Updating China's International Economic Policy After Thirty Years of Reform and Opening: What Position on Regional and Global Economic Architecture?

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30 March 2009

This is the revised version of a paper delivered at the annual conference of the Chinese Economic Association (UK), China's Three Decades of Economic Reform (1978-2008), held in New Hall, Cambridge University on 1-2 April 2007. I am very grateful to the participants for many deep insights, especially the guidance of Xiaohui Liu, Zhongmin Wu, and Wei Zhang. The ideas on regional integration have benefitted tremendously from the helpful comments of Barry Bosworth, Masahiro Kawai, Haihong Gao, and Yunling Zhang.

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Abstract

The 30 years of reform and opening have brought great material progress to China. By becoming a big country, China's actions created huge spillovers on other countries. The result has been a rise in trade tension between China and its trade partners. Recently, some have claimed that China's prolonged large trade surpluses have undermined global financial stability and tilted the world into a deep recession, if not, a 1930s-style depression. Others have claimed that the greenhouse gases from China's industrialization would soon cause cataclysmic global climate change. One blunt but effective way to eliminate these negative spillovers is to restrict imports from China.

Labor in the rich countries are under considerable stress because of the deep global structural adjustments brought by, one, the integration of the labor force of China, India and the Soviet bloc into the world economy; and, two, the acceleration of technological innovations (as exemplified by the revolution in information technology). The new global equilibrium could be a win-win outcome for the world but the process of moving to it is a painful one. Protectionism to avoid the transitional pains is, however, likely to end up in a lose-lose outcome for the world.

China must therefore, in its own interests, help to reduce international tension by updating its strategy of international economic engagement. China has to go beyond being a passive beneficiary of the WTO system to being an active promoter of WTO objectives. China should work with the US to bring Doha Rounds negotiations to a successful conclusion. China must also play a stronger and more constructive role in the forthcoming international talks on global climate change. China and India are simply too big to be exempted for a long time from national ceilings on the emission of greenhouse gases. China will have to face down its internal political opposition to replace the backward state-controlled financial system with a dynamic, but well-regulated, diversified private financial system in order to eliminate the odd phenomenon of a poor country lending to a rich country.

For its neighborhood, China should push for an Asian Economic Union that takes the form of a WTO-plus free trade and open investment area that has regional pooling of foreign exchange reserves. Since there is no prospect of free labor mobility within East Asia, monetary integration would produce an economically inefficient outcome. East Asia should therefore be focusing its energy on creating as large a free trade area as possible, and forgo the unrealistic goal of a common Asian currency.

Keywords: US-China relations, protectionism, technological innovation, globalization, currency manipulation, Asian Economic Union, free trade area, monetary integration

JEL code: F13, F15, F32, F36

January 20, 2009

Updating China's International Economic Strategy After Thirty Years of Reform and Opening: What Position on Regional and Global Economic Architecture?

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1.0: Don't Stop Thinking About Tomorrow

1.1: The Great Retreat from Soviet Economic Theory

In a speech in the Special Economic Zone of Shenzhen on January 19, 1992[1], Deng Xiaoping chose to characterize the policy decisions of the Communist Party of China (CPC) in December 1978[2] as "one central task and two basic points."[3] The central objective of the CPC was economic construction; and the two basic operational guidelines were the political leadership of the CPC and the economic practices of market allocation of resources and the opening-up of China to international trade and foreign direct investment (FDI). Deng then went on to declare that CPC "should adhere to the basic line for a hundred years, with no vacillation."[4]

Deng's speech was political dynamite because it was at odds with the general direction of the economic policies that were adopted after the Tiananmen tragedy of June 4, 1989. As the implosion of the Soviet Union in August 1991 had been widely interpreted within China to be proof that a Soviet-style economic system was incapable of catching up with the private market

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[1] The English version of the People's Daily, January 19, 2002, contains descriptions of this trip in "Records of Comrade Deng Xiaoping's Shenzhen Tour" on website: http://english.peopledaily.com.cn/200201/18/eng20020118_88932.shtml
[2] This meeting was the Third Plenum of the 11th Central Committee of the Communist Party of China (CPC), held on December 10-22, 1978.
[3] Quote from "Southern Campaign Speech by Deng Xiaoping" in website: http://www.shanghartgallery.com/galleryarchive/texts/id/448
[4] Quote from "Southern Campaign Speech by Deng Xiaoping" in website: http://www.shanghartgallery.com/galleryarchive/texts/id/448

economies of the West, Deng's speech was a castigation of those political leaders and economic technocrats who continued to favor central allocation of resources and near-total state ownership of capital. Chinese society at large rallied very strongly around Deng's interpretation of the verdict of the CPC in December 1978 and his call for continued marketization and internationalization of the Chinese economy. Deng's mobilization of the popular will allowed the 14th Congress of the CPC held in October 2002 to declare that the CPC's mission was to achieve "socialism with Chinese characteristics" and to finally drop the word "plan" from the official vocabulary in characterizing the ideal economy. China thereby not only returned to the 1979-88 path of convergence to a private market economy, but also accelerated the pace of convergence in a series of fairly abrupt changes.

The bulk of the collectively-owned township-village enterprises (TVEs) in the countryside were privatized under various guises such as their transformation into shareholding cooperatives.[5] Almost all of the small and medium state-owned enterprises (SOEs) were privatized[6]; and many of the large SOEs and state-owned banks (SOBs) were corporatized and had part of their shares sold in foreign stock markets.[7] On July 21, 2001, Jiang Zemin announced that capitalists could become members of CPC; and on December 11, 2001, China entered the World Trade Organization (WTO). Then, on March 14, 2004, the Standing

[5] The two turning points were 1994 and 1996, see Ho, Bowles and Dong (2003).

[6] SOEs are unincorporated firms that are entirely state-owned. The level of employment at state-owned units (SOEs plus state organs, state institutions and social organizations at the central and local levels) went up from 74.5 million in 1978 to 112.6 million in 1995, and then dropped to 85.7 million in 1999 and to 64.3 million in 2006. The employment at collectively-owned units was 20.5 million, in 1978, 36.3 million in 1991, 17.1 million in 1999, and 7.6 million in 2006. Source is Table 5-2 in National Bureau of Statistics (2007).

[7] Although the state shares of output and ownership of productive assets are now lower than in 1978, the state still controls a substantial proportion of economy. In the industrial sector in 2006, while SOEs (unincorporated firms that are entirely state-owned) accounted for only 9.7 of gross output value (GOV) and 16.8 percent of total assets, state-holding companies (corporations where the state is the biggest shareholder) accounted for 21.5 percent and 29.6 percent respectively. This means that state-controlled firms produced at least 31.2 percent of GOV and 46.4 percent of total assets in the industrial sector. Sources are Tables 14-1 and 14-8 in National Bureau of Statistics (2007).

Committee of the National People's Congress amended the constitution to give private property the same legal status as public property.[8]

In retrospect, China's accession to WTO is particularly significant development; and the process of WTO accession is particularly revealing about the vision of the top political leadership in 1986. The significance comes from WTO, being an organization designed to promote trade among capitalist economies, requires a new member to harmonize its economic institutions to those in the modern private market economies. Until China completes doing so, it would continue to be classified a "non-market economy" and be ineligible for the full benefits of WTO membership. Seeking WTO membership was an arduous process for China, it took almost 15 years to complete.[9] This determined effort by China to gain membership in this conformity-with-capitalism organization revealed that the top political leaders who pushed for the "reform and opening" of China had already subscribed to the belief in the mid-1980s that only convergence to a private market economy would generate higher economic growth.

The Chinese government has been justifying the dramatic policy shift away from central planning and state-ownership with two claims. The first is that China is now in the primary stage of socialism, and "will remain so for a long time to come" (Wen, 2007). The second claim is that within this present stage, the productive forces are better liberated and developed under a market economy that is predominantly private (i.e. a Chinese-style socialist market economy).[10]

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[8] Until about 2000, the academic literature in the West debated about whether China's sustained high growth had come from indigenous institutional innovations that were non-capitalist in essence or from convergence to a modern capitalist economy. For reviews of this debate, see Sachs and Woo (2000), Sachs, Woo and Yang (2000), and Sachs and Woo (2003).

[9] The negotiations had started in March 1987 under GATT, the predecessor of WTO; see Long (2001), and WTO (2001).

[10] These claims are consistent with a developmental perspective based on the following three hypotheses:

- there are different stages of economic development that are analytically distinct;
- certain conditions must be met before an economy could enter into the next stage;

It is appropriate for us on this occasion of the 30th anniversary of the policy regime shift in 1978 to recall Deng Xiaoping's order of January 1992 that the economic program of "reform and opening" must continue for a hundred years, and consider what should be the policy measures for the remaining seventy years of the "reform and opening" agenda. Since Deng Xiaoping did not leave his political successors a blueprint for future economic reforms, it is incumbent upon China analysts to adopt the line, which the Clinton presidential campaign did in 1982, of "Don't stop thinking about tomorrow."[11] What would likely to be the growth barriers in the next seventy years? What could the government do to overcome them?

1.2: The bust in gloom-and-doom talk (so far)

Most regrettably, a fairly large number of growth barriers come quite readily to mind. This is not surprising because predictions of gloom and doom for China have a long tradition amongst China economists. For example, in the mid-1990s, Nicholas Lardy of the Peterson Institute for International Economics started highlighting the de facto insolvency of the Chinese banking system with the implication that a bank run leading to financial sector collapse (which would then be likely to send the economy into a tail spin) was a strong possibility in the medium term.[12] The 21st century began with the claim by Gordon Chang (2001) that China's imminent

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- because the growth barriers are different at each stage, the focus and method of economic management are different at each stage.

[11] This line is from the song "Don't Stop" by the rock group Fleetwood Mac. A live performance is available on website: http://www.youtube.com/watch?v=WBKkwxCV5ls

[12] Lardy (1998) wrote that:

> "China's major banks are even weaker than most official data suggest .. On a realistic accounting, these banks' capital adequacy is negative, and they are insolvent (pp. 95) ... The failure of China's largest financial institutions would disrupt the flow of credit and disrupt the payments system, leading to a collapse of economic activity. The failure of major banks also could have long-term implications for the household savings rate ...A lower savings rate would mean a lower rate of investment and slower growth, in turn

accession World Trade Organization (WTO) would cause such widespread unemployment within China's already alienated population that China's economic and political systems would collapse.

These two dire predictions have turned out to be wrong. China, in fact, accelerated its annual GDP growth to double-digit rates after 2001. Nicholas Lardy was wrong because while the banks were indeed bankrupt, the Chinese government which owned them was not bankrupt and could hence afford to bail out the banks when necessary. The fiscal strength of the government made it irrational for depositors to contemplate a bank run. Gordon Chang was wrong because the WTO membership quickened the pace of job creation in China by greatly increasing the volume of FDI inflow. The WTO membership made China more attractive to FDI because it guaranteed the access of Chinese goods to the US market by eliminating the need for China to get the most-favored-nation (MFN) status annually from the US Congress; McKibbin and Woo (2003).

China has continued to surprise the China-watchers. The most recent major unexpected development is that significant pessimism about China's future growth has reappeared beginning 2006 despite the accelerated, growth since 2001. The most surprising part of this new pessimism is that the government itself appears uncharacteristically pessimistic about China's future. In Woo (2007), we had noted that unlike all the annual meetings of the Communist Party of China (CPC) since December 1978, the 2006 meeting did not end with the usual statement that the most important task for CPC the coming year was economic constructions. Instead the 2006 CPC meeting announced that the CPC's most important task was the establishment of a Harmonious Society by 2020. A Harmonious Society was characterized by democratic practices,

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depressing the rate of new job creation, leading to sustained higher levels of unemployment (pp. 143-144)" rule of law, justice, equality, and harmony with nature. The obvious implication from this announcement is that the present major social, economic and political trends within China would not lead to a harmonious society or, at least, not lead to a harmonious society fast enough.

Woo (2007) downplayed the importance of the still incomplete convergence to a modern private market economy as the primary threat to China's long-term economic growth, and he emphasized instead two non-economic factors: unsatisfactory governance by the state, and the environmentally unsustainable mode of growth.[13] The evidence is clear that there is growing social instability[14] caused by the inadequate development of the broader socio-economic institutions that lower the transaction costs in economic interaction. For example, while corruption can overcome the over-regulation in many economic sectors, it is not only an inefficient mechanism, it is also a socially-alienating practice. Similarly, while political repression can lower the costs generated by economic structural adjustments, it is both an unsustainable mechanism and a politically-delegitimizing instrument.

The evidence is also mounting that China lacks adequate foundations for physically sustainable growth, i.e. the pattern of China's economic growth is not consistent with the environmental endowment of China. For example, there is not enough water in China to sustain its present pattern of water usage. Presently, China uses 67 to 75 percent of the 800 to 900 billion cubic meters of water available annually, and present trends in water consumption would project the usage rate in 2030 to be 78 to 100 percent.[15] The present water situation in northern China is

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[13] Woo (2009) offered the assessment that the most probable internal economic threat to growth was a fiscal crisis, but a fiscal crisis was less likely to occur than either the outbreak of social disorder caused by outmoded governance, or the appearance of water shortage as a result of inept environmental management.

[14] For example, in 2004, there were 74,000 "mass incidents" (cases of social disorders) involving 3.7 million people compared to 10,000 such incidents involving 730,000 people in 1994; data from Pei (2005).

[15] "Top official warns of looming water crisis," South China Morning Post, November 7, 2006.

already fairly critical because of the lower than normal rainfall in the past fifteen years.[16] The utilization rate of Yellow River's water is 60 percent, far exceeding the internationally recommended utilization limit of 40 percent. All the mentioned factors have contributed to lowering the "amount of Yellow River water feeding into the Bohai Sea" from an annual 49.6 billion cubic meters in the 1960s to 14.2 billion cubic meters in the 1990s to the present 4.65 billion cubic meters.[17]

Overall, Woo (2007) was cautiously optimistic that China could succeed in establishing a harmonious society and completing the overhaul of its economic system.[18] His optimism, however, is not representative of the recent literature on China's future growth. One of the most astute of China analysts, Minxin Pei (2006a), has argued that China is now in a *trapped transition* that is described as "a transformative phase in which half-finished reforms have transferred power to new, affluent elites"[19] who are using crony capitalism to generate high economic growth that is not sustainable. While the newly introduced Harmonious Society program of Hu Jintao and Wen Jiabao could be interpreted as an attempt to extricate China away from its present state of *trapped transition*, Minxin Pei (2006b) is pessimistic about its effectiveness:

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[16] Right now, "[about] 400 of China's 660 cities face water shortages, with 110 of them severely short." ("China may be left high and dry," The Straits Times, January 3, 2004). Furthermore, the increasing amount of water pumped from the aquifers in northern China is causing the water table to drop three to six meters a year ("Northern cities sinking as water table falls," South China Morning Post, August 11, 2001).

[17] "Top official warns of looming water crisis," South China Morning Post, November 7, 2006.

[18] Woo's (2007) caution came from (1) the new major reforms being technically difficult to implement (e.g. setting up social safety nets), and having few, if any, successful precedents in the world to draw upon (e.g. designing market-compatible environmental regulation); and (2) the possibility that the many potential losers from these major reforms could successfully organise to resist meaningful implementation of the reforms.

[19] Pei (2006b)

> "In a 'trapped transition', the ruling elites have little interest in real reforms. They may pledge reforms, but most such pledges are lip service or tactical adjustments aimed at maintaining the status quo."

Pei's pessimism about the inevitable exhaustion of China's growth momentum is shared by another leading China scholar, Yasheng Huang (2008). In Huang's contrarian assessment, China in 1999 was actually less capitalistic than China in 1989. He asserted that the administration of Jiang Zemin and Zhu Rongji, that ended in March 2003, had reversed the march toward capitalism by systematically promoting the growth of large state-owned firms in the urban areas and suppressing the activities of the privately-owned small and medium firms in the countryside. Huang has attributed the deterioration in income distribution across classes and across regions to this re-occupation of the commanding heights of the economy by state-controlled companies (often in cahoots with foreign private companies), and the intensification of discrimination against the domestic private firms. Because Huang believes (very reasonably, based on international experience) that the state-controlled firms are intrinsically less innovative than the domestic private firms, he concludes that China is unlikely to be able to move on to the next stage of economic development in the near future (at least not before India does so[20]).

There is an important missing dimension in the gloom-and-doom discussions about China. Almost all of the well-known soon-to-collapse, or soon-to-stagnate, predictions are based on conditions internal to China, e.g. rising social disorder caused by social expectations rising faster than the performance of the state, worsening income distribution caused by the promotion of state-controlled economic activities and suppression of the indigenous private capitalists, and deteriorating natural environment caused by corruption and policy paralysis. What is not well explored in the usual gloom-and-doom talk is the issue of external constraints on China's

[20] As Huang (2006) sees that India does not discriminate against its indigenous capitalists in favor of foreign capitalists, he predicts that "[u]nless China embarks on bold institutional reforms, India may very well outperform it in the next 20 years."

growth. This point has received inadequate attention not only from many China-watchers but also from the official pronouncements of Hu Jintao and Wen Jiabao. The reality is that a non-harmonious world as exemplified by protectionism against China will doom its Harmonious Society Program. China needs therefore to help build a harmonious world and help foster an economically dynamic and politically friendly neighborhood to ensure its own growth.

2.0: The Need for a Harmonious World to Sustain China's Economic Growth

2.1: Rising complaints against China's trade and exchange rate policies

Table 1 shows that China is unusually deeply integrated into the international division of labor. In 2007, the trade-GDP ratio for China was about 66.8 percent, which was higher than in Brazil (26.2 percent), India (45.4 percent), Russia (52.2 percent), France (55.2 percent), Japan (33.6 percent) and the United States (28.9 percent). Of the comparator countries in Table 1, only Germany had a higher trade-GDP ratio of 86.5 percent. The implication is that China's economic growth is very vulnerable to protectionist actions by its trade partners. A trade war will mean a slowdown in China's catch-up with the developed world. In brief, without a harmonious world, China will find it more difficult to build a harmonious society within its borders.

Table 1 also shows another unusual feature about China's recent interaction with foreign economies. China's current account imbalances are unusually large. In the 2005-2007 period, there is only one instance in which its external imbalance was exceeded by another country (Russia in 2005), and it was temporary. China's current account has been in surplus since 1994 and it has shown a clear upward trend. It went from 1.3 percent of GDP (US$17.4 billion) in 2001 to 11.3 percent (US$372 billion) in 2007. Because of the China's much larger economy and much higher rate of growth, the Russian current imbalance of 11 percent of GDP in 2005 translated into a surplus of only US$84 billion – which is less than one quarter of the size of China's surplus in 2007.[21]

The large current account surpluses that have accompanied China's emergence as a major trading nation has caused increasing conflicts with the European Union (EU) and the United States (US) about China's trading practices and its exchange rate policy. At a US congressional hearing in March 2007, Morris Goldstein (2007) opined that the RMB was overvalued by 40 percent against the US$ and accused China of exchange rate manipulation; a charge echoed in Fred Bergsten (2007). On June 12, 2007, Peter Mandelson, the trade commissioner for EU described China's trade policy as "illogical", "indefensible" and "unacceptable" and accused of doing nothing to rein in rampant counterfeiting.[22] On June 14, 2007, a bill was introduced in the US Senate "to punish China if it did not change its policy of intervening in currency markets to keep the exchange value of the currency, the yuan, low."[23] In the 2007-2008 period, the US Trade Representative launched a record number of WTO suits against China's trade practices.[24]

On December 26, 2008, the front page of the New York Times carried the headline "THE RECKONING: Chinese Savings Helped Inflate American Bubble". It is relevant to the discussion in this paper to quote this story at length:

> In March 2005, a low-key Princeton economist who had become a Federal Reserve governor coined a novel theory to explain the growing tendency of Americans to borrow from foreigners, particularly the Chinese, to finance their heavy spending.

[21] Germany and Japan had current account surpluses of $252 billion and $211 billion, respectively, in 2007.
[22] "Surplus fuels EU-China war of words," Financial Times, June 13, 2007.
[23] "4 in Senate Seek Penalty for China," New York Times, June 14, 2007.
[24] In the February-April 2007 period, the US filed WTO suit against Chinese subsidies to exports, Chinese import restrictions on copyright-intensive imports, and China's weak protection of copyrights. On December 19, 2008, the US filed a WTO suit against China's programs to establish global brands for its products because they were seen as export subsidies.

The problem, he said, was not that Americans spend too much, but that foreigners save too much. The Chinese have piled up so much excess savings that they lend money to the United States at low rates, underwriting American consumption.

.... In the past decade, China has invested upward of $1 trillion, mostly earnings from manufacturing exports, into American government bonds and government-backed mortgage debt. That has lowered interest rates and helped fuel a historic consumption binge and housing bubble in the United States.

China, some economists say, lulled American consumers, and their leaders, into complacency about their spendthrift ways.

“This was a blinking red light,” said Kenneth S. Rogoff, a professor of economics at Harvard and a former chief economist at the International Monetary Fund. “We should have reacted to it.”

....“Achieving a better balance of international capital flows early on could have significantly reduced the risks to the financial system,” Mr. Bernanke said in an interview in his office overlooking the Washington Mall.

“However,” he continued, “this could only have been done through international cooperation, not by the United States alone. The problem was recognized, but sufficient international cooperation was not forthcoming.”

.... In Washington, some critics say too little was done. A former Treasury official, Timothy D. Adams, tried to get the I.M.F. to act as a watchdog for currency manipulation by China, which would have subjected Beijing to more global pressure.

Yet when Mr. Snow was succeeded as Treasury secretary by Henry M. Paulson Jr. in 2006, the I.M.F. was sidelined, according to several officials, and Mr. Paulson took command of China policy.

.... In late 2006, Mr. Paulson invited Mr. Bernanke to accompany him to Beijing. Mr. Bernanke used the occasion to deliver a blunt speech to the Chinese Academy of Social Sciences, in which he advised the Chinese to reorient their economy and revalue their currency.

At the last minute, however, Mr. Bernanke deleted a reference to the exchange rate being an “effective subsidy” for Chinese exports, out of fear that it could be used as a pretext for a trade lawsuit against China.

Critics detected a pattern. They noted that in its twice-yearly reports to Congress about trading partners, the Treasury Department had never branded China a currency manipulator.

> “We’re tiptoeing around, desperately trying not to irritate or offend the Chinese,” said Thea M. Lee, public policy director of the A.F.L.-C.I.O. “But to get concrete results, you have to be confrontational.”

More recently, Nicholas Lardy has graphically described China as being in a co-dependent relationship with the United States where:

> "The United States is the addict. We are addicted to consumption. China is the dealer. They're supplying the credit that makes it possible for us to over-consume."[25]

The unsettling realization about this large supposedly deleterious flow of Chinese savings is that it shows no sign of stopping on its own. Table 1 reports that the flow of addictive loans from China is anticipated to continue to run steadily at about 9.5 percent of China’s GDP in the 2008-2013 period, implying that the size of China’s annual savings outflow would increase at the same rate of China’s anticipated GDP growth rate (which is just slightly below 10 percent). China is not like Russia where the Russian huge trade surplus in 2005 (11.0 percent of GDP) would fall to 3.4 percent in 2009, to zero sometime in 2011, and then to -3.2 percent in 2013. Clearly, one (possibly inefficient but certainly effective) way to react to Ken Rogoff’s prolonged blinking red light, Ben Bernanke’s perception of unchanged non-cooperation by China, Thea Lee’s identification of the constant US fear to be confrontational is for the US Congress, and Nicholas Lardy’s interpretation of the bilateral relationship as akin to China being a drug dealer is to impose cold turkey treatment on the loans-addicted US consumers by ending the trade imbalance with import tariffs, import quotas, import licenses, and import bans. On the issue of financial opiates, treatment delayed is treatment denied.

Now in the current situation of a deepening global recession, where, over the period of October 8, 2008 to November 6, 2008, the International Monetary Fund (IMF) had to reduce its

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[25] News Release (Monday, March 2, 2009) on conference “Winter Institute: China and U.S. joined at the hip” that was held on February 27, 2009 at St. Cloud State University, Minnesota: http://www.stcloudstate.edu/news/pressreleases/default.asp?storyID=28126

growth projection of world output in in 2009 from 3.0 percent to 2.2 percent, we can only expect protectionist pressures on China to intensify.[26] If protectionist measures were indeed implemented, they would hit a Chinese economy that would already be slowing down, perhaps, significantly – see Table 2. Between October 8, 2008 to November 6, 2008, the IMF revised downward its 2009 growth estimate for China from 9.3 percent to 8.5 percent. Between September 18, 2008 and December 3, 2008, Jun Ma (a leading China analyst) lowered his 2009 growth projections from 8.9 percent to 7.0 percent. Ma (2008b) also then projected a 2010 growth rate of 6.6 percent. The emergence of protectionism against China would surely mean that a 6.6 percent growth rate in 2010 might well be the highest that China could hope for.

2.2: Understanding the Pain of US Labor and the Origins of China's Current Account Imbalance

It is not uncommon to encounter allegations that the bilateral US-China trade deficit represented the export of unemployment from China to the United States, and that it lowered the wage for labor. These allegations are not supported by the facts, however. The steady rise in the US trade deficit from 1.2 percent of GDP in 1996 to 5.9 percent in 2006 was accompanied by a fall in the civilian unemployment rate from 5.4 percent in 1996 to 4.6 percent in 2006, and by a rise in the total compensation (measured in 2005 prices) received by a full-time worker from $48,175 in 1996 to $55,703 in 2005.[27] What is actually fueling the rising resentment toward imports from China is that the US worker is feeling more insecure in the 2000s than in the 1980s because of the faster turnover in employment. For example, the median job tenure for males in the 45 to 54 age group has decreased from 11.8 years in 1987 to 8.1 years in 2006. The two most

[26] International Monetary Fund (2008a, 2008b).
[27] Compensation estimates are from Burtless (2007). Woo (2008) attributed this rise in compensation to the accelerated technological innovations in the US in the 1990s, and documented that the real compensation of US blue-collar workers increased fastest during the 2000-2005 period when the US current account deficit increased the fastest.

important causes for the more frequent job turnover are the large shift in the international division of labor that has been set in motion by the post-1990 acceleration of globalization[28]; and by the continued fast pace of technological innovations.[29] The resentment comes because the median US worker finds that there are considerable costs associated with the job change because of the inadequacies of the US social safety nets.[30]

It would be wrong, however, to think that China is blameless in the rapidly escalating trade tension between China and its trading partners. In Woo (2006), we identified the cause of China's chronic and growing overall trade surplus to be the failure of its state-controlled financial system to intermediate the growing amount of savings into private investments. At the same time, the backwardness of the state-controlled financial system encouraged the savings rate to rise in response to the new economic atmosphere produced by the dismantling of central planning.[31] In Woo (2008), we estimated "that the backward financial system in China made the

[28] The single biggest boost to economic globalization in the 1990s was perhaps the post-1990 integration of the labor force in the former Soviet Union, India and China (SIC) into the international division of labor. The number of workers already engaged in the international division of labor in 1990 was 1,083 million, and the combined labor force of SIC was 1,232 million. The international division of labor in 1990 was certainly an unnatural one because half of the world's workforce had been kept out of it by the SIC's autarkic policies. By 2000, the number of workers involved in the international economic system in 2000 had increased to 2,672 million (with 1,363 million workers from SIC); data are from Freeman (2004).

[29] Feenstra and Hanson (1996) estimated the impact of these two developments on US wages. Immigration has also increased the anxiety of US worker; see Ottaviano and Peri (2005).

[30] These inadequacies are Gary Burtless (2005) who reported that within the G-7 in 2004, only the United Kingdom had a less generous unemployment benefits scheme than the United States. An unemployed person in the US received initial unemployment benefits that equaled 53 percent of previous income compared to 78 percent in Germany, 76 percent in Canada and France, 61 percent in Japan, 60 percent in Italy, and 46 percent in UK. The duration of unemployment benefits was 6 months in the US compared to 12 months in Germany, 9 months in Canada, 30 months in France, 10 months in Japan, and 6 months in Italy and the UK.

[31] The savings rate rose because (1) the financial sector does not offer insurance against the increased risks that the public now faces (with the end f the iron rice bowl) in future employment, medical coverage, and pension benefits; and in these areas; (2) the financial sector does not offer adequate loans for housing and higher education, as these goods are no longer free (with the reduction in state subsidies); and (3) given the extreme difficulties in getting investment loans from the banks, entrepreneurial

non-government savings rate in China to be 7.0 to 12.2 percentage points higher than the private savings rate in the United States." Since the Chinese current account surplus was less than 7.0 percent of GDP before 2005, this meant that if China had financial markets that were as sophisticated as those of the United States, it would have been a net borrower instead of a net lender in the global financial markets during 1994-2004.

2.3: US-China Cooperation to Protect the WTO System

The optimum solution to reducing the friction in US-China trade relations is a policy package that emphasizes multilateral actions to achieve several important objectives. It is bad economics and bad politics to dwell on just one region (China alone), dwell on just one instrument (RMB appreciation alone), and dwell entirely on one target (external imbalance). In this time of deepening global recession, it is important that both China and US work together to forestall protectionism. China should focus on solving its trade surplus syndrome by undertaking import-intensive investments (e.g. sending students abroad on government scholarships) in the short-run, and promoting the growth of private financial institutions (that are diversified and adequately regulated) in the long-run. For its part, the US should reduce the pains of structural adjustment by strengthening social safety nets and programs that upgrade the skills of younger workers; and making healthcare insurance coverage independent of individual employers.

The most important action is for the United States and China start collaborating immediately to push the Doha Rounds to a successful conclusion. As China has so far played a passive role in pushing the Doha Round forward; by default, Brazil and India have assumed the leadership of the developing economies camp in the trade negotiations. According to Susan

individuals saved more in order to realise their desires to set up small and medium enterprises. Liu and Woo (1994) has formalised motive (3) as investment-motivated savings.

Schwab, the US Trade Representative, at the G-4 (the United States, the EU, Brazil, and India) meeting in Potsdam in June 2007, Brazil and India retreated from their earlier offers to reduce their manufacturing tariffs in return for cuts in agricultural subsides by the developed economies because of "their fear of growing Chinese imports."[32] The Brazilian-Indian action caused the Potsdam talks to fail and hurt the many developing economies that were agricultural exporters.

The reality is that Brazil is now attempting to bypass multilateral trade liberalization by entering into FTA negotiations with the EU. A growing number of nations like Brazil "are increasingly wary of a multilateral deal because it would mandate tariff cuts, exposing them more deeply to low-cost competition from China. Instead, they are seeking bilateral deals with rich countries that are tailored to the two parties' needs."[33] The current international atmosphere is ripe for protectionism, and China and the United States must now work together to provide leadership to prevent the unraveling of multilateral free trade.

3.0: What Kind of Regional Economic Architecture Should China Support?

3.1: The Push for Asian Economic Integration

Having a harmonious neighborhood is of course a prerequisite to building a harmonious world. Most of the countries in the two most prosperous regions in the world, Europe and North America, have entered into formal arrangements for regional economic cooperation by establishing, respectively, the European Union (EU) on November 1, 1993, and the North American Free Trade Agreement (NAFTA) on January 1, 1994. By 2009, the membership of EU has expanded from 12 to 27; with 16 members in the Eurozone, and with 9 non-EU members using the Euro as their national currencies. Three countries -- Croatia, Macedonia, and Turkey –

[32] "Schwab surprised by stance of India and Brazil," Financial Times, 22 June 2007; and "China's shadow looms over Doha failure," Financial Times, 22 June 2007.
[33] "Brazil, Others Push Outside Doha For Trade Pacts," The Wall Street Journal, 5 July 2007.

have been recognized as official candidate countries.[34] For NAFTA, there have been several talks aimed at expanding the agreement to encompass all the countries in the Americas (excluding Cuba) to form the Free Trade Area of the Americas (FTAA).

It is worth emphasizing that the EU and NAFTA are outliers in the global experience in terms of the amount of economic integration already achieved, and in terms of the continued attempts to deepen integration and enlarge membership. Most attempts at regional economic integration have ended in barely-integrating customs unions, with their high points being the signing ceremonies that announced ambitious targets and forecasted enormous gains all round, e.g. Mercusor and ASEAN.[35] EU and NAFTA are similar in that they permit free movement of goods and capital within their respective groupings. However, they also differ in many significant aspects. Unlike the EU, NAFTA allows only limited labor mobility across countries (notably restrictions on labor movements from Mexico to the other two countries); has no plans to coordinate exchange rate policies; and does not envisage an eventual political union.

Even then events in the recent period do not suggest that the EU and NAFTA might continue to evolve steadily toward their stated final forms. When the citizens of France and the Netherlands in 2005, and of Ireland in 2008, were allowed to express their choice at the voting booth about the desirability of moving on to the next stage of integration, they rejected the motion. It is commonly believed that if Great Britain and Italy had conducted referendums on the issue, their citizens would have also rejected continued European integration. During the US

[34] The EU started off as group of 6 countries forming the European Coal and Steel Community in 1951 under the Paris Treaty.

[35] Mercosur was founded in 1991 but its coverage has not expanded beyond the original members of Argentina, Brazil, Paraguay and Uruguay. ASEAN stands for the Association of Southeast Asian Nations, and it was established in 1967 by Indonesia, Malaysia, Singapore and Thailand. ASEAN now includes Brunei, Burma, Cambodia, Laos, Philippines and Vietnam. ASEAN was generally an inactive economic organization until the mid-1990s.

primary elections for nomination as the candidate of the Democratic Party, both Hillary Clinton and Barack Obama expressed the possibility of renegotiating the terms of NAFTA.

Yet in the midst of these contrary developments within EU and NAFTA in the last few years, more prominent Asian voices have emerged in support of building an Asian Economic Union (AEU). For example, in 2005, Haruhiko Kuroda, the President of the Asian Development Bank, called for Asia to move "towards a borderless Asia"; and in 2008, he reported that despite Asian economic integration being a challenging task, "Asia is poised to take these steps."[36]

There have indeed been a great number of successes in the promotion of free trade areas (FTAs) within East Asia, or at least substantial progress in the negotiations towards such agreements, e.g. ASEAN+China, ASEAN+Korea, ASEAN+Japan (three separate ASEAN+1 FTAs). The flurry of FTA formation activities has spilled into FTA agreements between East Asian countries and Oceania, and between East Asian countries and the United States. These FTA agreements are also in most cases also agreements on the removal of restrictions on investments by residents of one country in the other country.

Parallel to this escalation in trade and investment integration, there have also been a growing number of proposals for exchange rate coordination, and then eventual monetary integration. In 2004, Haruhiko Kuroda opined that:

> "The more we think about a single currency the greater the political factor seems to dominate. Especially in Asia, where political systems vary so much from country to country and political rivalries between countries are still so intense, we tend to be pessimistic about a single currency even in the long run. …[H]owever, if we look at the younger generations who are free from old nationalistic sentiment, we can be more optimistic."[37]

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[36] Haruhiko Kuroda, "Towards a Borderless Asia: A Perspective on Asian Economic Integration," 10 December 2005; and Haruhiko Kuroda, "The Challenges of Economic Integration," 12 September 2008.
[37] Reported in "The Case for Asian Monetary Union," Wall Street Journal, June 1, 2004.

The proposal for an Asian Currency Unit (ACU) is now on the table; and Masahiro Kawai (2006) has argued for its usefulness "as a statistical indicator summarizing the collective movement of Asian currencies; as a currency basket used by the market; and as an official unit of account for exchange rate policy coordination."[38] Clearly, in the eyes of some advocates of Asian economic integration, ASEAN, China, Japan, and South Korea must now act forcefully to coordinate their exchange rates in order to create the degree of stability in intra-regional exchange rates required for regional monetary integration.[39]

The issue is "what should be China's position toward regional economic integration?" Should China support a regional arrangement that is closer to EU or to NAFTA? Should China seek aggressive expansion of the partnership? If enlargement is desirable, should it occur on the basis of proximity (EU-style economic partnerships) or should it be open to all regardless of geographical location (Singapore-style economic partnerships)?

3.2: The Asian Financial Crisis as Impetus for Asian Economic Integration

In retrospect, the Asian financial crisis of 1997-1998 gave a huge boost to the impetus toward Asian economic integration. The yearn for greater economic integration in post-crisis Asia was due as much as to the consequences of the financial typhoon which appeared in the Gulf of Siam on July 2, 1997 as it was due to the causes of the typhoon and to the responses of the international financial institutions and the United States and Western Europe.

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[38] Masahiro Kawai, "Creating an Asian Currency Unit," The Japan Journal, September 2006.

[39] Such a view is expressed in Masahiro Kawai, "The Role of Asian Currencies in the International Monetary System," paper presented at the 2008 Macro Research Conference, The Global Monetary and Financial System and its Governance, sponsored by the Tokyo Club Foundation, 11-12 November 2008, Hotel Okura, Tokyo, Japan; which is why the terms "exchange rate coordination", "exchange rate stability", and "currency unification" are used interchangeably in the paper.

Numerous post-mortems have been performed on the Asian financial crisis.[40] Each autopsy report typically contained the following three hypotheses, with each work differing in emphasis on the importance of individual hypothesis in each country.

Hypothesis 1 – Prolonged Economic Mismanagement: Prior to July 2 1997, crony capitalism and economic mismanagement in the East Asian economies had loaded their national financial systems with weak loans, and hence rendered their continued high growth unsustainable. These Asian economies imploded for the same reasons the Soviet bloc economies had imploded in the early 1990s. Their industries were not viable without various forms of subsidies (e.g. directed credit, protection), and the aggregate subsidy had reached a level in 1997 that the state could no longer provide.

Hypothesis 2 – Financial Market Panic: International financial markets, just like domestic financial markets, are susceptible to bouts of mania, panics and crashes, causing them to help stoke booms and busts in their clients' performance (which in the periods of irrational exuberance are often dignified with self-congratulatory honors like The Asian Miracle, and Japan as No. 1). Paul Volcker (1999) has put the matter well: “International financial crises, I might even say domestic financial crises, are built into the human genome. When we map the whole thing, we will find something there called greed and something called fear and something called hubris. That is all you need to produce international financial crises in the future.”

Hypothesis 3 – The Wrong Medicine of the International Monetary Fund (IMF): By enforcing the abrupt shutdown of banks in difficulties, the tightening of central bank credit, and the reduction of budget deficits through cuts in government expenditure, the IMF’s “rescue” packages converted a minor downturn into a deep recession, and helped to exacerbate (if not

[40] See, for example, Woo, Schwab and Sachs (2000), and Blustein (2001)

initiate) the regional panic by constantly issuing dire diagnoses of the patient. This is why many Koreans have dubbed the perfect storm they found themselves in "The IMF Crisis."

It is convenient to embrace Hypothesis 1 readily because no economy is without flaws. However, the fact that output in Malaysia, South Korea and Thailand rebounded just as quickly as they had fallen falsifies the initial IMF belief that, beside monetary-fiscal tightening, drastic overhaul of the economic system and incentive structure similar to those undertaken earlier in the former Soviet bloc (e.g. immediate increase in the capital adequacy ratio and abrupt large-scale closure of financial institutions) were necessary to restart growth. This initial misjudgment explains why the IMF kept under-predicting until the end of 1998 the strength of the growth that occurred.

Now in light of the financial meltdown of the US financial markets in the last quarter of 2008 and the massive indiscriminate bailout of financial institutions now being conducted by the US Treasury and the US Federal Reserve, it is highly credible to believe that Hypothesis 2 (Financial Market Panic) was the root cause of the Asian financial crisis, and that Hypothesis 3 (IMF's incompetence) was an important contributor to the deepening of the crisis in Indonesia, South Korea, and Thailand. The V-shape of East Asia's re-bounce (except for Indonesia where the financial crisis sparked off a meltdown of the political system) rejected the view of Hypothesis 1 that structural adjustment was the precondition for economic recovery

The many careful studies in the voluminous literature on the Asian financial crisis have produced many valuable insights on every dimension of the crisis: the origins, early detection, pre-emptive interventions, emergency-room macroeconomics, and post-crisis recovery. For the topic of the types of economic policy cooperation that are appropriate for Asia, there are two lessons that are particularly useful. The first lesson concerns the natural working of the market mechanism, and the second concerns the availability of help during a financial crisis.

There has long been a tradition of resistance within the economics profession to acknowledge the phenomenon of disorderly market behavior. The fact that financial contagion has been common in the 1990's cannot be in serious dispute: the European Exchange Rate Mechanism crisis in 1992-93, the Mexican and Latin American financial crisis in 1994-95, the Asian financial crisis in 1997-98, the conversion of the Russian ruble to a rubble in August 1998, and the collapse of the Brazilian real in January 1999. It stretches credibility and the imagination that all these governments coincidentally shifted to destabilizing policies in the same decade. Herein lies the first lesson insight from the Asian financial crisis: *occasional excessive price movements in financial markets are normal and should not be labeled 'peso problems' in a knee-jerk fashion.*

The second important relevant lesson from the Asian financial crisis is that *"the only form of reliable help during an economic emergency is self-help."* The IMF could not be counted upon to be always correct in its diagnosis upon its first reading of the situation. Moreover, the United States could not be expected to be always ready to help out countries in desperate straits. In the three-decade long rule of General Soeharto, he had been bailed out several times before by the US and its allies (notably Australia, Japan, Holland, and the international financial institutions), and it was thus quite natural for him to expect some external aid when things started going awry in the last quarter of 1997. Soeharto was mistaken. He did not realise that with the end of the Cold War in 1992, he was dispensable to US security and ideological interests just as his fellow general, Joseph Mobuto of Congo-Leopoville, was dispensable; a newly-impoverished Indonesia was not as important to US policymakers as a newly-impoverished Mexico would because Indonesia was not an immediate geographical neighbor to the US and thence could not send a tsunami of unemployed workers into the US; and as he neared the end of his natural life-span, the Americans (after their costly experience with hanging on to the Shah of Iran until the bitter end in 1979) had become more interested in who would be replacing him than in maintaining him in power.

The only country that was willing to commit immediate large-scale financial assistance to the crashing Asian economies was the neighboring country of Japan, which proposed the Asian Monetary Fund (AMF). Japan did not succeed in establishing the AMF, however. Three of the key reasons for the failure of the AMF initiative were that some important developed countries believed in the crony capitalism explanation of the crisis and concluded that an AMF would merely mean throwing more money to the undeserving, corrupt elite of these countries; some other developed countries wanted to protect the monopoly position of the IMF so that they could continue to command a disproportionate influence on world affairs; and China was not prepared to be rushed by events into supporting a new regional institution without careful consideration of all the implications.

These two lessons propelled the East Asian countries after their recovery to go on a reserves accumulation spree to insulate themselves from future speculative attacks (i.e. be independent of the supervision of the IMF). These lessons also led the Asian countries -- the 10 ASEAN countries, China, Japan and South Korea, collectively called ASEAN+3 -- to start the process of currency and financial cooperation when they met in Chiangmai, Thailand, in 2000. The resulting Chiangmai Initiative had two major components.

The first component was that countries agreed to come to each other's aid if similar speculative attacks were to reoccur. This pooling of reserves to defend the existing values of their exchange rates was enabled by each country entering into a web of bilateral swap arrangements. The second component was the establishment of an Asian Bond Market (ABM) to keep funds within the region. The assumption is that if there were an unjustified (i.e. panic-stricken) capital flight from one Asian country, the existence of the ABM would channel these funds to the other Asian countries. ABM is a defensive mechanism (just like the anti-ballistic missile), and it worked by reducing the probability of a collective capital flight from out of Asia.

The Chiangmai Initiative turned out to be only the first part of a more comprehensive program of regional economic integration. In November 2001, China and ASEAN agreed to start negotiations for an ASEAN+1 free trade area (FTA) that would be achieved in 2010. By November 2002, China and ASEAN had made enough progress to sign the framework agreement for the ASEAN+1 FTA. This fast pace of economic embrace between ASEAN and China had the synergistic effect of accelerating what has been a leisurely-paced process of incremental economic integration within ASEAN, and energizing Japan into active FTA negotiations with ASEAN.

The ambition of Asian economic integration, or at least its rhetoric, has continued to broaden. The annual ASEAN+3 conference in 2005 was supplemented by the East Asian Summit (effectively an ASEAN+6 conference) to include Australia, India and New Zealand; and the host of the 2005 conference, Prime Minister Abdullah Badawi of Malaysia, expounded on his vision of an Asian community.

At the May 2006 meeting of the Asian Development Bank (ADB) in Hyderabad, India, the ADB led the call for the introduction of an Asian Currency Unit (ACU) to coordinate exchange rate movements within the region. This ACU proposal was similar to the first major step toward currency unification in Europe when the European Currency Unit (ECU), more popularly known as the European Currency Snake, was introduced in 1976 to coordinate a joint float against the US dollar. Would Asia in three years after Hyderabad, as Europe did in 1979, form the Asian equivalent of the European Monetary System? And then grow into an Asian Monetary Union another twenty years later?

Given the many parallels between the fast Asian developments in the last decade with the movement in Europe from the Treaty of Rome in 1957 that established the European Economic Community to the Maastricht Treaty in 1993 that formalised the European Union (EU), the sense of history repeating itself is naturally a strong one. Is there an Asian Economic Union (AEU) in the offing? Would it come soon, just like a late industrializer normally taking off at an explosive speed compared to the first industrializer?

We know enough from painful experiences, however, to be wary of linear thinking, otherwise, there would never be any turning points in history. We do well to remember the famous words of "History repeats itself, first as tragedy, second as farce."[41]

3.3: The Economic Basis for Exchange Rate Coordination and a Common Currency

The basic question is whether the final realized form of the Asian Economic Union (AEU) would be closer to EU or to NAFTA. So far, no prominent proponent of AEU has advocated a future political union as the final objective. While political objectives like avoidance of armed conflict among traditional competitors might suffice to drive the economic integration agenda, it would be more rational to also explicitly acknowledge the economic costs of these political decisions. To put the issue more fundamentally, is there a case for exchange rate coordination (and, maybe, monetary integration) within AEU in the absence of political unification?

[41] This is the common paraphrase of the opening sentences in Karl Marx (1852).

In our opinion, we cannot compare the relative merits of an EU-type AEU and an NAFTA-type AEU without stating what the world would look like in the future. Luckily for us, the conventional view of the state of the world in 2025 and 2050 are conveniently contained in a Goldman-Sachs study.[42] Table 3 reports the projections of the inflation-adjusted GDP in 2025 and 2050 in the major countries in EU, NAFTA and AEU.

Part A of Table 3 focuses on the three NAFTA countries; USA, Canada and Mexico. If we select for the normalisation of GDP in each year the current GDP of the country that had the smallest GDP in 2005, then the GDP ratio of USA-Canada-Mexico in each year would be

- 17.9 : 1.7 : 1.0 in 2005
- 8.2 : 0.8 : 1.0 in 2025
- 4.8 : 0.4 : 1.0 in 2050

While the United States would become increasingly large vis-a-vis Canada and decreasingly large vis-a-vis Mexico, the fact is that the US is the overwhelmingly dominant country in NAFTA at the present and will continue to be overwhelmingly dominant in the future. In 2050, the US would be twelve times larger than Canada and almost five times larger than Mexico. Given this great disparity in economic size, it will always be true that independent economic shocks in Canada and Mexico would have very limited impact on the US economy, while a sneeze by the US could send powerful tremors to the other two NAFTA members. In such an unequal situation, the survival of individual currencies is natural because the giant US economy sees no advantage in allowing its monetary policy to be influenced by the concerns of

[42] O'Neill, Wilson, Purushothaman and Stupnytska (2005).

the smaller economies, and Canada and Mexico could use the exchange rate as an additional instrument to help offset shocks (especially trade shocks) originating from the US economy.

Part B of Table 3 reports the GDP of the three largest economies in the EU; Germany, United Kingdom, and France. Again using the smallest country in 2005 (France in this case) to normalise GDP, we see that the GDP ratio of Germany-UK-France would be:

- 1.3 : 1.0 : 1.0 in 2005
- 1.2 : 1.0 : 1.0 in 2025
- 1.1 : 1.0 : 1.0 in 2050

The GDP ratios reveal clearly that the biggest EU economies are of the same magnitude now and will continue to be so in the future. This means that independent shocks in each country will have sizable spillover effects on the others. This high level of economic interdependence amongst EU members means that the welfare of each member would be increased if national economic policies were coordinated in a manner that reduces negative spillover effects. One instrument for achieving this welfare-enhancing cooperative solution is a common currency.

Furthermore, on the political dimension, the natural compromise solution for a group of equally powerful countries would be a common currency rather than the adoption of any particular national currency. The fact that Europe is anxious to undertake political union in order to minimise the possibility of another war among Germany, UK, and France means that a common currency is a necessary by-product. (In 1950, when the French foreign minister Robert Schuman pushed for the creation of the European Coal and Steel Community, the forefather of EU, he explicitly admitted that this was a way to prevent further war between France and

Germany. With the steel and coal industries under the control of a supranational organization, he would have made "war not only unthinkable but materially impossible."[43])

Part C of Table 3 projects that the distribution GDP of the three major East Asian economies -- Japan, China, and South Korea -- display drastic changes over time. The GDP ratio of Japan-China-South Korea will be:

- 6.6 : 2.4 : 1.0 in 2005
- 2.6 : 4.5 : 1.0 in 2025
- 2.2 : 13.1 : 1.0 in 2050

Unlike the EU, AEU will not be a club of equals at any point in time; and, unlike NAFTA, there is no stable dominant economic giant across time. Japan is the economic giant in 2005; but China will be the economic giant in 2050. If there is a compelling economic argument to form a Yen-bloc today, then the same compelling economic reasoning would dictate that this Yen-bloc transform itself into a Yuan-bloc by about 2035.

However, because Chinese policymakers must be well aware of the changing balance in economic power within East Asia over the next three decades, it is hard to see why China today would want to support the establishment of a regional economic architecture that would establish a Yen-bloc. Similarly, even if China were to agree to the formation of a Yen-bloc right now, it is hard to see why it would not seek to change the fundamental nature of the regional financial architecture after 2035. It is, in short, politically unrealistic to expect a common currency for East Asia in the foreseeable future.

Moreover, it is also economically undesirable for East Asia to adopt a common currency because there has not been serious consideration of complete integration of national labor

[43] Quote is from website: http://en.wikipedia.org/wiki/European_Coal_and_Steel_Community

markets in the official and academic discussions on an Asian Economic Union. If economy A is entering into inflation while economy B is entering into recession, A will want to raise the interest rate while B will want to lower the interest rate. The uncomfortable reality is that whatever the compromise interest rate policy might be, it would be optimum only if labor from B could move freely and costlessly into A.[44] Without unhindered labor mobility across A and B as the adjustment mechanism to a common monetary policy, the benefits of a common currency could be greatly reduced, if not, overwhelmed.

Our opinion is that, one, the NAFTA-like disparity in economic power in AEU at the present and in the future, and, two, the absence of policy-induced integration of national labor markets mean that the only stable configuration is the survival of individual East Asian currencies with limited coordination among them in normal times. It therefore appears to us that the many present efforts to promote closer exchange rate cooperation will not succeed in the long-run.

2.4: The 2008 Global Financial Crisis as another Wake-Up Call for Asian Financial Integration

In response to the present deep global financial crisis, President George Bush convened a G-20 summit meeting in Washington DC on November 15, 2008. A second G-20 summit will be held in London on April 2, 2009. President Nicolas Sarkozy of France and Prime Minister Gordon Brown of Great Britain have called on the G-20 to establish a New Bretton Woods. We do agree that China should support the establishment of a working group on the reform of the IMF to discuss:

- how much to increase its resources to allow it to fight global financial fires,

[44] This is the fundamental insight of Mundell (1961).

- how wide to increase its jurisdiction to authorize it to improve regulation of financial markets, and
- how radically to restructure its ownership to give it the legitimacy to impose its will on prostrate economies.

However, while an improved IMF is highly desirable, the fact is that the better first line of Asian defense against financial contagion would be a greatly enhanced Asian swap facility, the Asian Financial Fund (AFF), because Asia collectively now has enough reserves to fend off unwarranted speculative attacks on a subset of its members. It must be emphasized that the core mission of the AFF is to combat financial contagion and not to finance balance of payments adjustment caused by economic mismanagement. This present emphasis by AFF on the former is what distinguishes it from the International Monetary Fund, which has both functions as its core mission.

An AFF is necessary because it is simply impossible (certainly, inefficient) to increase the size of the IMF enough to enable it to have in-depth expertise on most of the countries to be able to respond optimally in a timely manner to each national crisis. Furthermore, the IMF policies are decided by Executive Directors who usually take their orders from their national ministries of finance and central banks, and it would be credulous to think that a significant proportion of these national economic agencies would have up-to-date understanding of most of the emerging economies. Even if the improved technical competence of the IMF is not doomed to disappoint the emerging economies, the emerging economies would be disappointed by the long time required for an improved IMF to appear. The negotiations on meaningful IMF reforms would inevitably be cantankerous and hence protracted.

The Sarkozy-Brown proposal for a New Bretton Woods should be recognized to be part of the continuing effort by Old Europe to maintain its disproportionate representation in global governance bodies like the UN Security Council, the IMF and the World Bank.[45] The proposal to make the unreformed IMF the super financial policeman of the world is foolishness because the concentration of so much power in its hands would magnify the impact of any wrong operational procedure and allow the mistake to be unchecked for a longer time. If need be, the assignment of global financial regulation to an expanded BIS would be a better alternative. The IMF should forgo its dream of jurisdiction-expansion and become instead a more specialized agency that undertakes macroeconomic surveillance for the world, and balance of payments assistance for the emerging economies.

Right now, East Asia has a thin network of swap lines to defend their currencies. It would be desirable to hasten the evolution of the existing swap facility into the AFF by two actions. First, the existing swap facility specifies that a cumulative drawing that exceeds 20 percent of a country's quota would require the country to accept IMF supervision. This "flight-to-IMF" clause should be removed because painful memories of 1997-98 make it politically suicidal for any East Asian leader to do so.

Second, the Asian swap facility must now establish a surveillance mechanism to pre-qualify its members for emergency loans.[46] Without a credible procedure to pre-qualify members, the removal of the "flight-to-IMF" clause would guarantee that the present system of (bilateral and multilateral) swap arrangements would not be sustainable and would not increase to meaningful sums. This is because the members want the pooled funds to be used only to

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[45] The veracity of this statement is strikingly seen in that the G-20 summit in November 2008 turned out to be a G-22 summit because some of the European members pressed successfully for the inclusion of the Netherlands and Spain in the summit.
[46] Wang and Woo (2004).

defend an exchange rate against speculative attacks not justified by fundamentals. The members would not support using the pooled reserves to defend an exchange rate that has been rendered overvalued by inflationary domestic policies. Without pre-qualification of potential borrowers, no member would be willing to risk committing a large part of its reserves to the swap facility.

During the height of the Asian financial crisis, the US, Western Europe and China opposed the establishment of an Asian Monetary Fund (AMF) to help handle the crisis. Why should they now support the setting up of the AFF that would have some of the same features as the rejected AMF? There are six reasons for their change of mind.

The first reason is that the 2008 global financial crisis has removed all doubt that financial panic and not crony capitalism was the cause of the Asian financial crisis, and that the IMF programs had made matters worse.

The second reason is that the US and Western Europe cannot really stop such a move anyway because, one, the East Asians now have the requisite amount of foreign exchange reserves to undertake self-insurance against speculative attacks on a subset of their members; and, two, China has now changed its mind about the desirability of a regional financial institution.

The third reason is that there is now realization by the US that, when dealing with Asia, it should rely less on the hard power of a formal dominant role in global leadership, and more on the soft power of US example, like helping Asia do what's best for Asia (which is an excellent start to the US re-engagement with Asia). The US support for AFF is the much-needed change toward an inclusive US approach that is diversified in modality to handle each specific multilateral issue. Such a change in modality by the US would be a realistic response to the Asia-ward movement in the center of gravity of the world economy.

The fourth reason is that with the end of the Cold War, the international agenda of the US is no longer so similar to those of the Western European countries. This is why when Sarkozy pressed Bush in October 2008 to convene a G-7 summit to deal with the global financial crisis, Bush chose to convene a G-20 summit instead. The international economic agendas of the US and some the major developing countries now share many more common elements that are at odds with the position of the EU, e.g. agricultural subsidies.

The fifth reason is that the US and the rest of the interested world would be members of the AFF just as they are now influential members of the Asian Development Bank. The creation of the AFF would not mean the disappearance of their policy engagement with Asia. Furthermore, just as we have the system of the World Bank and several regional development banks (like the Inter-American Development Bank, and the African Development Bank), it is also natural and desirable to have regional financial institutions in addition to the IMF. The IMF is by no means obsolete with the establishment of the regional financial institutions. The IMF can play a very helpful role in speeding up the institutional maturity of these regional financial institutions, and in keeping up the competition of ideas.

The sixth reason is that the AFF could expand over time to be an APEC-level institution; and be a good partner to the IMF because "two heads are better than one" in analyzing unexpected quickly-evolving crises and in preventing their contagion. In short, the better way to improve the supply of global public goods is not to simply increase the size of the existing providers but to increase the number of providers while seeking to improve the performance of existing ones.

Of course, over time, depending on the progress in reforming the operations and the governance of the IMF, and the new needs created by greater Asian economic integration, the

Asian community might empower the AFF to also extend adjustment loans with conditionality to countries that needed balance of payments assistance because of past economic mismanagement. It is important to note that pooling national foreign exchange reserve funds and using them to enhance regional welfare is independent of whether AFF would promote exchange rate coordination or not. One activity does not imply the other.

2.5: The Feasible Architecture for an Asian Economic Union

Earlier, we pointed out two features about East Asian economic integration. The first feature is that there are three separate ASEAN+1 FTA agreements but not an encompassing ASEAN+3 FTA agreement. The second feature is that the ASEAN+3 forum has effectively expanded to an ASEAN+6 forum since 2005. It is important to grasp that these two features reveal a key condition for the durability and effectiveness of any formal Asian economic integration, which is that the ASEAN+3 grouping is not a stable grouping. This is because some ASEAN+3 members were understandably concerned that China could quickly come to dominate the grouping through its sheer size. These members have therefore supported the admission of Australia, India and New Zealand into the regional grouping in order to create the possibility of forming a coalition to counterbalance China's weight in the economic union, if they feel the need to do so. In short, unlike ASEAN+3, ASEAN+6 is a politically stable grouping because it allows check and balance within the organization.

The expansion of ASEAN+3 to ASEAN+6 is actually desirable economically as well as politically. Adam Smith has famously argued that the division of labor creates wealth, and that the degree of the division of labor is determined by the size of the market. As the biggest market that is available is the world market, the optimum size of an FTA is therefore the whole world!

It is most probable that the bigger an FTA is, the bigger would be the gains from trade – which means that an ASEAN+6 grouping is economically superior to an ASEAN+3 grouping. The practical recommendation on regional trade and investment integration that emerges from our discussion is that an Asian Economic Union should go beyond being contiguously as large as possible to being as inclusive as possible, where geographical location is a secondary consideration.

On the financial side of the Asian Economic Union, our formulation of an Asian Financial Fund (AFF) is operationally the establishment of a large Asian swap facility that has its own surveillance mechanism to pre-qualify members for emergency loans. The primary mission of AFF is to calm panic in the foreign exchange markets and not to defend currencies that have been rendered overvalued by domestic inflationary policies. AFF's goal is to attenuate the cost of bad luck and not the cost of bad policies.

Given the large size of East Asian foreign reserves, the AFF should take on the additional task of designing a pooling scheme where part of the East Asian reserves could be safely used to finance sound infrastructure projects in the poorest Asian countries. This outcome would be superior to the present practice of putting almost all of the East Asian foreign reserves into the assets of G-7 economies.

It is important that the AFF does not suffer from the institutional inertia that is characteristic of the present global organizations like the United Nations, the World Bank and the International Monetary Fund. The leadership structure of the AFF should be designed to avoid simply locking in the balance of economic power that existed at the time of its founding; much like the unchanging composition of the permanent members of the UN Security Council, the head of the World Bank always being a US appointee and the head of the IMF always being a European. If AFF can adopt a self-updating type of leadership structure, its first contribution to the world (as well as to the East Asian region) would be the provision of an example to inspire positive developments in the reform of the leadership structure in the global organizations.

Final Remarks

The 30 years of reform and opening have brought great material progress to China. This change has also been felt throughout the world because, by becoming a big country, China's actions created huge spillovers (some positive, some negative) on other countries. China's thirst for energy caused the price of oil to rise above $140 per barrel in summer 2008, and its demand for iron ore revived the mining towns in northern Sweden and brought needed infrastructure investments into parts of Africa. In the standard Heckscher-Ohlin model, the unambiguous prediction for the rich countries about the integration of China's humongous labor force into the international division of labor is higher unemployment temporarily and lower wages permanently. Some observers have also claimed that the greenhouse gases from China's industrialization would soon cause cataclysmic global climate change. To the negative spillovers, one must now add the allegation that China's prolonged large trade surpluses have undermined global financial stability and tilted the world into a deep recession, if not, a 1930s-style depression.

If the rise of Germany and Japan in the first part of the 20th Century meant world wars, and the rise of the Soviet Union in the middle of the 20th Century meant geographically dispersed proxy wars, then it appears that the rise of China in the last part of the 20th Century had meant an economic war on the established powers. This is certainly one reading of the now well-known Paul Samuelson (2004) paper on immiserizing-the-rich type of growth generated by the poor country.[47]

We do believe that labor in the rich countries are under considerable stress because of the deep global structural adjustments brought by the integration of the labor force of China, India and the Soviet bloc into the world economy; and the acceleration of technological innovations (as exemplified by the revolution in information technology). It is also possible that these two trends might reinforce each other from the synergy created by the greater contact among people. The new global equilibrium could be a win-win outcome for most of the population in every country but the process of moving to it is a painful one, particularly because of the general inadequacy of social safety nets and the ineffectiveness of labor re-training programs. However, protectionism and other forms of conflict to avoid the transitional pains is likely to end up in a lose-lose outcome for most of the population in every country.

China must therefore, in its own interests and the world's, help to reduce international tension by updating its strategy of international economic engagement. China has to go beyond being a passive beneficiary of the WTO system to being an active promoter of WTO objectives. China can use its standing as a middle-income country to help bridge the breach in the Doha Rounds negotiations between the developed and developing economies; and to improve the rules on temporary protection in the face of massive structural dislocation. The strengthening of the WTO system would be one important way to prevent the world from into protectionism

China must also play a stronger and more constructive role in the forthcoming international talks on global climate change. China and India are simply too big to be exempted for a long time from national ceilings on the emission of greenhouse gases. China should avoid

[47] Samuelson (2004) showed that free trade could cause a decline in the welfare of the developed country if outsourcing accelerates the transfer of knowledge to the developing country, which would then import less from the former causing the terms of trade to shift in favor of the developing country.

its usual passive stance in international organizations. For example, China should be mobilising international consensus to form an international research consortium to develop ways to burn coal cleanly because China is now building a power station a week and is hence able to facilitate extensive experimentation on prototype plants to burn coal cleanly. If successful, this global cooperation on clean energy research will unleash sustainable development in China as well as in the rest of the world.

China should face down its internal political opposition to replace the backward state-controlled financial system with a dynamic, but well-regulated, diversified private financial system in order to eliminate the odd phenomenon of a poor country lending to a rich country. Savings behavior is not independent of the sophistication of the financial system. An advanced financial system will have a variety of financial instruments that would enable pooling of risks by providing medical insurance, pension insurance, and unemployment insurance; and transform savings into education loans, housing loans, and other types of investment loans to the private sector. *Ceteris paribus,* the more sophisticated a financial system, the lower the savings rate, the higher the investment rate, and hence the greater the probability of an optimum current account position.

For its neighborhood, China should push for an Asian Economic Union (AEU) that takes the form of a WTO-plus[48] free trade and open investment area that has regional pooling of foreign exchange reserves. And it cannot be over-emphasized that there is no economic logic for a regional financial facility to naturally morph into the regional central bank. Exchange rate coordination might occur sporadically but it is unlikely to be the norm in the medium term, and most possibly even in the long term. East Asia should therefore be focusing its energy on creating as wide a free trade area as possible (i.e. be geographically unrestricted), and forgo the

[48] WTO+plus = the degree of openness exceeds existing WTO standards

unrealistic goal of a common Asian currency. Given the great disparity in the present and future distribution of economic power in East Asia, and the greater restrictions on labor mobility within the (commonly proposed) Asian Economic Union, a NAFTA-type of Asian Economic Union would be preferable to an EU-type of Asian Economic Union.

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Table 1
Trade Dependency and Current Account Imbalance in International Perspective

	Trade as % of GDP			Current Account Imbalance as % of GDP								
	2005	2006	2007	2005	2006	2007	2008	2009	2010	2011	2012	2013
China	63.8	66.5	66.8	7.2	9.4	11.3	9.5	9.2	10.0	9.9	9.9	9.9
Emerging Economies												
Brazil	26.6	26.3	26.2	1.6	1.3	0.1	-1.8	-2.0	-2.0	-1.9	-1.8	-1.7
India	43.5	47.2	45.4	-1.3	-1.1	-1.4	-2.8	-3.1	-2.9	-2.7	-2.4	-2.1
Russia	56.7	54.9	52.2	11.0	9.5	5.9	6.5	3.4	1.5	-0.6	-2.0	-3.2
Developed Economies												
Germany	76.7	84.7	86.5	5.2	6.1	7.6	7.3	6.8	6.9	6.5	6.6	6.5
France	53.0	55.1	55.2	-0.6	-0.7	-1.2	-2.8	-2.7	-3.0	-2.9	-2.9	-2.9
Japan	27.3	30.9	33.6	3.6	3.9	4.8	4.0	3.7	3.3	3.5	3.2	2.8
United States	26.8	28.0	28.9	-5.9	-6.0	-5.3	-4.6	-3.3	-3.2	-3.1	-2.9	-2.8

Trade = Export+Import
Trade for China refers to only commodity trade. Data are from National Bureau of Statistics (2008), Tables 2-1 and 17-3.
Trade for other countries refers to commodity+service trade. Data from National Income section of International Financial Statistics. The trade-GDP for China calculated from this source is 67.3% in 2005 and 69.0% in 2006.
Current Account Imbalance as % of GDP is from database from World Economic Outlook (WEO), October 2008. Data for 2008-2013 are WEO estimates

Table 2

Changes in Growth Projections for China

(GDP growth rate in percent)

	2008	2009	2010
IMF (October 8, 2008)	9.8	9.3	10.0
IMF (November 6, 2008)	9.7	8.5	n.a.
Jun Ma (September 18, 2008)	9.9	8.9	n.a.
Jun Ma (December 3, 2008)	9.1	7.0	6.6

Table 3

The World Economy in 2005, 2025 and 2050

(GDP is measured in trillions of US$ in 2005 prices)

Case 1. NAFTA GDP: US dominates now and in future

	USA	Canada	Mexico
2005	12.5	1.2	0.7
2025	19.6	1.8	2.4
2050	37.7	3.0	7.8

Case 2. EU GDP: Fairly equal size

	France	Germany	UK
2005	2.3	3.1	2.3
2025	3.2	3.9	3.3
2050	4.9	5.4	5.1

Case 3. Asia GDP: Japan now, China in future

	China	South Korea	Japan
2005	1.9	0.8	5.3
2025	11.7	2.6	6.7
2050	48.6	3.7	8.0

Source: Jim O'Neill et al, op. cit.