

Foreign direct investment and China's bilateral intra-industry trade with Japan and the US[☆]

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Received 6 November 2006; received in revised form 14 March 2007; accepted 26 March 2007

Abstract

This paper analyzes the dynamic changes of China's intra-industry trade with its major trading partners, Japan and the US, from 1980 to 2004. The estimated intra-industry indexes demonstrate that, while shares of China's intra-industry trade with both Japan and US rose substantially, its intra-industry trade with Japan increased to 34% of the overall trade in 2004, considerably larger than 10% with the US. The Sino-Japanese intra-industry trade concentrated in electrical and machinery sectors and accounted for 52 and 46% of the total trade in those sectors, respectively. On the other hand, it is in chemical and food sectors where intra-industry trade represented a relatively large proportion of Sino-US trade. In addition, the paper investigates to what extent that foreign direct investment from those two countries promoted their bilateral intra-industry trade with China. The empirical results show that, Japanese direct investment performed a significant role in enhancing the bilateral intra-industry trade. However, it finds no evidence that the US direct investment contributed to the growth of the Sino-US intra-industry trade.

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JEL classification : F14; F23

Keywords: FDI; Intra-industry trade; China

1. Introduction

The fact that China has emerged as the largest country in making toys and exporting textile products in the world should not surprise its trading partners. The rich labor endowment and

[☆] The preliminary work and the first draft were finished when the author was a visiting researcher of BOFIT. The comments of the participants at the seminar of BOFIT are highly appreciated.

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seemingly unlimited rural labors released from the agriculture sector grant China both comparative and absolute advantages in manufacturing labor-intensive products. As its economy is gradually integrated with the world economy, China has naturally evolved as a major exporter in almost all of the categories of labor-intensive products, such as shoes, travel gears, clothes, toys, etc. This phenomenon is exactly what the conventional Heckscher-Ohlin theorem predicts.

If a country specialized in producing low value-added labor-intensive commodities forever, free trade would be a curse rather than a blessing for the country. That is actually one of the major suspicions that developing countries have on free trade. In the case of China, the economic integration with the global economy has not only greatly expanded the utilization of its abundant human resources and augmented its specialization in labor-intensive productions, but also facilitated the development of its manufacturing capacity into high value-added products, inducing fundamental changes in its trade structure.

According to reports by China's **Ministry of Commerce (2005, 2003)**, China's exports of high-tech goods have experienced rapid growth. In 2002, China exported \$67 billion high-tech goods, ranging from computers, mobile phones, biotech products, to aerospace equipments. In 2004, high-tech exports more than doubled that of 2002; jumping to \$166 billion (about 28% of China's total exports), representing a significant achievement in high-tech exports. A study released by the **OECD (2006)** on the global trade of information and communication technology (ICT) products, outlined an even more striking picture. It showed that China has not only been one of the largest ICT importing countries, but also one of the largest ICT exporters. It exported \$180 billion ICT products in 2004, exceeding Japan, the European Union and United States; becoming the number one exporter of ICT products in the world.

This paper attempts to analyze the changing trade pattern of China. The analysis focuses on the growth of intra-industry trade (IIT) between China and its major trading partners Japan and the US. IIT characterizes simultaneous imports and exports of goods under same industry classifications. Rising share of IIT indicates an increase in product varieties, improved economies of scales in production, and shortened technology gaps with competitors. Even if most of IIT belongs to vertical IIT (which covers simultaneous exchanges of goods in the same categories but different qualities), increased IIT in overall trade still marks the progresses in manufacturing capacity, expanded export capability, increased involvement in global production networks, and the transition in trade pattern.

In addition, the paper examines factors contributing to the growth of IIT. Particular attention is given to foreign direct investment in China. It has been recognized that foreign invested firms are the major forces driving the fast expansion of China's exports. In 2004, they exported \$339 billion, about 60% of China's exports (**CSB, 2005**). In the high-tech products category, foreign invested firms performed an even more important role. They produced about 88% of China's high-tech exports (**MOC, 2006**). Therefore, FDI not only boosted China's export growth, but also accelerated the transition of its exports from low value-added to high value-added products. Developing countries usually do not possess the necessary technology to produce high-tech goods. It is the multinational enterprises, which bring advanced technology and production know-how into developing countries with green-field FDI, consequently improving production capacities and product varieties of FDI host countries. Furthermore, technology spillovers associated with inflows of FDI also facilitate technological progresses of domestic firms, leading to improvements in production efficiency and product quality. Through alliances with MNEs, domestic firms of developing countries could take advantage of well-established global market distribution systems and recognized brands, which are critical for those firms marketing their products in the global market.

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