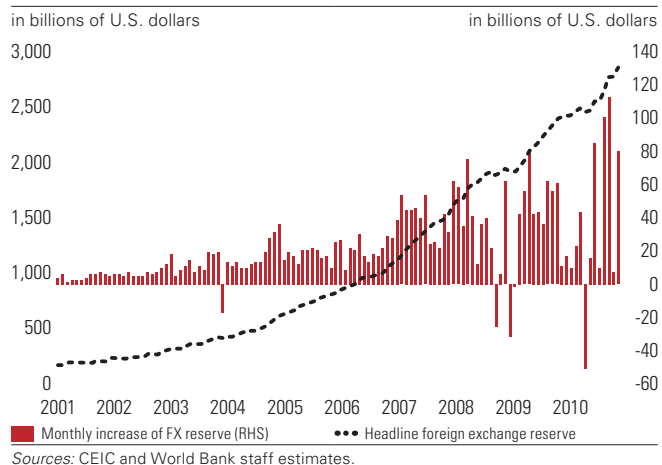
China's imports have also grown rapidly but they are much more diverse. Since 1978, China's imports have increased 128 times in nominal U.S. dollar terms, or by 16.4 percent a year. Since 2000, China's import volumes grew 4.4 times. In 2009 and 2010, driven by stimulus, China's continued import growth was an important contributor to global growth at a critical time.

Finally, China has increasingly affected the world as a net saver. Investment rose from an already high 35.1 percent of GDP in 2000 to 48.6 percent in 2010, but gross national savings rose even more—from 36.8 percent of GDP to about 54.2 percent over the same period. As a result, China's current account surplus jumped from \$20.5 billion in 2000 to about \$330 billion in 2010 (Figure 52). Given capital controls, most of the surplus savings were intermediated abroad by the public sector, largely in developed country securities. Thus, China's foreign reserves rose rapidly, reaching \$2.85 trillion, about 24 months of imports and 50 percent of GDP at end-2010 (Figure 53).

**Figure 52.** China's large current account surplus is a recent phenomenon...



**Figure 53.** ...as is the surge in foreign exchange reserves



### *China's economy through 2030: sustained albeit moderating growth*

Assuming significant reform progress continues, China's economy is likely to sustain robust but slowing growth through 2030. The structure of the economy will change in line with plans for a more balanced pattern of investment and economic activity, but investment will remain a powerful source of growth. China's global weight will rise, becoming the largest economy in the world before the end of the 2030s, albeit with per capita income still lagging the high-income economies.

The shift in the growth and investment patterns towards services and consumption was a key objective of China's 11<sup>th</sup> five-year plan and continues to feature prominently in the 12<sup>th</sup> five-year plan. Achieving the goals of this rebalancing requires putting more emphasis on channeling resources to sectors that should grow in the new setting and more permanent urbanization, with migrants taking their families along with them and living like urban citizens.<sup>15</sup> A successful transformation would mean more labor-intensive growth, with a larger role played by services. A higher share of wages and household income in GDP would increase the role played by consumption in the

<sup>15</sup> For a more detailed elaboration of the reform agenda for meeting these two objectives, see the World Bank China Quarterly Updates of June 2009, March 2010, and November 2010.

economy in an economically sustainable way and ameliorate the pressures for current account surpluses. Such growth would also reduce urban-rural inequality and make growth less intensive in energy, raw materials, and resources and thus less detrimental to the environment.

**The scenario through 2030 that we have developed in this chapter assumes substantial rebalancing along the lines presented above.** Under the scenario, potential output growth is estimated to moderate to 6.8 percent in 2016–20 and to 5.1 percent in 2026–30, half the pace seen during 1978–2009 period (Table 4).

**Despite substantial rebalancing, the contribution of capital accumulation to growth will remain sizeable in the medium term.** The investment to GDP ratio is likely to decline only gradually as many investment plans and projections are still in the pipeline and China actually still needs a lot of capital—the capital stock per worker amounts to 14 percent of the U.S. level.

**Other factors are likely to affect potential growth gradually.** Demographic projections suggest overall employment will start to shrink in 2015. Human capital per worker will continue to rise gradually. TFP growth will moderate to a still relatively high rate. Other salient features of the projections include:

- a rise in the share of consumption in GDP, with more urbanization and urban job creation and higher wage pressure boosting the share of wages and household income in GDP
- a decline in the relative importance of industry and a rise in that of services
- a decrease in the overall saving rate by enterprises, the government, and households
- a lower external surplus, despite lower investment
- higher rural productivity and incomes, and less urban-rural inequality.
- growth less intensive in energy and primary commodities, with lower pollution.

### *China's economy and its living standards in international perspective in 2030*

China's weight in the global economy is likely to double to 17 percent from 2010 to 2030 in constant prices. China will probably contribute around one-fourth of overall real global GDP growth through 2030.

**Table 4.** Slowing but still strong growth through 2030

percent change unless indicated otherwise						
	1978–1994	1995–2009	2010–2015	2010–2020	2021–2025	2026–2030
Potential GDP	9.9	9.9	8.7	6.8	5.7	5.1
Employment	3.3	1.0	0.2	-0.5	-0.5	-0.5
Labor productivity	6.4	8.8	8.5	7.3	6.3	5.6
From TFP growth	2.8	3.0	2.6	2.4	2.2	2.0
From higher H/L	0.5	0.6	0.5	0.5	0.5	0.5
From higher K/L ratio */	3.0	5.1	5.4	4.4	4.0	3.2
<i>Memoranda</i>						
Investment (% of GDP, average)	30.0	37.4	44.2	41.2	38.5	37.0
K/L (as a share of U.S., 2005 USD)	4.0	8.3	16.7	23.1	29.1	35.0
GDP pc (2000 prices), share of U.S.	...	4.4	8.9	12.8	17.0	21.8

Sources: NBS and World Bank staff estimates.  
Note: Methodology as in Kuijs and Wang (2006), but with human capital. \*/ This is influenced by the dramatic increase in investment in 2009.

**Table 5.** China's evolving economic structure under the baseline scenario

in percent of GDP unless indicated otherwise					
	1990	2000	2010	2020	2030
Investment	25.9	34.1	45.3	40.0	37.0
Consumption	64.8	62.0	48.6	57.0	61.0
Industry	41.3	45.9	46.9	43.0	38.0
Tertiary sector	31.5	39.0	43.0	50.0	57.0
Employment in agriculture (%)	60.1	50.0	38.1	26.0	15.0
Employment in services (%)	18.5	27.5	34.1	44.0	55.0
Urbanization rate (%)	26.4	36.2	47.0	61.0	71.0

Sources: CEIC and World Bank estimates.

**China's future share of global output in current prices depends on exchange rate projections.** Given the uncertainty over the pace of appreciation of the real exchange rate (RER) in the coming decade, consider two long-term paths. The lower bound assumes a real appreciation of 0.8 percent a year vis-a-vis the U.S. dollar, the average observed in a broad sample of countries during 1970–1996. The upper bound assumes 3 percent appreciation a year, broadly in line with Japan during 1965–1990 and South Korea during 1970–1996. Depending on the extent of RER appreciation, China's share in global GDP in 2030 will be in the range of 19–24 percent and that of the other developing countries in the range of 51–60 percent at current market prices.

**China's future living standards can be compared with other countries' current living standards.** Under the scenario outlined above, China's per capita GDP will reach \$5,000 in constant 2000 dollars by 2020 (similar to Turkey and Malaysia in 2009) and \$8,240 by 2030. To compare at current prices and market exchange rates, China's per capita GDP will rise from 9.4 percent of the U.S. level in 2010 to 25–39 percent in 2030.

### *China's rising regional and global role*

The implications of the developments described in the previous section will be profound for the region and the world. Consider the following broad implications.

**The favorable prospects for China augur well for further expansion of total and intra-regional trade.** Globally, China's trade volumes are likely to grow more slowly than during the pre-crisis period, partly because of more subdued growth prospects in traditional markets and partly due to saturation effects. Intra-regional trade is likely to increase.

**While rebalancing might shift the composition of China's imports, these shifts would be at the margin and dominated by the expansion of overall volumes.** Relative to a "business as usual" scenario, China would import fewer commodities and intermediate inputs and more consumer goods. However, the structure of China's economy contains significant inertia and is likely to change only gradually even with strong reforms. Even after such shifts, a growing China would continue to expand industrial output as well as its capital stock and to increase its overall demand for commodities.

**China looks well placed to retain or enhance its position in many global or regional production chains that are likely set for further consolidation.** This reflects China's increasingly diversified manufacturing base and the likely emergence of large domestic firms with a skilled labor force and R&D capability.

**Any shift in industrial production away from its current coastal locations is likely to be gradual.** As China moves up the value chain and rebalances its economy and as its real wages continue to rise, some of its export-oriented enterprises are considering moving to new locations. This will create opportunities for low-cost countries in the region and for China's inland areas. With effective distances having been drastically narrowed due to improved rail and road links, inland provinces such as Sichuan, Anhui, and Henan have already emerged as meaningful export production centers. Going forward, this process is likely to be gradual, including due to the resilience of the existing production areas. The specific pattern of wage increases across countries and within China will affect the degree to which such industrial transfer occurs within China vis-à-vis moving to other countries.

**Substantial gains for China and the region could be achieved from stronger service exports.** While China's service trade is growing rapidly, it still only constitutes 11 percent of China's total external trade, only half the figure for global trade on average. Expanded services trade would allow China to diversify its export base and provide its producers with necessary services, especially backbone services. Within East Asia, it would expand choices for users of such services while enhancing competition for their producers.

**There is immense scope for further increase in China's outward FDI.** China's non-financial outward FDI rose from \$2.7 billion in 2002 to \$47.8 billion in 2009, but this still amounts to less than 1 percent of GDP. So far, this expansion has been led by state-owned enterprises, often in resource sectors, with a negligible role played by private firms. This is likely to change, spurring increased investment in the region and boosting regional integration.

**China's financial integration with the rest of the world so far has been limited by capital controls, barriers to entering the financial sector, and the modest expansion abroad of Chinese banks.** A phased opening is underway in several of these dimensions. Deeper financial integration will allow households to earn more on their savings, increase the efficiency of domestic financial institutions through competitive pressures, and give firms access to more financial resources and instruments. Such changes could also have macroeconomic effects by expanding options for portfolio allocation. At present, most of China's excess savings are being intermediated abroad as official reserves held in securities of developed economies. Easing controls could allow a larger part of China's savings to finance development in East Asia and the Pacific, and possibly affect specific exchange rates. However, opening up to the global financial system will also increase risks as China's financial system would become more exposed and opportunities for risk taking by financial institutions and firms would increase. Thus, it will be imperative to strengthen regulatory and supervisory institutions. The dangers inherent in uncontrolled capital movements indicate that the removal of constraints on capital account transactions should be gradual.