



CHINA-EUROPE: RIVALRY OR COOPERATION?

By Alfredo Pastor

From the title of this talk you will have guessed at its conclusion: that cooperation is to be preferred to rivalry. Since rivalry looks more fashionable today, however, I will take some of your valuable time in explaining why cooperation is a much better strategy. This I will do on three different, but not mutually independent levels: macroeconomic imbalances, trade and the political landscape.

Looking at current-account positions, one can divide the world - most of it, anyway - into two large blocks: on one hand, the US, the UK and Australia - the Anglo-Saxon block, to use an expression by Martin Wolf of the Financial Times - has a current-account deficit of \$803 billion, of which the US accounts for almost 90%; on the other, the Eurasian block - China, Japan and the Euro-zone - has a combined current-account surplus of \$460 bn, of which almost 50% corresponds to China, 37% to Japan and the rest to Europe .

These imbalances cannot continue growing forever without generating, sooner or later, a financial crisis; but

neither can they be corrected by the unilateral action of one of the parties. If the adjustment had to be made only by contracting aggregate demand in the US, the contraction might be so severe as to push the world economy into a recession; in one entrusted the task to a depreciation of the dollar, this might be so large as to create a general financial crisis, since a large part of the world's liquid assets are dollar-denominated; a revaluation of the Asian currencies - since the euro has already experienced substantial appreciation against the dollar - would place Asian financial systems under stress and would harm growth in all the countries concerned, especially in China.

If, before thinking of possible remedies, one looks again at the nature of the problem, the nature of the solution suggests itself: the existing imbalances will be corrected when both blocks adjust their aggregate spending to their output: which means, for the Anglo-Saxon block, that internal demand must fall relative to its output: it must not continue spending more than its income. The reverse is the case, of

course, for the Eurasian block: there, spending will have to rise relative to income. Simplifying a little, one may say that Anglo-Saxon countries will have to save more; Eurasian countries will have to save less.

What one must notice here is that Europe and China have similar, not opposite roles: both must increase their internal demand: consumption, investment and government spending. In the case of China, where investment is already 43% of the Gross Domestic Product (GDP), it is probably consumption that must be stimulated, and perhaps government spending, since China has the task of adapting its welfare state to make it more consistent both with a more market-oriented economy and to a rising average per-capita income. For the euro-zone, both higher investment and higher consumption are the answer .

A diagnosis, however correct, does not bring forth immediately the correct remedy, although it helps in discarding wrong ones: so, for the Eurasian block, one may say with confidence that contractionary policies - be they stability

1. Data are for the twelve months ending with the first quarter of 2005. Source: *The Economist*. The difference between the current-account deficit of the Anglo-Saxon block and the Eurasian block's surplus is mainly due to the surplus of the oil-exporting countries.

pacts or the threat of structural measures never carried out - are surely the wrong medicine for Europe. The matter is more difficult for China, since no one seems to know how to persuade consumers to spend more; but there is general agreement that China's success in her development hinges on the existence of a stronger domestic market.

To say that China and Europe are on the same side of the current-account divide is not yet to say that they are on the same boat: although world imbalances will not be corrected until the entire Eurasian block has become less of a net exporter to the rest of the world, Europe might decide to stimulate its aggregate demand by exporting more to Asia, and Asia might decide to do the same with Europe: both sides could try to export their way out of their difficulties. Indeed, this is just what they seem to be doing: for, while we all have heard of how Chinese goods flood European markets, we should not forget that a country such as Germany, with negligible, or even negative GDP growth, has a current-account surplus of \$108 bn, and that, in the last three years, China has accounted for more than 30% of the growth of Germany's exports.

We know, however, that this strategy - based on rivalry rather than cooperation - is no solution: the period between the two world wars of the twentieth century has taught us that it leads to a rise in protection overall, to trade wars and to conflict; and, if conflict can be avoided, to a lower level of welfare than might be achieved otherwise. This seems to leave cooperation as the only, or at least as the better way out. It is difficult, however, to see how cooperation can be reconciled with the fact that, at least in appearance, China and Europe are more rivals than partners in trade; so it is necessary to look at the trade issue in more detail.

One must begin any discussion of the issue with a general disclaimer: since the integration into the world economy of such a large and singular country as China has no known precedents, one must not pretend to know how the process will unfold itself; only reasoning by analogy is possible, and analogies, especially in the case of China, have their limitations. We know, however, that the process is likely to be a long one, and that it may change the world as much as China is changed by it. The following

remarks, which one can venture with a reasonable degree of confidence, may serve to put the trade issue in perspective:

First, China's reliance on its export sector is by nature temporary: China's economy will become too large to rely on the rest of the world to buy more than a fraction of its output; at some point, most of the goods produced in China will be for domestic consumption, just as has happened in all large economies. While export promotion - the choice made by Japan and South Korea in the early stages of their development - is without doubt a better choice than import substitution, excessive reliance on exports carries both external and internal risks: on the external side, in the form of rising trade frictions; internally, because it may end in the appearance of a dual economy - a modern sector growing ever richer and a traditional sector growing ever poorer - and increasing inequality in income distribution is, already today, a danger that China has to address in the course of her development.

Second, the transition to a more balanced economy is likely to be a long one: China has a large reserve of unskilled labour ready to move to the modern sector in search of better opportunities, so that the need to create enough jobs in the modern sector is perhaps the main goal of economic policy, explaining both the need for sustained, high GDP growth and the reliance on the export sector. If this is true, one may expect China's dominance of the world markets for textiles, clothing and many manufactures to continue, and its market share to increase. It does not follow, however, that this dominance will extend, in the short run, to other sectors where more skilled labour is critical. Highly skilled workers and professionals are relatively scarce in China - and, as a result, they command high prices; so it is unlikely that China may extend its comparative advantage to those sectors before it has reached a higher level of development, with a stronger domestic market and a different cost structure.

Third, the goods produced in the euro-zone tend to be more complements than substitutes with respect to those produced in China. This does not apply to all European countries: while many EU industries are already benefiting from China's integration, they are more

concentrated in Europe's more advanced countries; in others which lag behind, as well as in other non-European countries, losers may well outnumber winners.

What these remarks suggest is that the integration process will not be stopped, or reversed, since too many people benefit from it; but that it must be managed, externally and internally. Externally, it must be recognized that success depends on timing: resources, especially labour, must be given a reasonable chance to reallocate, and trade flows should be monitored to that effect, on both sides - we must remember that there are losers on China's side, too. Internally, losers should be compensated, perhaps not so much by means of money transfers as by more education and training. Admittedly, this is easier said than done; but the WTO, on the external side, and domestic, or even EU-wide policies, should make it possible to reach a better solution than what the market, left to itself, can deliver. If some of this at last is not done, the risks of backlash are high - again, on both sides.

It seems as though, after looking at the trade issue, the advantages of cooperation over rivalry appear more clearly. Let us now, finally, look at the political landscape.

Even to an untrained - and unauthorized - observer like me, it is apparent that, when China looks at the other powers of our world, Europe is the only one with which there are no major political issues. On this level, cooperation is, not only necessary to make the world safer and more stable, but also natural, since there are no really contentious issues between us. Unfortunately, effective cooperation would require a more united Europe; and one may lament the fact that we Europeans pay too much attention to our differences, and too little to what we have in common; the result is that we are, for now, incapable of fulfilling what I believe should be our role in today's world.

But this is not something we still solve today; so in closing, and at the same time that I thank you for your attention, let me repeat what a remarkable man wrote some fifteen years ago: that 'human labour is, by its nature, meant to unite peoples, not to divide them from one another'. **THELINK**

The author is Spanish Chair Professor of Economics at CEIBS, and Professor of Economics at IESE.

2. Notice that European investment has maintained its pace; but it has taken place largely abroad. This suggests that the weakness of aggregate demand is concentrated on consumption; the weakness of investment is caused more by rigid supply conditions.