

STRATEGIES FOR FURTHERING THE PRC'S INTEGRATION WITH THE GLOBAL ECONOMY:

RECOMMENDATIONS FOR THE 13TH FIVE-YEAR PLAN

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KEY RECOMMENDATIONS FOR THE PRC'S 13TH FIVE YEAR PLAN

1. China's thirteenth Five Year Plan (FYP) will be implemented in a regional and international economic environment that has changed fundamentally since the last plan was formulated. In the last five years, the world economy has emerged from the most dramatic slowdown in two generations. While most of economies continue to recover, opportunities for future growth appear to be shifting significantly. From an updated perspective, this report evaluates China's prospects for increased international economic engagement in ten important policy areas. With more substantial background in the main body of the study, we make ten recommendations for consideration by the framers of the FYP.

Recommendation 1: Pursue bilateral, sub-regional, and regional trade agreements more intensively

2. The PRC's WTO membership is a valuable source of influence for the country and its conformity with WTO standards is an important precedent for relations with each of its trading partners. However, momentum of the WTO has slowed dramatically in recent years, and has not kept pace with rapidly changing trade realities in Asia and elsewhere. Western OECD markets remain important, but to respond effectively to emerging trade opportunities in the medium term, the PRC should more intensively pursue bilateral, sub-regional, and regional agreements. As the world's second largest economy and exporter, as well as its second largest importer, the PRC is in a good position to present the Asian region with an opportunity to pursue globalism through regionalism.

Recommendation 2: Develop a clear and consistent national policy for reciprocal market access.

3. The strongest basis for international market access is reciprocity. This is fortunate for the PRC, because the scale and dynamism of its economy offers unparalleled opportunity to leverage reciprocity for the benefit of PRC exporters and investors overseas. Over the next five years, the PRC should take advantage of this with a clear consistent national policy for reciprocal market access. Because of their unusually large share of activity in the PRC economy, state enterprises and their sectors offer the government the opportunity to set a strong example for market openness.

Recommendation 3: Adopt international standards of goods in the PRC's domestic market

4. Although the PRC is much larger now relative to overseas markets, expanding international trade can continue to make important contributions to the Chinese economy. For the promotion of international trade, the PRC should promote adoption of international standards of goods in the PRC's domestic market. This will open up more the PRC domestic market to global producers, make the PRC producers to be more concerned about the quality of their products (thus benefiting the domestic consumers), and to allow more PRC industries to participate in regional and global trade.

Recommendation 4: Establish overseas agrifood partnership through trade and investment arrangements

5. Like other advanced Asian economies, the PRC is experiencing changing food consumption patterns with economic growth. As household incomes rise, food demand generally becomes more resource-intensive, with rapid increases in spending on meat and dairy products. Because the PRC is home to 20% of the world's population, but only 7% of its farmland and 5% of its renewable fresh water resources, this poses a significant challenge to domestic agriculture. Despite dramatic improvements in productivity and water efficiency, the PRC cannot increase output of extensive (land-intensive) crops fast enough to keep pace with evolving domestic consumer tastes. In two decades, China has gone from food self-sufficiency to become the world's largest food importer.

6. To improve long-term food security, the PRC should step up medium-term commitments to overseas agrifood partnership. These include incentives and other policies supporting private investment in foreign agriculture, food processing, and supply chain logistics, as well as public partnerships to strengthen agrifood development and trade policy in counterpart governmental institutions. Particular attention should be given to lower income Asian neighbors, where agrifood partnerships with the PRC can facilitate rapid productivity growth, self-directed poverty reduction, and greater food security for on both sides. In this way, the PRC can contribute to win-win food security solutions, meeting the needs of its growing middle class and supporting poverty reduction, middle class emergence, and stronger development partnerships.

Recommendation 5: Keep opening up the PRC's financial markets and the capital account, and further develop domestic legal framework to protect investors

As the emerging economic hub of the Asia region, the PRC must assert leadership in delivering the financial infrastructure needed for the next generation

of domestic and regional growth and trade. Asia has huge reserves of domestic and external saving, yet their current allocation is well below its potential to promote national and regional growth. Without more determined reform and innovation in its financial sector, the PRC risks a decade or more of slowing of productivity growth. For the promotion of international investment, the PRC needs to keep opening up the PRC's financial markets and the capital account, and further develop domestic legal framework to protect investors.

Recommendation 6: Improve RMB's international liquidity and risk characteristics through more determined financial sector reforms

7. The PRC's economic scale is consistent with reserve currency status, but its current financial policy framework is not. Reserve currencies are technologies for managing international financial liquidity and risk, and their adoption is a voluntary global process responding to the quality of these two services. Over the next five years, the best approach to promoting internationalization of the RMB is to improve the currency's international liquidity and risk characteristics through more determined financial sector reforms, including capital account opening, interest rate deregulation, central bank independence, and greater participation of private sector in financial sector.

Recommendation 7: Be more proactive in facilitation of trade with neighboring countries connected by land or sea

8. To the extent possible, the PRC should be more proactive in facilitation of trade with neighboring countries connected by land or sea. This includes improving expediency and consistency in customs administration, prioritizing urban development and expansion at existing borders, and stronger partnership initiatives for development across the PRC's borders. The latter should include targeted lending and grants to trading partners for bidirectional trade facilitation, local infrastructure for transport, urbanization, training, and technology transfer.

Recommendation 8: Support the next generation of multilateralism, including trade and investment facilitation across the Asian region, and promoting knowledge sharing

9. The PRC can set an essential example by supporting the next generation of multilateralism, including trade and investment facilitation across the Asian region. In addition to more active engagement with existing international institutions, the PRC should take leadership in investing in institutional and infrastructure connectivity, and establishing a regional multilateral framework

aimed at facilitation of trade, financial integration, and development assistance. Instead of treaty-based, binding trade agreements, this arrangement could be modeled on the OECD, a venue for collaborative dialog that actively and consistently promotes standard setting, policy coherence, and transparency. These commitments will be essential to achieve inclusive regional growth.

Recommendation 9: Expand imports of natural gas to reduce public health risk from air pollution

10. China's energy system has become a critical source of public health risk, and it is imperative that per capita toxic emissions be reduced, especially in urban areas. Natural gas fuel substitution in electric power and ground transportation is the fastest way to accomplish this goal. Domestic shale gas has significant potential, but its development will be constrained in the short run by logistics and the water intensity of existing extraction technology. To meet its emission reduction needs, China should significantly expand gas imports over the next five years, particularly from Central Asian and other regional partners.

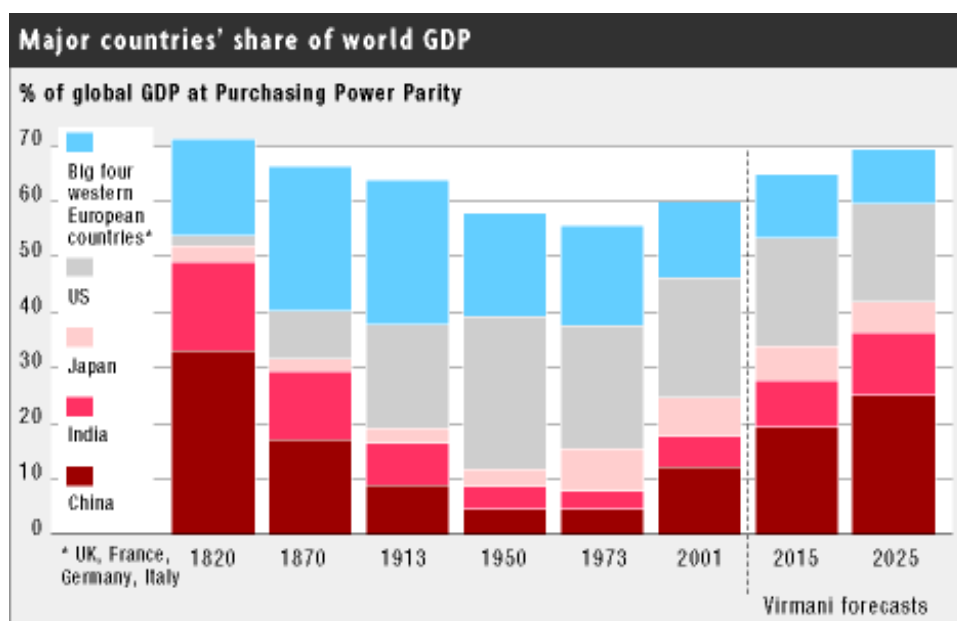
Recommendation 10: Intensify collaboration with neighboring countries in promotion of regional economic cooperation initiatives for mutual benefits

11. The PRC's historical growth experience makes it a valuable partner for developing Asia. Across the region, the PRC can exert beneficial influence by promoting knowledge sharing, trade, and investment. The PRC's own development experience contains valuable lessons for each of its lower-income neighbors, and it can play an influential role in regional development assistance. By improving bilateral and regional trade relations and partnering to expand infrastructure, the PRC can offer its neighbors access to the world's most dynamic internal market. By promoting private Chinese investment overseas, the PRC can help lower-income regional partners overcome domestic savings and technology constraints. China can set an important example by supporting the next generation of multilateralism. In addition to more active engagement with existing international institutions, the PRC should assert leadership in establishing a regional multilateral framework aimed at trade facilitation, financial integration, and development partnership. Rather than being treaty-based like binding trade agreements, this arrangement could be more like the OECD, a venue for collaborative dialog that actively and consistently promotes standard setting, policy coherence, and transparency.

INTRODUCTION

12. Over three decades since 1978 when the PRC embarked on reform and opening up, the country has achieved profound economic growth. In 1950, the PRC economy comprised less than 4% of global GDP, its trade with the world economy was negligible, and per capita income was below US\$2/day. This macro situation stood in sharp contrast to history (Figure 1) and it was also temporary. In 2010, the PRC became the world's second-largest economy, and by 2013 it was the world's largest exporter, second largest importer, and the world's largest creditor. The PRC is also a leading global destination for foreign investment and its outbound financial flows have been growing very rapidly. While various factors have contributed to this significant success, the PRC's steady integration into the global markets, particularly the WTO accession, has played a critical role, bringing huge benefits to the country and the rest of the world.

Figure 1: Historical GDP Shares by Country



Source: Maddison.

13. Opening up served the PRC well in the past. Further integration with the global economic system will continue to serve the country well in the future. The 18th National Congress of the Communist Party pointed out that it is of utmost

importance for the country to “adapt to new megatrends of economic globalization, implement more proactive opening-up strategies, and establish and improve an open economic system.” Further integration will also be helpful for deepening domestic reforms and letting the market to play a decisive role, through better competition, improved transparency, higher product standards, prudent governance, efficient financial services, and easy connectivity and efficient transport and trade logistics.

14. As the PRC becomes increasingly integrated with the global economic system, prospects of the PRC economy are intricately linked to the health of the regional and global economy. PRC's “domestic policies” have larger spill over impact on the entire world - and also what happens in the world will have greater impact on PRC than before. Since the last serious economic downturn about five years ago, the global composition of economic growth has changed in important ways. OECD economies experienced generally positive but relatively slow growth, while so-called emerging market economies grew faster, and Asia had the greatest concentration of higher growth economies. While trade with OECD and other non-Asian partners will continue to grow, it cannot be expected to deliver aggregate export growth rates that have been seen in the past. For these reasons, as the PRC looks to future globalization, it should do so with special attention to expanding regional opportunities.

15. The PRC's 13th Plan will be implemented in an international economic environment that has changed fundamentally, since the last plan was formulated. In this period, the world economy has emerged from the most dramatic slowdown in two generations. While most of economies have recovered, opportunities for future growth are shifting significantly. To a significant extent, opportunities and challenges for the PRC's globalization are also an expression of domestic economic structure. In this context, the PRC's economy is experiencing an important structural transition over the next five years. The three main features of this are rebalancing of aggregate demand and supply, demographic transition, and tapering of aggregate growth.

16. The PRC's success with globalization was once interpreted as a threat to other Asian exporters, but today a very different picture has emerged. Apart from labor and coal, however, the PRC is a resource-constrained economy that must import to grow as well as to export. Moreover, its transition from low-wage global competitor to consumer society now presents the Asian region with a new generation of growth opportunities. Traditional, East-West (“North-South”) trade will continue, but regional economic integration now allows Asian economies to

diversify away from slow-growing western markets, expanding their export supply chains to the world's most dynamic internal markets, Asia.

17. Expanding international trade can continue to make important contributions to the PRC economy, but this expansion should be done in ways that recognize emerging opportunities and risks. The PRC should pursue further globalization through regionalism, leveraging superior growth and diversity among Asian economies. It should also build upon comparative regional advantages for higher value added and higher technology goods and services, recognizing the economy's need to sustain higher labor productivity and real wages.

18. With an updated perspective, this study evaluates the PRC's prospects for increased international economic engagement. The report starts with a look into the global macroeconomic trends and their impact on the PRC, focusing on the risks and challenges they may pose for the PRC economy. The study then assesses the opportunities for the PRC's further opening-up and integration with the global economic systems in four major areas: (i) expanding international trade and investment, (ii) greater participation in global financial system, (iii) further integration through enhanced regional and global connectivity, and (iv) achieving PRC's greater role as a development partner.

INTERNATIONAL TRADE AGREEMENTS

A. Recommendation 1: Pursue bilateral, sub-regional, and regional trade agreements more intensively

19. The PRC's WTO membership is a valuable source of influence for the country and its conformity with WTO standards is an important precedent for relations with each of its trading partners. However, momentum of the WTO has slowed dramatically in recent years, and has not kept pace with rapidly changing trade realities in Asia and elsewhere. Western OECD markets remain important, but to respond effectively to emerging trade opportunities in the medium term, the PRC should more intensively pursue bilateral, sub-regional, and regional agreements. As the world's second largest economy and exporter, as well as its second largest importer, the PRC is in a good position to present the Asian region with an opportunity to pursue globalism through regionalism.

Table 1: Current Status of China's Trade Agreements

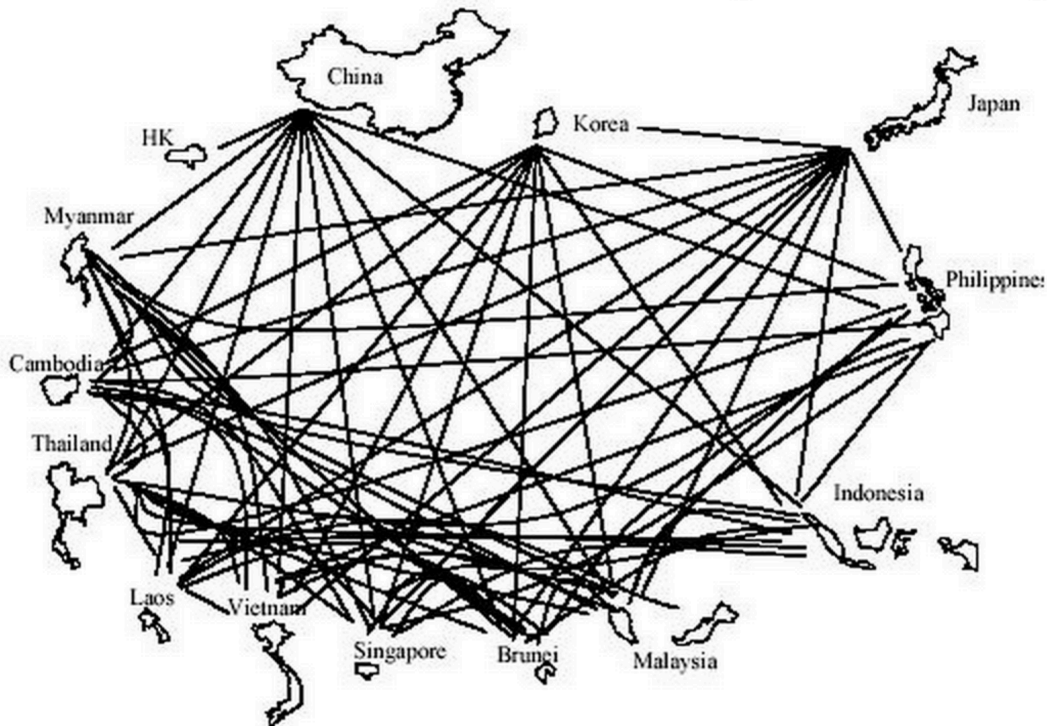
Free Trade Agreements Completed	
1	China-ASEAN FTA
2	China-Pakistan FTA
3	China-Chile FTA
4	China-New Zealand FTA
5	China-Singapore FTA
6	China-Peru FTA
7	Mainland and Hong Kong Closer Economic and Partnership Arrangement
8	Mainland and Macau Closer Economic and Partnership Arrangement
9	China-Costa Rica FTA
10	China-Iceland FTA
11	China-Switzerland FTA
Free Trade Agreements Under Negotiation	
1	China-GCC (Gulf Cooperation Council) FTA
2	China-Australia FTA
3	China-Norway FTA
4	China-Korea FTA Joint Feasibility Study
5	China-Japan-Korea Joint Study
Free Trade Agreements Under Consideration	
1	China-India Regional Trade Arrangement Joint Feasibility Study
2	Joint Feasibility Study on a China-Sri Lanka Free Trade Agreement
Preferential Trade Agreement	
1	Asia-Pacific Trade Agreement

B. Globalization Through Regionalism

20. China's accession to the World Trade Organization was a watershed event for the country and the global economy. While pursuing globalization by this pathway, however, China has also promoted bilateral and regional trade agreements when these were more expedient. In the process, China has established official trade partnerships with a large number of individual countries and groups of countries. As the table below indicates, there are 11 FTAs in place, 5 under negotiation, 2 being considered, and one preferential regional agreement in place. In addition to these, a number of less stringent bilateral and group agreements are in force (e.g. China-US, China-EU, etc.) are also in place. Asian economies make up the majority of counterparts to existing agreements. This is typical of regional arrangements because they focus on cross border trade and can be easier to negotiate between countries with shared historical

experience and legacy trading networks. Simply put, history demonstrates that bilateral and small group trade negotiations are more expedient, can cover deeper trade issues, and be agreed and implemented at lower costs. While there is a risk of the so-called Noodle Bowl Syndrome (Figure 11), it is apparent from the proliferation of these voluntary arrangements that they benefit the parties involved.

Figure 11: Asian Regional Trade Agreements: The Noodle Bowl



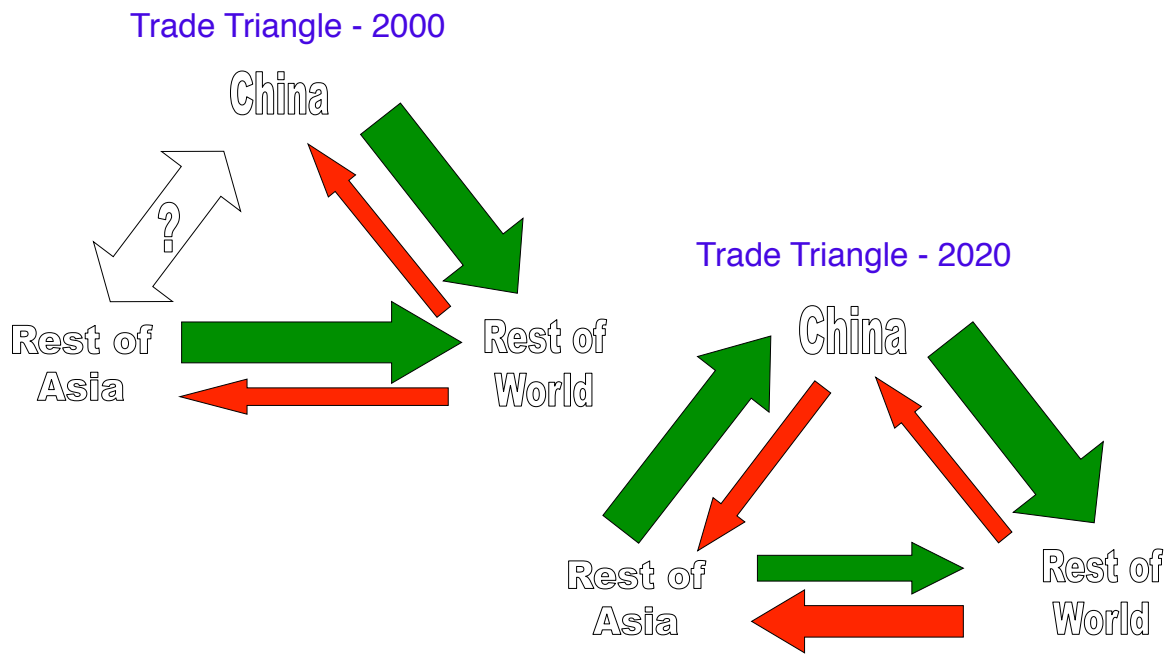
21. Global agreements represent a kind of ideal reference point, and it has been argued by some that regionalism should continue to promote globally consistent trading standards. The two need not be inconsistent for agreements among WTO members in any case because of the latter are bound by non-exclusion and non-bias conditions (e.g. Baldwin and Low: 2009). The important point for China is that deeper trade liberalization can be achieved, more expediently and with less effort, across some of its higher priority relationships. This is particularly so for Asian neighboring economies, where partner commitments to infrastructure and cross-border trade facilitation can yield substantial, local and regional, growth and convergence (inequality reducing) dividends.

22. China's dramatic rise has opened another perspective on globalism and regionalism, however. As the world's second largest economy and exporter, as

well as its second largest importer, China presents the Asian region with an opportunity to pursue globalism through regionalism. China is a critical player in the regional strategic environment because its large and fast growing domestic market is a great prize for neighbors who rely on external demand as an essential source of growth. Moreover, regional economies can leverage China's globalization by participating in supply chains that support China's exports around the world. For both these reasons, in an era when Asian economic fundamentals are evolving much faster than global trade negotiations, it makes sense for China and its neighbors to pursue globalization through deeper and more extensive commitments to regional integration.

23. These ideas are illustrated schematically in the figure below, depicting a Trade Triangle between China, the Rest of Asia (ROA), and the Rest of the World (ROW). In 2000, leading Asian exporters were competing directly and running surpluses with the ROW, while net trade between China and ROA was mixed. By 2020, our own forecasts (Weiss and Roland-Holst: 2004, 2005) show China sustaining large surpluses with ROW, but at the same time ROA running a comparable surplus with China. In this way, East and Southeast Asia can capture substantial growth from full globalization by promoting regional integration. In other words, head-to-head export global competition becomes less important than leveraging opportunities presented by East Asia's fastest growing internal market. The best strategy for East and Southeast Asia is to pursue globalism through more comprehensive regionalism.

Figure 12: China and the Trade Triangle



Source: Author forecasts.

C. Institutional Considerations

24. A final but important consideration in this context is the political economy of China's trade relations. To some extent, it can be tempting to offer reciprocal market access as a form of diplomatic competition, and trade dealing by most large global economies including China (Kwei: 2009) has been interpreted this way from time to time. From an economist's perspective, the real gains from trade expansion follow from the drivers of comparative advantage, economic fundamentals, rather than political rivalries. To achieve the full economic potential of globalization for China and the rest of its Asian trading partners, it is essential to be mindful of this. Political considerations can never be completely absent from negotiations between nation states, but excessive politicization of economic policy weakens market institutions, distorts incentives and resource values, and undermines efficiency.

INTERNATIONAL MARKET ACCESS

A. Recommendation 2: Develop a clear and consistent national policy for reciprocal market access.

25. Recommendation 8: Support the next generation of multilateralism, including trade and investment facilitation across the Asian region, and promoting knowledge sharing. The strongest basis for international market access is reciprocity. This is fortunate for the PRC, because the scale and dynamism of its economy offers unparalleled opportunity to leverage reciprocity for the benefit of PRC exporters and investors overseas. Over the next five years, the PRC should take advantage of this with a clear consistent national policy for reciprocal market access. Because of their unusually large share of activity in the PRC economy, state enterprises and their sectors offer the government the opportunity to set a strong example for market openness.

B. Background

26. Despite multiple rounds of global trade negotiation, falling global tariffs, and dramatic growth of international trade and investment, there remain barriers to market access around the world and across a wide spectrum of goods and services. For China, export competitiveness has overcome many such barriers and, ironically, intensified others because of China's success. As mentioned in the last section, China's WTO accession was a watershed event, opening markets North and South for this emerging economy. China's success in taking advantage of these new opportunities was a primary driver of its transformative growth over the last two decades, yet the country still faces barriers in a variety of markets and sectors. We examine its experience the three major categories of trade, final products, intermediates, and finance.

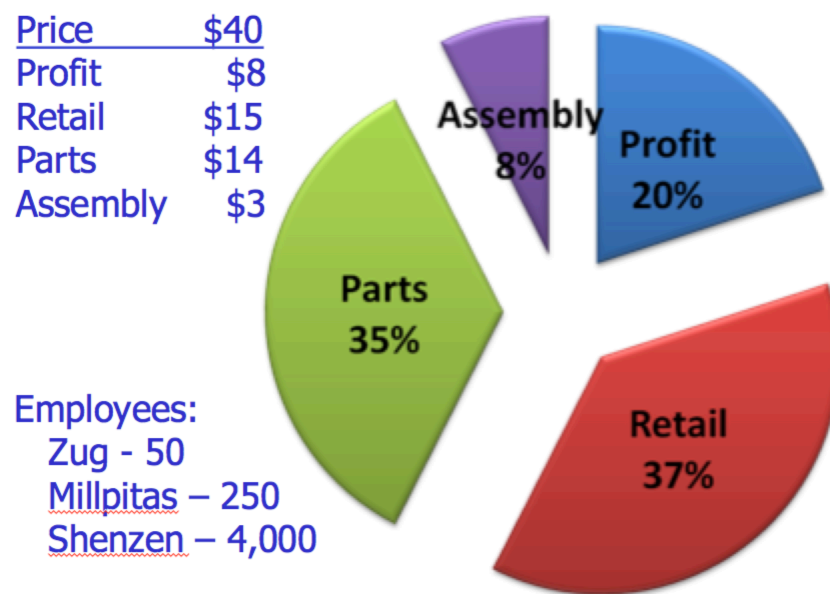
1.1.1 Final Goods and Services

27. As the world's largest exporter, China has been extremely successful at penetrating overseas markets for final goods. The fact remains, however, that over two-thirds of these products carry foreign brand names. This fact has two implications. Firstly, market access for these goods must be seen as somewhat conditional, particularly in countries that are home to the brands they import. Subsidiaries or contractors of US corporations, for example, manufacture about half of China's exports to the United States. Of course this arrangement simplifies the market access challenge, and Chinese companies are well aware of this as well as the benefits of technology transfer and foreign investment.

However, Chinese producers would capture more value added if they established their brands internationally and on a competitive basis.

28. Completing this transition would also permit China to internalize the higher skill and higher wage components of the production cycle, including design, marketing, and management. The figure below illustrates this issue for a simple computer product. China's "workshop" role is essential to this supply and represents the vast majority of employment, yet only a small fraction of value accrues to the domestic economy.

Figure 13: Global Value Decomposition of a Computer Mouse



Source: Harvard Business Review

29. From the reciprocity perspective, China should reexamine the issue of international market access for consistency between its domestic policies and emerging global norms. While the PRC faces significant barriers to some of its products and services, leading international and regional trading partners have challenged China for a variety of restrictive conditions in domestic markets (e.g. European Commission: 2012). These cover areas that are also sensitive elsewhere, such as security-related technology and food safety, but they also include issues related to the progress of China's institutional reforms, such as

inconsistent implementation of customs rules, monopoly power of state enterprises, financial protectionism, and equal legal and regulatory treatment. It is often argued in these cases that China is in transition, but the PRC needs to recognize that gradualism will also apply to the benefits of further globalization unless its partners see reform a credible basis for equitable competition.

1.1.2 Intermediate Goods

30. To a significant extent, the “anonymity” of intermediate goods make them less a target of protectionism globally. China has benefitted from this on both sides of its trade accounts, facilitating exports and allowing greater import penetration to improve local competitiveness and technology transfer.

Figure 14: China’s Trade Balance with Selected Markets



Source: China customs authority.

31. In the context of further internationalization and intermediates, China has two primary considerations: reciprocity and value added hierarchy. China has benefitted significantly from its position in the global supply chain, exporting final goods and advanced intermediates to (e.g.) the US and Europe, while importing (on average) lower value raw materials and components. As the figure above shows, this strategy has been so successful that the PRC runs a substantial deficit with the latter group to sustain it. To sustain and expand these benefits in a competitive region like Asia will require reciprocity. In other words, to be a successful participant in global (and especially regional) supply chains, China must be seen by its neighbors and international investors as minimizing contracting, trade, and other transactions costs (Amiti et al: 2008). Barriers to either import or export of components will result in “wiring around” Chinese suppliers in their home markets, excluding them from international production systems or driving them overseas.

Table 15: Recent Trends in International Wages

Country	Minimum Wages Per Month in USD						Y/Y Change in Minimum Wage					CAGR
	2007	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012	07-12
U.S.	1239	1244	1255	1253	1260	1246	0%	1%	0%	1%	-1%	0%
Korea	616	675	686	628	605	648	10%	2%	-8%	-4%	7%	1%
China	96	119	116	160	183	204	25%	-3%	38%	14%	12%	13%
Philippines	133	150	167	173	182	193	13%	11%	4%	5%	6%	6%
Indonesia	98	95	103	106	133	151	-3%	8%	3%	25%	14%	7%
Thailand	66	67	75	79	79	118	2%	13%	5%	1%	48%	10%
Lao PDR	27	28	30	64	63	72	6%	6%	114%	-1%	14%	18%
Vietnam	20	26	30	38	50	64	32%	15%	26%	31%	29%	22%
Cambodia	41	41	41	41	43	43	0%	0%	0%	5%	0%	1%
China – Vietnam	\$76	\$93	\$86	\$122	\$133	\$140	23%	-8%	41%	9%	5%	11%
China – Cambodia	\$55	\$78	\$75	\$119	\$140	\$161	44%	-4%	58%	17%	16%	20%

Source: CIMB.

32. In the second context, China’s place in global supply chains should evolve with its changing economic structure, especially its technology and skill composition. As the table above indicates, there is substantial wage divergence across Asia, meaning investors have many choices. At the same time, higher wages usually mean higher productivity. This China needs trade, industry, and investment policies that match its goals for productivity and real income growth. This implies movement up the hierarchy of value added, toward every more skill

intensive production and services. The best way to achieve this is to foster education and competitive innovation, not protectionism.

1.1.3 Capital Markets

33. While China has encountered occasional resistance to its private investments in overseas assets, by far the biggest issue for the PRC with financial market access is reciprocity. At the present time, China has the most closed financial sector of any advanced economy. Until these conditions are changed by further financial reforms (see discussion of the RMB below), there is likely to be little change in the external environment. Indeed, a careful examination of China's current financial regulations suggests that the primary barriers to outbound investment arise from domestic regulations.

34. Apart from this, China can still facilitate market access for its producers and service providers by expanding trade finance by Chinese banks and appropriate official agencies. This kind of financial service support is the hallmark of advanced trading economies, and China should not allow its firms to be at a disadvantage, particularly as they reach out to compete with established international brands.

GLOBAL MACROECONOMIC TRENDS AND THE PRC

A. Recommendation 3: Adopt international standards of goods in the PRC's domestic market

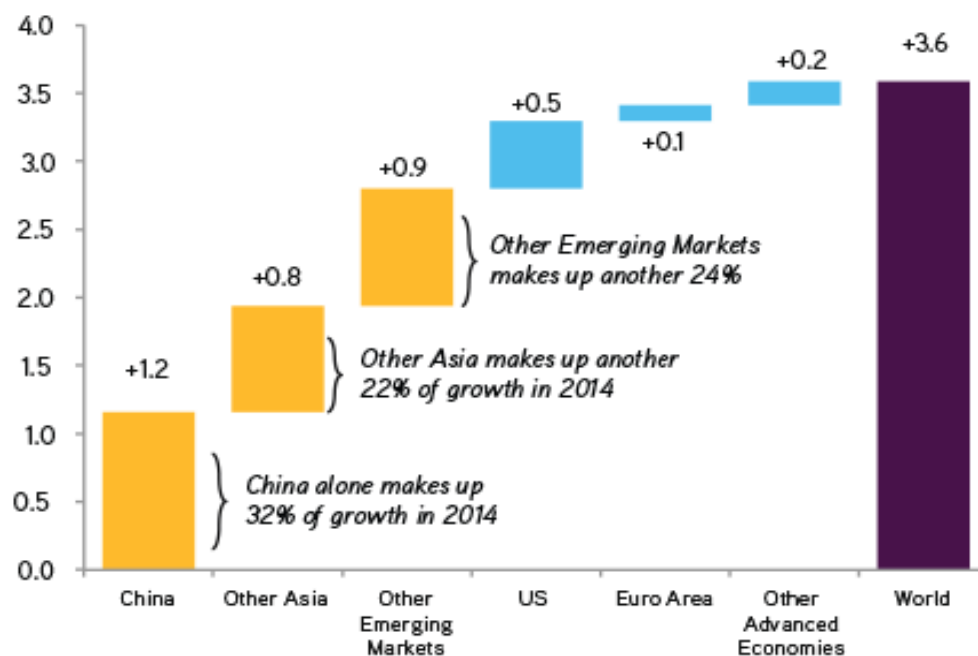
35. Although the PRC is much larger now relative to overseas markets, expanding international trade can continue to make important contributions to the Chinese economy. For the promotion of international trade, the PRC should promote adoption of international standards of goods in the PRC's domestic market. This will open up more the PRC domestic market to global producers, make the PRC producers to be more concerned about the quality of their products (thus benefiting the domestic consumers), and to allow more PRC industries to participate in regional and global trade.

B. Regional and International Macroeconomic Trends

36. Since the last serious economic downturn about five years ago, the global composition of economic growth has changed in important ways. Before the 2008 financial crisis, OECD economies experienced generally positive but relatively slow growth, while so-called emerging market economies grew faster, and Asia had the greatest concentration of higher growth economies. Today all these characteristics remain in a qualitative sense, but regional growth rate disparities appear to be rising. As a whole, the OECD continues positive average growth, but with much less consistency and certainty across the group (see e.g. He: 2014). Although the initial downturn affected much of Asia, they generally recovered faster and are closer to pre-crisis growth rates.

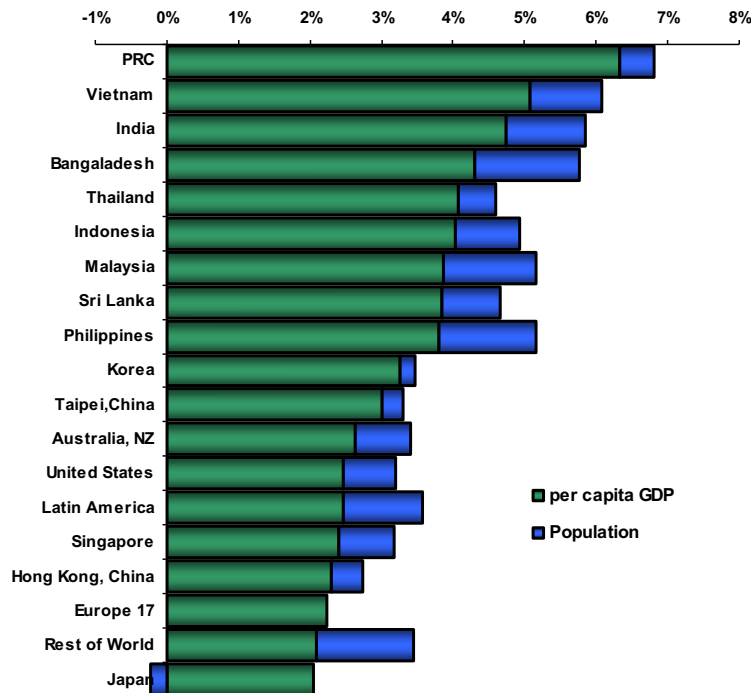
37. For these reasons, as China looks to future globalization, it should do so with special attention to expanding regional opportunities. As Figure 2 illustrates, in the last year Asia made the dominant contribution (54%) to global economic growth. These markets are thus the most attractive places to expand trading partnerships over the next five years and, looking further ahead, Figure 3 suggests that Asia will continue to be a majority among the world's fastest growing economies.

**Figure 2: Global Growth Decomposition, 2014
(percent growth of real GDP)**



Source: IMF.

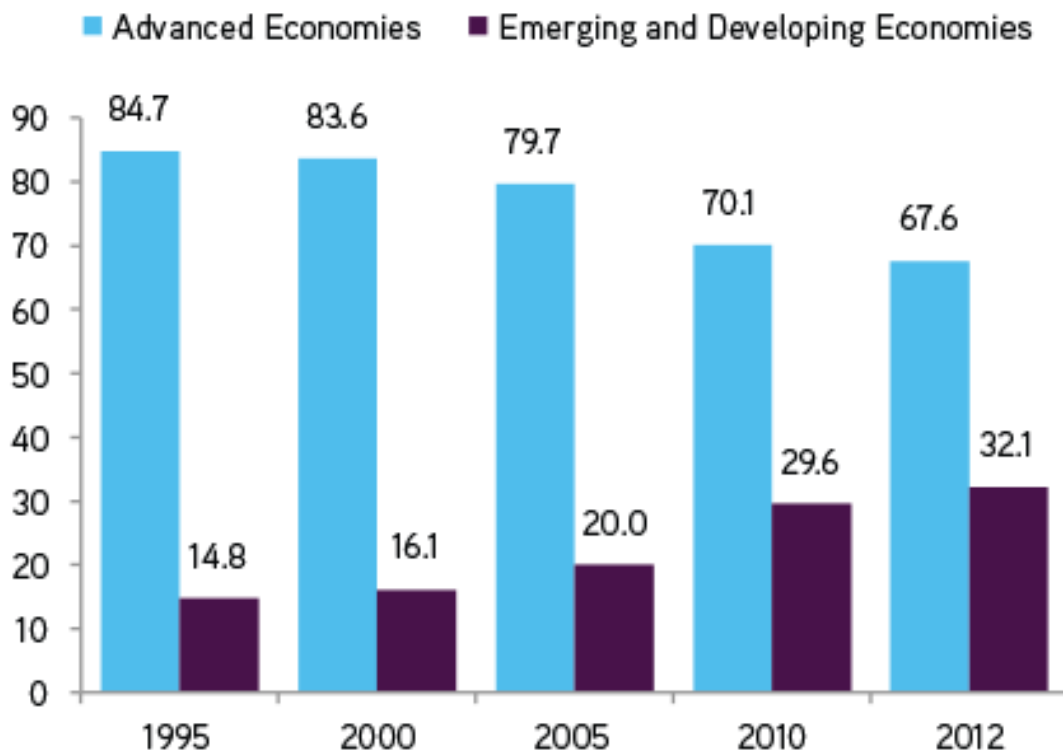
**Figure 3: Real GDP and Population growth by country/region
(annualized percentage change, 2010-2030)**



Sources: IMF, UN, World Bank.

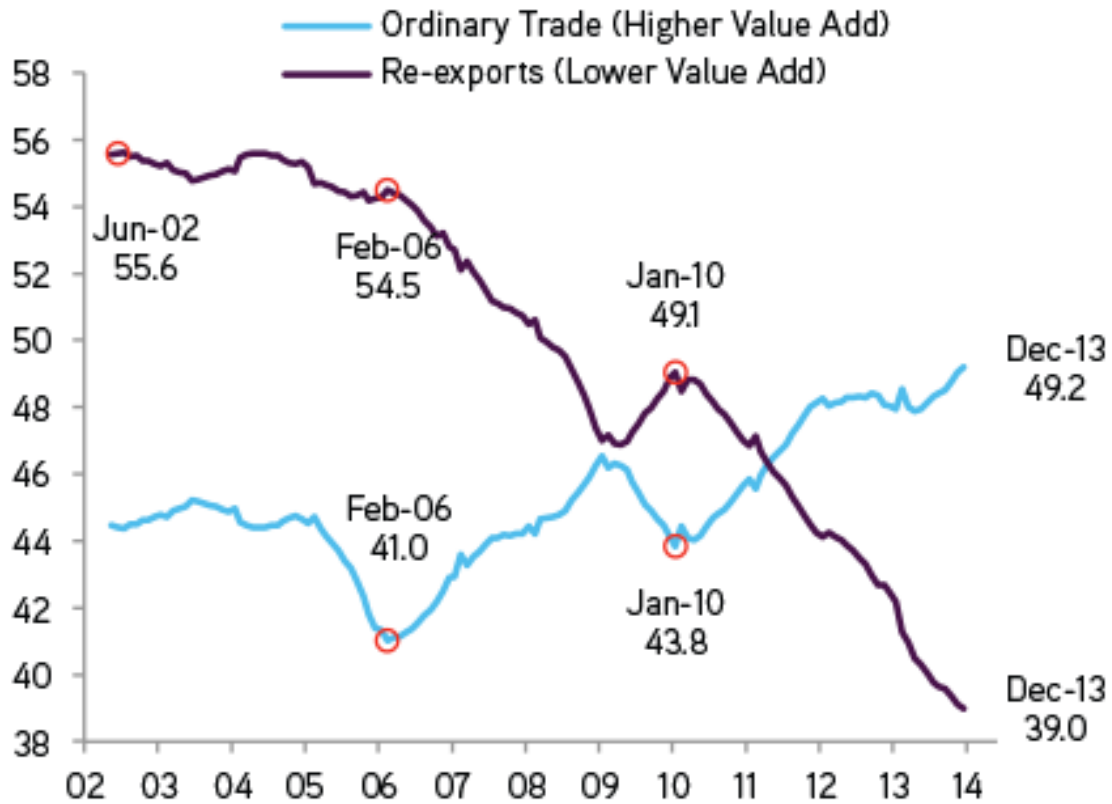
38. The implications of these trends for China are obvious – trade growth strategies should be targeted toward the Asian region. While trade with OECD and other non-Asian partners will continue to grow, it cannot be expected to deliver aggregate export growth rates that have been seen in the past. When China was small relative to these established markets, it could expand exports to them rapidly by increasing market share. Today, Chinese GDP is so much larger that exports to slow growing partners, regardless of their size, cannot make such a dynamic contribution. It must also be acknowledged that Western economies are facing new macroeconomic risks (particularly in Europe), and in this sense expanding trade within Asia offers important diversification against transmission of these risks. As Figure 4 makes clear, China's exporters and trading partners are well aware of these opportunities and have already been taking advantage of them. Policies that facilitate these new trade patterns will have superior growth dividends for the PRC.

**Figure 4: More Chinese Exports are Destined for non-OECD Markets
(percent of total exports per year)**



39. Another important issue with China's trade orientation relates to the composition of the country's exports in terms of comparative advantage and value added. As one would expect for its stage of development, China is shifting export composition to increase value-added and average wages. This means that expanding trade over the next five years can also contribute to rising average wages and productivity. In terms of targeting, China should give special attention to expanding exports of more technology and skill intensive goods, while importing goods to which it can add significant domestic value. These range from agricultural raw materials to manufacturing components, and will depend on China's place in global supply chains. The important thing is to be careful of re-export traps and natural resource intensive exports.

Figure 5: Value Added Characteristics of China's Exports

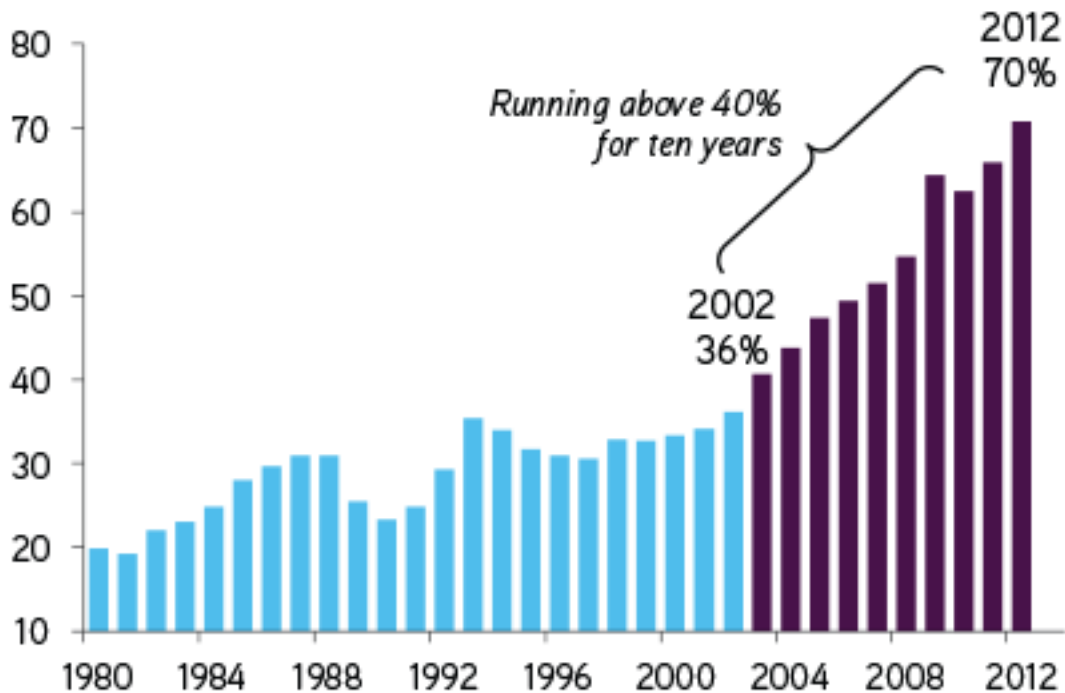


Source: China customs authority.

C. Domestic Macroeconomic Trends

40. To a significant extent, opportunities and challenges for China's globalization are an expression of domestic economic structure. In this context, China's economy is experiencing an important structural transition over the next five years. The three main features of this are rebalancing of aggregate demand and supply, demographic transition, and tapering of aggregate growth. To give context to our conclusions regarding China's expanded international role, we summarize the main features and drivers of each of these three domestic macroeconomic trends.

Figure 6: Fixed Asset Investment as a Percent of GDP



Source: China National Bureau of Statistics

1.1.4 Rebalancing

41. During its dynamic growth phase, China's aggregate demand was dominated by external consumption (exports) and domestic investment, the latter significantly financed by external savings (FDI) and export surpluses. As in the other Asian Miracle economies, these two components of GDP offered strong growth leverage to a low-income economy with limited aggregate demand and savings to finance capital accumulation. After two decades of dynamism, however, cannot expect the same aggregate stimulus from these sources. When China was small relative to the global economy, it could growth exports rapidly by increasing overseas market share. Today it must rely mainly on organic growth of destination markets, which are smaller now relative to China's export capacity and, on average grow much more slowly than China has. Secondly, investment is to a significant extent a commitment of future supply, this will have to slow with tapering growth of domestic and external markets (see Figure 6).

42. China is thus in the midst of a structural rotation of demand. All GDP components will grow, but shares will change, away from exports and investment and toward domestic consumption. This is a natural and healthy transition, as domestic markets are within the scope of government policy and consumption goods are general higher in employment content and value added than investment goods. As the following figure indicates, with rotation toward consumption in China's urban economy, employment intensive service sector growth is improving job creation in urban areas. As we see in the next sub-section, this has important implications for meeting the needs of China's demographic transition.

Figure 7: Relative Growth Rates of GDP and Urban Employment (percent)

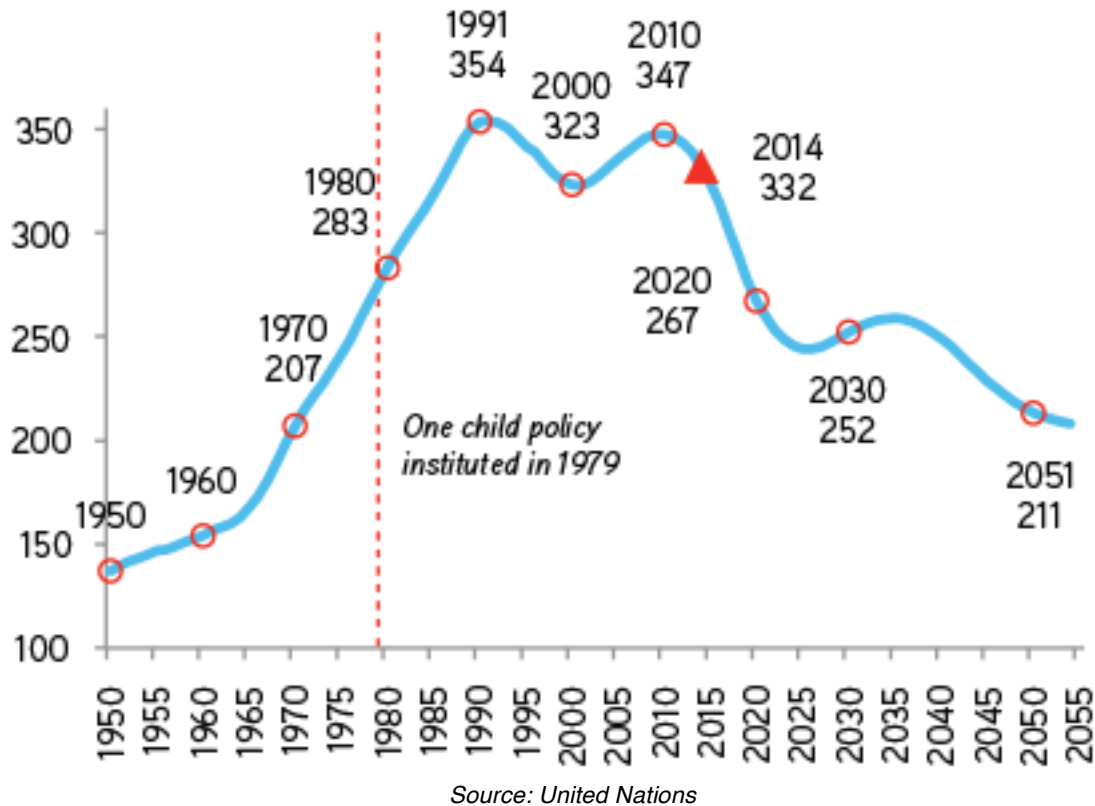


Source: China National Bureau of Statistics.

43. On the supply side of the economy, China is progressing through the second stage of the classical Agrarian-Industrial-Services economic growth transition. Having achieved dramatic successes with industrialization, China is now seeking to move away from the “Workshop of the World” model of low wage production shifting toward increased employment in activities with higher value-added, productivity, and wages. We already saw this in the export share data above, but it is apparent across the economy and supported by rising shares of personal

consumption, an increasingly service and technology intensive final demand category.

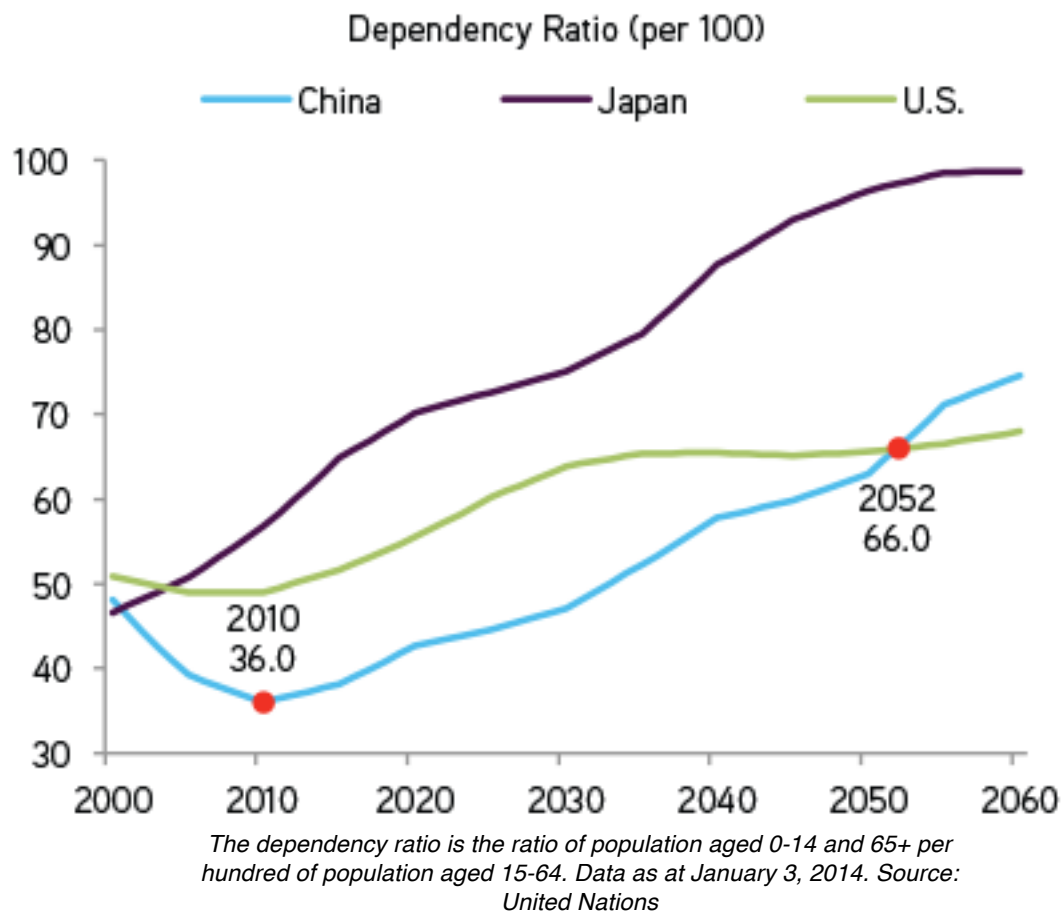
**Figure 8: Labor Force Entrants are Declining
(Chinese population Aged 15-29)**



1.1.5 Demographic Transition

44. The structural rotation toward higher value added demand in turn supports China's shift in the labor market. The country's population trends clearly show that new labor market entrants are reaching an historical maximum that will decline monotonically for at least several decades. This shift, combined with rising dependency ratios that will accompany it, mean that the PRC must shift its employment strategy now from maximizing the number of jobs created to improving wages for existing workers. Without attention to this transition, China's social insurance system will be brought under tremendous pressure and private savings may be unable to sustain long terms growth.

Figure 9: China at the Turning Point: Dependency Ratio by Country

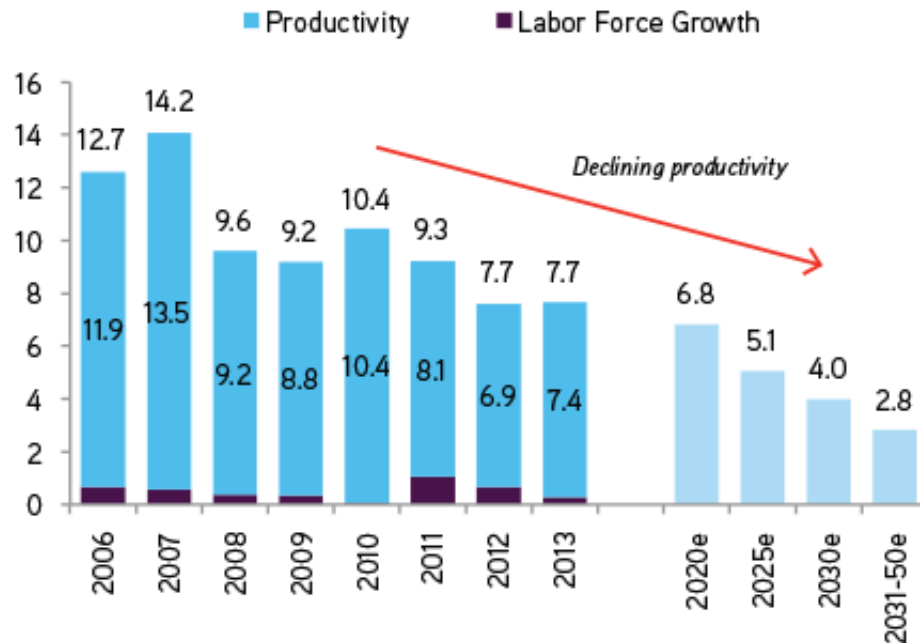


1.1.6 Tapering Growth

45. China's growth experience over the last generation has been quite unprecedented for an economy of its geographic and demographic scale. The reasons for this are complex, but this achievement, in terms of livelihood transformation, is as remarkable as it is unique. From a macroeconomic perspective, the keys to high sustain growth were commensurately high investment and productivity growth rates. Most domestic and international observers agree now that the momentum of these two drivers must slow. For investment, we have already explained why moderating its share of GDP is desirable and necessary. For productivity, the evidence is already apparent that China is transitioning to more moderate growth. As the following figure indicates, average labor productivity growth remains significantly positive, but is declining over the longer term. Reasons for this are completely familiar, as they have been

typical of the maturing growth process of every OECD economy. Of course these are averages, and there will remain islands of dynamism throughout the Chinese economy, but while the scope innovation widens across advanced economies, incremental productivity gains tend to moderate.

**Figure 10: Real GDP Growth and Labor Productivity Trends
(annual percent change)**



Sources: China National Bureau of Statistics, World Bank, United Nations World Population Prospects, OECD Economic Outlook long-term database estimates for 2020-2050.

INTERNATIONALIZATION AND FOOD SECURITY

A. Recommendation 4: Establish overseas agrifood partnership through trade and investment arrangements

46. Like other advanced Asian economies, the PRC is experiencing changing food consumption patterns with economic growth. As household incomes rise, food demand generally becomes more resource-intensive, with rapid increases in spending on meat and dairy products. Because the PRC is home to 20% of the world's population, but only 7% of its farmland and 5% of its renewable fresh water resources, this poses a significant challenge to domestic agriculture. Despite dramatic improvements in productivity and water efficiency, the PRC cannot increase output of extensive (land-intensive) crops fast enough to keep pace with evolving domestic consumer tastes. The result has been a transition over two decades from food self-sufficiency to becoming the world's largest food importer.

47. To improve long-term food security, the PRC should step up medium-term commitments to overseas agrifood partnership. These include incentives and other policies supporting private investment in foreign agriculture, food processing, and supply chain logistics, as well as public partnerships to strengthen agrifood development and trade policy in counterpart governmental institutions. Particular attention should be given to lower income Asian neighbors, where agrifood partnerships with the PRC can facilitate rapid productivity growth, self-directed poverty reduction, and greater food security for on both sides. In this way, the PRC can contribute to win-win food security solutions, meeting the needs of its growing middle class and supporting poverty reduction, middle class emergence, and stronger development partnerships.

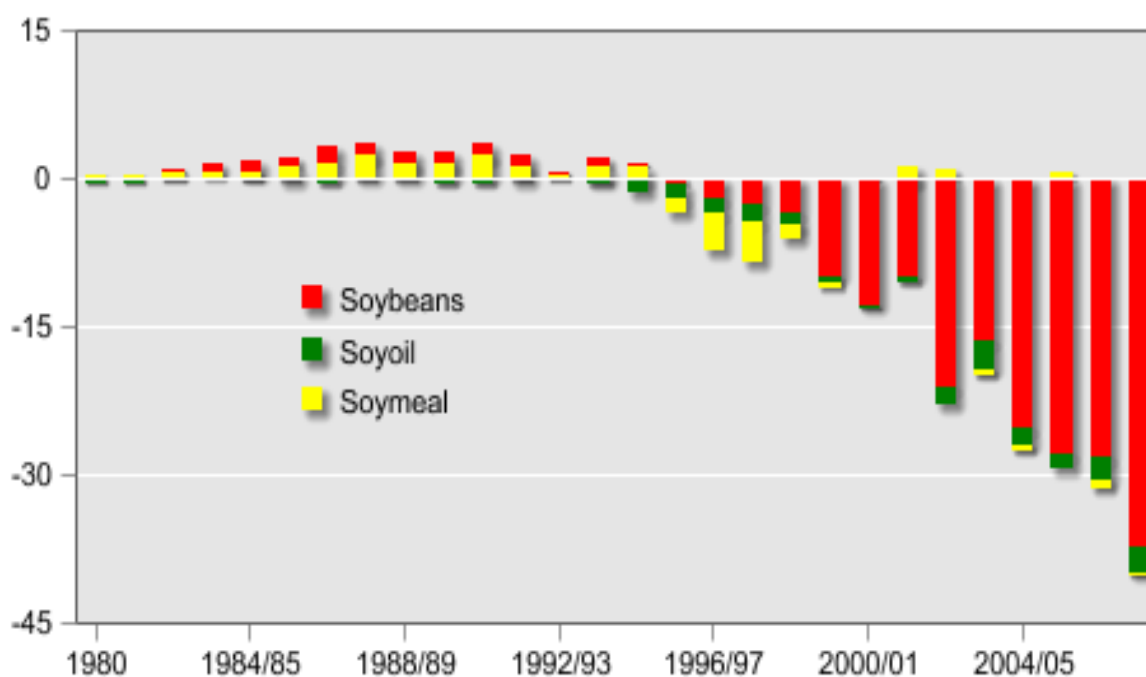
B. Background

48. Like other advanced Asian economies, China is experiencing changing food consumption patterns with economic growth. As household incomes rise, food demand generally becomes more resource-intensive, with rapid increases in spending on meat and other livestock products, processed and formerly "exotic" specialties like imported wine. Because China is home to 20% of the world's population, but only 7% of its farmland and 5% of its renewable fresh water resources, this poses a significant challenge to domestic agriculture. Despite dramatic improvements in productivity and water efficiency, China cannot

increase output of extensive (land-intensive) crops fast enough to keep pace with evolving domestic consumer tastes.

49. Other Asian economies have faced similar challenges, and adapted through agricultural trade. In Korea and Japan, for example, the rice market for human consumption is essentially closed to imports. Despite this, both countries import over half their total domestic supply of cereals to satisfy demand for animal feed. The same process is underway in China, as the following figure makes clear. Most soy for human consumption in the PRC is domestically produced, yet last year this single country purchased over 40% of the world's traded soybeans and soy meal.

Figure 29: China's Soy Tsunami
(net trade in soy products, millions of metric tons)

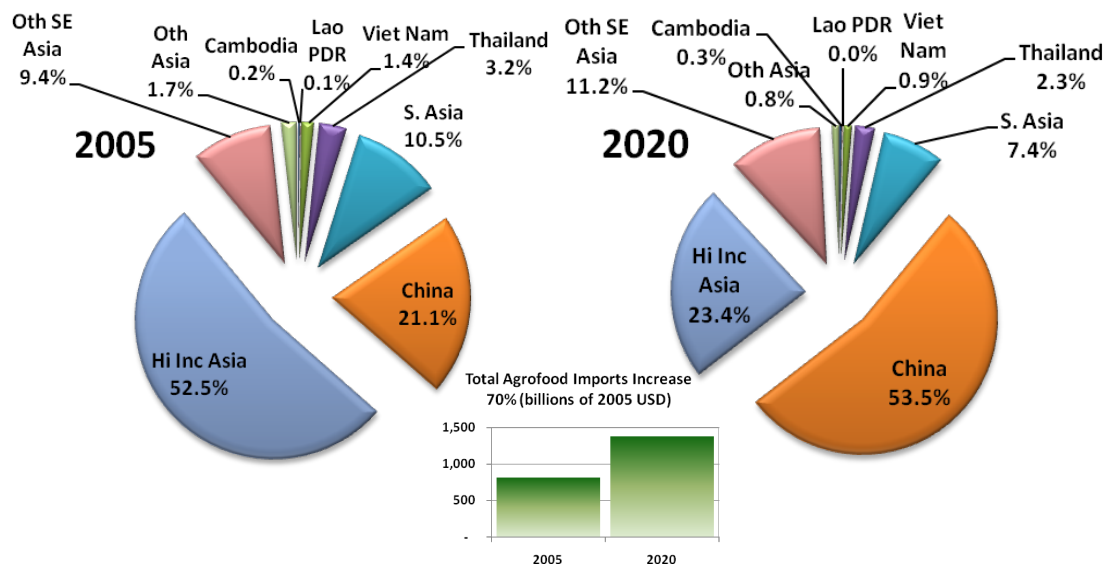


Source: USDA/ERS

50. The challenges of these demand side forces actually present a new and exciting opportunity for Asian regional partnership, growth, and economic convergence. Over the last generation trade in food and other agricultural products has become increasingly important across East and Southeast Asia, where high income Asian economies have historically driven significant

agricultural expansion through investment in overseas agriculture, food processing, and supply chains. Now the momentous growth of China's economy promises even stronger stimulus to realize the region's agrifood potential. The PRC is already Asia's largest net importer of agrifood products, and will dominate the region in the coming decades (Figure 30), offering a new catalyst for rural poverty alleviation to the Asian region. Low income Asia is generally seen to be well below its agrifood potential, a situation that suggests significant opportunity for self-directed poverty reduction through regional agrifood market expansion.

**Figure 30: Shares of Asian Food Imports
(percent)**

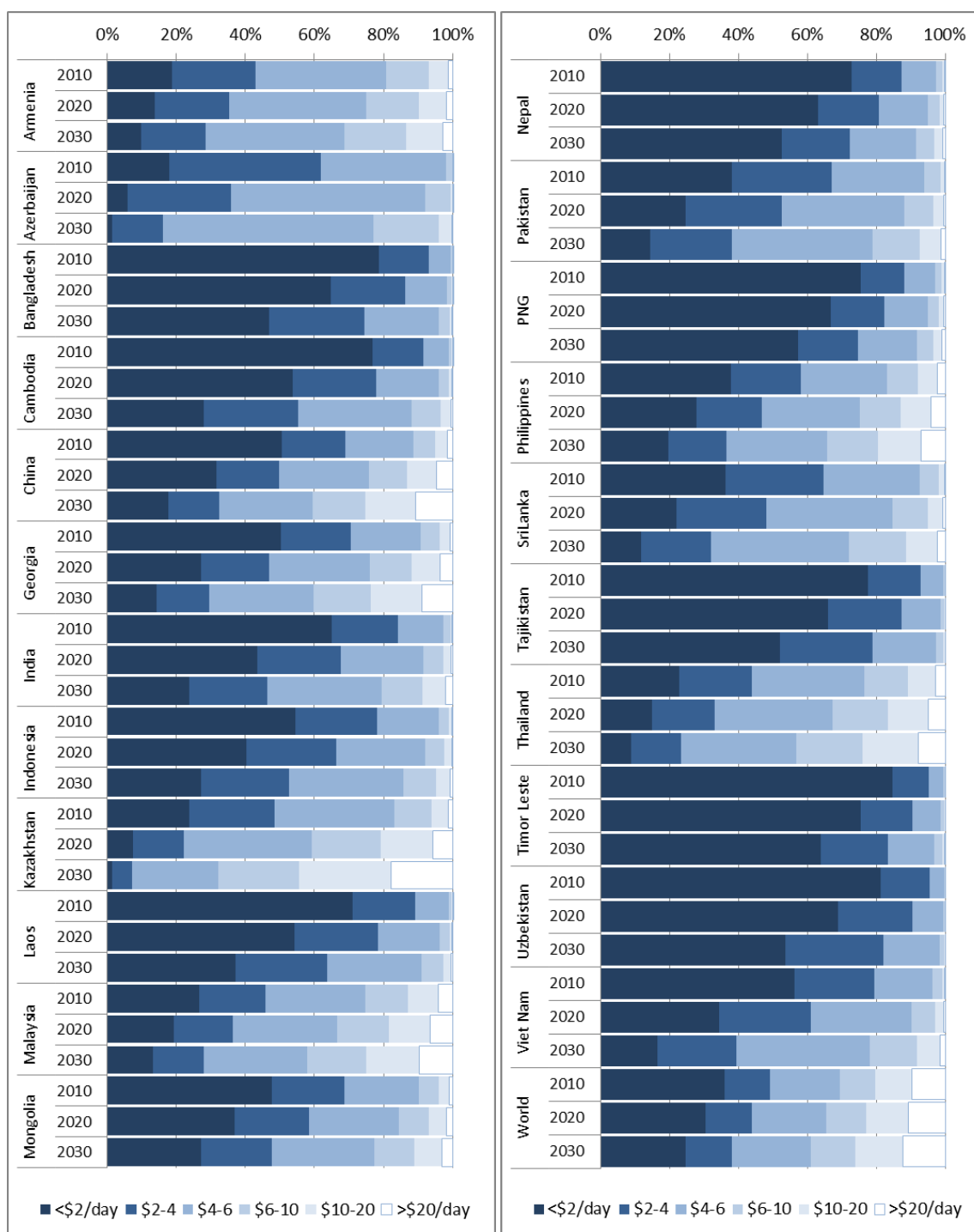


Source: (Jha et al: 2010)

51. Thus, as rising incomes across Asia have accelerated agrifood trade, China's emerging demand can sharply increase the growth leverage that agriculture offers to low-income Asian economies. To capture these benefits and realize the full potential of this process, regional economies must increase agrifood productivity, investment, and value-added in processing and marketing. Otherwise, expanding this traditionally low-wage sector will more likely contribute to increased regional inequality, delivering basic agricultural commodities to higher-income countries with little value-added capture by producers and exporters.

52. With more determined commitments to regional agrifood partnership, the PRC can contribute to a win-win food security solution, meeting the needs of its growing middle class and supporting poverty reduction, middle class emergence, and new market development among its neighbors. The last aspect is particularly important for the longer term. Like Korea, Japan, and Taipei, China, China's agrifood industries will extend to take the lessons they learn at home into new regional markets, expanding rapidly with rising incomes and trade volumes (see the figure below).

Figure 31: Baseline Income Distributions for Consensus Real GDP Growth Trends (percent of population in each income group)



Source: Roland-Holst et al: 2012

INTERNATIONAL FINANCIAL INTEGRATION AND THE PRC

A. Recommendation 5: Keep opening up the PRC's financial markets and the capital account, and further develop domestic legal framework to protect investors

53. As the emerging economic hub of the Asia region, the PRC must assert leadership in delivering the financial infrastructure needed for the next generation of domestic and regional growth and trade. Asia has huge reserves of domestic and external saving, yet their current allocation is well below its potential to promote national and regional growth. Without more determined reform and innovation in its financial sector, the PRC risks a decade or more of slowing of productivity growth. For the promotion of international investment, the PRC needs to keep opening up the PRC's financial markets and the capital account, and further develop domestic legal framework to protect investors.

B. Background

54. Throughout history, financial services have been the essential companion of international trade and dynamic economic growth. This was apparent during early globalization, with Italian banking services during the Renaissance. When Western Colonial trading empires expanded, innovative financial markets in Amsterdam and London fueled them. Modern globalization has likewise been supported by transformative growth of financial services in a dozen prominent locations, including New York, London, Hong Kong (China), Singapore, Tokyo, etc.

55. In two generations since the middle of the last century, Asia has achieved steadily rising incomes as a result of globalization and determined commitments to investment in enterprises and people. The by-product of this "Asian Miracle" is the accumulation of an unprecedented regional reserve of public and private savings. Most Asian societies have promoted high private savings rates and fiscal prudence, while a legacy of export success has garnered substantial reserves of external savings. The result is that Asia has an average gross saving rate (domestic saving as a percent of GDP) of 45%, compared to 17% for the EU and 12% for the United States. Because of historical reliance on traditional depository banking, however, Asia's vast financial reserves are being underutilized, with low returns to savers and inadequate services to private and public investors. This disparity explains why Asia has parked trillions of dollars in low-yield Western government debt and regional investment still remains well

below its potential. Despite relatively high investment from retained profits and traditional bank lending, financial depth in Asia is low because the financial services industry is still in its infancy.

56. Three salient trends will change all this: sustained low yields on OECD debt, emergent investment needs for Asian regional integration (see below), and explosive growth of the Asian financial services industry. Simply put, the region has a vast overhang of underutilized savings and huge emergent regional needs for infrastructure, supply chain expansion, and higher long-term returns to saving. To match these needs and reallocate regional savings to regional investment, Asia's financial services must expand to an unprecedented extent, creating new markets for retail brokerage, public and private bond finance, insurance, and derivatives. These services have already appeared in leading regional capitals (Shanghai, HK, Singapore, etc.), but remain very limited in terms of regional and local intermediation. Like the historic financial revolutions in the trading centers of Renaissance Florence, 17th century Amsterdam and London, investment and risk management needs from globalization will trigger an explosion of regional financial innovation in Asia.

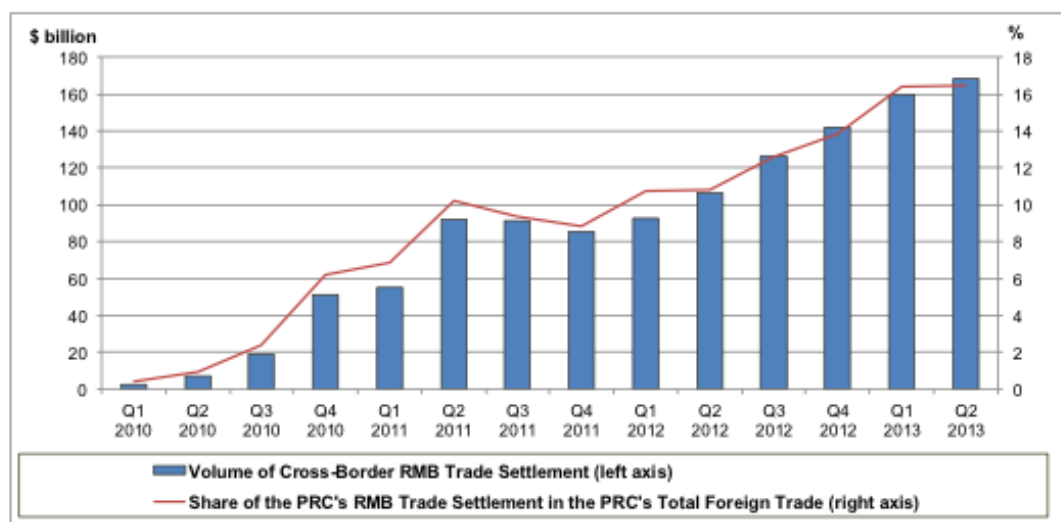
57. Looking at China in the above context, we see considerably less integration with the global financial system than its importance as a major exporting country and leading investment destination would suggest. Its relatively unique circumstances are best understood in the context of PRC overarching domestic priorities for stable growth with urban employment creation as it restructures the economy and moves people out of low-productivity agriculture.

INTERNATIONALIZATION OF THE RENMINBI

A. Recommendation 6: Improve RMB's international liquidity and risk characteristics through more determined financial sector reforms

59. The PRC's economic scale is consistent with reserve currency status, but its current financial policy framework is not. Reserve currencies are technologies for managing international financial liquidity and risk, and their adoption is a voluntary global process responding to the quality of these two services. Over the next five years, the best approach to promoting internationalization of the RMB is to improve the currency's international liquidity and risk characteristics through more determined financial sector reforms, including capital account opening, interest rate deregulation, central bank independence, and greater participation of private sector in financial sector.

Figure 16: RMB Trade Settlement



PRC = People's Republic of China, RMB = renminbi.

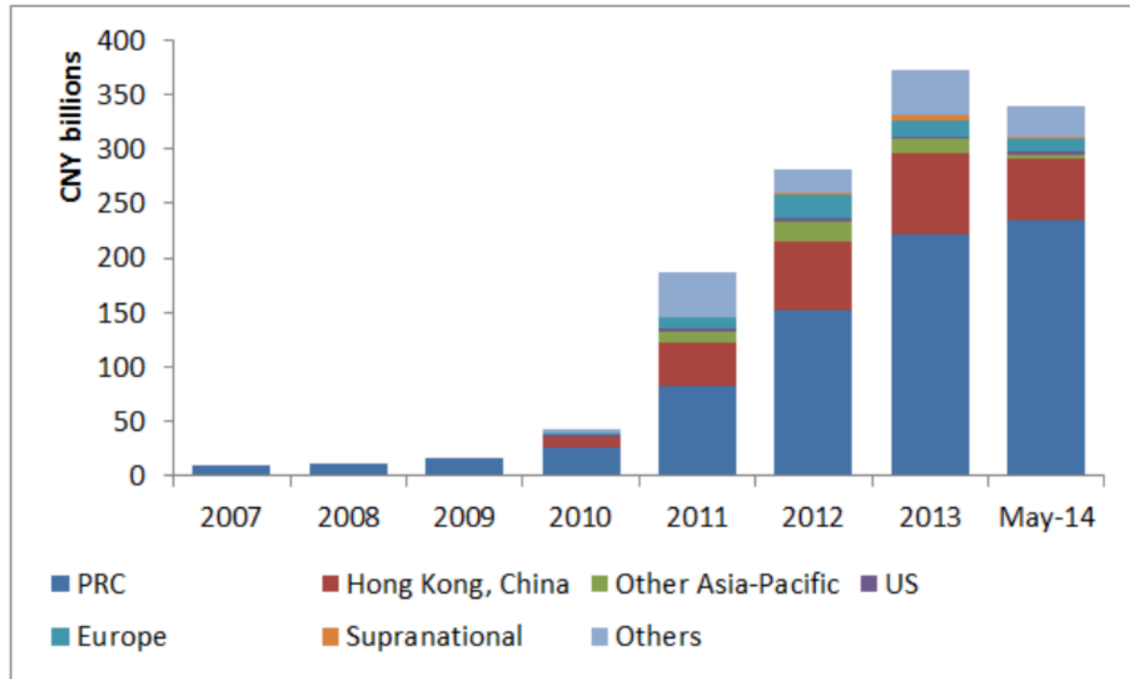
Sources: CEIC, PRC Premium Database; International Monetary Fund, *Direction of Trade Statistics*.

B. Background

60. It is a consistently stated goal of the PRC government that the RMB achieve global reserve currency status. To support this process, the government has sponsored a variety of initiatives that, together with complementary action by bilateral and multilateral partners, has rapidly expanded offshore access to RMB liquidity. In two primary services, trade and bond finance, growth rates have been truly explosive, but from a very low initial base. Figures 16 and 17 given an

indication of how these markets have expanded more than tenfold in the last five years.

Figure 17: RMB Bond Issuance by Country of Issuer



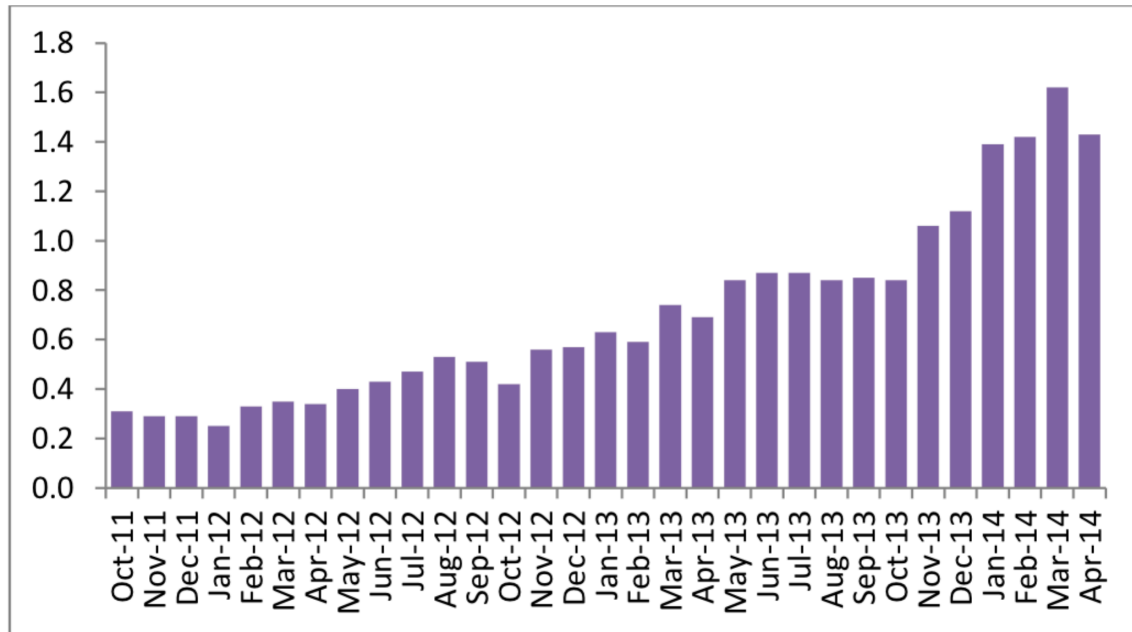
Source: Bloomberg

61. These trends clearly demonstrate fast growing, non-negligible demand for offshore RMB services, yet the drivers of may be complicated. For example, there is a widely held suspicion that a significant component of these holdings may be motivated by currency speculation, recognizing the RMBs long-term path of appreciation against the USD. This behavioral driver has recently been tested by intermittent downturns in the RMB/USD rate, but it remains unclear if those episodes fundamentally changed expectations.

62. Whatever the speculative share of these holdings, a more important issue is the relative scope and importance of RMB reserve services across the global trade and financial community. As the following figures indicate, RMB-denominated international finance is still very limited in terms of market share and geography. Certainly the services reflected here are important to existing participants, but their relative magnitude, sector specialization, and geographic concentration suggest only a very limited influence on global finance at the moment. If RMB reserve services continued to grow at recent rates, this could

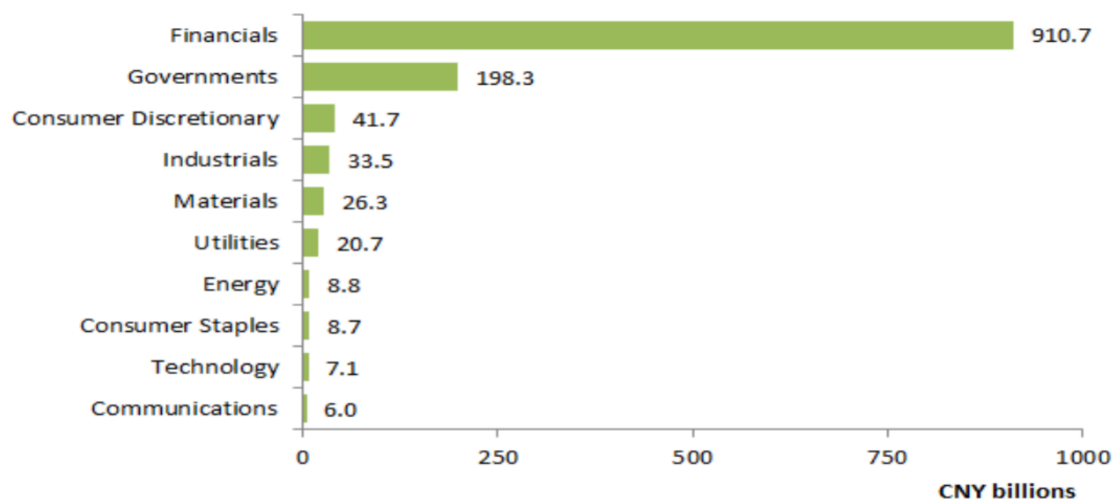
change, but in the discussion that follows it becomes apparent that this growth will probably moderate soon.

**Figure 18: RMB Share of World Currency Payments
(percent)**



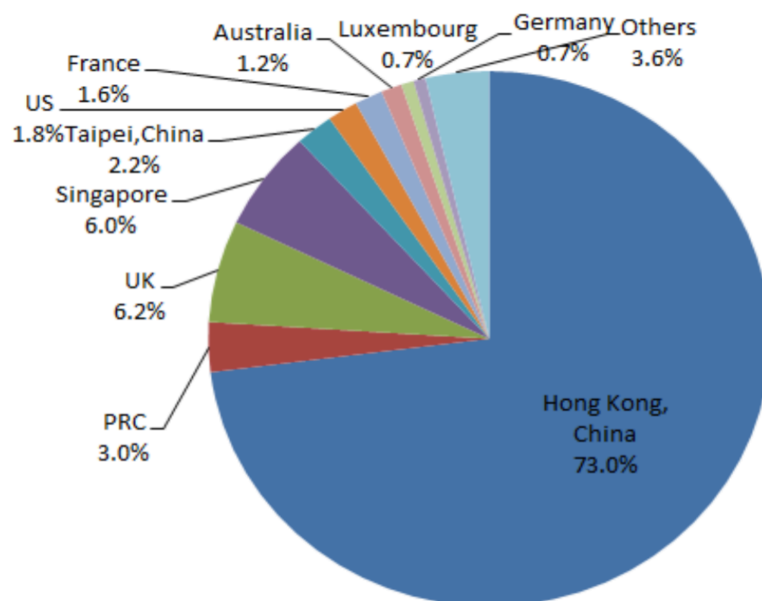
Source: Bloomberg

Figure 19: RMB Bond Issuance by Sector



Source: Bloomberg

Figure 20: RMB Adoption by Country of Intermediation



Source: SWIFT

63. Thus we see that international RMB adoption has grown rapidly in recent years, reaching seventh place among national currencies used in this manner. Having said this, offshore RMB settlement, lending, and other instrumental use remains a small fraction of that for the leading reserve currency. Combining all types of RMB deployment that could be interpreted as reserve services, a stock of less than US\$400 Billion is probably represented. In contrast, as the following figure shows, about US\$5.6 Trillion of US T-bills alone are in the hands of overseas institutions. Ironically, the largest individual holder is the central bank of the PRC (Figure 22). When all reserve services are taken into account (Figure 23), the US dollar and the Euro comprise over 90% of the currency portfolio.

Figure 21: Holdings of US Government Securities

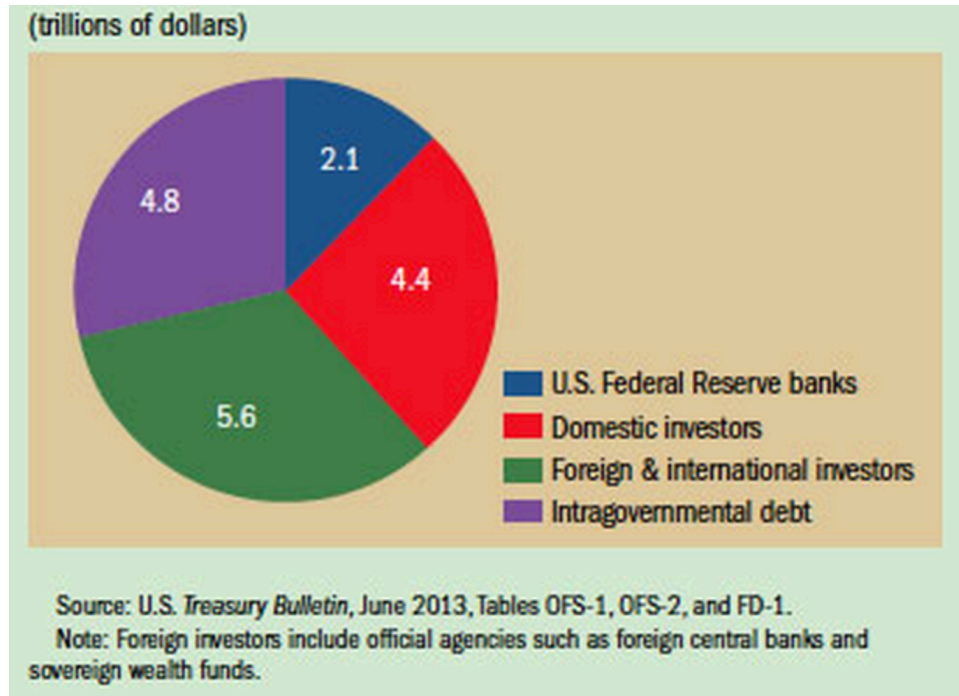


Figure 22: Emerging Market Foreign Exchange Reserves

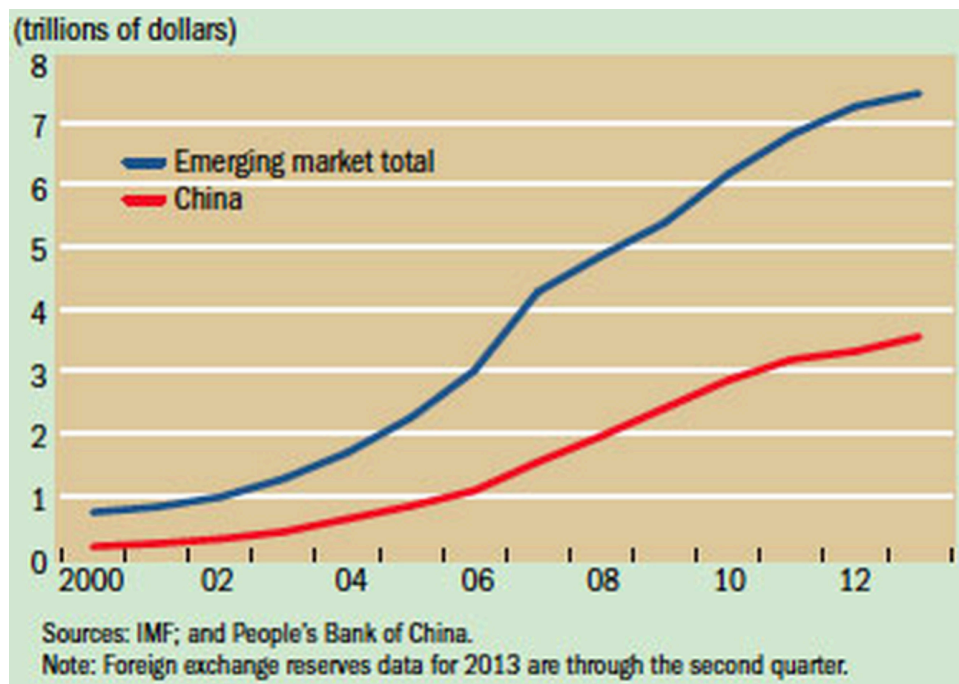
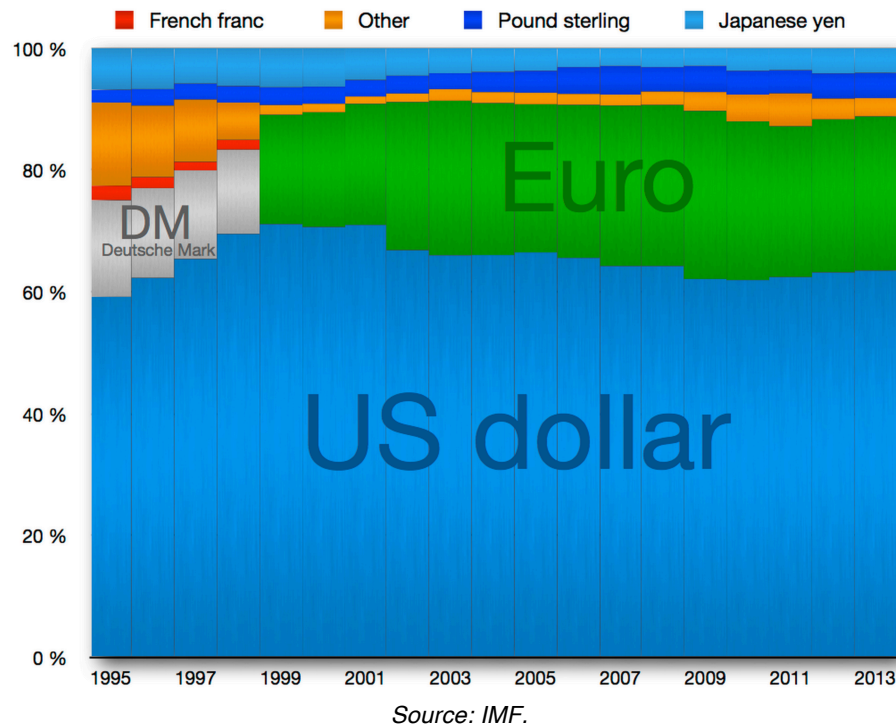


Figure 23: Reserve Currency Distribution



64.Despite the absolute size of the PRC economy and its prominence in international trade then, the country’s currency still comprises a small fraction of international settlements and financial flows. Eventual reserve status for the RMB could confer many benefits on the Asian region and beyond. Three of these are of particular importance:

- Offshore RMB liquidity for trade settlement, reducing exchange rate exposure in supply chain and other counterparty transactions for goods and services.
- Financial and intermediation services denominated in a major currency of global corporate balance sheets, private investment portfolios, and international commercial and sovereign bank holdings.
- Foreign exchange diversification and attendant risk management tools (e.g. derivatives).

65.Despite the appeal of these reserve currency services, as well as their appropriateness to China’s economic scale (Chinn and Frankel: 2007), most expert observers agree that the RMB’s progress toward reserve status will be

gradual, and there are good reasons in the PRC's own domestic economy to justify cautious expectations about RMB internationalization (e.g. Loungemar: 2014, and Eichengreen and Kawai: 2013). Fundamentally, the capacity of a currency to provide reserve services depends on the real scope and risk characteristics of those services. These, in turn, depend critically on the home economy's policy environment and the depth, integration, and market dynamics of its financial sector. In the following discussion, we highlight some salient issues relevant to the RMBs progress toward international adoption. It is apparent from closer examination that both the scope of RMB services and their risk characteristics will slow international adoption relative to the initial surge seen in recent years.

66. The first issue to consider is China's overall progress toward market reform. While this economy has dramatically advanced both private agency and market institutional development, the financial system remains heavily influenced by state decision making, directly in terms of regulation and indirectly in terms of state ownership. China's unique approach to this kind of economic management makes historical comparison with other reserve currencies (Sterling and USD) quite difficult.

67. Expert observers also agree that a currency cannot be effective in reserve service unless the home economy has an open capital account. The reasoning is simple – a closed capital account rations offshore RMB, leading to systemic distortions in relative (domestic and international) asset values. Some agree that capital account regulation remains important to the stability of the PRC economy, but it must be recognized that it is not fully compatible with reserve status.

68. Another prominent issue, closely related to the last, is the degree of openness and market responsiveness of the Chinese financial sector. Interest rates remain strictly regulated across the banking system, which many authors have noted have noted is inconsistent with an open external capital account. This kind of regulation also conflicts with efficient, market based risk valuation, and creates systemic distortions like spontaneous informal competition with the commercial banking system (see figure below). Opening China's capital account under these circumstances would merely leverage these instability risks in the formal banking sector. The most decisive way to remove structural risk like this would be to privatize the banking sector.

Figure 24: China Domestic Credit by Source



Source: People's Bank of China, World Bank

69. A third obstacle to the RMB's performance as a reserve currency is lack of policy independence on the part of PRC monetary authorities. Advanced economies like China need independent and transparent monetary management. This can support efficient and equitable capital allocation domestically and effective financial coordination with the rest of the world. In the present circumstances, with opaque policies of foreign reserve accumulation, preferential credit allocation to state entities, and a variety of ad hoc interventions in real and financial asset markets, PRC monetary policy cannot meet these international standards.

70. All these factors have an important characteristic in common – they represent structural market barriers that transfer risk to financial actors holding RMB, especially offshore. As such, risk characteristics are the primary limitation to wider RMB adoption. It is essential to recognize that reserve currency status is the result of a global process of voluntary adoption in millions of individual bilateral transactions and financial decisions. While this international diffusion can be facilitated by home country policies, this is most effectively done indirectly, by creating conditions for effective liquidity and risk management. In

this sense, reserve status must be recognized as a consequence of economic reforms that open Chinese financial markets and make them operate more efficiently. With determined reforms, substantial progress can be made in this area over a five-year period. Without it, international RMB adoption will be driven more by political than economic forces, and is unlikely to achieve status commensurate with the size of the national economy.

CROSS BORDER TRADE AND SPILLOVERS

A. Recommendation 7: Be more proactive in facilitation of trade with neighboring countries connected by land or sea

71. To the extent possible, the PRC should be more proactive in facilitation of trade with neighboring countries connected by land or sea. This includes improving expediency and consistency in customs administration, prioritizing urban development and expansion at existing borders, and stronger partnership initiatives for development across the PRC's borders. The latter should include targeted lending and even grants to trading partners for bidirectional trade facilitation, local infrastructure for transport, urbanization, training, and technology transfer.

B. Background

72. As has been emphasized above, Asia region is now China's prime theatre for trade-driven economic growth. Bordering no less than fourteen different economies, China would be an Asian hub even if it were a small economy.¹ Given its size and trade shares, however, China is now more like an economic engine of the region. This fact was more apparent in the first phase of globalization when the so-scaled Silk Road was active, but a transition to maritime transportation during Colonial times led to very different trade patterns. These persist today and will continue to do so because of the relatively low cost of water transport, yet the promise of growth in Asian regional trade will depend critically on more intensive cross border trade.

73. Many of China's borders are in historically remote areas, and geographic have constrained development there. China has demonstrated over the last generation, however, that determined commitments to infrastructure and

¹ By comparison, Germany borders nine countries, the United States just two.

supporting public and private services can overcome this. Opening the historically remote Western and Southwestern, and Northwestern regions of China has unlocked tremendous resource potential, and expanding these links across neighboring borders would enable the PRC to share this potential and open new market opportunities for actors on both sides. Moreover, cross-border trade can also mark the beginning of routes to larger and more distant markets, offering wider networks for supply chain expansion and value creation.

74. Most of China's immediate neighbors are lower income countries, many with severe domestic savings constraints. For this reason, it may not be realistic to expect parity of infrastructure and other trade facilitation measures on both sides. Both countries lose from this situation, as uncertainty and delays undermine both the volume and value of trade in both directions. As the larger economy, China is likely to be sacrificing more in absolute terms, and thus it has greater incentive and capacity to contribute to solve this problem. Over the next five years, China could make dramatic improvements in transboundary trade capacity, but promoting urban development on its own side and targeting lending and even grants to improve hard and soft infrastructure on its neighbors' side of the border. This arrangement might at first seem unorthodox, but trade facilitation financed from pooled resources is a central premise of the most successful economic unions (e.g. Europe). By improving transit at individual borders, both countries improve their trade prospects with multiple downstream markets, all of which can also benefit. In the case of the PRC and its neighbors, the asymmetry of benefits makes the case even more strongly.

75. A final consideration is the developing country status of many of China's neighbors. Trade facilitating investments in those economies, especially at the border of a dynamic trading partner, can be seen as a very growth-oriented form of development assistance. We have more to say about this in the next section, but China should consider its regional development mission to include Asian connectivity, as this would promote faster growth in lower income, saving/investment constrained economies, accelerating poverty reduction and economic convergence.

CHINA'S ROLE AS A DEVELOPMENT PARTNER

A. Recommendation 8: Support the next generation of multilateralism, including trade and investment facilitation across the Asian region, and promoting knowledge sharing

76. The PRC can set an essential example by supporting the next generation of multilateralism, including trade and investment facilitation across the Asian region. In addition to more active engagement with existing international institutions, the PRC should take leadership in investing in institutional and infrastructure connectivity, and establishing a regional multilateral framework aimed at facilitation of trade, financial integration, and development assistance. Instead of treaty-based, binding trade agreements, this arrangement could be modeled on the OECD, a venue for collaborative dialog that actively and consistently promotes standard setting, policy coherence, and transparency. These commitments will be essential to achieve inclusive regional growth.

B. Background

77. Asia is comprised of very diverse economies, presenting both challenges and opportunities. Challenges include institutional differences that can undermine regional policy coherence and escalate both costs and risks for regional investors. Also impeding growth are limited domestic savings resources in lower-income Developing Member Countries (DMCs), a situation that hinders investment and technological progress. Today's most dynamic Asian economies have relied heavily on public and external finance for to facilitate their transit to prosperity. Foreign direct investment has been a potent catalyst for growth in some countries, and with more effective Asian regional integration, Asia's prosperity can accelerate significantly. Private agency and capital markets, however, can only do part of the work in a region with such disparities of initial conditions, and more determined public commitments to investment will also be needed. For this reason, more advanced economies in Asia must coordinate their efforts to overcome capital market failures and other development barriers, combining development resources to facilitate enterprise development, public investment, and social progress across the region. Competing development assistance is an artifact of Western colonialism, and the Bretton Woods institutions were intended to render this irrelevant. In Asia, enlargement of the regional market can benefit all the region's established exporters, and these countries need to establish new standards for pooling risk and opportunity to

develops regional markets without rivalry or exclusion. In this way, the second and perhaps greatest stage of modern Asian economic emergence - growth through open regionalism - could make history's greatest contribution to improving human livelihoods.

78. Because much its early development assistance has been focused on basic infrastructure and natural resource investments, China has been seen by some as rather opportunistic and narrow in its development partnerships, delivering turn-key projects or resource barter agreements that have very narrowly focused economic impacts. As China expands its commitments to development partnership, it can dispel these impressions by taking advantage of a broad array of accomplishments from its own development experience.

C. Knowledge Sharing for Development

79. Because of China's remarkable success with rapid economic development, many in the developing world see the country as a role model. Although the PRC's institutional characteristics are unique and there are always limits to transferability of development experience, there is no question that many of China's accomplishments in public health, education, and technology could be effective models for countries that are still contending with serious development challenges. In addition to traditional financial assistance, China's overseas aid could have a stronger institutional outreach component, with Chinese medical, educational, and technology professionals going abroad to train developing country counterparts. These programs would complement and be more cost effective than existing programs that bring individual foreign trainees to China. Such programs would also offer China's supporting industries opportunities to transfer technology and develop market partnerships.

D. Trade for Development

80. Although it is by no means unique in this respect, China has also been challenged for taking a neo-mercantilist approach to trade with developing countries, bartering high value added manufactures in exchange for low value added resources. Given differences in stage of development, such trade patterns are hardly surprising and cannot fairly be said to arise from deliberate policy bias. Having said this, it would not be difficult for China to promote greater local employment and technology transfer in commercial relations with developing countries. This kind of mutually beneficial cycle is already engaged across parts of Asia, where Chinese investors are transferring productive capacity to lower

wage economies in SE Asia and more resource rich low-income economies in Central Asia. The PRC government can strengthen these synergies with a variety of policies that simultaneously promote growth at home and among its development partners. These would include more open capital markets, promotion of technology standards, negotiation of more effective joint venture agreements. Beyond these targeted policies, all initiatives at trade facilitation, including more determined commitments to hard and soft regional infrastructure, can reduce trade and transport margins, expanding the horizon of profitably regional investment for all, including Chinese investors, to more fully realize the benefits of Asia's vast resource potential.

E. Investment for Development

81. In addition to promoting trade as a source of regional and global growth in developing countries, China can expand production, trade, and employment in three dimensions of investment policy. The first of these is capital account opening and other policies to support Chinese investment abroad. To more fully participate in international supply chains, technology and innovation networks, and to more efficiently utilize global resources, Chinese companies of all sizes need to be able to invest abroad. In the present circumstances, limitations on capital flows and convertibility remain significant constraints.

82. A second essential need in this context is more determined negotiation by the PRC to remove or relax barriers to Chinese investment in developing economies. Chinese FDI can help these countries overcome domestic saving constraints, transfer technology, and gain export market access. Because of issues related to property rights, colonial legacy, and sometimes simply politics, developing countries can be inhospitable to foreign direct investment. Because of its own more recent transition experience, however, China unique among advanced economies in its opportunity establish new standards for mutually beneficial investment partnership. Building such trust relationships will require policy discipline, but has many long term benefits.

83. A final dimension of China's potential role regarding investment for development relates to development lending activity. China is a well-established member of this financial service community, including its membership in Bretton Woods institutions, the Asian Development Bank, and through international expansion of the China Development Bank. Beyond this, China is pursuing two more initiatives, the International Infrastructure Bank and a BRICs Development bank. All these services will dramatically increase the country's capacity to promote

international development. One can only hope that this expansion proceeds efficiently, without undue duplication of effort, and with effective risk management.

INTERNATIONALIZATION AND ENERGY POLICY

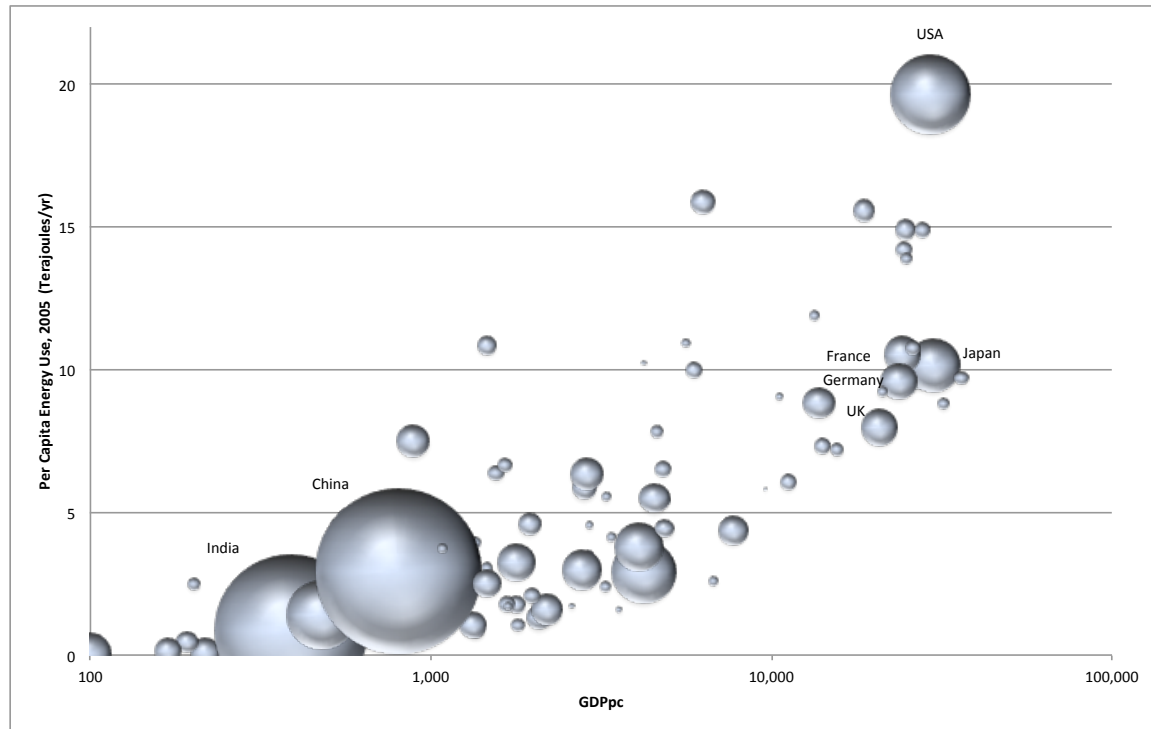
A. Recommendation 9: Expand imports of natural gas to reduce public health risk from air pollution

84. China's energy system has become a critical source of public health risk, and it is imperative that per capita toxic emissions be reduced, especially in urban areas. Natural gas fuel substitution in electric power and ground transportation is the fastest way to accomplish this goal. Domestic shale gas has significant potential, but its development will be constrained in the short run by logistics and the water intensity of existing extraction technology. To meet its emission reduction needs, China should significantly expand gas imports over the next five years, particularly from Central Asian and other regional partners.

B. Background

85. As the figure below makes clear, energy consumption in Asia generally, and China in particular, remains relatively low on a per capita basis. Energy use in the PRC continues to accelerate with expanding consumption of electricity and transportation, and these activities have sharply increased public health risk in urban areas. Higher emissions of particulates and other criteria pollutants are closely linked to the carbon intensity of the current energy supply, and China is taking long term measures to mitigate this in three ways: renewable energy development, nuclear energy, and displacement of coal with natural gas. The first of these two options will take a decade or more to significantly reduce the carbon intensity of China's economic activity. Natural gas is already being developed from China's vast reserves of petroleum-laden shale, but technology constraints also make domestic shale gas a long-term commitment. What China can do over the next five years is to expand imports of gas, especially with Asian trading partners, while it simultaneously expands its own offshore gas development.

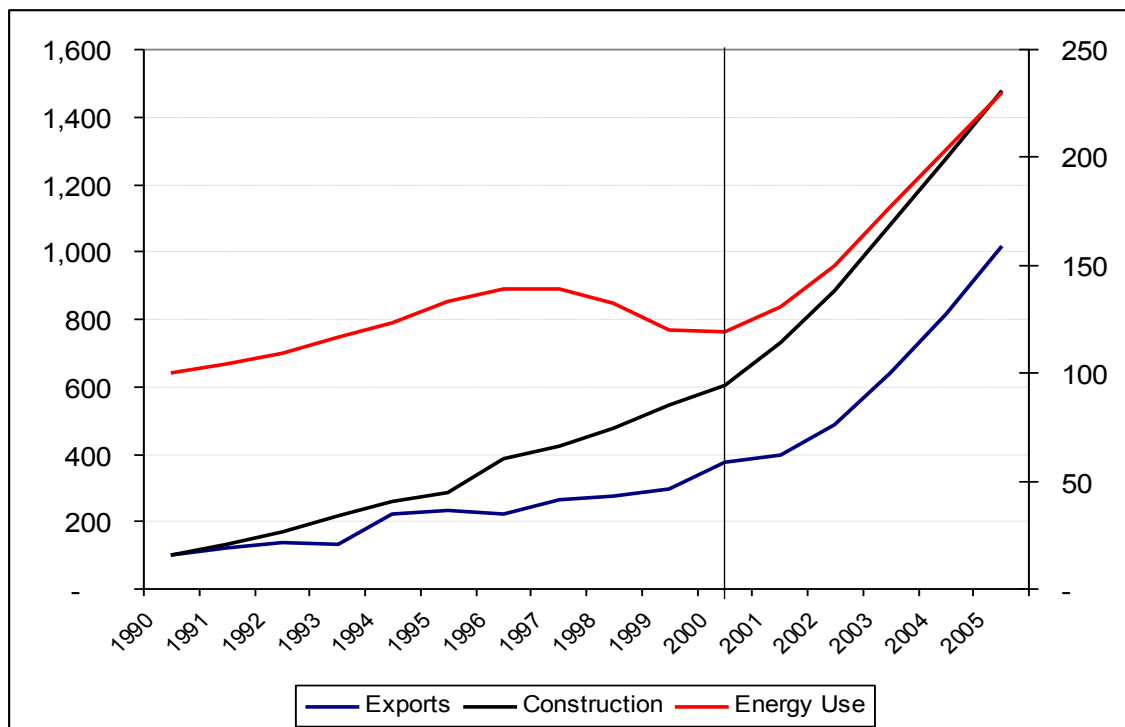
**Figure 25: Per Capita Energy Use and Income by Country
(bubble diameter proportional to population)**



Source: Author estimates from IEA and World Bank data.

86. Historically, China's recent energy past and near future are complex, driven on the demand side by strong domestic and international forces. As the figure below shows, the energy intensity of economic activity in China was improving before the country joined the WTO. In the mid-1990's, an apparent trend of so-called "decoupling" economic growth from energy demand growth began. This improving trend in the energy intensity of economic activity was brief, however, ending around 2000 when China became the "workshop of the world." By 2010, fully one third of China's domestic energy use was fueling export production, i.e. foreign consumers were responsible for about as much PRC domestic energy demand as the China's own households.

**Figure 26: Trends in PRC Trade, Construction, and Energy Use
(indexed to 1990=100)**

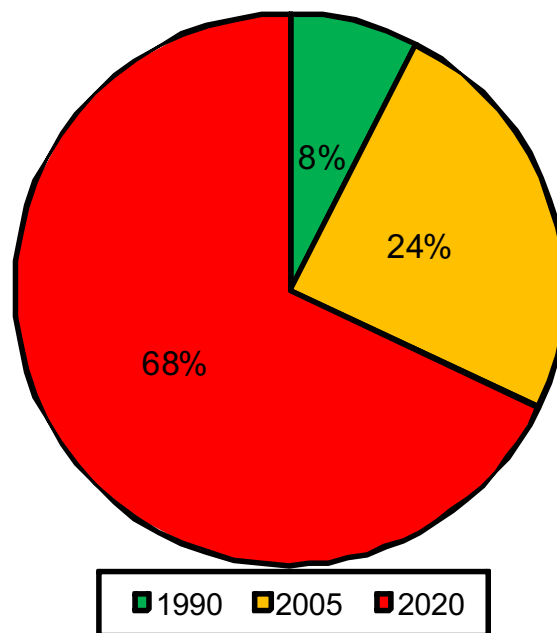


Source: National Bureau of Statistics. Trade and construction output in constant (1990) prices.

87. This fact, taken together with the emissions created, presents an interesting consideration for global climate negotiations, but meanwhile China has a responsibility to secure the public health of its own population. To do this, the emissions intensity of domestic energy production must be reduced. Unfortunately, legacy commitments to one of the leading energy fuels, coal for electric power, will make this transition difficult. As the figure below indicates, China tripled its electric power capacity during the fifteen-year interval 1990-2005, and plans to do so again by 2020, an increment larger than the 2010 installed capacity of the entire European Union (27). Plans for this originally called for over half the new generation capacity to be coal-fired, but the current FYP offers an opportunity to shift in favor of less emission intensive technology. The most attractive alternative in terms of medium term feasibility would be natural gas, but to do this substantively will require sharply increased investment in new technology, trade, and gas exploration/extraction. China has sharply increased its commitments to gas development, but medium term logistical and

water availability constraints will restrict shale gas development. This fact increases the importance of rapidly expanding gas imports and marine gas development during the term of the current FYP.

Figure 28: China's Electric Power Capacity in 2020, by vintage



STRATEGIC FRAMEWORK FOR COOPERATION - TRADE, INVESTMENT, ASSISTANCE

A. Recommendation 10: Intensify collaboration with neighboring countries in promotion of regional economic cooperation initiatives for mutual benefits

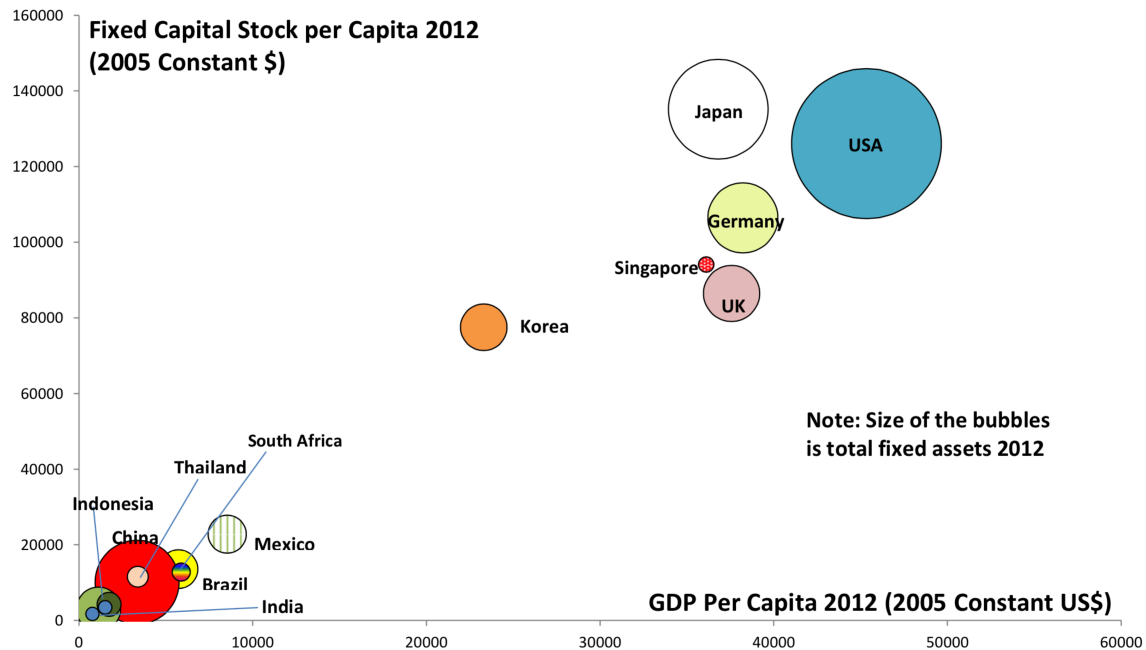
88. The PRC's historical growth experience makes it a valuable partner for developing Asia. Across the region, the PRC can exert beneficial influence by promoting knowledge sharing, trade, and investment. The PRC's own development experience contains valuable lessons for each of its lower-income neighbors, and it can play an influential role in regional development assistance. By improving bilateral and regional trade relations and partnering to expand infrastructure, the PRC can offer its neighbors access to the world's most dynamic internal market. By promoting private Chinese investment overseas, the PRC can help lower-income regional partners overcome domestic savings and technology constraints.

B. Background

89. To fulfill the potential of the next generation of globalization will require unprecedented investments in Asian regional infrastructure and connectivity (Figure 32). The first phase of modern globalization intensified colonial patterns of maritime trade, which were cost effective between North-South hubs but excluded substantial parts of Asia. To realize the benefits of more inclusive growth across this region, comprising 61% of humanity, 30% of global land area, but only 18% of global income, will require extensive investments in all forms of connectivity. These commitments will be essential to achieve inclusive regional growth.

90. There are two major theaters of for these developments, Central Asia and Southeast Asia, both extending outward from Asia's largest economy. Central Asian networks will improve the efficiency of global resource extraction and allocation, connecting to important EU and Russian markets, and promoting income and market growth in many lower income Asian economies.

Figure 32: Much Remains to be Done in the Asian Region



Source: World Bank. Note: Capital stock is cumulative fixed investment since 1960 with a depreciation rate of 5 percent

91. Following the Mekong Corridor investments, deeper infrastructure commitments across Peninsular Southeast Asia will further expand regional markets. It will also link the world's two most populous economies, an unprecedented feat of regional economic integration. Because of geographic realities, the full growth potential of India-PRC trade, for the region and the global economy, will depend critically upon infrastructure. Although their boundaries are proximate in some areas, the Himalayan plateau is unlikely to sustain more than a small fraction of their bilateral trade. The more attractive bridge between these giants is Southeast Asia, already a robust trading environment and one that would capture many of the indirect benefits of intensified India-PRC trade. For these reasons, the entire Asian region has an important stake in expanded Southeast Asian trade infrastructure. This is particularly true of many low-income economies that would be directly in the path of new transport axes. Myanmar, Laos, Cambodia, and (to a lesser extent) Viet Nam have long been at the margins of larger East and South Asian growth dynamics. They could become central pillars of a comprehensive bridging infrastructure between China and India.

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