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A view from Europe, as compared with the US, about the impact of China and India on the world economy

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With their GDP expanding rapidly, both China and India (who account for 38 % of the world population) have the potential to become leading economic powers in the decades to come.

China is already the fourth economic power (and even the second if one computes GDP on a purchasing power parity basis) and India's working population will be the strongest and the youngest in the world in 2020.

How is Europe, as compared with the US, adjusting to this spectacular change in the world economy ?

In touching briefly on this wide and complex subject, I shall focus on three main topics :

1. immediate reactions from Europe and the US on trade issues ;
2. medium term perspective : how are Europe and the US preparing for the challenges posed by the very low unit labour costs prevailing in the two rapidly integrating Asian countries ?
3. globalization is a two way process. Many stumbling blocks are still to be removed on both sides.

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I. Immediate reactions on trade issues :

1. China seems to attract more protectionist reactions from the US than from Europe :

Indeed, the rising trade surplus of China vis a vis the US (close to 200 billions dollars in 2005) is significantly higher than the one with the eurozone (51,8 billion euros in 2004). And Europe, contrary to the US, has no external global imbalance. But the European trade deficit with China is rising fast (from 31,8 billion euros in 2002 to 73 billion -estimates- in 2005).

Perhaps more significantly, the share of Chinese goods in total US imports has increased dramatically (from 8,6 % in 2000 to 13,8 % in 2004), while the figures are respectively 2,8 % and 4,2 % for the European Union.

Still, Europe has not witnessed the type of “Schumer amendment”¹ reactions that one can observe in the US (although there have been limited European quota restrictions, for example, on clothing goods in 2005 and shoes and auto parts more recently).

It is likely that the structure of European exports to China (where capital goods, -aircraft, transportation, energy equipment...- feature predominantly) explains, to some extent, this difference in trade deficits as well as in reactions (the US exports being more geared to services, finance, electronics... for which China’s market is more difficult to access).

But Europe is not monolithic in this respect. Germany -followed by Sweden and Italy- has been the best performer during the period 2000-2005 (it has actually gained significant market shares -more than China- in the most dynamic sectors of manufactured exports), while France has lost market shares. The biggest “losers” have been the UK (nearly as bad as the US). See table I appended.

Be it as it may, Europeans do not generally consider that the exchange rate is a major political issue, although the undervalued Yuan affects the European economy in the same way as it does the US (even more so, because of the weakening of the dollar against the euro which has compounded competitive conditions in Europe).

As a side remark, I would like to observe that many European economists doubt whether a re-evaluation of the Yuan (barring an extreme adjustment) would impact significantly the US-Chinese trade relations. Indeed the US industrial manufacturing output -which has shed a large part of its traditional production- proved to be very rigid since the mid 90’s and has not reacted much to increases in domestic demand. How would it react to a change in the Chinese exchange rate? The answer is not obvious. It may well be that an increase in domestic demand in China (which would, in principle, be encouraged by an appreciation of the Yuan that would tend to reduce prices and boost households incomes) would, eventually, be met by an increase in Chinese production and not by an increase in US exports, given the over-investment and the low costs of the Chinese economy.

But this is not to say that exchange rate flexibility and adjustments are not called for. They are. However, one should not overestimate their impact.²

¹ Senator Schumer has proposed a bill that would impose a 27,5 % tariff on Chinese exports to the US if China does not let its currency appreciate significantly.

² One can note that, in spite of an appreciation of the Euro by 44 % since mid-2001 against the US\$, the US bilateral trade deficit with the Eurozone has grown by 75 % (from 53 billion \$ in 2001 to 93 billion in 2005). Table I (annex) also shows how structural changes have occurred over the last five years : the US has lost market shares in the most dynamic sectors of manufactured exports although countries like Germany (with a more appreciated currency than the \$) have gained shares. See in Annex II, the evolution of the \$/euro exchange rates in along term perspective.

2. India is a different case in point :

Contrary to China, India is running since 2004 a current account deficit which amounted to 13,5 billion dollars in 2005 (i.e. close to 2 % of GDP)³ and is projected to reach 3 % of GDP in 2006/2007. Furthermore, its trade integration is significantly lesser than the one of China⁴.

Therefore, India is not seen as a threat but as a country that is opening up gradually and where European exports and FDI are developing.

The public debate is more in the field of services off shored to India -which has a highly qualified and skilled English speaking labour force- by multinational corporations (in all sectors and in particular in investment banking⁵). Here, it is Europe that seems to react with more anxiety than the US.

But a recent study by the McKinsey Global Institute (MGI) shows that service off shoring has a strong potential to increase value, not only for the emerging countries where jobs are created, but also for the countries that outsource. In 2003 and 2004, the MGI⁶ has published reports that suggest that the US derives more positive benefits from services outsourced than Germany. This is mainly because labour market flexibility and adaptability are much higher in the US⁷. From 1992 to 2000, service off shoring accounted for around 11 % of the productivity growth in the US manufacturing industries.⁸

This is an illustration of the fact that the economic impact of globalization in industrialized countries is all the more significant and a matter of concern where economic reforms are lagging.

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II. A medium term perspective : Europe and the US face the challenge of low wages in China and in India :

1. The challenge :

These two emerging countries are a huge reservoir of cheap and hard working labour. The supply of that labour force entering the international “tradable” economy has trebled over the last three decades. This gives China and India a significant comparative advantage over more

³ The figure for China is a surplus of 115 billion in 2005 (5,6 % of GDP).

⁴ Exports (goods) account for 16 % of Indian's GDP (40 % for China). The global market share of Chinese exports of manufactured goods has gone from 0,8 %, in 1980, to 8,3 % in 2004 (against, respectively, 0,5 % and 0,9 % for India). Indian exports of manufactured goods only represent 1 % of total US imports (0,6 % for the European Union).

⁵ For example, Deutsche Bank will have moved to India almost half the back-office jobs in its sales and trading operations by the end of 2007 (see Financial Times, March 27, 2006.)

⁶ See MGI (June 2005) : « Comment la France peut-elle tirer parti des délocalisations de services ? ».

⁷ For one \$ spent in India by companies engaged in outsourcing, the US economy « gets back » 1,15 \$, while the figure is negative in the case of Germany : 0,74 €.

⁸ See “The NEBER Digest”, March 2006, Mathew Davies.

mature economies with high wages⁹, but also over other emerging economies with somewhat higher labour costs¹⁰.

But the world is not perfectly integrated and a number of countries and regions with relatively high wages will continue to thrive, whilst compensation costs, especially of skilled labour, will inevitably increase over time in emerging countries. This is already happening in Central and Eastern Europe where a shift of FDI-production is taking place towards Asian countries. And this is starting to happen even in China where one has observed recently a “double digit” increase in labour costs, compounded by higher energy costs. Beneficiaries of Chinese rising prices in the textile sector are India, Bangladesh and Cambodia¹¹.

It remains that labour cost differentials are staggering : average unit labour costs per hour in China accounted for 60 cents in 2002 against 24 \$ in Germany (who remains nonetheless the strongest exporter of manufactured goods in the world), 22 \$ in the US and 17 \$ in France.

How should high income countries react to this formidable shock ?

2. The answers :

The protectionist temptation is present everywhere, in the US¹² as well as in Europe (albeit perhaps less politically vocal in the latter).¹³

But we know that this answer is not the proper one : blocking or taxing imports of cheaper foreign goods in order to keep high standards of living at home, is not a lasting solution.

The true solution, for high income countries, is to focus on productivity gains, on high value added industries and services, innovation, human capital and technology. There is no doubt, of course, that the industrialized countries will suffer (and are suffering) from a lessening of job opportunities in labour intense manufacturing industries while they benefit from the lower costs of imported goods. It is also true that high income countries will also be negatively affected by rising costs of commodities (themselves influenced by the high growth of emerging countries).¹⁴

⁹ According to the OECD, if one were to obtain equilibrium in a completely integrated economy, wages (in real terms) of high income countries would have to fall by 15 %. See Martin Wolf, Financial Times, March 15, 2006.

¹⁰ For example, Turkey is said to have “lost”, mainly to China, one million jobs in the textile industry over the last years.

¹¹ See a report by the Hong-Kong based Li and Fung Group. Financial Times, March 23, 2006.

¹² 41 States in the US have introduced legislation restricting outsourcing (State contract bans, in-State preference,...). But there are few restrictions at the Federal level.

¹³ The fear of « delocalisations » in France is particularly acute. But the facts -at least up to now- do not seem to substantiate those fears. If one takes into account companies that have simultaneously laid off workers in France and increased their imports of goods that were locally produced before, one observes that 13.500 jobs have been outsourced annually between 1995 and 2001 (0,35 % of industrial labour). But outsourcing towards low wage countries accounts for only half of this effect. (see Aubert and Sillard (2005) : “Délocalisations et réductions d’effectifs dans l’industrie française”, L’économie Française, Paris, INSEE.)

¹⁴ In spite of the lower costs of manufactured imports from emerging economies, countries like the US and Germany have suffered from a deterioration of their terms of trade since 2002. Higher energy and commodity costs are the main explaining factor. If emerging countries growth is to continue at its current rate and according to its present pattern, the environmental consequences of this phenomenon cannot be overlooked. The issue of energy conservation (nuclear, renewable resources,), of CO2 emissions, will be at the heart of the future of our planet.

The challenge for the high income countries is, thus, to promote innovation, research, energy conservation, skilled labour (including selective immigration), training, and to orient unskilled workers towards non tradable goods and services. Policies should encourage domestic consumption of non tradable goods and services and discourage unskilled labour immigration, as well as they should reduce taxes on unskilled labour incomes....

Here also, we see that the adjustment process much depends on governments ability to reform. In this respect, the fact that structural reforms in Europe (Lisbon Agenda) are lagging will only compound the consequences of the impact of globalization.

The US, because of the adaptability of its economy, its high productivity growth, and its strong domestic demand as well as its ability to borrow abroad in its own currency and its apparent indifference to external imbalances may well be better placed than Europe in this respect. The US, in spite of its major losses in world exports has maintained a much more dynamic economy (4,7 % unemployment and a 3,5 % growth rate) than Europe (more than 10 % unemployment and a growth rate of 1,5 to 2 %).

However, US growing imbalances cannot continue for ever and the very large portion of the US public debt held by the Chinese authorities adds a potential element of vulnerability and political tension between the two countries.

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III. But globalization is a two way process. Many stumbling blocks are still to be removed on both sides :

1. Competition is moving toward high technology :

The problem is getting more complex : indeed, countries like China and India are not only destined to export cheap consumer goods. They also are joining the group of high technology producers and exporters, and are determined to be present worldwide on all the segments of the production chain.

China is intensifying its efforts to expend its investments aboard : in Africa, in Asia, in Latin America, with the aim of securing its sources of commodity and of diversifying its export markets.

This growing technological intensity of industries in China and India is under way¹⁵. Many equipment contracts won by western firms include clauses on the transfer of technological know-how. Joint ventures and partnerships have accelerated this evolution : they are actually the new form of technological transfer. This phenomenon sometimes generates reactions particularly in Europe where high technology is very much the core of its exports.

¹⁵ While textile-garment sales accounted for 24 % of Chinese exports in 1997, the figure is only 15 % in 2004. Conversely, the share of high technology goods has moved from 15 % in 2000 to 28 % in 2004. China has now overtaken the United States as the first world exporter of electronic goods.

A recent example of dilemmas faced by large companies and of their different reactions to this phenomenon is provided by the bidding process in China related to four 3rd generation nuclear plants. Westinghouse appears as having a competitive edge, basically because it seems ready to sell the know-how pertaining to this new technology which will allow China to produce the next wave of those reactors. The French company, Areva, doesn't seem to wish to make that concession, because it wants to keep its technological advantage for other developing markets.

Be it as it may, transfers of technology are taking place constantly (automotive industry, energy, aircraft, high speed trains...). The growing competition in these industrial fields of excellency and innovation, which were (up to now) the core of the European comparative advantage, is bound to lead to some protective reactions, although many multinational companies understand that partnerships are inevitable and desirable. In this respect, one should have in mind that a large part of Chinese exports to the US and other countries is produced by Japanese and western firms operating in China¹⁶.

One can also observe defensive reactions vis a vis certain takeovers attempted by emerging markets firms (Mittal Steel of India on ARCELOR, CNOOC of China on UNOCAL,...). But there is no doubt that such foreign direct investment initiatives from emerging countries will intensify in the future. Why, indeed, should these countries export and keep their money in US Treasury instruments, while they could make a more productive and strategic use of their surpluses ? However, tensions will inevitably occur and one should not underestimate their political dimension.

2. The globalization process must function both ways :

Similar protective reactions are also manifest in emerging countries themselves. India and China are opening up to foreign direct investment¹⁷, but there are still significant limitations to foreign investment and to open trade (i.e. unfair “local content “ rules through complex tariff systems) in some of those countries. One can also observe negative reactions especially in China, to what is sometimes perceived as a takeover of important economic sectors by foreign, and in particular Japanese, companies.

These reactions are not surprising. Indeed, one should not underestimate the impact of globalization and liberalization on the emerging economies themselves.¹⁸

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¹⁶ 60 % of Chinese exports to the US come from subsidiaries of US global firms. The figure is 50 % for the European Union. Companies of industrialized countries are, indeed, the main vehicle for emerging markets exports.

¹⁷ Foreign Direct Investment in India has exploded : from 129 million \$ in 1991-92, to 3,9 billion in 2001-2002 (annual flows). China has attracted 450 billion dollars over the last 10 years and India 40 billion.

¹⁸ For example, between 1990 and 2003, the number of workers in Chinese State owned companies fell from 68,7 millions to 34,7 millions. From 1995 to 2003, 27,8 million people (in non-state owned companies) “officially” lost their jobs (but the figure is more likely to be around 50 million). Rapidly increasing rural emigration to cities is also raising problems and discontent. See Ramsès, IFRI, 2005, Paris

Multinational companies are already widely integrated : barring strategic dilemmas on technological transfer as noted above, they tend to choose, on a “ricardian” basis, the most efficient sites for their production units and they outsource and off shore according to a global strategy based on maximized profits. But governments have the tough responsibility to manage politically the domestic consequences of the formidable transformation that is taking place in international competition and that is far from having exhausted its consequences. Let us hope that the benefits stemming from open trade -even if they are not evenly distributed, even if positive (indirect) benefits are sometimes difficult to detect, even if certain groups and sectors are bound to lose at some point in time- will be the predominant element in decisions taken by governments.

In this respect, a meaningful progress in the Doha Round -based on a balanced set of measures pertaining to goods but also to services- would give the right signal. India, still a deep rural country, rightly insists, for example, on the necessary elimination of agricultural subsidies granted to their producers both by the US and in the European Union. But what is also needed is a move towards the liberalization of services (investments, telecoms, finance, transparency in public bidding, protection of intellectual property), and the fight against counterfeiting....

Therefore, structural reforms and initiatives are called for on both sides.

Table I. Evolution of market shares according to sectorial dynamism as a percentage of manufactured exports

	1992-2000				2000-2004			
	Gains in sectors		Losses in sectors		Gains in sectors		Losses in sectors	
	dynamic	less dynamic	dynamic	less dynamic	dynamic	less dynamic	dynamic	less dynamic
China	35.4	64.6	0.0	0.1	43.6	55.6	0.8	0.0
New EU member States	32.6	65.9	1.5	0.0	67.8	30.7	1.6	0.0
Germany	1.4	30.7	32.8	35.1	65.0	24.8	10.2	0.0
Finland	37.2	53.2	4.2	5.5	42.6	2.6	11.3	43.4
Malaysia	40.0	10.4	28.9	20.7	26.6	29.2	15.2	29.1
Sweden	22.3	10.8	21.4	45.4	46.4	17.2	22.5	13.9
Brazil	3.8	24.2	14.9	57.1	52.7	17.1	22.9	7.3
Italy	4.5	18.7	22.4	54.4	45.2	11.3	28.4	15.1
Ireland	71.5	15.8	1.8	10.9	42.4	0.8	28.4	28.3
Korea	46.1	22.6	8.0	23.4	23.5	25.3	39.0	12.2
France	10.4	27.6	25.3	36.7	21.3	16.6	51.4	10.7
Mexico	39.8	56.4	3.8	0.0	6.4	0.3	55.6	37.7
Swiss	0.4	10.4	49.8	39.5	28.2	4.6	57.0	10.2
UK	5.5	24.9	40.0	29.6	12.9	2.5	58.2	26.3
US	12.5	25.6	32.4	29.6	3.2	0.3	61.1	35.4
Japan	1.1	5.6	42.0	51.2	2.1	0.2	73.7	24.0

Source : "Commerce mondial : le retour de la "Vieille économie" ? , IFRI, study from Luis Mioti and Frederique Sachwald, Paris, February 2006.

