Introduction

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RISE OF CHINA

This volume consists of chapters that were originally submitted as papers to the KDI conference, Growth and Structural Changes of the Korean Economy after the Crisis: Coping with the Rise of China, 21–22 July 2008. After the conference the chapters were revised in light of comments by discussants and other participants in the conference, as well as the editors. A common theme is the rise of the Chinese economy and its impact on Asia, in particular Korea. After a sharp downturn in 1998, the Asian economies have recovered. The V-shaped recovery and continuing growth in East Asia are impressive. Among others, China’s performance, with its apparent acceleration of growth, stands out. The chapter by Quah, (Chapter 1) describes the growth process of Asia, in particular China, and how that was made possible. He emphasizes the roles of high human capital investment, in particular education.

In order to sustain growth, however, a country needs to maintain productive dynamism and improve its resiliency to shocks in response to changes in the economic environment. In this regard, the rise of China and its integration into the world economy is probably one of the most important changes in the world economy for the past several decades. Since the economic reform in the late 1970s, the Chinese economy has made tremendous advances in economic growth, driven by the expansion of a modern, export-oriented industrial sector. The growth rate has been around 10 percent since 1991. At this rate of growth, the size of the economy doubles every seven years, just as Japan’s did in the 1960s and 1970s. The chapter by Wong (Chapter 3) compares the Chinese economic development to earlier episodes in Japan, Korea and other Asian economies.

China’s rise has been accompanied by another important development in the world economy: fragmentation of production. For the past several decades, the fragmentation of production, driven by the technical progress which allows more finely divided production processes to find their best location worldwide, has allowed the formation of so-called regional
The rise of China and structural changes in Korea and Asia

production networks. This phenomenon is most pronounced in East Asian region, with China providing the preferred production location for many production stages of many manufacturing goods.

The impact of the Chinese economic developments was felt all over the world. Foremost, the rapid growth of China, or the improvement of the standard of living of more than 1.3 billion people, reversed the trend in world income distribution which had been worsening for about 200 years since the industrial revolution. Meanwhile, a sharp rise in exports, especially after 2001, to the United States and Europe raised concerns in these countries, not only because of claimed displacement of jobs but also because of a sense of unfairness relating to the near fixed exchange rate to the US dollar. The global imbalances – large Chinese current account surpluses and large US current account deficits, among others – have provoked a debate in the G7 and the Internal Monetary Fund (IMF) since 2003.

The rise of China also affected the Asian economies in a complex way. Its rapid growth meant that most Asian economies enjoyed a sharp increase of exports to China. For Korea and Japan, China became the number one destination of their exports. China became an engine of growth by absorbing more goods and accepting foreign direct investment (FDI). Chapter 2 by Zhang emphasizes this positive role of China. Nevertheless, the rise of China is also perceived as a threat, particularly to middle-income countries (for example, Lall and Albaladejo 2004; Gill and Kharas 2007). The huge increase in exports from China depressed prices of labor-intensive manufactured goods. This decline in manufacturing prices does not mean that labor-intensive growth strategies are impossible. It does, however, imply that they are more difficult to start and less effective in elevating incomes than they were in the past (World Bank 2008). Whether the rise of China benefits or hurts, on balance, other middle-income countries seems to be an empirical question.

China’s rise has had a particularly large effect on the growth and structural transformation of the Korean economy through various channels. Above all, the rapid growth of the Chinese economy has provided a large export market for Korea. Between 1990 and 2007, China’s share of Korea’s exports rose from 0.9 percent to 22.7 percent. Major beneficiaries were capital- or skill-intensive industries, such as steel, machinery, electronics and transport equipment. Also, the large supply of unskilled labor in China, together with the formation of the regional production network, provided geographically close Korean firms with the opportunity of low-cost production and outsourcing. As of 2003, China is the number one destination of Korea’s outward foreign direct investment, with about two-thirds of outward FDI in the manufacturing sector going to China. At the same time, however, the intensifying competition with China in both the
domestic and the foreign market had the effect of speeding up the decline in labor-intensive manufacturing industries. Overall, for the past several decades, the rise of China has facilitated the structural transformation of the Korean economy from labor-intensive to skill- and capital-intensive industries; the value-added share of light industries in Korean manufacturing has rapidly declined from 56.3 percent in 1980 to 32.6 percent in 2002. Also, China’s rise, together with its skill-biased technical progress, is likely to have contributed to the unprecedentedly rapid decline in employment share of manufacturing in Korea since the early 1990s.

Thus, the rise of China has presented Korea not only with opportunities but also with several challenges for sustained catch-up growth. For example, the rapid pace of structural transformation requires a huge amount of labor and capital to be reallocated both across and within industries in a relatively short period of time. This process should have involved non-trivial adjustment costs. Also, Korea needs to maintain factor endowment conditions that are distinct from those of China in order to benefit from China’s rise. This requires, for example, upgrading the quality of human capital and enhancing innovation capabilities. How did Korea respond to these challenges? Several chapters in this volume try to provide at least a partial answer to this question by assessing the impact of China on Korea, and evaluating Korea’s growth performance in an era of China’s rise.

THE ASIAN CRISIS TO THE SUBPRIME CRISIS

The Asian crisis of 1997–98 was an epoch in the region that made countries aware of the importance of economic integration and cooperation. The Association of South East Asian Nations (ASEAN) Plus Three framework has been firmly established and many regional meetings have taken place regularly to discuss wide-ranging issues: the Chiang Mai Initiative – the bilateral swap network; the Asian Bond Market Initiative – a cooperative arrangement to build bond market infrastructures to issue and trade Asian currency denominated bonds; and the Asian Bond Fund, I and II – central banks’ efforts to invest in Asian bonds and to create listed markets for Asian bonds.

About ten years after the Asian crisis, the subprime crisis erupted in the United States. Many investment banks in the US and Europe suffered huge losses in having created, traded and dealt with securitized mortgage loans and asset-backed securities in general. Asian financial institutions, including sovereign wealth funds, are now agreeing to capital increases of these institutions. After the Asian financial crisis, the Western institutions
The rise of China and structural changes in Korea and Asia were buying up near-bankrupt financial institutions all over East Asia. The tables turn occasionally in the financial world. We have just witnessed another example.

In 2007, the crisis started in the housing sector in the US and by mid-2008 the impacts of the credit crunch and difficulties among financial institutions were evident all over the world. In the initial stage of the global financial crisis, the economies in Asia, including Japan, remained largely unaffected, since the Asian financial institutions had not invested in the US housing-related securities. However, as US investors and financial institutions sold off assets in Asia as well as in other emerging markets in order to repatriate gains back home, the Asian markets became affected, especially after Lehman Brothers failed in mid-September 2008. In the fourth quarter of 2008 (at the time of writing), the US economy is slowing down substantially, and it will bring down the rest of the world too. It remains to be seen whether the Asian economies remain strong, keeping their growth rates high, with China and India being the new twin engines of growth in the region. The ultimate test of the so-called decoupling theory will come in the next few years.

Some observers believed that the Asian crisis of 1997–98 had been predicted by Alwyn Young (1995, 2003) and Paul Krugman (1994), as they asserted that Asian growth was only possible due to high inputs of capital and labor, and sooner or later would hit the wall of supply constraint. There was a debate whether estimates by Alwyn Young were robust. Challenges came from Hsieh (2002) and Jorgenson and Vu (2005) asserting that growth was due to productivity increases. Some of their evidence, especially for Singapore, seem to contradict the Young hypothesis.

The controversy over the source of growth is summarized by Quah (Chapter 1 in this volume). The sources of growth of the Korean economy are carefully explored by Hahn and Shin (Chapter 4 in this volume). According to them, total factor productivity (TFP) growth of Korea in the post-crisis period was estimated to be higher than in the pre-crisis period in the 1990s – lending support to the view that pre-crisis growth was mostly labor and capital input growth for Korea. An interesting question is whether Chinese economic growth produces evidence one way or the other.

**KEY QUESTIONS**

So far, China’s economy seems to be invincible, and it looks almost certain by extrapolation that, at least in terms of the size of gross domestic product (GDP), China will overtake Japan in ten to 15 years, and the US
Introduction

5

economy in 20 to 30 years. So far, China has recorded current account deficits against East Asian countries, while it has recorded much larger current account surpluses against the US and Europe. From the mercantilist viewpoint, the rise of China is a blessing for Asian countries, while it may be a threat to the US and Europe. However, there are some doubts as to whether the trading pattern and growth trend will continue in the next few decades just like it did in the past few decades.

Quah’s chapter in this volume (Chapter 1) puts China and East Asian countries into a historical pattern of growth in the world economy. Wong (Chapter 3 in this volume) reviews the long history of political economy in China. These chapters give a good basis for understanding the past and predicting the future.

The following questions, regarding the impacts of Chinese growth upon Asian neighbors, have been frequently asked among policy-makers and researchers, and are repeated in several chapters in this volume. The first set of questions concern the pace of economic growth and its sustainability. Will China continue to grow at its current pace? There are several dark clouds on the horizon. First, the resource constraint: China may soon face ever-increasing resource costs, along with other countries, and may have to slow down to install energy-saving technology. Second, a failure of macro policy management: Chinese Consumer Price Index (CPI) inflation and the property price bubble may throw the macro-economy into chaos. If China continues to allow only a gradual appreciation of its currency (the renminbi, RMB) and maintains a low interest rate, then this risk will increase. Third, the social unrest due to inequality: there are many signs that the fruits of economic development in China are not shared widely – at least, more unequally than in the previous Japanese and Korean experiences. Inequality certainly exists between the coastal region and the inland regions. Inequality is also felt between the rich and poor in the coastal area and major cities – on average high-income areas. Uneven development may hit a critical point at which social and political conflict may emerge to disrupt economic development.

The second set of questions concerns China’s relationship to neighboring economies. Do the neighboring countries continue to benefit from China’s fast development? The neighboring countries both benefit and suffer from China’s rapid economic growth: benefits come from an increase in exports to China; and suffering may come from reduced exports to competing destinations, like Japan, the US, and Europe. Wong (Chapter 3 in this volume) emphasizes different impacts from China on Japan, newly industrialized economics (NIEs) and ASEAN countries.

Middle-income Asian countries may be particularly vulnerable because they compete over a wide spectrum of goods against China. An interesting
aspect of China’s rise in industrialization is that their exports are simultaneously rising from low-tech industries to high-tech industries. Rodrik (2006) shows that the Chinese export structure is much more sophisticated than can be predicted by the level of development. It has been frequently mentioned that Asia has followed a ‘flying geese pattern’, which is mentioned by Wong (Chapter 3, this volume). The leader, Japan, has upgraded its industrial structure from low-tech (toys, apparel, sandals) to mid-tech (radio, TV, and other not-so-sophisticated electronics goods, and steel), to high-tech (auto, shipbuilding, sophisticated machine tools). Japan released low-tech industry to other follower countries when it moved to mid-tech, and again released mid-tech when it moved to high-tech. Now, Korea is producing very sophisticated electronic goods, autos and other high-tech goods, second only to Japan. Thailand, Indonesia and Malaysia seem to be developing their mid-tech industries, sometimes with FDI companies from Japan and Korea. In a sense, China suddenly started to increase exports of low-tech to mid-tech goods simultaneously. Wong (Chapter 3, this volume) thinks that China’s exports will sooner or later compete with even Japan’s exports.

China does not seem to be following the ‘flying geese’ pattern but is fast overtaking several birds in the formation. If this depiction is correct, the Asian countries will sooner or later lose their production platform to China. As China becomes a center of the regional economy, as Wong’s chapter predicts, will China use economic power for its political advantage? This may be beyond the scope of this volume, but is certainly an interesting international political economic question.

Hahn and Choi (Chapter 6, this volume) examine the trade relationship between Korea and China: import competition, third-market competition, and exports from Korea to China. Regression results show that capital goods industry in Korea enjoyed a sharp increase in exports to China, especially after the Asian financial crisis, while import competition from China had negative effects on Korean manufacturing industries, especially before the crisis. Kim (Chapter 8, this volume) has examined the impact of trade with China on the Korean labor market.

Sangsubhan (Chapter 11, this volume) argues that an impact of expanding Thai–Chinese trade has been the transformation of Thai manufacturing industries. Exports from Thailand to China became more capital-intensive than labor-intensive; and Thailand benefited from the ‘early harvest’ of agricultural products in the Thailand-China Free Trade Agreement. Kimura (Chapter 10, this volume) describes how various production networks in Asia have been developed, and how China is being integrated in such a production network. Fukuda (Chapter 9, this volume) has analyzed impacts on the Japanese economy. He shows that the capital-
intensive, high-tech companies in Japan enjoyed an increase of exports to China. For Japanese production activities, dependence on exports to China has become more important than exports to the US.

One possible piece that would solve the puzzle is the vast disparity of the level of development among the provinces and the limited mobility of production factors (capital, labor and technology) across provincial boarders. The coastal provinces are very much connected to the rest of the world, but inland provinces are left behind. Wage rates in the coastal regions have started to increase, while wage rates of the inland region remain flat. The limited mobility of workers due to various difficulties is well known. Foreign companies are reluctant to invest in projects in inland provinces, maybe due to unfamiliarity with local provincial governments, and high transportation costs. Thus, China will be able to continue exporting both low-tech and mid-tech industries, because in a sense it has many ‘countries’ within the national border. Lee (Chapter 7, this volume) found that Korean outward FDI generally had positive effects on subsequent exports, lending support to the beachhead hypothesis.

China is an easy target in the blame game of international problems, because of the growing size of its economy and its growing influence. Just a few years ago, China was blamed for causing global imbalances and exporting deflation, as it produced more goods – in scope, variety and volume – and exported them to the rest of the world. The competing tradable-goods industries in the West felt the strong competitive pressure and prices tended to go down as China produced more. Thus, wages in these industries did not rise either. Kim (Chapter 8, this volume) showed that unskilled workers in Korea suffered from competition from China. Now, China is blamed for causing energy and commodity price inflation. As China imports more and more oil, precious metals and food, the rest of the world experiences price increases due to tightening global markets. A demand shock due to Chinese economic growth is regarded as exporting inflation, or a supply shock, to the rest of the world. In particular, how inefficiently China is burning oil and coal for electricity is a concern to the world, from both the energy price point of view and the environmental point of view. This is due to the sheer size of the Chinese economy. It is a small player, and its behavior affects the global price. Hence, there may be a limit to decoupling.

In sum, the challenge is how we are going to reap the benefits of China’s rise while managing the risk that is associated with fast growth. Opportunities and risk reside in both China and its neighboring economies.

Below are the summaries of each chapter. In Part I the three chapters, by Quah, Zhang and Wong, give a good overview of China’s remarkable
The rise of China and structural changes in Korea and Asia

PART I  CHINA AS A GROWTH ENGINE OF ASIA AND THE WORLD

Chapter 1: ‘Post-1990s’ East Asian Economic Growth’ by Danny Quah

Immediately after 1997 the Asian economies were viewed as catastrophes of financial excess, corporate and political misgovernance, and diminishing returns to overinvestment. But they are now freshly restored as the world’s economic powerhouses, just as before the 1997 financial crisis when they were the growth miracles and the successes of a then-emerging consensus on managed economic development. From a broad perspective of global growth and income distribution, the economic successes of
East and Southeast Asia are striking: poverty alleviation in China alone has recently accounted for 100 percent of that for all of humanity. Even if still relatively small in size, the current contribution to world economic growth from East and Southeast Asia already matches that of economies many times larger. When the rest of the world economy has temporarily slowed, East and Southeast Asia have provided a stabilizing force in world business cycles. How have underlying fundamentals for economic growth changed since 1997? Is the current growth path sustainable; and if so, what has brought that about? What role has China played in driving economic growth throughout East and Southeast Asia? Have patterns of trade changed towards greater global balance? This chapter finds that in the main, productivity growth has improved since 1997. Increasing inequality is no obstacle to poverty reduction provided that economic growth is sufficiently rapid. Finally, international trade patterns have shifted towards greater exchange within the region itself.

Chapter 2: ‘China’s Economic Rise and Its Impact’ by Zhang Yunling

China has achieved great success in developing its economy since it conducted economy-wide reforms and opened itself to the outside world. Since the late 1970s, China has become a leading world economy, the second-largest in terms of FDI inflows, the third-largest in foreign trade, the fourth-largest in GDP. One of the key factors for China’s success has been its integration into the world economic system, enabling it to use global market resources (markets, capital and technology). Accession to the World Trade Organization (WTO) has made the Chinese economy more open, transparent and integrated into the world economic system.

China’s economic rise has been a positive factor in keeping the world economy dynamic since it has become an important engine for global and regional economic growth. The Asia and Pacific region is the source of most of China’s FDI inflows, as well as the principal destination of its exports. East Asia accounts for half of China’s foreign trade and more than 70 percent of FDI inflows. With its increasing exports and imports, China has become the major trade partner in the Asia-Pacific region, especially in East Asia.

China’s economic rise has also brought about significant change in the global and regional economic structure and relations. China is one of the most important parts of the production network in the region and plays a crucial role in the balance of the regional and global trade structure.

With such high growth of the economy, Chinese people have become richer. Aside from the steady increase of GDP per capita, a sizeable middle class is emerging. This will work as an internal force supporting
Chinese economic growth. In new sectors, such as the telecommunications sector, the numbers of mobile phone, Internet and computer users are all increasing, bringing China into the world’s top rank.

Along with the high economic growth, China’s production capacity has been significantly increased, and in many areas it has become the world’s largest producer, or is among the major producers, such as for color TV sets, refrigerators, DVD players, computers and so on. If the current trend continues, China may become the world’s second-largest country in foreign trade by 2010 and in GDP by 2025, after the United States.

However, China is facing the new challenges in its economic development, including rising labor costs, rising prices of raw materials, environmental deterioration, and global market uncertainty.

Chapter 3: ‘China’s Rise and East Asian Economies: Towards a Sino-Centric Regional Grouping?’ by John Wong

China’s economy has chalked up spectacular performance since the start of its reform in 1978, growing at 9.8 percent a year for almost three decades. With a total GDP of US$3.4 trillion at market exchange rate, China’s economy today is about to replace Germany’s as the world’s third-largest after the USA and Japan. Speed combined with size creates its own dynamics. Accordingly, China’s economic rise has produced profound regional and global impacts.

Regionally, China’s economy has become an important engine of growth for its neighboring economies, which are making use of China’s huge domestic markets (for both manufactured products and primary commodities) as a source of their own growth. China’s rise has also radically altered the region’s trade patterns and financial flows, catalyzing the process of regional economic integration. This is because China is the home of many regional supply chains (or regional production networks). Beijing has reinforced these trends by initiating several regional economic cooperation schemes such as the China–ASEAN Free Trade Agreement (FTA).

It is well known that East Asia constitutes the world’s most dynamic economic region. Its growth process is marked by three waves: the rise of Japan; the rise of the four East Asian NIEs (newly industrialized economies); and, more recently, the rise of China. The first two waves were dominated by Japan. But the third wave, heavily gravitating towards China, promises to be politically and economically more significant than the previous two.

As China continues to sustain its high economic growth, East Asia’s geopolitics and geo-economics will also shift. China is set to develop
an even closer economic symbiosis with other East Asian economies. Economic activities in the region will then increasingly be drawn towards China, giving rise to a kind of economic grouping that is largely oriented towards China. Over the longer run, it would not be unrealistic to argue that the emerging Chinese-dominated grouping could well dwarf the past Japanese-dominated grouping, given China’s vast size and Japan’s unfavourable demographics. Such could be the scenario for a Sino-centric East Asian Economic Community in future.

PART II IMPACTS ON KOREA’S ECONOMY

Chapter 4: ‘Understanding the Post-Crisis Growth of the Korean Economy: Growth Accounting and Cross-Country Regressions’ by Chin Hee Hahn and Sukha Shin

Korea maintained miraculously high and sustained economic growth at least up until the 1997 financial crisis, but after the crisis, its growth has slowed down significantly. Exploring some empirical facts that are helpful for understanding the post-crisis growth performance of Korea, this chapter examines sources of growth of Korea’s economy for the period from 1981 to 2005, based on both primal and dual growth accounting methodology employed by Young (1995) and Hsieh (2002). Also, this chapter evaluates the post-crisis growth performance of Korea, using cross-country comparison of growth accounting results and cross-country regressions. Above all, it was found that the growth slowdown after the crisis has been mainly driven by the slowdown of per worker capital accumulation. By contrast, the estimated total factor productivity growth (TFPG) of Korea for the period from 2001 to 2005 seems higher than, or at least roughly comparable to, the estimated TFPG in the pre-crisis period of 1991–95. In these respects, there were no substantial differences between the results obtained from primal and dual growth accounting methodology. Next, the cross-country regressions reveal that the post-crisis growth slowdown of Korea’s economy can be largely attributed to world growth slowdown (decade effect) and East Asia-specific effects. In particular, it was found that the noticeable deceleration in per worker capital accumulation can be mostly attributed to some unknown factors which commonly affected East Asian countries. Viewed from an international perspective, the lowered post-crisis per worker GDP growth rate, as well as per worker capital growth, which triggered concerns and debates in varying contexts, still seems respectable. So, the slowdown in capital accumulation is likely to be mainly a story of the spectacularly high rate
of capital accumulation in the pre-crisis period, not a story of ‘weak’ investment after the crisis.

Chapter 5: ‘The Economic Growth of Korea since the 1990s: Identifying Contributing Factors from Demand and Supply Sides’ by Seok-Kyun Hur

This chapter’s purpose is to identify major factors that explain the path of the Korean economy in the past decades and evaluate their relative contributions. To that end, the author devises two economic models, which contrast the recent changes in the determination of foreign exchange rate as well as the monetary policy rule that the Korean economy underwent right after the East Asian Currency Crisis in 1998. Converted into the corresponding structural vector auto regression (SVAR) systems with long-run restrictions, the estimation results confirm that Korea’s decreased rate of economic growth since 2000 seems attributable to the decrease in Korea’s potential growth rate.

PART III IMPACTS ON KOREAN FIRMS AND WORKERS

Chapter 6: ‘China’s Rise and Production and Investment Growth in Korean Manufacturing Industries: Channels and the Effects’ by Chin Hee Hahn and Yong-Seok Choi

In this chapter, the authors examine what effects the rise of China has had on the growth of production and investment of Korean manufacturing industries. In doing so, they consider three main aspects of trade relations between Korea and China: import competition, third-market competition and export to China. In addition, they further divide exports to China into capital goods exports and (non-machinery and non-capital equipment) intermediate goods exports. From various regression results, the authors obtain both positive and negative effects of China’s rise on the production and investment growth of Korean manufacturing industries. On the one hand, capital goods exports to China, rather than intermediate goods exports, are estimated to have positive effects on the production growth of Korean manufacturing industries, especially during the period after the crisis. Results based on further division of capital goods into two subcategories reveal that in particular exports of parts and accessories of machinery and capital equipment to China promoted the growth of industries. Although some evidence was obtained that outward FDI to China promoted intermediate goods exports to China, particularly before the crisis,
the authors were not able to find evidence that it promoted exports of parts and accessories (of machinery and capital equipment). On the other hand, import competition from China was estimated to have negative effects on both production and investment growth of Korean manufacturing industries, especially before the crisis. Overall, the regression results suggest that the positive effects from China’s rise on the growth of Korean manufacturing industries have been strengthened after the crisis.

Chapter 7: ‘The Impact of Outward FDI on Export Activities: Evidence from the Korean Case’ by Siwook Lee

This chapter empirically investigates the relationship between outward FDI and exports in the case of Korea for the period after the 1990s. In particular, this chapter examines the issues by using three-tiered Korean data, comprising of aggregate, industry and individual firm levels.

According to the estimation results, there is little evidence that the expanded FDI of Korean companies has replaced exports or other domestic production activities. Generally, the author finds that FDI complements exporting activities, and that such a relationship is most apparent in the high-technology industries and in the period after the financial crisis. The industry-level analysis, which is useful in identifying the net effect of FDI on overall manufacturing, further suggests that Korean outward FDI has a so-called ‘beachhead effect’ and thus plays an important role in promoting subsequent exports. In addition, as for Korean multinationals, the estimation results indicate that the FDI–exports nexus mainly works through intra-firm exports from parent companies to foreign affiliates.

Finally, while China is a major destination of the Korean FDI and its importance is expected to be ever increasing in the future, the author observes that the linkage between FDI activities and the Korean trade with China seems to be weakened in the 2000s. To maintain the strong FDI–export nexus found in this chapter, it is therefore important for Korea to make great efforts to enhance the industrial structure and secure its competitive edge in advanced high-tech products and core components.

Chapter 8: ‘The Rise of the Chinese Economy and Korea’s Job Growth’ by Dae Il Kim

This chapter evaluates how the labor demands, or job growth potentials, of Korea have been affected by the increased economic trade with China. The analysis focuses on three channels: the increase in goods trade; the increase in competition in the world market arising from the export growth of China; and the increase in direct investment of Korean firms in China. The
results indicate that the large surplus in goods trade with China has led to an increase in labor demand, except for unskilled men in Korea, but at the same time Chinese exports have increasingly taken away Korea’s share in the world market of the key products such as electronics, suppressing Korea’s domestic labor demands. Overall, the effects on aggregate labor demand do not appear to have been large, but the labor demands for unskilled workers in Korea have been relatively suppressed and their relative wages have fallen. Given that trade with China is expected to expand, the trend is likely to continue.

PART IV IMPACTS ON OTHER COUNTRIES


After prolonged recessions, the Japanese economy has recovered from the crisis in the first half of the 2000s and has recorded sustained growth in the last several years. Tremendous structural changes during and after the financial crisis were one of the main driving forces for the recovery. However, dramatic increases in exports were another. In particular, increases of Japanese exports to China were substantial in the 2000s and supported the recovery of the Japanese economy from its demand side. The purpose of this chapter is to examine the role of the exports to China for the recovery in the 2000s.

The dependence of the Japanese export sectors on the Chinese economy has risen especially since the 2000s. China now almost surpasses the United States as destination of Japanese exports. The author’s vector autoregressions (VARs) show that Japanese production, which had been driven by exports to the United States until the mid-1990s, started to be driven by exports to China after the late 1990s. However, the effects on production were very different across sectors. The increased exports to China were beneficial for the recovery of manufacturing industries with advanced technology. They also had beneficial impacts on small firms with advanced technology. The impacts were, in contrast, insignificant for the recovery of labor-intensive small firms and of non-manufacturing firms. Consequently, the sustained growth during the last several years was accompanied by widening inequalities across sectors. The results suggest that the rise of China is an opportunity for several large firms with advanced technology but a threat to other Japanese firms, particularly labor-intensive small firms.

Heterogeneous effects across firms in different industries and with
different firm sizes might be problematic in terms of income distribution. Even in terms of resource allocation, the heterogeneous effects may cause efficiency losses if sectoral adjustment costs exist. It is the sectoral adjustment costs that magnify the threat of the rise of China. Some policies that mitigate the adjustment costs may increase complementarities between the Chinese economy and Japanese economy.

Chapter 10: ‘East Asian Production Networks and the Rise of China’ by Fukunari Kimura

This chapter argues that China has become an important player in East Asia’s production and distribution networks and that recent changes in location advantages in China may call for reshuffling of the networks extended by Japanese and Korean firms. The chapter starts by examining international trade statistics to confirm the enhancing role of China in production and distribution networks, then reviews the essence of the fragmentation theory, and discusses the impact of a rapidly changing China on the operations of Japanese and Korean firms.

Chapter 11: ‘The Rise of China and Structural Change in Thailand’ by Kanit Sangsubhan

The rise of China has profound implications for the economies of the members of ASEAN. Increasingly, ASEAN is depending on China markets and reducing its export share to Korea and Japan. In the case of Thailand, there exists a strong regional bias in trade as 45 percent of exports are channelled to ASEAN+3 markets, with China’s share sharply expanding. The trade relationship between Thailand and China has become more complex and in line with the regional network. As a result, the pattern of production in Thailand has continuously changed.

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