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Commentary

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The Border Papers

Taking a Giant's Measure:

Canada, NAFTA and an Emergent China

Wendy Dobson

In this issue...

Canadians must respond creatively to China's emergence as a major economic force. Canadian manufacturers will have to face the painful possibility that they can be priced – or pushed – out of their main U.S. market by low-cost, China-based producers and Canadian policymakers should recognize that China may eventually supplant Canada as the largest trading partner of the United States. There is still time to develop public policies that take advantage of China's surging growth — but not much.

The Study in Brief

Canadians must take more seriously both the opportunities and the potential risks of China's emergence as a major economic force. If there was ever a time for Canada to have both a North American strategy and a long-term non-North American strategy, it is now. The latter approach requires significant changes in our thinking about trade and investment. Much of the Chinese competition is based on its position in the global value chains of foreign companies, very few of which are Canadian. This approach also demands awareness that Canadian manufacturers can be priced — or pushed — out of their main U.S. market by low-cost, China-based producers. This *Commentary* examines these issues — of trade, investment and the exchange rate regime, as well as China as a source of systemic risk — before considering the implications for Canada and its NAFTA partners. Risks for Canada include short term ones of currency changes, direct import competition in the Canadian market, and indirect import competition in the U.S. market, as well as the new possibility — for which Canadian policymakers should begin to prepare — of China supplanting Canada as the largest trading partner of the United States.

Canada benefits from China's demand for its natural resources, but if we settle for these benefits now, we will pay the cost later. Inevitably, our services producers and manufacturers will face intense direct import competition as China's comparative advantage shifts. They should be investing in China to reduce costs; increasing the sophistication of their products, using unique Canadian knowledge and skills, and identifying market niches or global production chains in order to market there. Domestic policy should be focused on increasing our own productivity, and our own China-policy framework should be more farsighted, with three main prongs:

(1) A bilateral approach that addresses China's interests in correcting structural weakness in its own economy and supports the market-access needs of Canada's small- and medium-sized enterprises; consistent high level government-to-government contacts;
(2) A multilateral approach that encourages China's participation in global management forums, such as the G-7 and G-20, and
(3) A contingency plan for setbacks in the Chinese economy.

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China's emergence as an economic colossus has sparked enthusiasm about its role as a new locomotive of world growth and dismay at the potential for a train wreck. China joins Japan, Taiwan and South Korea as Asian countries that have staged economic revolutions in the last 50 years, industrializing rapidly and raising living standards dramatically. Though China's per capita income growth has not yet reached rates achieved by Japan in the 1960s, it has attained the levels of Taiwan and South Korea in the 1973-to-1990 period (Maddison 2001). Those economies were smaller entities, however, and their rapidly growing affluence and economic influence went relatively unnoticed for some time. By contrast, the sheer size of China's economy and the speed of its export-led industrialization will profoundly alter political and trading relations among countries around the world, all of which will have to adjust to that nation's success, as well as to possible political, economic and environmental setbacks.

During the past year, the press has trumpeted reports and testimony on the potential for a train wreck. U.S. voters and lawmakers expressed dismay during the presidential election year about unemployment, unfair import competition, an allegedly undervalued Chinese currency and, more recently, the dangers of the Chinese economy spiraling out of control. Analysis of each of these concerns illustrates the costs and benefits of adjusting to shifting comparative advantage and international macro-economic imbalances.

While Canada Sleeps

Why do the trade and employment issues, aired with such urgency in Mexico and the United States, not receive the same attention in Canada? I argue in this *Commentary* that Canadians currently benefit from China's growth because of the two countries' complementary economic structures. In the long term, though, the Canadian standard of living will depend on how the economy adjusts, as is the case with Canada's North American Free Trade Agreement (NAFTA) partners.

For that reason, the locomotive-train wreck analogy is directly relevant to Canadian business and public policy and to an analysis of what Canadians should do both to benefit from the locomotive and to be prepared for setbacks. If there was ever a time for Canada to have both a North American strategy (Dobson 2002), as well as a long-term non-North American strategy, it is now. This strategy, discussed in this paper, requires significant changes in our thinking about trade and investment in global value chains. It requires awareness that Canada could be priced out — or pushed out — of the U.S. market as a result of China's emergence as a low-cost producer. I discuss short-term issues of U.S. dollar depreciation, direct import competition in the Canadian market, and indirect import competition in the U.S. market, as well as a new possibility for which Canadian policymakers should begin to prepare — China supplanting Canada as the largest trading partner of the United States.

While the final responsibility for the manuscript is mine, I would like to express special thanks to Danielle Goldfarb for her input and oversight of this project; to anonymous reviewers, and to Dan Ciuriak. Kevin Doyle applied his superb talents to transform sometimes-turgid prose and Steve Grigoriou and Hanan Stefan, students at the University of Toronto provided patient research assistance. I am very grateful to them all.

Table 1: *The Chinese Economy, 1990 and 2002*

	1990	2002	Ave. ann. growth rate (%)
GDP (billions US$)	355	1,210	18.5
GDP (billions PPP basis)	1,474	5,625	21.6
Total trade/GDP (%)	33.5	51.3	4.1
Exports/GDP (%)	18.2	26.9	3.7
FDI inward stock (million US$)	24,762	447,892	131.4

Sources: IMF, International Financial Statistics; World Bank, World Development Report; UNCTAD.

The *Commentary* begins with a brief overview of China's trade and investment position as a context for developing options for dealing with import competition from that country's exports to Canada and to its largest trading partner, the United States. It goes on to discuss China's monetary framework and currency choices and the implications for Canadian exporters of an appreciating domestic currency. The paper then evaluates the systemic risks posed by Chinese economic performance and concludes with the strategic considerations for Canada, as well as its NAFTA partners.

There has been an avalanche of analyses and opinions on the dramatic changes that characterize China's emergence since 1978 from a strife-torn, autarchic and isolated entity into one of the world's largest and most dynamic economies. Still, it is useful to recall some major elements of the story. Starting from almost no international economic flows, China is now one of the world's largest traders and it has been a top destination for foreign direct investment (FDI) in the past two years. Out of an industrial structure once dominated by state-owned enterprises (SOEs), China has struggled, not always successfully, to replace central control with market forces, while avoiding widespread bankruptcy and unemployment. China's economic transformation since 1978 is estimated to have lifted the incomes of about 100 million people above the absolute poverty level (World Bank 2000:12) and at least half of the labour force has moved out of agriculture since then.[1] Since 1990, China's economy has grown fourfold (Table 1). On a purchasing power parity basis, it ranks second in the world behind the United States.[2] Trade has grown from a mere 15 percent of gross domestic product (GDP) in 1980 to about 33 percent in 1990 and as much as 50 percent of the economy in 2002. The stock of FDI has grown more than 400 times since 1990 alone.

1 By one estimate, the share of the labour force in agriculture fell to 47 percent from 81 between 1965 and 2000 (Cooper 2004); another estimate, which excludes workers in township and village enterprises, puts the share as low as 34 percent. I am indebted to Dan Ciuriak for the latter estimate.

2 In 2002, China's GDP on a purchasing power parity basis totaled $5.7 billion, while Japan's was $3.3 billion. U.S. GDP on this measure was $10.1 billion (World Bank Development Indicators Database). All currency amounts in this paper are in U.S. dollars, unless otherwise stipulated.

However, much remains to be done. Unequal growth rates in the coastal and urban areas threaten to leave millions of rural dwellers behind. Market institutions lag developments in the economy; without a fully developed legal framework, corruption is a critical problem. As well, Chinese governments, ever fearful of dramatic increases in unemployment, still support many loss-making SOEs, directing state-owned banks to buy their bonds, instead of subjecting them to hard budget constraints that would compel them to become profitable or to declare bankruptcy. The state-owned banks (and the asset-management companies originally created to take bad loans off their balance sheets) have huge debt overhangs that governments must address with injections of public capital.

Trade and Investment

As China integrated into the world economy, one of its major foreign economic policy goals was to join the World Trade Organization (WTO).[3] Negotiations began in 1986 with the General Agreement on Tariffs and Trade, the WTO's predecessor. Since the WTO's founding in 1995, its rules of the road have been used as benchmarks to encourage domestic economic reforms. In 2001, 15 years after initiating its quest and after committing to further major reforms by 2007, China became a WTO member.

WTO membership, in signaling China's commitment to adopt international rules, reduced the perceived risks of producing there for many foreign investors. As a result, since 2000, China has surpassed the United States as the world's leading destination for FDI. It has also become the destination of choice for parts of the global production chains of manufacturers of electronics, telecommunications equipment, automotive products, and textiles and apparel, among others (Roach 2003). Other reasons for its magnetism are the size of its domestic market, its abundant quantities of low-cost, skilled labour and the evolution of the Special Economic Zones — where market forces were first experimentally introduced — into significant economic clusters that facilitate innovation and attract new investment, just as such clusters do in North America and Europe.

The recent flood of FDI (totaling $53 billion in 2002, but dropping back slightly in 2003) represents a stock adjustment by manufacturers responding to reduced uncertainty and risks of doing business in China.[4] The increase also reflects a survival strategy for foreign multinationals dealing with a strong U.S. dollar (before its subsequent weakening, however short-lived that may be) and intensifying competitive pressures in price-sensitive, commodity-related goods.

3 Some observers have noted another major objective: to secure more certain access to the U.S. market. Hence, U.S. membership conditions figured at the top of the list of those to be met. Accession allowed the U.S. administration and Congress to confer Permanent Normal Trading Relationship (PNTR) status. See W. T. Woo (2003), for example.

4 The total drops to around $40 billion when round-tripping is removed. Flows are generally overreported because they include investment from locations abroad by investors located in China who take advantage of incentives available only to foreign investors (UNCTAD 2003:43). With WTO accession, this phenomenon is gradually declining as preferential arrangements are phased out.

China has also become a significant location for the export processing link in global supply chains. Manufacturers produce components in other locations, before shipping them to China for processing into final goods that are then exported. Many of these operations are managed from yet another location. In the 1997-to-2002 period, processed exports accounted for 56 percent of China's total; the export share of foreign invested enterprises (FIEs) — both multinational affiliates and joint ventures between Chinese and foreign companies — was 48 percent in 2002 (Feenstra and Hanson 2003:37). Motorola and IBM alone accounted for nearly 1.5 percentage points of the total exports in 2000. U.S. and Japanese multinationals each accounted for nearly 2 percentage points; European Union companies for 1 percentage point, and South Korean and Taiwanese affiliates for less than 1 point each (UNCTAD 2002:165).

Clearly, China's trade has changed radically since 1980. It is now the world's sixth largest trading nation, accounting for a 4.3 percent share of global exports (just over a third of the U.S.'s dominant share of the total). Its exports to the United States had risen fourfold to more than a fifth of its total by 2001, while the U.S. share of China's imports had shrunk . Japan's shares of China's exports and imports have also declined. Most significantly, the export share of the East Asian economies, excluding Japan, has remained stable, while their share of China's imports has grown nearly seven times during this period (Table 2).

These trade patterns yield two significant developments. For one thing, China is integrating with its East Asian neighbours. For another, the changes are affecting the distribution of global employment, just as such a shift in comparative advantage would be expected to do. The advanced economies — not just the United States — are transferring low-value-added manufacturing jobs in exporting industries to China because these standard technology positions are most efficiently performed there by the relatively low-paid, though skilled, labour force. At the same time, while manufacturing jobs are vaporizing in the advanced economies, they are disappearing in China, as well. Indeed, one of the nightmares for Chinese authorities is that with capital readily available, it will be misallocated to labour-saving technologies in a labour-surplus economy, adding to the nation's unemployment pressures.

China's increased imports also contribute to its growing integration with its Asian neighbours. China's imports now account for 3.8 percent of the world total (still only about one fifth the U.S. share), though as Table 2 shows, there is a particular pattern to these imports in that more and more of them originate in East Asia, not in the United States or other major industrial nations. China's Asian neighbours produce many of the components that are shipped to China for assembly and later sale in North America and Europe.

In 2002, imports into China and Hong Kong from the rest of the region accounted for 16 percent of that area's total exports, while the United States and Japan accounted for 20 percent and 13 percent, respectively. Indeed, China has been running a trade deficit with the rest of the region. Not only that, one study of the local content of China's exports estimates that only 30 percent of all final goods exports is accounted for by domestic value added, compared with 20 percent for U.S. exports; the rest is content contributed elsewhere in the region (Xikang et al., 2001).

Table 2: *China's Trade by Geographic Region, 1980, 1990 and 2002*

	(Percent Share of China's Total)		
China's exports to	1980	1990	2001
US	5.8	8.2	20.4
Japan	22.2	14.3	16.8
East Asia	30.7	48.4	30.1
Rest of World	41.7	29.1	32.7
China's imports from			
US	19.2	12.1	13.1
Japan	26.0	14.1	12.2
East Asia	6.2	32.7	40.9
Rest of World	48.7	41.1	33.8

Source: McKinnon and Schnabl 2003.

For OECD-country-based investors and exporters, the chance to market their products to 1.3 billion Chinese consumers has long been a magnet for FDI and export promotion initiatives. Yet hoped-for profits have often failed to materialize promptly, partly because China wants foreign investors to generate exports, not serve the domestic market. As well, China is still a poor country with per capita incomes far below those in the OECD countries. A significant middle class that demands western consumer imports is only beginning to emerge.[5]

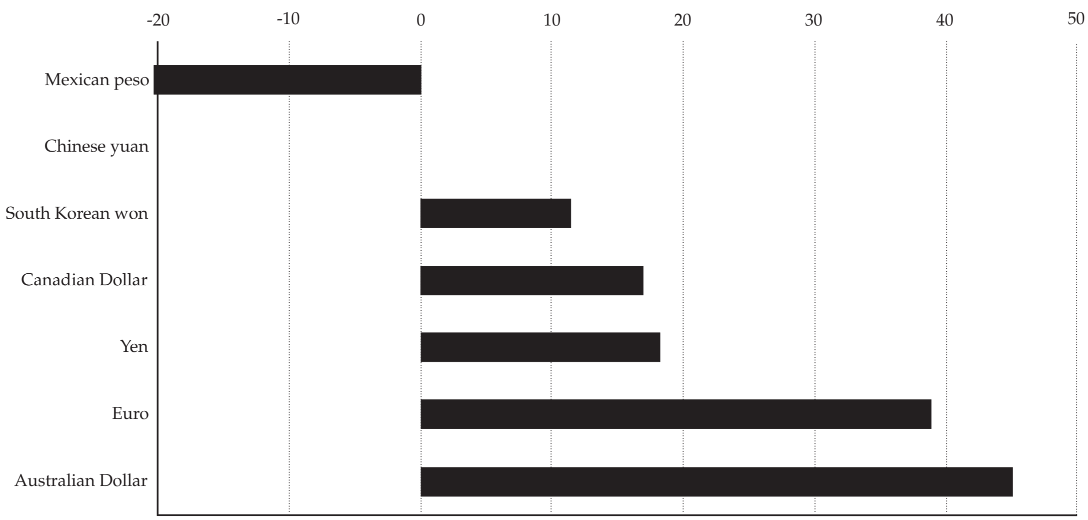
China's Exchange Rate

One of the most controversial dimensions of Chinese economic dynamism is its monetary framework and exchange rate regime, under which the government has pegged the yuan to the U.S. dollar in a relatively narrow band since 1996. The currency peg is significant to Canadian policymakers because the Canadian dollar is among the five currencies that have appreciated most rapidly against the U.S. dollar — which serves effectively as the only internationally accepted reserve currency — since 2002 (Figure 1). Exporters whose countries have flexible rates, allowing their currencies to rise against the dollar and the yuan, are bearing a disproportionate share of the adjustment to their hand-in-hand weakening. Thus, Canadian policymakers have a case (but not as strong a one as the Australians) for asking others to share more broadly the burden of adjustment to the declining U.S. currency.

As China's exports penetrate world markets, its competitors are looking at all the sources of its advantages in that regard. These include such propellants as its natural resource endowments, infrastructure, skilled, low-cost labour force and

5 A common rule of thumb in East Asia is that per capita incomes need to reach $1,000 or more for consumption of non-essentials to become significant as a component of domestic demand.

Figure 1: *Percentage Changes in Nominal U.S. Dollar Exchange Rates January 1, 2002 - March 1, 2004*



Source: Federal Reserve Bank of St. Louis. Economic data from FRED II.

policy environment. Still, most commentators target the exchange rate as China's foreign exchange reserves approach $500 billion.[6] While these reserves accumulate from private sources, such as export receipts, repatriation by domestic residents of assets held abroad and FDI inflows, they also include official assets, such as U.S. treasury bonds acquired by the Peoples Bank of China (PBOC) as it sells the yuan and buys foreign currencies (mainly U.S. dollars) to maintain the parity of the yuan. China's trade competitors have called repeatedly for an upward valuation, or revaluation, of the exchange rate. U.S. competitors, mainly small and medium-sized enterprises, pressed the case in Congress in 2003. Southeast Asian countries and Japan also called for revaluation, in part because of their own reluctance to undertake painful structural adjustments required to avoid direct competition with Chinese-manufactured commodities.

Most of the criticism is directed at the nominal exchange rate. However, there are better measures of the impact of the exchange rate that reflect underlying, not just short-term, market forces on economic behavior. Movement of the trade-weighted currency, for example, has been small in the past five years (IMF 2003:7). By another measure, the real effective exchange rate that estimates the currency value that produces a sustainable current account balance depreciated by 10 percent in the February 2002–to-June 2003 period (IMF, 2003:36).

China's capital account is administered so that only long-term capital in the form of FDI inflows is legally permitted. Short-term capital and other forms of portfolio capital inflows are restricted. This policy reduced China's vulnerability to

6 Reported at $471 billion by *The Economist* (August 28, 2004:90).

the 1997/1998 Asian crisis by avoiding the short-term capital inflows and reversals that afflicted the crisis economies and is generally supported by mainstream economists. Capital outflows are also heavily restricted. Most yuan assets must be reinvested in China because they cannot legally flow abroad: such outflows would exert downward pressure on the exchange rate.

Awash in FDI, China's central bank has to sterilize the macroeconomic impact of these capital inflows by issuing domestic bonds in exchange for the foreign currencies added to its reserves.

Usually a combination of large foreign exchange reserves and a current account surplus are indicators that a currency is undervalued. Is that what these indicators tell us about China? The answer is yes, with a qualification. Yes, because while foreign exchange reserves are desirable to cushion against external shocks, China's holdings are much larger than needed for that. There is no single rule of thumb for desirable reserves coverage — one is to hold reserves equivalent to three months of import bills. China's quarterly import bill was around $75 billion in 2002, a more than 20 percent increase over the previous year (IMF, Direction of Trade), pointing to a reserves cushion of about $225-to-$300 billion.

The significant qualification has to do with China's financial system, which is still immature and bank-dominated; indeed, the banking system is the Achilles heel of China's financial and monetary policy. By restricting deployment of foreign earnings and investment to domestic uses, savers must channel deposits into such domestic assets as real estate, or into the Chinese commercial banking system, which is unable to redistribute savings efficiently. Indeed, before recent large capital injections, non-performing loans (NPLs) were estimated to be between 25 and 50 percent of total loans. The proceeds of foreign capital inflows, unless they are invested in creditworthy projects, are exacerbating the NPL problem and represent a major misallocation of capital. In an economy with an efficient modern financial system, the obvious course of action would be to remove capital controls and allow market forces to play a greater role in determining the exchange rate. But in China, the weak domestic financial system constrains such action. The 1997/1998 Asian financial crises strengthened the case for capital controls when a country lacks sound banking and modern financial systems.

In addition, the size of the current account surplus is probably exaggerated. While China has a large trade surplus with the United States, its overall current account surplus and trade balance are shrinking. Imports grew at a relatively fast clip of 40 percent a year recently, a counter to the contention that the currency is undervalued.

Even if the case for greater exchange rate flexibility were clearer, the challenge would be to introduce market forces in an orderly fashion. The real exchange rate would rise if world, particularly U.S., inflation declined. Current indicators show inflation actually rising slowly.[7] The yuan would also rise if the domestic inflation

7 There is no international consensus on this point. Some (including *The Economist* 2003) argue that China's industrial capacity is more than adequate to meet demand, suggesting deflationary consequences. In fact, it is possible that investment statistics are overstated. Because the gap between saving and investment in the long run must equal the current account balance, China's current account surplus implies that saving in the short term exceeds investment.

rate accelerated — a development that seems likely as China's asset bubble expands. The PBOC has for some time warned commercial banks against reckless lending and the State Council recently announced that it will discourage additional construction of new factories. Capacity has grown particularly rapidly in aluminum and steel production in the past three years (Bradsher 2004).

Estimates of the desirable size of a nominal revaluation differ. Some U.S. interest groups claim the yuan is 40 percent undervalued, though more disinterested estimates put the figure around 15-to-20 percent (Goldstein 2003). However, Xikang et al. (2001) and Goldstein (2003) estimate that a 20-percent revaluation would increase the price of Chinese exports by only 4 percent-to-5 percent, which would improve the U.S. current account deficit marginally, by about $50 billion.

Many experts recommend a gradual change in Chinese exchange rate policy by first pegging the yuan to the world's three major currencies, not just the U.S. dollar, but also the yen and euro, then introducing a widening range of permissible movement. Such changes would facilitate gradual revaluation if warranted and provide more room for maneuver in the conduct of domestic monetary policy (Goldstein and Lardy, 2003).

China is unlikely to change its monetary framework, however, except for reasons that clearly serve its own long-term interests. The central bank has increasing difficulty sterilizing foreign assets accumulated in exchange for the yuan it sells to hold the peg. Excess liquidity is a growing problem that can be addressed by gradually widening the float band. This is a risky strategy because of the possibility of speculative attacks, though it is likely to work as long as capital controls are strict enough to repel speculators. China is also taking other measures, such as permitting larger outflows of FDI to acquire natural-resource companies.

As the exchange rate regime is revised, it is instructive to recall Japan's past experience with its own yen revaluations, beginning in the mid-1970s. The United States has a savings-investment imbalance with China, as it did with Japan in the past and, indeed, still does. China is one of the world's largest savers and now a major creditor; the United States is the world's largest debtor. It is quite possible that a technical fix for the exchange rate would have little impact on China's trade and current account surpluses because of its high savings rate — as was the case with Japan for many years. A stronger yuan would not shield China from accusations that it is an unfair trader behaving in a mercantilist fashion.

China as a Source of Systemic Risk

The speed and magnitude of China's penetration of world markets is a source of dismay, not just because of the competitive implications, but because deeper global integration will allow domestic developments and policy mistakes to spill over to other economies through trade and financial channels. Minimizing spillovers and preventing domestic crises are in everyone's interest. But anticipating adversity should be part of business and public-policy planning. There are several sources of risk — both immediate and economic. They include the immature financial system and cyclical overheating, as well as longer-term and economic-demographic factors, such as China's aging population and the challenges of managing regional inequalities.

The immature financial system. The business and financial problems of the SOEs and other deeply entrenched political interests have obstructed or slowed attempts to create a modern commercial banking system. Recent initiatives to recapitalize the large state-owned banks and sell them to the public aroused great international interest. However, there has been less attention paid to the critical requirements to make them sustainable businesses by creating incentive systems through modern risk-management systems and mechanisms for accountability and transparency and by developing banks' human capital — with independent boards of directors, trained managers and employees.[8] The Chinese authorities have employed an imaginative incentive framework to induce the four large, state-owned banks to clean up their balance sheets and improve oversight provisions: those that do so will be permitted to issue their shares in public markets (Kynge and McGregor, 2003). But such cultural changes take time to put in place; they do not occur overnight. Other needed reforms include the strengthening of transparency and governance of capital market institutions to diversify sources of funding away from the almost exclusive reliance on banks and short-term debt. The central authorities will need time to create a sound, strong financial system. And underlying each of these challenges is the need for a credible legal system (McGregor, 2004).

Cyclical overheating. Concern about cyclical overheating is growing; reports of supply shortages in the industrial sector, power shortages, and rising prices are now daily occurrences. High rates of fixed investment are part of the problem. For example, economists estimate that in 2003, the share of investment in GDP reached 47 percent. Chinese analysts argue that such high rates address large backlogs of demand in residential and commercial property and infrastructure. As a result, much of the investment is "likely to prove premature rather than useless" (Wolf, 2004). Most experts agree on two things: first, much investment has been inefficient and wasteful in the absence of accurate market signals[9] and, second, while a slowdown is inevitable, it is better to be smooth rather than disruptive.

Yet the PBOC can make only limited use of the banking system to tighten monetary policy smoothly through the financial intermediation activities of the commercial banks because of their balance sheet problems. Instead, the central bank has to resort to quantitative credit restrictions, which are potentially disruptive.[10] Such disruptions have caused domestic political problems in the past; now, they will also spill over to China's major trading partners through a reduction in imports, a problem that would be magnified by excess industrial capacity and over-investment. As profits dry up, the closure of factories in China would also hurt exports of intermediate goods from neighbouring economies in the region, and beyond.

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8 This concern is expressed increasingly. See for example "Wasteful Transfusion". 2004. *Far Eastern Economic Review*. January 22: 26-29.

9 This point is made in Hodgson (2004) and by noted China scholars Thomas Rawski and Terry Sicular in a discussion entitled "China's economic transformation" at the Canadian Economics Association meetings in June 2004.

10 A lending holiday was declared during the first week of May 2004, for example. During this period, banks were prohibited from making loans.

Population aging. China has one of the world's most rapidly aging populations because of the one-child policy imposed in 1979.[11] While population growth has slowed significantly, by 2050, China will have only three people of labour-force age to each person at or over retirement age, compared with 10 workers per retiree in 1995 (World Bank, 1997). Traditionally, urban workers relied on SOE employers for their health, education and housing services, as well as for their retirement incomes. These arrangements have disappeared or migrated to governments because of the privatization or closure of bankrupt SOEs. The government created a private, fully funded pension system for urban workers in the 1990s, though coverage is patchy. Rural workers have traditionally relied on the extended family; however, such arrangements are disappearing with urbanization and shrinking family size. The Chinese government must create a financially sustainable pension program, which requires modernization of the financial system to develop insurance and risk-management products. Lack of reform will contribute to social strains (Hejazi and Shum, 2002).

Regional inequality. There is a growing threat to social stability from the increasing economic inequality between the dynamic, relatively wealthy coastal regions, which, after 20 years of economic liberalization are deeply tied to foreign markets, and the hinterlands, located far from overseas markets and supporting large numbers of poor rural families. Poor transportation and communication infrastructures make the rural poor dependent on the domestic market and on government investment in public enterprises. At the same time, opportunities for urban migration are restrained by a system of residency permits. Without a permit, an urban migrant is part of an amorphous and illegal floating population, estimated at 100 million people, or about 10 percent of the whole. The risks are exacerbated by the lack of a system or process to finance the needs of this surging mass as it ages.

Successful economic development is usually a lumpy process that creates income inequalities. The challenge to the state is to enable people to take advantage of emerging economic opportunities by providing such essentials as education and skills training, venture finance and mobility. Political problems occur when rising expectations are frustrated by corrupt officials and others with power, and by such restrictions as residency requirements that trap people in rural poverty or condemn them to float without legal status or social entitlements.

The risks are tightly inter-related, yet so far the Chinese authorities have been able to manage them. Still, a modern financial system is needed to efficiently channel China's large and growing domestic savings into productive investments. It is also essential to address the financial burden of the aging population. It is a key part of any central bank effort to cool an overheating economy without major disruptions. Because these structural changes cannot be made overnight, policy miscalculations, bad luck or unexpected external shocks could trigger economic setbacks that China's neighbours, and indeed the rest of the world, will not escape.[12]

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11 A related issue that will have profound implications is China's gender imbalance. It has a growing surplus of males because of the popular practice of determining the sex of fetuses in utero using ultrasound, and aborting females.

12 Environmental problems, power and water shortages are also risks that this analysis can only note in passing. Potential political instability is also a persistent concern.

Implications for the North American Economies

China's emergence creates both opportunities and risks for business and policy planning. This section focuses on the implications for the NAFTA economies, beginning with a summary analysis of the issues that Mexico and the United States face, followed by a suggested Canadian strategy. As will be evident, Canada's current position differs from the other two but there is no reason to be complacent.

Mexico and the United States

There are some striking similarities and some stark differences between the challenges the two southern NAFTA partners face in their economic relationships with China.

Though goods manufacturers in both countries must adjust to competition from Chinese exporters, Mexico faces the added challenge of China's relative attractiveness as a direct competitor for the kind of FDI that Mexican authorities have been counting on to help modernize their industry. Unfortunately, Mexico's record of adjustment to trade liberalization under NAFTA has been incomplete; weaknesses, particularly as they affect manufacturing productivity, are now magnified by Chinese competition.

That is not to say that Mexico has not gained from liberalized trade and FDI flows within NAFTA. Some analysts have measured growth trends in the past 10 years and concluded that NAFTA has helped Mexico close the development gap with its northern partners, through exports, which would have been 25 percent less without the accord, and FDI, which would have been 40 percent lower in its absence.[13] But a large measure of income inequality persists and these analysts attribute it to institutional features, such as corruption and lack of law enforcement, as well as to deficiencies in policies affecting education and innovation.

The significance of these deficiencies is that they constrain Mexico's ability to absorb the potential technological spillovers from FDI. Educated technicians and entrepreneurs could rectify the situation, but they are still scarce in Mexico. Significant reforms of the tax system and electric power regulation are needed to increase cost competitiveness (Lederman et al, 2003). Small business formation, an engine of new job creation, is overly constrained by red tape (Authers, 2004). There is wide recognition of the merit of structural change, but political leaders lack the clout needed to adopt the appropriate policies. In short, Mexico cannot use China as a convenient scapegoat for the long delays in structural adjustment which, if they were made, would raise the productivity of Mexican workers and move Mexican goods producers up the value-added chain and out of direct competition with Chinese-based exporters.

Mexico's dilemma can be seen in U.S. import shares. Mexico's share of U.S. imports in critical manufacturing industries is compared to those of China, Canada and Japan in Table 3. In the auto industry, for example, Mexico faces no Chinese competition (yet); its share of U.S. imports is smaller than Canada's or

13 Others, such as Pastor (2002), argue that the failure to fund the agreed North American Development Bank also accounts for lack of adjustment in Mexico.

Table 3: *U.S. Import Shares and Changes in Import Shares with Leading Trading Partners 1998-2002, Selected Manufactures (Percent)*

Total manufactures

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	21	44	76	0	26
Share of total in 2002	18	12	11	10	49

Motor vehicles

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	10	43	0	24	74
Share of total in 2002	31	16	0	27	26

Auto parts

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	21	43	174	61	39
Share of total in 2002	25	29	2	22	22

Television receivers and video monitors

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	160	22	923	399	133
Share of total in 2002	2	49	8	16	27

Measuring, testing, and controlling instruments

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	32	43	212	32	27
Share of total in 2002	10	24	8	19	44

Electric motors, generators, and related equipment

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	4	36	68	77	63
Share of total in 2002	7	29	8	19	37

Toys, dolls, games, sporting goods, and bicycles

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	0	40	36	-18	-12
Share of total in 2002	3	6	66	11	14

Footwear

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	-32	-20	28	0	-12
Share of total in 2002	0	8	67	0	31

Apparel

	Canada	Mexico	China	Japan	All other
Change 2002 over 1998	16	14	34	135	17
Share of total in 2002	3	12	15	0	70

Source: Watkins 2003.

Japan's, but has shown the fastest growth in the 1998-to-2002 period. In other vital industries, such as auto parts, consumer electronics and electric motors, Mexico has a robust market share compared to China; however, the growth rate of China's relatively small share is much faster. The Japanese share is much higher than China's and growth rates are also above those of Mexico. In footwear and apparel imports, Mexico is losing share to China directly.

As noted, China is a convenient scapegoat in U.S. debates about currency values and jobless growth. Executives of multinationals have sat quietly on the sidelines in the debate about outsourcing to China (and India) because they have already located their manufacturing operations abroad to enhance efficiency and competitiveness. What is less well understood is that much of the manufacturing capacity in electronics components and consumer electronics production relocated to China is moving from other East Asian economies, not from the United States.

At the same time, U.S. Treasury Secretary John Snow has called repeatedly for revaluation of the yuan, although Federal Reserve Board Chairman Alan Greenspan has been more measured and cautious in his public comments. In January 2004, the United States Trade Representative (USTR) employed a safeguard accord, which was part of China's WTO membership agreement, to re-impose quotas on knitted fabrics, brassieres and dressing gowns, arguing that imports were increasing too rapidly, creating market disruption.[14] Those who have to adjust to the emerging economic giant, mostly workers, are identifiable and vocal, while those who benefit from lower-cost products and more choice, as well as from China's comparative advantage in low-cost skilled labour, are unorganized (consumers), or quiet (producers).

Underlying the U.S. debate are two issues: One is about the burden of adjustment to foreign competition that is borne by U.S. workers when jobs are lost to foreign competition; the second is the macroeconomic adjustments that occur as the U.S. current account deficit improves to more sustainable levels.

There have been numerous economic analyses in recent years of the causes of job loss caused by cheap imports from developing countries. Many commentators say that the main cause of job loss is not import competition at all, but rapid technological change in developed economies. Some recent studies (Feenstra and Hanson, 2001; Morrison and Siegel, 2001) qualify that reasoning, showing that jobs are eliminated as a result of import competition in intermediate goods and in industries where a policy decision is made not to apply protectionist measures that would affect the price or quantities of goods imported.

The implication of these arguments is that adjustment assistance should be available to help people back into the job market. A number of innovations have been suggested to augment the traditional approach of helping workers upgrade their skills. One is to offer wage subsidies and assistance with health insurance costs for up to two years for displaced workers who find new fulltime jobs. Whether the new jobs pay lower wages — and many do — the purpose of a market-oriented subsidy of this kind is to help reduce the fear of economic change. While import competition is not a significant cause of job losses relative to the

14 Data indicated that domestic production had declined, but these data included outsourced production as well (www.emergingtextiles.com; accessed March 2004).

other reasons attributable to economic adjustments, the difference is that where explicit policy decisions — not to employ trade protection measures — are associated with job loss, there is an argument for compensation of the losers (Kletzer and Litan, 2001).

The second issue is sharing the burden of adjustment for improving the U.S. current account deficit. A debate exists about the sustainable size of the deficit. Amid growing evidence that U.S. productivity is increasing as IT innovations diffuse into the economy as a whole, larger current account and budget deficits may be more sustainable than they would have been a decade ago.[15] However, it is also possible that productivity growth could slow, in which case the favorable patterns that policymakers currently rely on will unravel. Either way, prudent policy should be based on the assumption that the current account deficit must move toward greater balance.

One channel of adjustment is U.S. dollar depreciation, which has already begun fitfully. However, U.S. trading partners do not share the burden of the decline equally. The euro, and the Australian and Canadian dollars float freely. Those currencies have appreciated, raising the relative cost of exports. The Chinese yuan, as discussed, is pegged to the dollar and backed by capital controls; the Japanese yen and most other East Asian currencies are managed in ways that slow or even prevent appreciation against the U.S. currency. These currencies have benefited from the effective depreciation in the price of their exports to third countries. This is a tense issue for Europeans; Canadian dollar appreciation ranks well down the list of currencies as Figure 1 illustrates. The issue for Canadian exporters has been the speed of the Canadian dollar's rise.

Even so, it is unlikely that Chinese imports have displaced Canadian products in the U.S. market, largely because U.S. imports from China are labour-intensive consumer goods, such as toys, textiles and apparel, footwear, consumer electronics and office equipment and machinery. By contrast, U.S. imports from Canada are mainly automotive products and natural resources. The burden of adjustment in imports falls on China's direct competitors, such as Mexico, where the currency has depreciated, as shown in Figure 1, and East Asian countries.

Despite widely publicized tensions over trade — and, intermittently, the Taiwan Strait — Chinese and U.S. relations are relatively good and their officials are engaging in increasingly productive high-level consultations on strategic issues. They are cooperating on security, particularly with respect to issues in third countries, such as North Korea. They are also cooperating on economic issues, with Chinese authorities giving assurances of their intentions to increase imports and adjust the exchange rate regime in order to create a win-win relationship in the long term. And they are beefing up non-governmental exchanges for students, as well as business people.

Implications for Canada

What is Canada's place in this dynamic picture? China is now Canada's third largest trading partner after the United States and Japan. Two-way trade with

15 See Baily (2002); Mann (2003).

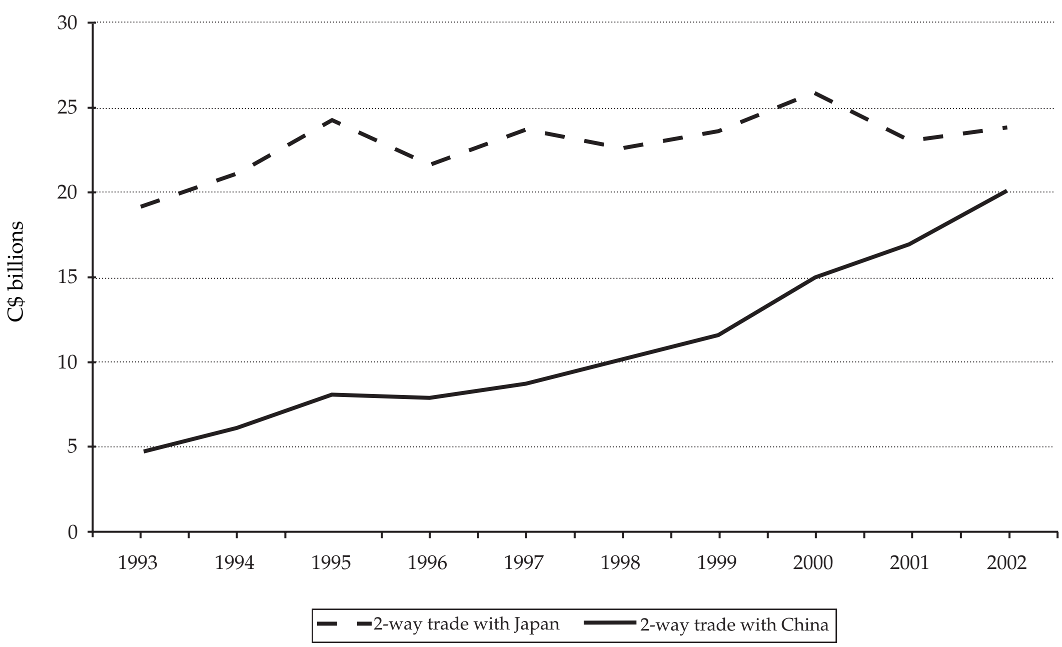
Japan is at a higher level, but it is stagnating, while trade with China is rapidly closing the gap (Figure 2).

Canadian consumers are major beneficiaries of these trends, enjoying greater price advantages and wider choices of toys, textiles, apparel, and standard-technology consumer electronics, auto parts and other goods than would otherwise be the case. But the picture for Canadian producers is mixed. As Figure 3 shows, exports to China as a share of Canada's total exports have been stagnant. This trend is also evident in Figure 4, which shows a declining market share of Canadian exports since 1999.

Canada's commodity exports have been the main bright spot. In the future, China looks set to become one of the world's dominant commodity importers and will greatly influence many raw materials prices. While China has substantial reserves of coal, lead, silver, antimony, and phosphate, recent figures put Chinese demand for aluminum, copper, crude steel, zinc and nickel at, or above, U.S. levels (Hale 2004), pointing to future opportunities for Canadian commodity producers.

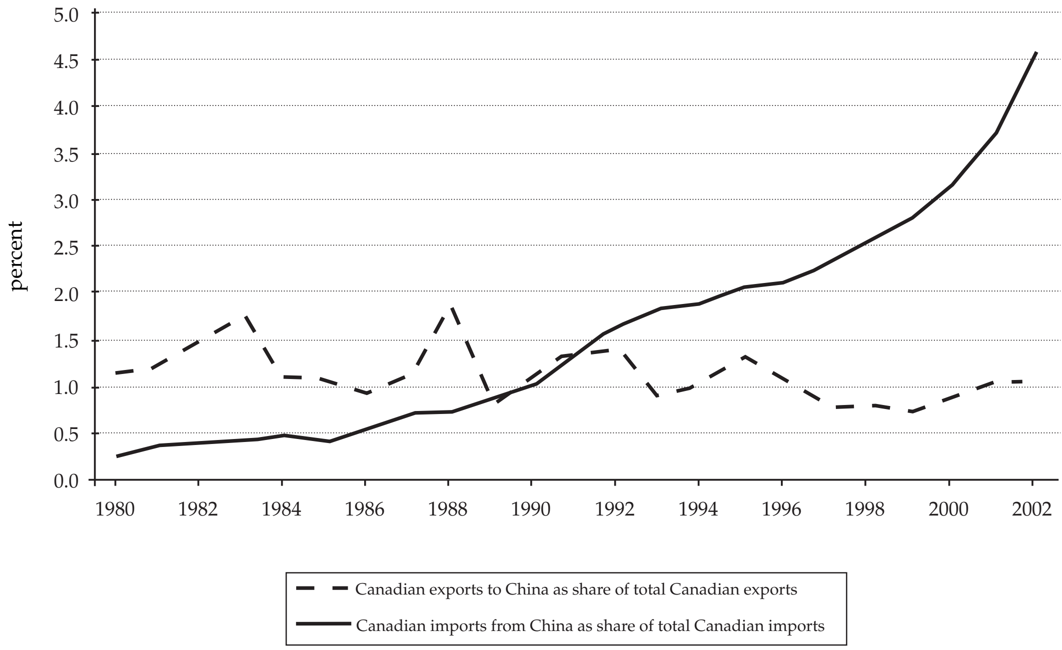
However, as an aspiring high-value-added economy, it is in Canada's economic interest to diversify the composition of its exports beyond commodities to higher-end goods and services. China's Canadian imports have included transportation equipment, including planes and rail cars, as well as telecommunications

Figure 2: *Canada's Two-Way Trade with China and Japan, 1993-2002*



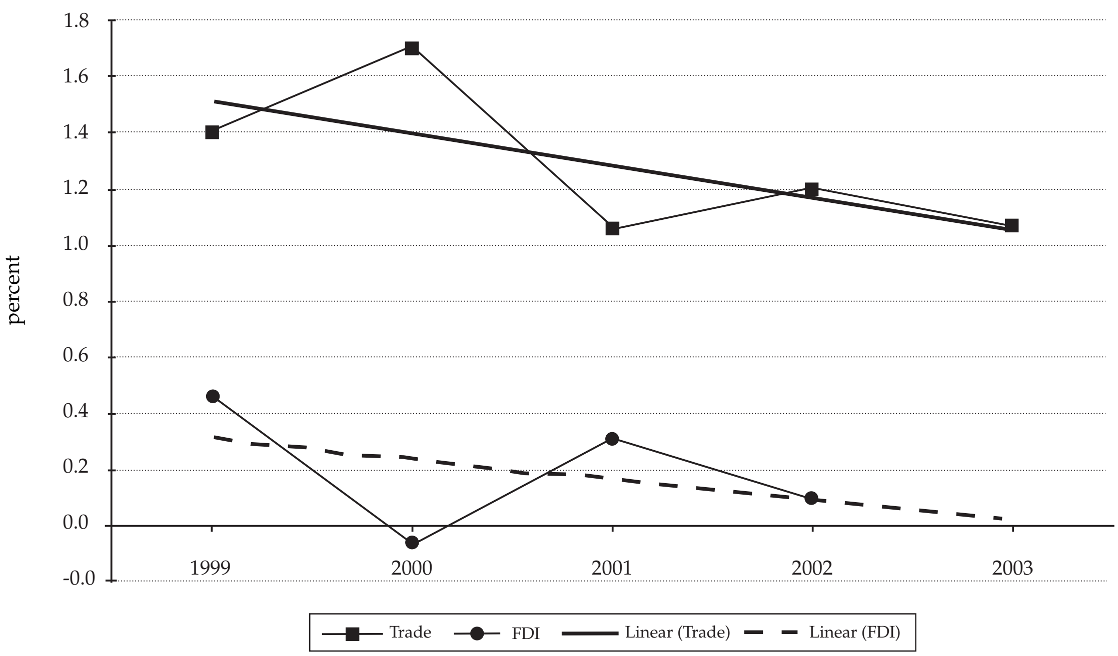
Source: Trade data online. Strategic.ic.gc.ca (April 2004).

Figure 3: *Canada's Merchandise Trade with China as a Share of Total Canadian Trade, 1980-2002*



Source: Trade data online. Strategic.ic.gc.ca (April 2004).

Figure 4: *Canada's Market Share of World Exports and Investment Flows to China, 1999-2003*



Source: Export Development Canada, 2004

Table 4: *Canada's Merchandise Trade with China, 1992 and 2003*

A. Canadian imports from China (% share of world imports)

Imports	**1992**	**2003**
Toys	10.2	9.2
Small electrical appliances	6.1	5.3
Audio visual equipment	3.5	5.8
Leather goods	5.8	1.9
Footwear	6.4	4.5
Apparel	24.5	11.3
Machinery	3.2	5.9
Telecommunications equipment	5.2	21.2
Other misc. manufactures	4.4	3.4

B. Canadian exports to China (% share of world exports)

Exports	**1992**	**2003**
Oilseeds	0.0	1.8
Oil and ores	5.0	10.3
Animals and seafood products	0.0	7.2
Forest products	7.0	18.5
Chemicals	6.9	18.6
Non-ferrous metals	0.6	2.1
Plastics	0.0	1.4
Telecommunications equipment	4.2	7.2
Motor vehicle and aerospace parts	7.5	10.5

Source: Asia Pacific Foundation of Canada trade statistics.

equipment. But as Table 4 shows, there is a long way to go before merchandise exports reach the level of commodities in Canada's exports.

The data in this regard are incomplete, however, because they exclude services trade and the impact of Canadian FDI in China as expressed by local sales of Chinese affiliates. In 1994, for example, Nortel Networks, which located in China in the 1980s, held nearly 10 percent of China's digital switching market (Falkenheim 1995). Nortel is also a major technology supplier to China Mobile for the expansion and upgrading of its digital cellular networks in several provinces and major cities. Nortel has wireless networks in 17 of China's 31 provinces.

The overall pattern of FDI (Figure 4) is not particularly encouraging; Canada's share of China's total annual inflows has been declining in recent years.

This trend might be explained in part by the lumpiness of some investments, though more likely reasons are the distance and lack of familiarity with the Chinese market (Head and Ries 1995; Falkenheim 1995). Recently published accounts of foreign investors' experiences underline the risks of partnering with relatively unknown business entities, whether private or state-owned (Clissold 2004), as well as the rigidities implied for business decision making by the need to cultivate and maintain political relationships with state officials (Gilboy 2004).

In short, Canadian consumers and producers are increasingly involved in China's booming trade and investment activities; however, neither the magnitude nor composition of Canadian participation is consistent with Canada's economic strengths.

At the beginning of this paper, I raised the issues of whether Canadian manufacturing exporters might gradually be pushed out of the U.S. market, as well as the starker prospect that China may supplant Canada as the largest trading partner of the United States.

Turning to the immediate issues first, as the U.S. dollar depreciates, and East Asian currencies along with it, Canadian exporters lose out in pricing competition in those markets. Since direct Canadian exports to East Asia are relatively small (some difficult-to-measure share of Canadian production undoubtedly competes in East Asian markets through intra-company channels of multinationals, such as E.I. Dupont, IBM and Pratt & Whitney, which have Canadian affiliates) and exports to the United States are relatively large, the main impact of U.S. dollar depreciation is felt by Canadian companies exporting to the United States.

U.S. imports from Canada are dominated by forest products, energy — Canada is the main energy supplier to the U.S. market — agricultural products, autos and auto parts and machinery and equipment. Much of this trade is also intra-company, with production managed on both sides of the major exchange rate. Companies also manage currency volatility through hedging and netting techniques.

For now, Canada is little affected by import competition with Chinese exporters in the U.S. market because China does not compete in natural resources or autos or machinery and equipment. At least, not yet. Autos and machinery and equipment tend to be produced in the markets in which they are sold because of transportation and coordination costs incurred in long distance trade. Comparisons in Table 3, however, indicate that the auto parts trade will not be immune from Chinese import competition. The patterns also show that China's rise could inevitably increase the pressure of a shakeout in the North American auto industry, an issue to which I return.

Direct competition in the Canadian market is the largest immediate economic threat from China. It is a challenge that Canada must meet with innovations that are akin to those adopted by the United States: apply more advanced technology to the production of goods and develop a highly skilled labor force. The basic principle should be to use Canadian expertise to complement, rather than compete with, China's comparative advantage in low-cost skilled labor. I return to this and other strategic issues in the next section.

Developing a Long-Term Strategy

Canada has a relatively well-established relationship with China, having recognized the Communist regime in 1970, while U.S. policy was still mired in cold-war rigidity. This first-mover advantage still exists. The symbolism has not (yet) been forgotten by the Chinese leadership; nor have memories entirely faded of Dr. Norman Bethune, the Canadian hero of the 1949 Communist revolution. Canadian foreign policy accords some special status to China and some major business links are based on longstanding personal relationships forged between Chinese leaders and executives of such companies as Power Corp. and Nortel. More recently, large numbers of Chinese immigrants in Canada have provided a base on which to erect future trade and investment relationships (Head and Ries 2002). Canadian policy can build on these advantages.

Still, Canada's external interests will always focus primarily on the United States, and a priority is renewing and enhancing that relationship. There is also an urgent need for Canada to solidify and deepen its position as a North American economic partner. Bolting the Canadian economy onto the North American economy can be consistent with developing closer relations with China. In a decade or two, the strength of both the Chinese and Indian economies may begin to overshadow the U.S. As a result, it is essential that Canada diversify its relationships, primarily with Asia as a region, and with India and China as its economic powerhouses.

Ottawa is late in moving in this direction — and is in danger of missing a potentially great opportunity in China. There are at least three dimensions to such a Canadian strategy with China: building a closer trade and investment relationship; working towards more inclusive multilateral forums, such as the G-20, that include the large emerging economies, and developing contingency plans for China risk.

A Closer Economic Relationship

The closer economic relationship has two dimensions. The first is bringing Canadian expertise to bear on solving some of China's most pressing structural problems. This could be done through public and private sector partnerships. The second is the overall policy framework that makes such partnerships possible.

Partnerships To Address China's Structural Challenges.

Earlier discussion in this paper highlights a number of China's structural priorities. The first is to fix its weak financial system. Much work has been done already to create the necessary policy frameworks for banking and capital market institutions. The over-riding challenge now is to increase the skill levels in credit allocation, risk management and supervisory oversight. These are challenges that China must meet on its own. But there is still a role there and in three other areas:

The immature financial system. The major challenge that China faces is to change incentive structures. A few major Canadian financial entities, such as Manulife Financial Corp., are active and successful in their Chinese businesses, and foreign entrants can be a useful source of technology transfer and skill training that subsequently diffuses into the domestic industry. Canadian regulatory institutions and the Toronto Leadership Centre should also be offering more training and technical advisory programs.

The weak health care system. China's health care system is a major concern as its population ages rapidly and the country faces a dearth of adequate services. Here too, Canada's health care system and health care funding, for all their flaws and inadequacies, have lessons to teach. Some Canadian private sector initiatives in China already exist. Canada should make it a priority to share know-how on funding, service delivery and system oversight to help meet China's challenges.

Trade strategy. China has embarked on a series of bilateral and multilateral trade initiatives with its Asian neighbours to assure them that as China rises, their economies will expand, too. Unfortunately, almost no attention has yet been paid to the downside of creating unwieldy and costly hub-and-spoke arrangements in the region, each with differing and burdensome rules of origin that businesses must satisfy to take advantage of liberalized market access. Canada has acquired extensive experience with the design of trading and investment arrangements over the past two decades and could share this expertise with the Chinese.

Rural development and human security. One of the most awesome challenges China faces is the prospect of managing the movement of as many as 300 million people into towns and cities by 2020. Kynge (2004) calls this the "biggest movement of rural people to the cities that the world has ever witnessed". Where will people find jobs, housing and other infrastructure? One of the answers lies in commercialization of the rural sector in ways that serve growing domestic demand. Canadians have skills and experience with commercialization and distribution of agricultural commodities. By some reports, the Chinese government has closed down or cut the funding of numerous agricultural research stations because of lack of knowledge of how to make their operations commercially viable. The rural sector is ripe for outside collaboration to introduce modern technologies (see, for example, Charoen Pokphand's activities in this area at www.cpthailand.com in Chinese).

How Canada Can Modernize its China Policy Framework

Canada should update the overall trade and investment framework with China from one that is mercantilist, stressing export promotion and seeking inward FDI, to one that has FDI in China as its cornerstone. While FDI is ultimately a business decision, it is deeply influenced by knowledge of and familiarity with the host economy. As Gilboy (2004) and others point out, Chinese political leaders and governmental institutions play major roles in enterprises that affect innovation, trade and FDI decisions. This situation underlines the validity of advice that China experts Jefferson and Rawski (1996) gave to foreign companies: "Do not expect quick success…prepare for fierce competition…appreciate China's economic dynamism [and expect rapid change]…do not underestimate costs…remember that market economy practices and beliefs remain fragile…[and] maintain a broad, informed perspective on the economy".

A regular high-level government-to-government presence in China is essential. Highly knowledgeable consular and trade\FDI facilitator services are also needed on the ground in the major cities.

Beyond these practical imperatives, the assumptions underlying Canadian trade and industrial policies have to be addressed. In the global supply chains in which more and more world trade takes place, seeking market access for Canadian exporters in foreign markets and attracting foreign investors to Canada is outdated. Trade and FDI are now closely linked. In this context, Canadian companies should be investing abroad for several reasons: to secure an advantage for their own global production chains; to be represented in someone else's supply chain; to secure a market position for exports of goods and services, or to access knowledge and technology that is not available in the home market. Perhaps Canadian policy is moving in this direction, but available statistics provide little assurance that this is the case. Presumably, MNE affiliates in Canada supply the Chinese market through the operations of their parent companies.

Global supply chain analysis illustrates that Canadian producers should be thinking about how best to serve the Chinese market, not only in China or from North America, but also from other points in East Asia. For example, as Hodgson and Worrall (2003) have noted, the Korean economy is rapidly restructuring to become a design center in the region. Korean economic policy also aims to make some of its ports adjacent to the China Sea transportation hubs for Northeast Asia. Canadian producers that are active in those markets can use these relationships to advantage in the Chinese market.

Another dimension of the overall framework is trade and investment facilitation. This might sensibly involve sectoral mutual recognition agreements (MRAs) between Canada and China, or among Asia Pacific Economic Cooperation (APEC) members. A first step could be to reduce technical and regulatory obstacles to cross-border private sector activities in health, finance, environmental services and communications. MRAs could be negotiated to stimulate trade and investment. MRAs are generally consistent with WTO rules, although some principles specific to each sector have to be followed to ensure consistency.

MRAs focus on technical regulations that may impede trade and product certification. Partners can agree to mutual acceptance of conformity results, or they can comply with relevant guides or recommendations issued by international standardizing bodies. An APEC MRA in telecommunications that has existed since 1998 might be a stepping stone in that sector. Trade barriers in health and medical services arise mainly from regulatory structures targeted by governments at service providers. Yet within the WTO, members are making commitments on cross-border supply of services, consumption abroad and commercial presence. Joint business organizations in both countries could organize ad hoc groups in the services areas to lay the groundwork for inter-governmental negotiations.

I have not suggested that Canada and China consider negotiating a bilateral FTA to improve market access, as some observers have advocated from time to time. There are several reasons for not doing so. For one thing, China's WTO commitments already constitute a major step toward dismantling its high trade barriers and these have yet to be fully phased in; substantial market access gains are still available. For another, bilateral improvements in market access are beneficial when they promise the mutual economic benefits that flow from intra-industry trade and specialization. Currently, and probably for some time to come, Canada-China intra-industry trade indexes would seem to be very small and the gains marginal relative to the negotiating effort required.

Thirdly, trade and FDI tend to flow by gravity; that is, ties tend to be denser with close neighbors than with distant entities. So there is less trade to facilitate with such an arrangement. Fourth, though it can be argued that China's trade with its southeast Asian neighbors is also complementary, there are compelling historical and strategic reasons for deeper economic ties there, as discussed in the following section. Canada's historical ties with China do not overcome the relatively weak economic rationale for pursuing an FTA.

Still, Canadian officials should give more weight to the importance of the large Chinese diaspora, a substantial part of which now resides in Canada. Head and Ries (1997) examine the evidence that immigrants are catalysts for trade. Much of this activity takes place with no fanfare. On average, they find that an immigrant generates C$8,000 of additional imports and C$3,000 of exports because they posses the information and contacts to promote international transactions. More imagination is needed to encourage these linkages. For its part, the Chinese government has learned from the NAFTA business-visa program and is initiating a green card to make it easier for ethnic Chinese residents abroad to operate in their native country, as well as in their current locations.

Multilateral initiatives

China and its East Asian neighbours directly influence issues affecting world economic prospects. These matters should be addressed in multilateral forums. Canada should promote China's participation in existing world economic management and crisis-management groups. The G-7 is the best forum, although perhaps no longer deservedly so. Chinese economic leaders were included in the G-7 finance forum at Doha in September 2003, though China is not a regular member. Reports following the Washington meeting in April 2003 indicate that the U.S. is coming around to this way of thinking.[16]

Government leaders must address two particular dangers immediately. The first is the rising pressure for protectionism caused by currency movements and the consequences for trade. As I have argued, the danger with respect to China is not its allegedly undervalued currency; it is the willingness of politicians to use this contention as a pretext for protectionist measures. The overriding concern is that rising trade frictions will become trans-Pacific, adding to already strained trans-Atlantic relations. Canadian trade officials should follow through on their soothing sounds about the future of the WTO, by pressing the developed world to address the concerns of developing nations about market access for their agricultural exports and to simplify the overall trade liberalization agenda.

A second strategic issue arises from East Asian leaders' efforts to deepen integration among their economies through a plethora of sub-regional trade and financial agreements. China's initiatives are the main catalyst. Its proposed negotiations with ASEAN over a 10-year period prompted both Japan and India to follow suit with their own proposals. Japanese, South Korean and Chinese leaders have also agreed to liberalization talks in Northeast Asia. These discussions would not have been possible even a year earlier; they are driven by two factors: strategic competition between China and Japan for a leadership position in the region and the growing conviction that sub-regional negotiations may produce more and faster progress on reducing trade barriers than will be possible in the Doha Round at the WTO.

Some analysts argue that East Asian initiatives could be the strategic threat that drives the United States and Europe back to the WTO for a genuine negotia-

16 See "Washington in Call for Closer G7 Links With China" in Balls and Crooks (2004).

tion. More likely, however, because of the prospect of a series of hub and spoke arrangements around Japan and China, is the development of an unintentionally confusing and costly "spaghetti bowl" — trade economist Jagdish Bhagwati's colourful term for the growing list of differentiated rules of origin facing businesses organizing trade and investment in these economies from such outside countries as the United States, the European Union, Australia, New Zealand and Canada. When these differences create new barriers to trade by raising transaction costs, means will have to be found to reduce them — unless the spaghetti bowl stays empty.

The G-20 is the best multilateral economic forum to address these issues.[17] That forum is currently confined to finance ministers and central bank governors, where representatives of the largest, and potentially largest, economies in the world, from both North and South, meet to manage issues arising from shifting comparative advantage and from external financial imbalances. This is an arena where China's monetary policy framework and fixed exchange rate regime can be discussed in a measured way — with buffer countries that can moderate bilateral disputes and prevent them from becoming acrimonious.

It is also a place in which the consequences of sub-regional trade agreements in all parts of the world could be studied. Prime Minister Paul Martin recently called for it to be elevated to leaders' level to deal with a much wider range of global issues.[18] Canadian exporters, who bear a disproportionate share of the burden of adjustment to U.S. dollar depreciation, should have an interest in seeing Canadian leaders and officials use such channels to help manage China's interaction with the rest of the world in a sustainable, rather than disruptive, fashion.

Canadian leaders should also make better use of APEC. Although APEC has fallen into some disrepair in recent years, it is where Chinese and North American leaders will continue to meet regularly at the highest levels. As such, it is quite possible that APEC will regain some of its early promise as a trans-Pacific forum in the years ahead. Canadian policymakers can nurture this development by upgrading APEC to higher-level participation.

Non-official agencies that span the Pacific — called track-two forums in the political and security worlds — should also receive more priority in Canadian policy. Ottawa should be prepared to be a serious host and facilitator of initiatives to deepen trans-Pacific economic understanding and cooperation. For example, Canada was host to the APEC leaders' summit in 1997; however, since then it has undertaken no major Asia-Pacific initiatives. Resources for track-two forums that build knowledge and ties among people and institutions, especially in economic relations, are modest.

Contingency Planning for the China Risk

I have described some of the main risks in China's deeper integration. In the short term, Canadian businesses should assess whether their preferred investments

17 See Dobson (2001). The group should not be confused with an ad hoc coalition of trading nations in the WTO.

18 See "Speech by the Prime Minister", April 29, 2004, at www.pm.gc.ca.

might add to the growing excess industrial capacity in China. Will these investments have a unique competitive advantage that will survive the inevitable downturn in economic activity as Chinese growth slows to a more sustainable rate? Other policies should include hedging strategies — selecting global supply chains that locate in neighbouring East Asian economies, as well as in China. In the event of a disruption in China, sales and production could then be switched to other locations in the region.

Public policymakers should also hedge with a regional strategy. One approach could include the major East Asian economies, as well as Australia and New Zealand; another would be to allocate financial and ministerial resources to the revival of APEC as a serious forum for cooperation. Canada's business associations should also consider consolidating into a regional association rather than spreading necessarily thin resources across many small bilateral groups.

Another risk lies closer to home. While some observers contend that autos are unlikely to be exported from China anytime soon, the speed with which other industrial strategies have changed raises questions about the wisdom of location incentives by state and provincial governments in North America, most recently in Ontario. It is possible that these inducements will simply exacerbate the cost and disruption of an inevitable North American industry shakeout. There is little evidence that policymakers have given this structural issue adequate attention.

China as the Top U.S. Trading Partner?

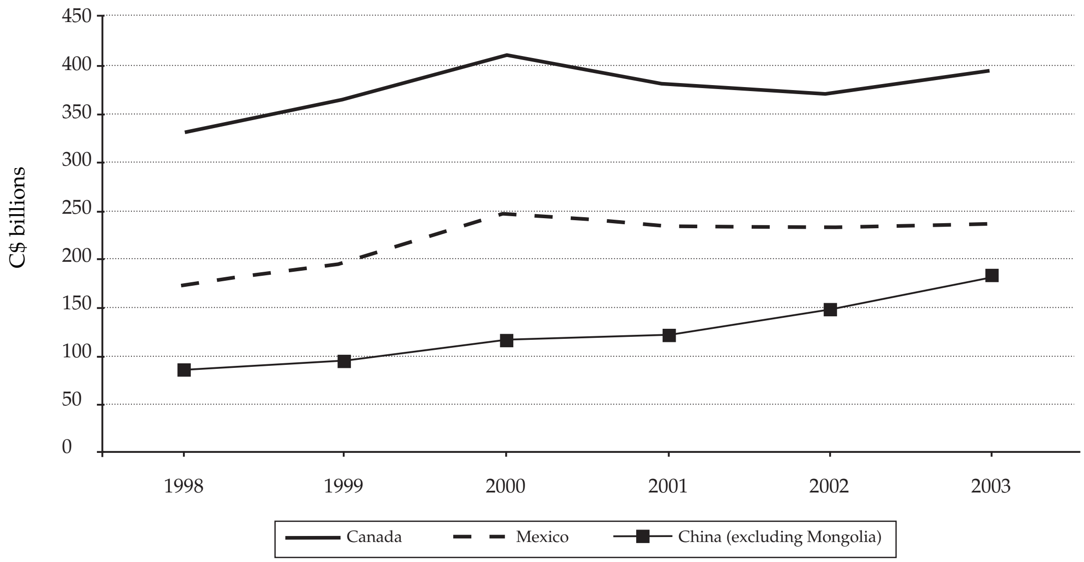
Yet another risk lies in the implications of the emergence of China for Canada's U.S. strategy. As Figure 5 shows, Canada is still the top trading partner, with China closing in on Mexico. Figure 6, however, shows the far faster rates at which China-U.S. trade is growing. Canadian leaders are still not anticipating the eventual displacement implied by Figure 6, though they should be acting now to develop a strategy that makes Canada a more attractive partner, rather than just a major supplier of natural resources. A more advanced economic and security relationship as proposed in Dobson (2002) is increasingly required, as are domestic reforms along the lines proposed by Mintz (2001) to encourage Canadian businesses to capitalize on the advantages of being a North American base in the world.

Conclusion

This *Commentary* began with the metaphor of China as locomotive and potential train wreck. As I have illustrated, the truth probably lies somewhere in between. China's unsustainable growth rate is now slowing. China's economic success does not depend on an undervalued currency, but rather on low-cost skilled labour, increasingly modern infrastructure and institutions, and on the commitment by its leadership to the reforms necessary to modernize and integrate into the world economy.

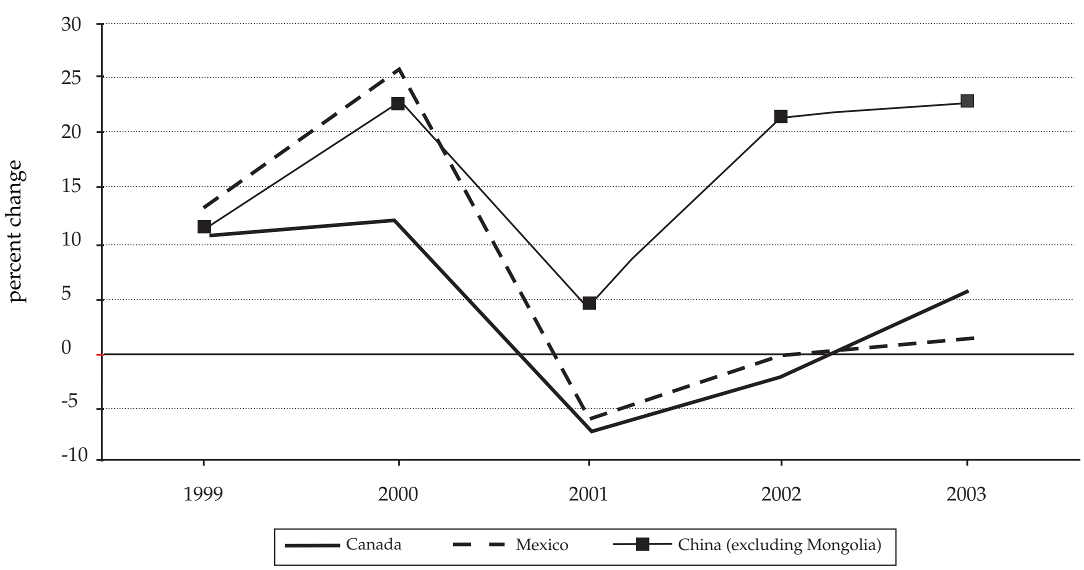
China's success matters to Canadians because the natural resource and agricultural commodities that have long dominated our bilateral trade will not sustain our own standard of living. Nor will the wider choices and lower prices provided to Canadian consumers by Chinese imports.

Figure 5: *Two-way U.S. Trade with Canada, Mexico and China, 1998-2003*



Source: Trade data online. Strategis.ic.gc.ca (April 2004).

Figure 6: *Two-way U.S. Trade Growth Rates With Canada, Mexico and China, 1999-2003*



Source: Trade data online. Strategis.ic.gc.ca (April 2004).

Inevitably, our services producers and manufacturers will face increasingly intense and direct import competition from China. Comparative advantage in most standard-technology, labour-intensive production of goods has shifted to China. Canadian producers should also be investing in China to reduce costs by accessing East Asian components and Chinese labour. They should increase the sophistication of their North America-based products using the knowledge and skills that are found more intensively at home. Producers and investors of higher-value-added goods and services that do not compete directly with China's labour-intensive offerings should identify market niches or participate in global production chains in order to market there.

The policy framework should be a supportive one, geared to the needs of Canada's small and medium-sized enterprises, but also designed to encourage rationalization and adjustment of Canadian production. Seeking protection will only delay the inevitable pain of adjustment. As well, consideration should be given to measures that ease the burden of adjustment and help to allay the fear of change by individual workers. But public assistance to North American auto producers looks ill advised. If such assistance maintains non-competitive capacity instead of assisting with the inevitable rationalization necessary to move out of direct competition with future Chinese exports, we are creating the conditions for greater pain in the future.

China's increasing interdependence with other economies creates systemic risks. At the same time, China's stake in the international system increases as its modernization and industrialization strengthen the cross-border flows of trade, FDI, technology and people. Such interdependence implies that it is not in China's interest to be a global economic or security threat. Tension and conflict will amount to the protagonists shooting themselves in their economic feet. Instead, China's policymakers should be included in the official groups that manage economic relationships among countries and address crises. Canada's prime minister has already grasped this fact and supplied some of the political momentum to make that happen. Canadian policies should build on that foresight with an equally farsighted strategic framework for the overall bilateral relationship.

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