COMPARATIVE ADVANTAGE: REAL OR MANIUPILETED?

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"Globalization has enriched the world scientifically and culturally, and benefited many people economically as well". - Amartya Sen, a Nobel-Prize winning economist

ABSTRACT

A country can gain comparative advantage majorly because of its cost i.e. at which a country is able to trade a product at the cheapest price. However, cost of a product is determined by factors like wages, exchange rates, taxes, transportation costs etc. Also the trade strategy and the trade bindings also play a significant role in determining the competitiveness of the product. Therefore, this paper shall talk about what is comparative advantage and how it can be manipulated for the country's own interest. Further this paper will specifically look as to how china created a comparative advantage over its products over the years, which led china to become one of the major exporters worldwide. This paper is divided into various parts each talking about how china manipulated its various inputs, which majorly helps in determining the cost of the product, to create a comparative advantage over its products and thereby take its advantage. The last section of the paper will talk about how China's comparative advantage over its production is affecting Indian economy, also, this paper will talk about the reason as to why India and China should not enter into the free trade agreement. At the end of the paper it will be discussed about what could be the possible measures to avoid the impact of china's comparative advantage on Indian economy.

INTRODUCTION TO COMPARATIVE ADVANTAGE

International trade is the result of globalization. International trade means trading of goods and services between two or more countries. Trading also gives various countries an opportunity to import goods which cannot be produced by them, or export good which are produced in excess. Therefore, the economic foundation of free trade was laid down by the economist such as David Ricardo and Adam Smith.

It was observed by Ricardo that the trade between the countries should occur based on their comparative advantage rather than their absolute advantage. Comparative advantage is when a country is more productive in producing a particular type of goods than producing all other types of goods i.e. producing such goods using less inputs (cost) than any other country who may require to produce the same good. Therefore such country shall be economically benefited if it trades according to its comparative advantage.[1]

For example India may be as productive as china, its trading partner in manufacturing LED lights, and it's three times more productive in making food products. Then India will benefit more from exporting food products and at the same time importing LED lights. However, China will gain more in exporting LED lights as it will have a comparative advantage over it but not the absolute advantage. Also comparative advantage between the countries may raise the living standard of both the trading countries.

Hence, the concept of comparative advantage states that even if a particular country is efficient enough to produce almost everything (absolute advantage), it should put its resources in the most competitive sectors and create a comparative advantage.

INTRODUCTION TO CHINA'S ECONOMY

China's economy in the past two decades has shown a significant growth. The reason for the growth in china's economy is resources reallocation from agricultural sector to industrial sector. Thereby leading to the rapid change in the export composition, reflecting the countries comparative advantage. Moreover, trade distortion were induced by the planning commission of china, in reality the export composition of the country now, was inconsistent to the country's comparative advantage if determined by its factor.[2]

Since 1980's, the export performance of china has been remarkable as compared to that of India. In the year 1980-2004, china's share in the world export increased from 1% to 6%, whereas India's export share only increased from 0.4% to 0.8%. Therefore, it can be seen that the trade

[1] Brad McDonald, *International Trade: Commerce Among Nation*, Last Visited (March 11, 2016) http://www.imf.org/external/pubs/ft/fandd/basics/trade.htm

[2] Changiun YUE, Ping HUA, *Does comparative advantage explains export patterns in China?*, Last Visited(March 12, 2016) http://down.cenet.org.cn/upfile/47/2005930153018101.pdf

liberalization was the out-growth of resources reallocation based on the comparative advantage which occurred in china.[3]

Average Annual Growth Rates of Exports (Millions of US dollars)[4]

Period	India	China	World
1950-70	2.49	6.29	7.48
1970-80	17.25	20.04	20.42
1980-90	7.29	12.78	5.99
1992-2004	9.74	15.38	6.33

Source: Author's estimation using data from Handbook of Statistics, UNCTAD

This show that the export composition of china went on increasing since the year 1980's. Therefore, a conclusion can be drawn that only due to the existence of the comparative advantage, a country cannot directly attain high market share across the world, and it can only happen if the country is exploiting its comparative advantage to a great extent. [5]

WHY IS CHINA HAVING A HUGE EXPORT COMPOSITION?

China has a huge population, followed by the labor reallocation, led to the development of the labor intensive manufacturing sector with low skilled and cheap labor. Also the cheap labor was not only the result of resources reallocation but also the absence of effective labor law in china. China's labor law which was first enacted in 1995 was overly simplified, vague, barely focused, and the compliance was inconsistent. Therefore forced the Chinese worker to work in an environment with low protection and low pay, ultimately leading to the low cost of production for the producers. Also, the china's managerial skills combined with imported technological know-how through FDI provided the input to the final manufacturers.

[3] C. Veeramani, *India and China: Changing Patterns of Comparative Advantage?* Last Visited(March 12, 2016) https://smartech.gatech.edu/bitstream/handle/1853/36314/Veeramani.pdf
[4] Ibid
[5] Ibid

It is also important to note that financial markets in china are not well developed. The private firms does not have an access to these financial markets whereby compelling them to have a labor intensive manufacturing sector rather than having a capital intensive manufacturing units.[6]

Hence, in two decades from 1980-2000, china's export has increased from 19.3 billion dollars to 249.2 billion dollars, thereby increase the share of china in world export from 0.96% to 3.9%, becoming the seventh largest exporter in the world.[7]

WHY IS CHINA'S PRODUCTS LOW PRICED?

Chinese products are low priced because the cost of production is low, due to export friendly policies and minimal capital investment. The production in china is based on the strategy of mass production and mass consumption. China buys the raw material from the other countries in the world at a very low price, assemble them in china and sell the end product back to the world. The manufacturers in china produces goods in bulk i.e. high productivity per person, and has a very structured vendor base. Moreover, the supply chain in china is very less. Also, the china government levies less import duties and other indirect taxes, further making the product much cheaper. The government of china also provides with incentives and subsidies to the manufacturers to increase the production for export. Hence, it can be said that by putting less taxes and giving subsidies and other incentives china is distorting the free trade capability of a country and creating a manipulated comparative advantage over its products.[8]

China has cheap labor because the annual average wage is 8750 RMB in 2000s, the entry of china in WTO further led to the reduction of trade barriers put by the importing countries. All these factors led to the tremendous increase in the export consumption of china.[9]

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[6] Yingqi Wei and V. N. Balasubramanyam, *A Comparative Analysis of China and India's Manufacturing Sectors*, Last Visited(March 13, 2016*)* *https://www.lancaster.ac.uk/media/lancaster-university/content-assets/documents/lums/economics/working-papers/LancasterWP2015_003.pdf*

[7] Changjun YUE, *Comparative Advantage, Exchange Rate and Exports in China*, Last visited(March 14, 2015)

[8] Ramandeep Kaur, *Impact Of Chinese Goods On Indian Industries*, Last Visited(March 14, 2016) http://www.mapsofindia.com/my-india/business/impact-of-chinese-goods-on-indian-industries

[9] Ibid

Exports 1970-2002 (billions of US $)[10]

	1970	1980	1990	1995	2000	2002
World	298.4	1921.8	3377.6	5079.1	6387.5	6478
China	2.3	18.1	62.1	148.8	249.2	326
Hong Kong	2.5	19.8	82.2	173.8	201.9	200.1
S. Korea	0.8	17.5	65	125.1	172.3	162.8
Singapore	1.6	19.4	52.8	118.3	137.8	125.2
US	42.7	225.6	393.6	584.7	781.1	693.9

Source: IMF, International Financial Statistics.

From the above table, it can be seen that china is the only country amongst the few which shows a consistent increase in its exports over the years due to its manipulated trade advantage.

HOW IS CHINA PROVIDING QUALITY PRODUCTS WITH LOW PRICE?

Trade liberalization in china led to the inflow of FDI. With the incoming of FDI, china provided various incentives to the exporting firms such as retention of earned foreign exchange, trade zones, special tax concessions etc.

China is the major recipient of FDI investment in the East Asian region receiving $50 billion of FDI annually i.e. almost 50% of the FDI inflow in the East Asian region. The inflow of FDI in China did not only bring in capital but also the management skills and technology with it, whereby, considerably improving china's ability to produce goods to meet up to the expectation of the foreign markets. Moreover, the huge amount of these FDI is going towards the export industries in china[11].

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[10] F. Gerard Adams, Byron Gangnes, Yochanan Shachmurove, *Why Is China So Competitiv?*, Last visited (March 15, 2016) http://www.economics.hawaii.edu/research/workingpapers/WP_04-6.pdf

[11] Ibid

Before 1990s, china exported simple goods with low quality. However, the increase in the FDI inflow after liberalization increased china's competitiveness in exporting products which is capable to meet the demands of the market based on the technological content, design, and quality. Foreign producers invest in china with the ultimate objective to use china as an export platform, because it provide with a huge domestic as well as foreign market.

Also, many foreign investment projects are done, is a form of a joint venture with Chinese partners. Thereby, giving the Chinese partner the knowledge of foreign technology, which are then used by them to promote their own projects.

Therefore, for the above mentioned reasons Chinese manufacturers have known technically know-hows, which further led to the acceptance of Chinese goods in the foreign market. Hence, it can be said that with the help of FDI inflow and cheap labor and other various factors, china is able to export to the world, low priced quality goods and creating a manipulated comparative advantage over its products.

IS CHINA MANIPULATING ITS EXCHANGE RATE?

China has its trade policy of volatile exchange rate and low costing to sustain its competitiveness in the world market. However, it can be seen that china is interfering with the exchange market by buying on an average of $1 billion per day for the last five years from the market to make them expensive and in the meanwhile, selling Chinese Renminbi (RMB) to make them cheap. Thereby, interfering with the market forces. Moreover, as mentioned earlier, China subsidize all its exports over and above the permissible limit by at least 20% and at the same time levies an additional tariff of at least 20% on all its imports.[12]

[12] ANLI SURESH, *Exchange Rate Impact on Bilateral Trade between India and China*, Last Visited (March 19, 2016) http://www.gsmi-ijgb.com/documents/v3%20n2%20jfam%20p02%20-anli%20suresh%20-exchange%20rate%20impact%20on%20bilateral%20trade.pdf

Income per Capita: Exchange Rate and PPP Basis and Undervaluation[13]

Country	$XR basis	$PPP basis	Undervaluation %
China	890	4260	79%
S. Korea	9,400	18,110	48%
US	34,870	34,870	0%
Singapore	24,740	24,910	1%

Source: World Bank

Chinese currency is barely free floating as china controls the value of yuan i.e. based on the official guidelines, Yuan trades only 2% above or below from the midpoint (generally based on the previous day's trading) which is set on the daily basis by the central bank of china.[14]

Hence, Chinese products are trading at much cheaper rate in the world market than its actual price, whereby, giving china a manipulated comparative on its products as compared to the products of the various other countries.

HOW IS CHINA AFFECTING INDIAN ECONOMY?

International trade is a way by which two or more countries enter into an agreement to import and export goods and services across the national borders. In the era of globalization international trade has become the backbone of every economy as it opens the market for the producers outside their domestic countries to expand their market. International trade has also helped the economies of the developing countries to grow faster through wide market accessibility.

India and China being the world's oldest civilization and the two most rapidly growing economies, also shares a long history of culture, scientific and economic linkages. Both the countries have incorporated deeper economic relations with rest of the world. India is a founding member of the

[13] Ibid

[14] Owen Davis, *Why Is China Devaluing Its Currency? Us Lawmakers Call It Manipulation, Others See China Moving Towards Free Market*, Last visited (March 20, 2016) http://www.ibtimes.com/why-china-devaluing-its-currency-us-lawmakers-call-it-manipulation-others-see-china-2050418

World Trade Organization whereas china is a member since 2001.[15] Trade between India and China started long back in 1951, but both the countries signed the agreement in 1954, which was renewed in August 1984, which also provided for the "Most Favored Nation" (MFN). This bilateral trade between the two countries is growing rapidly with volume of trade continuously increasing whereby leading to the strong communication between the two countries.[16]

To take a look at principle items of trade between India and China, India's imports from china mainly includes metal products, raw silk, medical products, textile products, light industrial products, chemical industrial products, machinery, sheet and paper pulp, food etc. these electronic product and machinery which are imported from china to India mainly include electrical wires and cables, CKD components, spare parts and accessories of TV, power equipment's, machine tools, radio and telecommunication parts etc. whereas China's import from India includes gem, leather, iron ore, raw materials of chemical industry, vegetable oil etc.[17]

With the list of these items which are imported and exported by both the countries it can be clearly seen that Chinese export to India majorly relies on fully manufactured and processed goods which are ready to meet the demands of the growing market whereas India's export to china are merely primary products and the raw materials. Moreover there exists a non-tariff barrier for importing of agriculture goods in china with limited market accessibility for Indian products.[18]

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[15] Anil K. Gupta & Haiyan Wang, *India and China: Greater Economic Integration*, (September 1, 2009), http://www.chinabusinessreview.com/china-and-india-greater-economic-integration/ (last visited oct 2, 2014)

[16] Economic And Trade Relations Between China And India, December 15, 2004, 13:08 BJT (07:38 GMT) http://bombay2.mofcom.gov.cn/article/bilateralcooperation/inbrief/200412/20041200010319.shtml (last visited oct 2, 2014)

[17] ibid.

[18] ISikkim, *Indo- China Trade Relations: Trade deficit With China*, (April 30, 2012), http://isikkim.com/2012-04-indo-china-trade-relations-trade-deficit-with-china-30-6/ (last visited oct 2, 2014)

Details of trade between India and China during last three years are given below:-

TABLE-1: Bilateral Trade Statistics

					(Value in USD Million)
S. No.	**Export/Import/Growth**	**2008-09**	**2009-10**	**2010-11**	**2011-12(P)* April-December**
1.	**Exports**	**9,353.50**	**11,617.88**	**19,615.85**	**12,975.31**
2.	**Imports**	**32,497.02**	**30,824.02**	**43,479.76**	**43,800.86**
3.	**Total Bilateral Trade**	**41,850.52**	**42,441.90**	**63,095.61**	**56,776.17**

(P) Provisional* *(Source; DGCI&S)*. [19]

Through this it can be clearly seen that there is an issue of trade deficit between both the countries at its highest level. India in the year 2011-12 has imported almost three times more than its exports ultimately leading to a huge trade deficit. This growing trade imbalance between both the countries also accounts for lowering the value of the Indian currency. Recently India and China is pursuing FTA but no such progress has been shown so far towards the signing of a FTA, even after being two of the fastest and largest growing economies of Asia.

With the amount of export done by the Chinese government it can be clearly seen that the China's government provides wide range of subsides to boost its domestic industries to produce products solely for the foreign market. Therefore it can be said that China is providing with export subsidies, which is prohibited under WTO rules whereby leading the Chinese government for an investigation due to the allegations made by Mexico and USA about export subsides.[20] Based on the available documents the amount of subsidies provided to the manufacturers in China between year 2009- 11 was $1 billion whereby making it harder for the manufacturers of the other countries to compete with the Chinese products in the world market.[21] China generally buys raw material by importing it from the world market and sell the processed goods back to the world market, whereby becoming the second largest exporter in the world after Germany. With the help of export friendly policy of the Chinese government their production is of low cost with low investment which at the

[19] ibid

[20] ***WTO Investigates Allegations Of Illegal China Subsidies,*** **http://abcnews.go.com/Business/story?id=3550476 (last visited oct 2, 2014)**

[21] *Office Of The Unted States Trade Representative,* http://www.ustr.gov/trade-agreements (last visited oct 3, 2014)

end results in mass production at very low cost, whereby making it widely available to the foreign market at a very low price.

A large part of these products are imported in the Indian market at relatively very low price whereby leading to dumping, also leading to a major concern for the domestic market. To further define dumping it is when a country exports its products at a lower price than the price charged in its own country is said to be "dumping" the product in another country as stated by WTO.

The prices at which the Chinese products are sold are 10-70% lower as compared to the Indian products. Bulk availability and relatively low price are some prominent features of the Chinese products, when this good are sold into the Indian market it badly affect the domestic market. Not only these goods affect the domestic market of a country but also affect its capacity to export to the rest of the world.[22]

Therefore excessive import from china causes a threat to the Indian manufactures and producers because the infrastructure in India is not sufficient to observe economies of scale like that of china. Moreover the Chinese industries are strengthening itself by selling its commodities in bulk to the countries from which it has a comparative advantage. Hence it can be said that if this current situation prevails then probably infant Indian industries will cease to exist. Dumping activities of china is quite evident by taking a look at the sectors like steel, aluminum, rubber and auto parts, which are apparently filled by Chinese products hence covering the entire domestic market. For e.g. the chines tyres which are sold in India are 30% cheaper than the tyres which are manufactured in India, hence 80- 85% demand of these tyres are met with Chinese products however market for the domestic product is left to only 15- 20%. Due to the less demand in the market for the domestic products the manufactures of these products are not able to reach to the level of full utilization of the resources with the raising share of china in the Indian market.[23]

The tag "made in china" is taking over a large section of the Indian market such as textile and garments industries, electronic goods, toys etc. another industry which is majorly affected by

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[22] Ramandeep Kaur, *Impact of Chinese Goods On Indian Industries, http://www.mapsofindia.com/my-india/business/impact-of-chinese-goods-on-indian-industries (*last visited oct 5, 2014)

[23] *India Faces Chinese Dumping Threat,* The Statesman, (May 18, 2009) http://www.iitrade.ac.in/kmarticle.php?topic=India%20faces%20Chinese%20dumping%20threat (last visited oct 5, 2014)

invasion of chines products is the toy manufacturing industry in India. As stated in the reports of ASSOCHAM that there exists a wide range of toys made by china that the Indian toy industries are finding it hard to survive in the market. The report also states that in the previous five years about 40% of the Indian toy manufacturing industries have been crashed and were forced to shut down whereas another 20% of these industries are about to close. Therefore excess of Chinese goods in the domestic market are the root cause of the closure of many manufacturing units in India and also the loss of market share. The main reason for the low priced products from china is because the cost of supply chain in china is low as opposed to India, less import duties and indirect taxes make it cheaper moreover export subsidies provided by china also boosts the production to a much larger extent.[24]

The economists who emphasize on welfare may state that the imports are beneficial for the consumers as it provides with a better quality of goods and much lower cost hence it is consumer favorable and market efficient than our own industries than it can be argued that import might be market efficient but excessive amount of import may not be in favor of the producers which may further lead to an hindrance in the export because of low production in the home country therefore it will also affect the growth of the particular country.

At the end it can be said that India should not sign a FTA with china because this agreement would be highly in favour of China and India will not gain much out of it. The most important reason for not signing a FTA is that the Indian products are not enough competitive as compared to the products made by china, as there exists a difference in manufacturing powers between both the countries i.e. a vast difference in nature of trade, however even after the a biased FTA India will still have a huge trade deficit even without the trade barriers as the imports are much higher than the exports. Moreover China's tariff on imports made by it are very low, therefore a FTA will not have much effect on the exports made by India, also about 45% of the products which are exported by India fall under the category of zero tariff rate. Hence a large part of the export will remain unaffected even after signing a FTA with china.

On the other hand china might be benefited as India's is a big market for the china product and if the tariff rates are lowered then the Chinese product would be able to sell at a much lower rate,

[24] Source Cited (Supra) note 8

whereby increasing their profit. This would also be difficult for the Indian industries to accept it, and due to the non-performance the infant industries in the domestic countries it could be crashed further leading to loss of export and growth. This may also have a far reaching affect can may further lead to increase in unemployment and poverty in the country moreover with a excessive increase in trade there always exists a threat for devaluation of the home currency in the foreign market. Therefore signing of a FTA with china will not be much beneficial to India.

CONCLUSION

Since, it is established that china is taking advantage of its manipulated comparative advantage is affecting India and other parts of the world by exporting cheap products.

The national treatment agreement mentioned under Article III of GATT says that the national goods and foreign goods should be treated equally once they enter into the domestic market. Since, goods cannot be discriminated once they enter into the domestic market, few measures can be taken before the goods enter into the domestic market which shall not violate the national treatment agreement. Firstly, to increase the tariff binding for the Chinese products as they are destroying the Indian infant industries and other industries directly with their low priced products. Increase in tariff binding will make the Chinese product expensive, and it will help the domestic products to compete with the Chinese products.[25] Also, with an increase in the tariff binding china will not be able to dump their products into the domestic market. Also the anti- dumping duties can be imposed on the highly cheap imports from china.[26]

Secondly, to put quota for the entry of these products. This will regulate the amount of import in the country, helping to reduce the trade deficit in the country. These will also help the Indian industry to acquire a market for its products and develop infrastructure and other economies of

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[25] ANI, *Duty Increased on Chinese Goods to Stop Them From 'Dumping' in India*, Last visited (March 28, 2016)http://www.newindianexpress.com/nation/Duty-Increased-on-Chinese-Goods-to-Stop-Them-From-Dumping-in-India-Rajnath/2015/09/05/article3012386.ece

[26] ANURAG AGARWAL, *India Faces Chinese Dumping Threat*, Last Visited (March 28, 2016) http://www.iitrade.ac.in/kmarticle.php?topic=India%20faces%20Chinese%20dumping%20threat

scale, as less Chinese goods will enter the market. This measure will also check the dumping strategy (mass production and mass consumption) acquired by china.[27]

Moreover, china being the most favored nation, it has signed a bilateral trade agreement with India in 1984.[28] Therefore, it shall not violate the MFNs clause under Article 1 of GATT Agreement as these bindings can be negotiated between the partner countries.

[27] PIYUSH PANDEY, *Extended quota restriction on China to benefit India*, Last Visited (March 28,2016) http://www.business-standard.com/article/economy-policy/extended-quota-restriction-on-china-to-benefit india-104100701064_1.html

[28] Embassy Of India, Last Visited (March 30, 2016) http://www.indianembassy.org.cn/DynamicContent.aspx?MenuId=3&SubMenuId=0