Taking Advantage of China's Rebalancing

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2017 PECC Singapore Conference on "APEC's Post 2020 Agenda: Rising Protectionism, Economic Rebalancing and Diversified Growth"

Panel 1: Session 1: Asia-Pacific Economic Cooperation in a Changing Global Context: Globalization and its Discontents, Protectionism and Coherent Approach Towards External Economic Relations

APEC 2017 will take place in a rapidly changing regional and global context. Several mega-trends are changing not only the shape of the global economy but also the way in which economic interactions take place. Protectionism is on the rise as economies facing challenges turned inward looking, energy prices have slumped increasing uncertainty in international markets. Given imbalance regional development, income inequality is widening both between and within developing and developed economies. While middle class consumption and services activities in the region's emerging economies are picking up but not fast enough to cope with the on-going restructuring of the manufacturing cluster and production value chain. Rapid technological advances and proliferation of E-commerce present both opportunities and risks for future economic growth.

Introduction

The 2008 Global Financial and Economic crisis highlighted the drawbacks of globalization. Greater economic integration has allowed crises to spread more rapidly and extensively. What began as defaults on subprime loans in the US quickly spread to other countries the banks and citizens of which invested heavily in assets backed by these loans. Meanwhile, the GFC put the issue of inequitable income and wealth distribution at the center of the debate. Arguably, the most significant event at that time was the Occupy Wall Street movement, where protesters adopted the slogan "the 99 percent". They brought attention to the claim that only one percent of the US population was unaffected by the crisis.

The main channels of increasing inequality within countries have been the bias towards skilled rather than unskilled labor, capital rather than labor, and urban and coastal areas rather than rural and inland regions. Globalization has played a role in all these channels. More recently, globalization has been criticized as resulting in job gains in developing economies at the expense of developed countries.

Policy responses to the GFC have had a significant impact on the structure of international economic relations. One major change was the decision of China's policymakers to rebalance its economy. As a result, China's economy has been slowing down over the past few years. GDP growth moderated from 7.3 percent in 2014 to 6.9 percent in 2015.[1] One reason of course is that economic growth in advanced economies has been sluggish especially after the 2008 Global Financial and Economic Crisis.

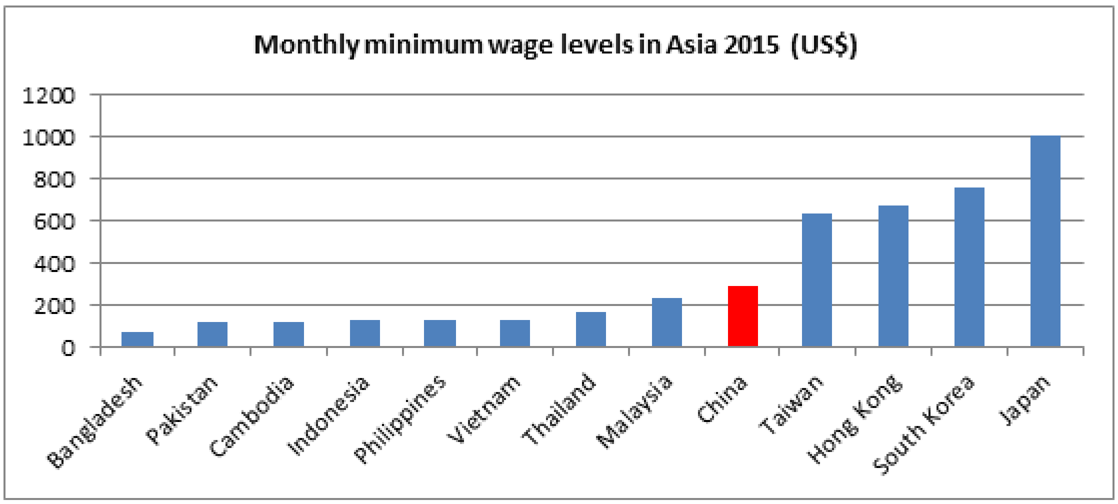
At the same time China has been shifting from investment and exports to domestic consumption as the main driver of economic growth. Corollary to this is the continued acceleration of the service sector relative to industry. The 12th Five-Year Plan (2011-2015) was explicit in associating structural reform with the promotion of domestic consumption. The plan had three major priorities: sustainable growth,

[1]http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2015&locations=CN&start=1961&view=chart&year_high_desc=true

industrial upgrading, and the promotion of domestic consumption. Specifically, the objectives were first to rebalance the country's growth strategy by moving away from exclusive export-orientation towards developing the domestic market, and secondly, to move the economy up the value chain in the coming years so as to enhance its technological independence.

The shift towards greater domestic demand and higher-value added production has contributed to the economic deceleration. It has also added pressure to wages which is already affected by tightness in labor markets caused by rapid economic expansion and declining population growth. Internationally, China's minimum wage (in coastal cities at least) is now in the mid-range of Asian countries (Figure 1). Although wage levels are in general still far below those in Japan, Korea, and Singapore, wages for Chinese factory workers are now significantly higher than for factory workers in Bangladesh, Viet Nam and Cambodia.

Figure 1: Monthly minimum wage levels in selected Asian Countries



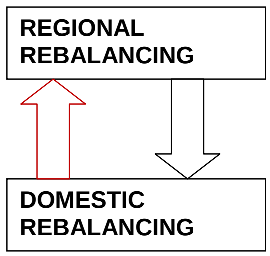
Source: http://www.clb.org.hk/en/content/wageschina

How Can the Philippines and other Southeast Asian Countries Benefit?

The increasing trend in wages and the shift in China's economic strategy will have profound effects on the pattern of regional production networks. Higher wages has already prompted many low cost, labor intensive industries such as garments, toy and shoe manufacturing to transfer some production to cheaper locations. China's role in processing trade will therefore diminish. This will provide opportunities for other economies in East Asia particularly the CLMV countries. Intra-regional trade will then be geared towards China as a destination of finished goods.

The realignment of regional production networks provides challenges and opportunities for the Philippines and other countries in Southeast Asia. The general approach is to align regional rebalancing with domestic rebalancing (Figure 2). To be sustainable, however, domestic rebalancing must address the proble of wealth and income inequality.

Figure 2: Linking regional and domestic rebalancing



One issue is whether the labor intensive countries in China will transfer to locations in the western part of the country—as described in the first section—or to countries with lower wages. An analysis by a French corporate and investment bank Natixis (Herrero and Iwahara, 2015) shows that wages for engineers and employer's mandatory social contribution in the east and the west of China are generally higher than those in ASEAN (Figure 1). Hence, manufacturing sites could relocate to ASEAN rather than to the west of China. This provides a valuable opportunity for the Philippines.

Approximately 80 percent of China's global trade is sourced from multinational corporations (MNCs). The decision to relocate part of the global value chain from China will therefore largely emanate from MNCs. The good news for the Philippines is that its political and diplomatic tensions with China will not influence the decision where to relocate components of the global value chain. However, the challenge lies in how the Philippines fares in terms of the factors that do matter.

Bhatia (2012) identifies four crucial factors that affect value-chain decisions: "First, the potential of the local market which means that the business case is simply more compelling when the country at issue represents a large or potentially large market. Second, the availability of suitable human resources. For a technology-intensive company productivity is more important than labor cost, and for design-intensive activities access to the best possible knowledge is critical. Third, availability of physical infrastructure. Fourth, and most crucial, strong legal and policy environments that embed the rule of law."

Unfortunately, the Philippines does not fare too well in these factors when compared with its neighbors in Southeast Asia. This much is evident from the Natixis report which concludes that "the hub of manufacturing is expected to relocate to Viet Nam given its enormous market access, very low wages, relatively good infrastructure and business environment. Thailand can be another important destination, once the political situation improves and even more so if the country finally joins TPP."

The relatively poor performance of the Philippines with regard to these factors is related to its inability to attract FDI at the same level as its neighbors. The challenge therefore is to implement at the soonest possible time structural reforms to address what can be described as "supply side constraints." While there has been progress during the term of President Benigno Aquino III, it is apparently not enough as deemed from the Natixis report.

Maximizing employment through SMEs and regional rebalancing

In this context, Asia's outward-oriented development model does not need to be overhauled. What will be required is an adjustment in net exports and some shift towards production for Asian demand. In other words, the main thrust of regional rebalancing should be an increase in intraregional trade and investment among East Asian economies, but with more of the final exports going to economies in the region instead of to the United States and Western Europe.

Another challenge in the Philippines is to overcome the low and declining employment elasticity – particularly in the manufacturing sector – and significantly increase the number and quality of jobs that will be generated. This is especially true for the manufacturing sector, which is estimated to have the lowest employment elasticity.

Participation of SMEs in regional production networks must, therefore, be encouraged. SMEs have a larger impact on employment than large firms. This will help reduce income inequality.

The studies of Wignaraja (2012), the Economic Research Institute for ASEAN and East Asia (ERIA) (2012) and Narjoko (2012) and provide analysis and recommendations on how this can be accomplished. The following highlights the major constraints that SMEs face and policy recommendations from Wignaraja's econometric results (2012, pp. 5–6, 22).

"Implicit in most of the … theories is the notion that SMEs are at a disadvantage in participation in production networks compared with large firms. SMEs face, to a higher extent than large firms, resource constraints (in terms of finance, information, management capacity and technological capability). In addition, SMEs suffer disproportionately from external barriers like market imperfections and regulations. Accordingly, the probability of SMEs joining production networks (as direct exporters, indirect exporters or overseas investors) is lower than that of large firms. Furthermore, justification exists for public policies to support the entry of SMEs into production networks. In the main, such support should be geared to an enabling environment that opens access to markets, reduces bureaucratic impediments against SMEs and provides appropriate institutional support services (e.g. technological, marketing and financial support).

"Our research suggests that large firms [were] the leading players in production networks in ASEAN economies in the late 2000s while SMEs [were] relatively minor. Nonetheless, the available information also hints at a modest increase in the participation of SMEs in ASEAN economies between the late-1990s and the late-2000s, as measured by the share of SME exports. More developed ASEAN economies, like Malaysia and Thailand, which are more established in production networks, have higher SME export shares than other ASEAN economies. The outcome of the econometric exercise suggests that size, foreign ownership, educated workers, experienced CEOs, technological capabilities and access to commercial bank credit all positively affect the probability of SME participation in production networks. By contrast, age has a negative relationship.

"The exploration of policy influences on SME business activity provides additional insights. A trust deficit seems to hamper the requisite intra-firm cooperation needed for effective SME participation in production networks. Supply-side factors – like lack of access to finance, high electricity costs, variable quality of transport systems and inadequately educated workers – are an additional hindrance to SMEs. On the policy and incentive side, behind-the-border issues, like high corporate tax rates, as well as economic uncertainty also play their part. Finally, the limited evidence from Malaysia and Thailand suggests that the affordability and quality of business support services are an issue. Tackling these constraints at firm and country level would help to unleash the full potential of SMEs as players in production networks in the future."

ERIA (2012, pp. 61–62) specifically recommended (with paraphrasing):

- Prioritize the implementation of measures in a strategic plan by focusing on setting up and strengthening the technology incubators, the establishment of a one-stop SME service centre and strengthening SME financial facilities by 2015.
- Intensify the initiatives to encourage business matching for SMEs, with multinational firms as well as with other well-performing SMEs within the region and in East Asia.
- Promote SME clusters, networks and alliances.
- Establish the ASEAN SME Policy Index by 2013 to ensure policy coherence between the regional initiatives and national SME policies. The SME Policy Index assesses the quality and level of implementation of policies in support of SMEs by quantifying and comparing some qualitative policy features.

Narjoko (2012) cited access to finance as a major constraint both for the development of SMEs and their participation in regional production networks. In particular, financial access has a heavy impact on SMEs' innovation capability and participation in export markets. Narjoko proposed several policy reforms, including the establishment of industry organizations for SMEs that will represent the interests of Member States and provide market information and capacity building and introducing credit guarantee schemes that are subject to rigorous and viable business plans and a reliable credit rating and information system.

Increasing physical connectivity and enhancing the role of SMEs will be the pillars of the strategy to rebalance economic growth in East Asia and expand employment. Rebalancing will mean different things for different economies. For example, in China, there is a need to increase the share of consumption expenditures. Meanwhile, the investment to GDP ratio in the Philippines is relatively low and is one of the major constraints to economic growth. Rebalancing in the Philippines implies higher investment growth with a slant towards SMEs.

China's One Belt, One Road Strategy and the AIIB

An increasingly confident China has proposed the establishment of a Maritime Silk Road linking East Asia to the Middle East and Eastern Europe. Under the slogan "One Belt, One Road" this project is designed to strengthen Southeast Asian linkages with China. The Silk Road Economic Belt brings together China, Central Asia, Russia and Europe (the Baltic), linking China with the Persian Gulf and the Mediterranean Sea through Central Asia and West Asia, and connecting China with Southeast Asia, South Asia and the Indian Ocean. The 21st-Century Maritime Silk Road is designed to go from China's coast to Europe through the South China Sea and the Indian Ocean in one route, and also from China's coast through the South China Sea to the South Pacific.

Related to these initiatives is the establishment of the Asian Infrastructure Investment Bank (AIIB). The Asian Development Bank estimates that developing Asia requires USD8 trillion of physical infrastructure spending between 2010 and 2020. Based on official announcements from the Chinese government there will be synergy between the AIIB and the One Belt, One Road project. The main takeaway from these initiatives is the concept that China is diversifying the use of its foreign exchange holdings. As of November, 2016 China held USD 1049.3 billion worth of US treasury bonds which carry very low interest rates.[2]

[2] This was USD 1264.5 billion a year ago indicating that China has already embarked on this diversification process.

Accumulation of foreign exchange reserves is usually prompted by the need to insulate economies from external financial shocks and speculative attacks. However, the level of accumulation may be deemed excessive. In China's case it has foreign exchange reserves equivalent to 41.6 percent of its GDP although several economies have higher levels. Nevertheless, with the advent of regional financial cooperation, particularly the multilateralization of the Chiang Mai Initiative, monetary authorities can and should reduce their holdings of foreign exchange reserves.

The need to diversify foreign exchange holdings and reduce the level of its foreign exchange reserves is one reason behind the AIIB and One Belt, One Road initiatives. This is where the Philippines stands to gain if only to improve its physical infrastructure. By doing so, the Philippines can attract more components of global value chains.

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