

## The rise of China: What does it mean for the least developed countries in the Asia-Pacific?

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### ABSTRACT

China's unprecedented economic growth and integration into the world economy have attracted global attention. Its boom in exports of processed goods and the emergence of regional production networks, and thus production complementarity, has spread high rates of growth across several Asian—especially East Asian—economies. The poorer economies, especially the region's least developed countries (LDCs), derive the least benefit from the “China effect”, as they are not integrated into the regional production networks. Poorer economies in the region supply mostly raw materials and resource-based products to China.

This paper examines the challenges and opportunities China presents to LDCs in the Asia-Pacific region. The main conclusions are: (a) there is a surging trade imbalance between LDCs and China; (b) there is an increasing concentration of LDC exports to and imports from China, by commodity and by country; (c) LDCs and China do not compete in any significant way in third-country markets; and (d) foreign direct investment (FDI) flows to China have a positive effect on FDI flows to LDCs. An important policy implication is the need for more equalizing growth in the region and, in particular, between the emerging economies—such as China—and LDCs, which can be achieved by addressing the challenges and constraints caused by supply-side issues and market access.

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## 1. INTRODUCTION

China has become the centre of global attention in recent years. Thirty years of rapid economic growth at 9 per cent annually led to an elevenfold increase in per capita gross domestic product (GDP) between 1975 and 2006<sup>1</sup> and structurally transformed the Chinese economy. If the average growth rates of the past two decades are projected, China's GDP would reach \$3,825 billion by 2015. Sustained rapid growth has lifted millions of people out of poverty: the number of people living on \$1 a day fell by 288 million between 1990 and 2003 (Asian Development Bank, 2005).

China's export boom and the emergence of regional production networks have spread high rates of growth across several Asian economies. However, not all economies have benefited in equal measure. The more advanced ones (Hong Kong, China; Singapore; the Republic of Korea; Japan; and Taiwan Province of China) have benefited the most, followed by the Association of Southeast Asian Nations (ASEAN)-4 economies, consisting of Malaysia, Indonesia, Thailand and the Philippines. Particularly in the case of emerging Asia, the export boom is "built increasingly around rapid growth in intraregional trade that has China playing a central role". (Gruenwald and Hori, 2008) The poorer economies, especially the region's least developed countries (LDCs),<sup>2</sup> derive the least benefit, as they are not integrated into the regional processing production networks; they mostly supply raw materials and resource-based products to China.

While LDCs generally have very open economies and liberalized trade regimes, their integration into the global economy has not progressed smoothly. Effective integration is hindered by geographical constraints, limited market access, the small size of their domestic economies, inadequate infrastructure and weak industrial and institutional capacities, among other things. Thus, while China's growth offers opportunities to LDCs, there is a fear that challenges may far outweigh potential gains.

There has been extensive discussion on the impact that China, including its accession to the World Trade Organization (WTO), is having on the global economy and on other developing countries.<sup>3</sup> Most of these studies are largely aggregative in that they examine the impact of China's growth on broad regions of the world or for specific

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<sup>1</sup> In constant 2000 United States dollars; *World Development Indicators* online (available by subscription at <http://publications.worldbank.org/WDI>), accessed from <http://ddp-ext.worldbank.org/ext/DDPQQ/report.do?method=showReport> on 17 March 2008.

<sup>2</sup> A country is categorized as a least developed country (LDC) based on three criteria: low income, weak human assets and economic vulnerability (United Nations Development Programme, 2008). There are 14 LDCs in the Asia-Pacific region: Afghanistan, Bangladesh, Bhutan, Cambodia, Kiribati, the Lao People's Democratic Republic, Maldives, Myanmar, Nepal, Samoa, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu. Unless otherwise specified, LDCs in this paper refer to the Asian and Pacific LDCs only.

<sup>3</sup> See, for example, Martin and Ianchovichina (2001), Shafaeddin (2002), Lall and Albaladejo (2004), Kaplinsky, McCormick and Morris (2007) and Jenkins and Peters (2007).

products or sectors. To our knowledge, no study has focused specifically on the impact of China on the Asian and Pacific LDCs. This paper takes up this task and examines some challenges and opportunities that China's robust growth presents to LDCs.

Following Jenkins and Edwards (2004), three kinds of direct effects have been identified:

- *Complementary trade effect*: growth of exports from the Asian and Pacific LDCs to China
- *Competitive trade effect in third markets*: increased competition of LDCs with China for exports to third markets
- *Competitive or complementary investment effect*: the effect of the rise of China on FDI flows to the Asian and Pacific LDCs

The overall gain for any of the Asian and Pacific LDCs from the growth of China will depend on the sum of complementary and competitive effects. Of course, these effects may operate differently in the short and long term and, while this is an important issue, the focus of the paper is on structural issues.

The rest of the paper is structured as follows: section 2 examines the evolution of the trade balance between China and LDCs. Trends in merchandise trade between China and LDCs are reviewed in sections 3 (exports) and 4 (imports). Competition between China and LDCs in third-country markets is discussed in section 5. Section 6 examines an unsettled issue: does the attractiveness of China as a destination for FDI divert such flows from LDCs? The final section summarizes the main findings of the paper and draws out the policy implications.

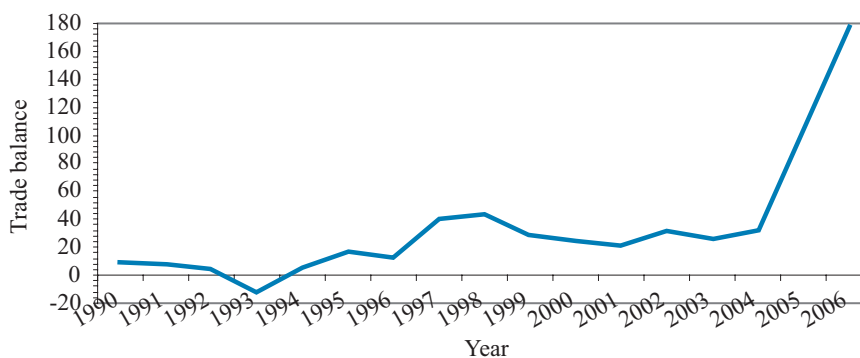
## **2. CHINA AND THE LEAST DEVELOPED COUNTRIES: EVOLUTION OF THE TRADE BALANCE**

While China's economy has recorded sustained and robust growth, it is the ballooning trade surplus that has attracted more attention in recent times. Based on data reported by China to the United Nations Commodity Trade Statistics Database (Comtrade), the country's trade balance was less than \$9 billion dollars in 1990; three years later it slumped to negative \$12 billion. The sustained recovery that began in 1994 led to a cumulative *trade* surplus of \$551 billion against the rest of the world. What is remarkable, however, are the extremely high levels of surplus recorded in 2005 and 2006: \$102 billion and \$177 billion, respectively (see chart 1).<sup>4</sup> This is a sixfold increase from 2004 and, for

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<sup>4</sup> Cui and Syed (2007) reported that China's trade surplus was nearly \$215 billion (balance of payments (BoP) basis) at the end of 2006, which was 8 per cent of that year's GDP.

**Chart 1. China: evolution of the merchandise trade balance, 1990-2006**  
(Billions of United States dollars)



Source: United Nations Comtrade database, available at <http://comtrade.un.org/db>.

the first time during the 17-year period from 1990-2006, the trade surplus surpassed 5 per cent of GDP in 2006.<sup>5</sup> During the past three years, China's trade surplus increased by close to \$80 billion per year, but it is expected to stabilize this year (*The Economist*, 2008).

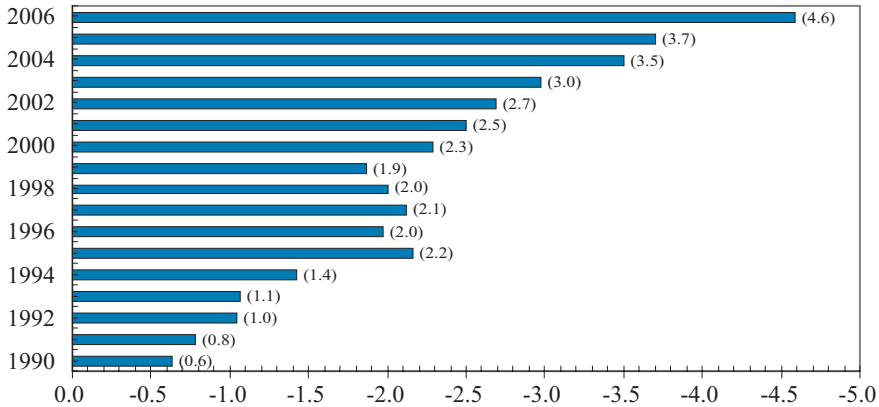
How large is China's trade surplus with the Asian and Pacific LDCs? The available data show that China amassed a cumulative merchandise trade surplus of \$571 billion against the rest of the world during the period 1990-2006. Of this amount, \$28 billion was built up against LDCs in the region.<sup>6</sup> In other words, about 5 per cent of China's trade surplus during the 17-year period was amassed against 10 LDCs in the region. What is noteworthy is not so much that the surplus against LDCs has grown at an accelerating rate over time, but that almost 60 per cent of it was amassed during the last five years. The surplus in 2006 was 24 times larger than that in 1990, rising from \$207.1 million to \$5 billion. While fluctuating, the trade balance grew at 23.8 per cent annually; growth began to accelerate in 2002 and reached 33.7 per cent in 2006.

As share of GDP, the trade imbalance of LDCs with China moved from 0.6 per cent in 1990 to 4.6 per cent in 2006, growing steadily since 1999 when it stood at 1.9 per cent (see chart 2). The most rapid growth throughout the entire period was witnessed in 2007, with a jump of 0.9 per cent from the previous year.

<sup>5</sup> According to *The Economist* (2008), China's current account surplus reached 10 per cent of GDP in 2007.

<sup>6</sup> Data have been obtained from the United Nations Comtrade database, with China as the reporter country. Timor-Leste, Tuvalu, Kiribati and Vanuatu are excluded from the analysis because of the dearth of data.

**Chart 2. LDCs: trade imbalance with China**  
(Share of GDP)



Source: United Nations Comtrade database, available at <http://comtrade.un.org/db> and World Bank, *World Development Indicators*, accessed online.

Throughout the entire 17-year period, Bangladesh, Cambodia, the Lao People's Democratic Republic, Myanmar, Nepal and Samoa incurred a *persistent negative* trade balance with China. Except for the first year of the period, this observation was also true for Afghanistan, Bhutan and Maldives. Solomon Islands, on the other hand, has run a positive and growing trade balance with China since 1998, which amounted to \$345 million in 2006. Timor-Leste incurred a trade surplus with China in 2006 (see table 1).

**Table 1. Least developed countries: trade balance pattern with China**

<i>Surplus</i>	<i>Accelerating deficit</i>	<i>Decelerating deficit</i>
Solomon Islands	Afghanistan	Bhutan
Timor-Leste (based on data for 2006)	Bangladesh	Maldives (although the pattern is unclear)
	Cambodia	
	Lao People's Democratic Republic	
	Myanmar	
	Nepal	
	Samoa	
	Vanuatu (based on available data)	

Source: Authors' calculation based on data from the United Nations Comtrade database.

Bangladesh accounted for more than half of the cumulative trade imbalance of the Asian and Pacific LDCs with China: it amassed a \$15.5 billion merchandise trade deficit with China during the 17-year period. The country's deficit began to grow rapidly in 2003, when it reached \$1.3 billion (up from \$1 billion in the previous year); it posted a record of almost \$3 billion in 2006. Bhutan ran a cumulative deficit of \$8.6 billion, but its deficit began to decline rapidly after peaking at \$2 billion in 2003, reaching \$161.2 million by 2006. The other country with a major deficit is Myanmar. Its deficit amounts to \$7.2 billion for the 17-year period; nearly \$1 billion of it was built up in 2006. Two other countries accumulated deficits in excess of \$1 billion during the period: Cambodia and, to a lesser degree, Nepal.

If these patterns persist, it seems likely that several LDCs in the region will continue to incur relatively large trade deficits with China. This may affect their ability to reduce poverty and contain rising inequality and, more generally, achieve the Millennium Development Goals.

### **3. ASIAN AND PACIFIC LEAST DEVELOPED COUNTRIES: EXPORTS TO CHINA**

Total exports by LDCs<sup>7</sup> to China represented a mere \$134 million in 1990, but that figure rose to \$235.8 million a decade later, representing an increase of 75 per cent. The pace picked up thereafter and, by 2006, LDC exports to China had reached \$571.2 million, which was 2.4 times the value recorded at the beginning of the decade. However, absolute numbers can be deceiving: LDCs sent 4.7 per cent of their combined exports to China in 1990 compared with 2.6 per cent 17 years later. Either the Asian and Pacific LDCs do not produce commodities that the Chinese market demands, or they can do so, but not at sufficiently competitive prices, or exports are constrained by both tariff and non-tariff trade barriers, especially for agricultural products.

Myanmar and Bangladesh supplied 90 per cent of total LDC exports to China in 1990, but this figure had contracted to slightly less than two thirds by the end of the period. Cambodia had become a major exporter to China by 2000, displacing Bangladesh as the second largest exporter. Yet the combined exports of these three countries—Myanmar, Cambodia and Bangladesh—accounted for only 86 per cent of LDC exports to China by 2000 and had slipped even further six years later to a little over two thirds. Myanmar remained the top exporter to China, even though its share of total LDC exports declined

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<sup>7</sup> Most of the trade-related data were obtained from the United Nations Comtrade online database, with China as the reporting country, as trade data for most LDCs are generally not available or lack consistency. Therefore, China's *imports* from LDCs were taken as *exports* by LDCs to China; similarly, China's *exports* to LDCs were taken as LDC *imports* from China. Kiribati, Timor-Leste and Tuvalu were excluded from the analysis owing to a lack of data.

from 77 per cent in 1990 to 44 per cent in 2006; that of Bangladesh, which recovered from a steep plunge in 2000, was 4 per cent higher at the end of the period than at the beginning; that of Cambodia, having risen dramatically from 1990 to 2000 (from less than 1 per cent to 25 per cent), had contracted sharply to 6 per cent by the end of the period; and that of Nepal fell steadily from 3.9 per cent in 1990 to 1.5 per cent in 2006.

On the other hand, the Lao People's Democratic Republic and Solomon Islands gained ground, with their exports to China as a share of total LDC exports growing steadily. The exports of the Lao People's Democratic Republic increased from 4.6 per cent at the beginning of the period to 8.7 per cent at the end, while Solomon Islands became the second largest exporter to China among the Asian and Pacific LDCs, with 22 per cent of total LDC exports.

How important was the Chinese market for LDCs? Only Myanmar, Nepal and the Lao People's Democratic Republic shipped more than 2 per cent of their respective exports to China in 1990. At the end of the period, the exports of the Lao People's Democratic Republic to China remained unchanged at about 8 per cent; Myanmar's exports had plunged to 6.9 per cent from 31.7 per cent; and Nepal's had fallen to 1 per cent from 2.5 per cent. Bangladesh sent about 1 per cent of its exports to China at the beginning of the period but only 0.8 per cent in 2006. Indeed, of the 11 LDCs for which data are available, only Cambodia, Solomon Islands and Vanuatu sent a larger share of their exports to China in 2006 than in 1990. For Solomon Islands, the rise was dramatic: from almost nothing in 1990 to 92.5 per cent in 2006, with most of the exports comprising cork and wood.

These changes suggest that, apart from Solomon Islands, the Asian and Pacific LDCs have yet to establish a firm footing in the Chinese market. This is evident from the fact that the relative importance of the Chinese market for the exports of a given LDC changed, sometimes sharply, from 1990 to 2000 and again in 2006. Since the Chinese market is vast, the unsettled situation does not seem to be the result of competition but is more likely linked to supply constraints faced by LDCs.

The major commodities exported by LDCs to China were concentrated in four categories (2, 6, 5 and 3) of the *Standard International Trade Classification* (SITC) Revision 2 (United Nations Statistics Division, 1986) and accounted for 80 per cent of exports in 1990 and an even higher share in 2006 (see table 2). The major change arose from the growing importance of crude matter, excluding food/fuel, in 2006, which dominated LDC exports to China, representing close to three quarters of all exports compared with less than 40 per cent in 1990. In terms of composition, three quarters of crude matter exports to China consisted of cork and wood, most of which were supplied by Solomon Islands.

**Table 2. Least developed countries: major export commodities to China**  
(Millions of United States dollars)

Commodity Classification (SITC Rev. 2)	Value		Percentage of total exports	
	1990	2006	1990	2006
2 – Crude matter, excluding food/fuel	51.45	418.95	38.4	73.4
6 – Manufactured goods	35.23	49.81	26.3	8.7
5 – Chemical products n.e.s.	11.43	19.60	8.5	3.4
3 – Mineral fuel/lubricants	9.39	19.91	7.0	3.3
<b>Subtotal</b>	<b>107.50</b>	<b>507.56</b>	<b>80.2</b>	<b>88.7</b>
Total LDC exports	134.01	571.20	100.00	100.00

Source: United Nations Comtrade database and authors' calculation.

Abbreviations: SITC Rev. 2 – Standard International Trade Classification, Revision 2 (published by the United Nations Statistics Division); n.e.s. – not elsewhere specified.

Note: The numbers in the SITC Rev. 2 column preceding the commodities groups are the SITC commodity classification codes at the single digit level.

What is the relative importance of key commodities in the export structure of selected LDCs to China (see table 3)?<sup>8</sup> Fertilizers comprised 70 per cent of Bangladesh's exports to China in 1990; coffee, tea, cocoa and manufactures thereof, comprised another 21 per cent. The export basket was more diverse in 2006: leather and leather manufactures accounted for 35 per cent of exports to China; textile fibres, 33 per cent; artificial resins and plastic materials, 8 per cent; fish, crustaceans and molluscs, 7 per cent; and apparel and clothing, 7 per cent. More than a third of Cambodia's exports to China in 2006 consisted of cork and wood, followed by crude rubber (25 per cent) and textile yarn and fabrics (20 per cent) (exports were insignificant in 1990). The supply of cork and wood from the Lao People's Democratic Republic to China fell from two thirds of its total exports at the beginning of the period to about 47 per cent at the end. By this time, however, crude, synthetic and reconditioned rubber accounted for slightly over a third of the country's exports to China.

The export bundle of Myanmar to China had become narrower by 2006 and was marked by a heavy concentration of cork and wood products (60 per cent of total exports to China, rising from 13 per cent in 1990). Nepal's exports to China had become more diversified by 2006: its main export in 1990—crude animal and vegetable matter—had dried up, while that of leather manufactures had contracted by half. On the other hand, new commodities had emerged in its export bundle: cork and wood (20 per cent), processed animal and vegetable oils and waxes (20 per cent), textile yarn and fabrics (14 per cent) and metal manufactures (14 per cent). Most of the exports leaving Solomon Islands in 2006 went to China, and practically all of them consisted of cork and wood (exports of this commodity to China were zero in 1990).

<sup>8</sup> The criterion for selection was LDCs with exports of more than \$5 million to China in either 1990 or 2006.

**Table 3. Selected least developed countries: major export commodities to China**  
(Percentage of total exports)

Country	SITC Rev. 2	1990	2006
Bangladesh	07 — Coffee, tea, cocoa, spices and manufactures thereof	21.3	—
	26 — Textile fibres	—	33.1
	56 — Fertilizers	69.4	—
	61 — Leather, leather manufactures and dressed fur skins	4.2	35.1
Cambodia	23 — Crude/synthetic/reconstituted rubber	—	24.8
	24 — Cork and wood	—	34.3
	65 — Textile yarn, fabrics, made-up articles n.e.s. and related products	—	20.1
Lao People's Democratic Republic	24 — Cork and wood	66.8	46.9
	23 — Crude/synthetic/reconstituted rubber	—	34.2
Myanmar	22 — Oil—seeds and fruits	18.4	—
	24 — Cork and wood	13.3	59.7
	23 — Crude/synthetic/reconstituted rubber	—	8.4
	66 — Non-metallic mineral manufactures n.e.s. and related products	29.6	—
Nepal	24 — Cork and wood	—	19.5
	29 — Crude animal and vegetable materials n.e.s.	23.7	—
	43 — Animal and vegetable fats and oils, processed; waxes of animal or vegetable origin	—	21.0
Solomon Islands	24 — Cork and wood	—	99.9

Source: United Nations Comtrade database and calculations by authors.

Abbreviation: n.e.s. – not elsewhere specified.

What are the broad categories of exports from LDCs to China? The ensuing discussion is based on data for 2000 and 2006 and employs the same categories as Shafaeddin (2008).

*Labour-intensive products.* This group includes labour-intensive agricultural products, manufactures, and textiles and garments:<sup>9</sup> their relative importance in LDC export baskets to China declined from 31.5 per cent in 2000 to 19.4 per cent in 2006.

<sup>9</sup> The figures for labour-intensive products were obtained by adding the figures in the *Standard International Trade Classification (SITC), Rev. 2* categories representing labour-intensive agricultural products (037, 042, 05, 06, 07, 232), labour-intensive manufactures (892, 893, 894, 895, 898, 899, 269, 61, 63, 665, 666, 821, 831, 851) and labour-intensive textiles and garments (65, 84).

During this period, the share of labour-intensive exports from four of the poorest countries (Afghanistan, the Lao People's Democratic Republic, Myanmar and Nepal) to China increased. Bangladesh and Cambodia, on the other hand, supplied a smaller share of labour-intensive products to China in 2006 than in 1990. Myanmar, the biggest LDC exporter to China, mostly supplied China with products that were not labour-intensive. Samoa and Maldives did not export labour-intensive products to China in 2000, but they did so six years later, with Samoa exporting less than 2 per cent of its total exports to China and Maldives, about two thirds.

*Other agricultural products and manufactures.* These exports stagnated at 15 per cent between 2000 and 2006. In the case of Afghanistan, Samoa and Vanuatu, this category of products contracted by more than 20 per cent. On the other hand, Bangladesh almost doubled its share of these commodities, while Cambodia's share, although still less than 10 per cent, has surged more than fourfold in absolute terms since 2000.

*Forestry.* Cambodia, the Lao People's Democratic Republic, Myanmar, Nepal and Solomon Islands supply the Chinese market with forestry products, primarily cork and wood. The value of such exports rose from 37 per cent of total LDC exports in 2000 to 51.8 per cent in 2006.

*Mineral and petroleum products.* Exports of mineral and petroleum products from LDCs to China are relatively small, but they have increased from 4.1 per cent to 6.7 per cent of total LDC exports; oil in Cambodia has recently attracted investors, including Chinese investors.

*Consumption products.* All LDCs supplied the Chinese market with consumption products<sup>10</sup> in 2006, which contrasts sharply with 2000, when only five LDCs did. Nevertheless, the relative importance of such exports seems to be declining, as they contracted from 12 per cent to 6.8 per cent of total LDC exports to China from 1990 to 2006. The major consumption commodities include three SITC categories: coffee, tea, cocoa, spices and manufactures thereof; apparel and clothing accessories; and vegetables and fruits.

#### **4. ASIAN AND PACIFIC LEAST DEVELOPED COUNTRIES: IMPORTS FROM CHINA**

The value of LDC imports<sup>11</sup> from China has grown very rapidly: in 2006, they represented 14.5 times their 1990 value; in absolute terms, they rose from \$386.2 million to

<sup>10</sup> The figures for consumption commodities were obtained by adding the figures in the following SITC Rev. 2 categories: 00, 01, 02, 03, 04, 05, 06, 07 09, 11, 12, 269 and 851.

<sup>11</sup> Comparable data for all LDCs, except Kiribati and Timor-Leste, are available from the United Nations Comtrade database.

\$5,587.5 million in that period. The value of LDC imports from China in 1990 was 2.9 times the value of its exports in that year, while that figure rose to almost 10 times in 2006.

As with exports, LDC imports from China are heavily concentrated by country: 77 per cent of the demand came from Bangladesh and Myanmar in both 1990 and 2006. Bangladesh, the most populous and one of the poorest LDCs, saw its imports from China surge to \$3,090.4 million in 2006 from \$125.8 million in 1990. This represented a rise from 32.6 per cent of total LDC imports from China in 1990 to 55.3 per cent in 2006. At this level, China supplied 3.5 per cent of Bangladesh's import demand in 1990 compared with 19.3 per cent in 2006. Myanmar ranked next, even though its share of LDC imports declined from 47.6 per cent to 21.6 per cent; nevertheless, China supplied 63 per cent of Myanmar's imports at the end of the study period, 4 per cent less than at the beginning.

The value of Cambodia's imports from China in 2006 was more than four times that of 2000, rising from \$164.1 million to \$697.8 million (these imports were insignificant in 1990); this was equivalent to 12 per cent of total LDC imports in 2006. Imports to the Lao People's Democratic Republic from China in 2006 were almost five times those of 2000, rising from \$34.5 million to \$168.7 million (they represented just \$8 million in 1990). In relative terms, the country accounted for only 3 per cent of total LDC imports from China in 2006, compared with 2 per cent in 1990. On the other hand, both Afghanistan and Nepal, despite growth in absolute terms, accounted for a smaller share of total LDC imports in 2006 than they did in 1990.

Imports from China to all LDCs except Bhutan increased in absolute terms, in some cases considerably. The increase was particularly robust for countries in the Pacific, which hardly imported anything from China in 1990. For example, Vanuatu's imports from China in 2006 were 16.6 times those in 2000; Samoa's, 6.5 times; and those of Solomon Islands, 5.0 times. For Tuvalu, 83.8 per cent of its 2006 imports (\$10.9 million) came from China, rising from nothing six years earlier. No other LDC is as import-dependent on China as Vanuatu.

These LDCs, however, were not important, relatively speaking, to the total pool of imports from China due to the dominance of Bangladesh and Myanmar. Since 1 per cent of total LDC imports from China in 2006 amounted to \$56 million, Bhutan, Maldives, Samoa, Solomon Islands, Tuvalu and Vanuatu—all of which imported less than this amount—simply got lost in the numbers.

LDC imports from China are less concentrated than their exports (i.e. they import a broader range of commodities than they export), even though there is a tendency for increasing import concentration over time. Two SITC categories (6 and 7) are of major importance (see table 4). Manufactured goods not only topped the list of imported commodities; they also increased in importance, rising from 28.7 per cent of total LDC imports from China in 1990 to 41.7 per cent 17 years later. Machinery and transport

equipment, the second major category of commodities, accounted for 25.6 per cent of LDC imports from China in 1990 but declined to 17.5 per cent in 2006. Even so, these two SITC categories comprised the bulk of LDC imports from China: 54.3 per cent and 59.2 per cent in 1990 and 2006, respectively. A similar situation, albeit one of more rapid movement, was found for exports: the share of the top two commodity categories rose from 64.5 per cent to 82.1 per cent during the same period.

**Table 4. Imports of LDCs from China: major commodities**  
(Millions of United States dollars)

<i>Commodity Classification</i> (SITC Rev. 2)	<i>Value</i>		<i>Percentage of total imports</i>	
	<i>1990</i>	<i>2006</i>	<i>1990</i>	<i>2006</i>
7 – Machinery and transport equipment	99.0	980.3	25.6	17.5
6 – Manufactured goods	110.8	2 332.3	28.7	41.7
8 – Miscellaneous manufactured articles	4.1	140.3	1.1	2.5
5 – Chemical products n.e.s.	10.4	0.7	2.7	0.0
9 – Commodities n.e.s.	—	140.7	—	2.5
3 – Mineral fuel/lubricants	—	112.8	—	2.0
2 – Crude matter, except food/fuel	7.0	-	1.8	-
<b>Subtotal</b>	<b>231.4</b>	<b>3 707.1</b>	<b>59.9</b>	<b>66.3</b>
Total LDC imports	386.2	5 587.5	100.0	100.0

*Source:* United Nations Comtrade database and authors' calculation.

*Abbreviation:* n.e.s. – not elsewhere specified.

About 4.5 per cent of the imports from China to Bangladesh were deemed special transactions (unclassified commodities) in 2006; this was not the case in 1990. Myanmar was the only large LDC that imported petroleum and petroleum products from China in 2006. These products represented 9 per cent of its imports in that year; such imports were absent in 1990.

What were the major commodities that LDCs imported from China between 1990 and 2006?<sup>12</sup> First, there was a significant compositional shift in the import basket during that period, with both a broader range of commodities being imported in 2006 and noticeable changes occurring in the relative importance of the commodities imported (see table 5). For both years, however, imports from China were concentrated around manufactured goods and machinery/transport equipment. The former group dominated imports in 1990, while the latter group dominated in 2006. Of the four LDCs included in the analysis, imports of petroleum and petroleum products from China were important for Tuvalu and Vanuatu, representing 15 per cent and 13 per cent of their imports from China in 2006, respectively.

<sup>12</sup> As with exports, only LDCs that imported more than \$5 million from China in either 1990 or 2006 have been selected for the analysis.

**Table 5. Selected least developed countries: major import commodities from China**  
(Percentage of total imports)

<i>Country</i>	<i>SITC Rev. 2 category</i>	<i>1990</i>	<i>2006</i>
Afghanistan	62	10.13	6.96
	67	-	8.57
	69	9.82	—
	07	48.39	—
	76	—	32.75
	77	—	7.74
	78	5.40	8.67
Bangladesh	71	17.66	—
	72	21.24	6.01
	76	—	8.20
	78	8.75	—
Cambodia	65	—	62.17
	66	40.00	—
	72	27.78	—
	78	8.98	—
Lao People's Democratic Republic	71	—	8.47
	77	8.88	6.34
	78	8.75	23.09
Maldives	66	-	6.58
	77	-	9.48
	82	-	7.81
Myanmar	33	—	9.01
	65	37.47	16.34
	69	6.86	—
	72	—	5.37
	76	5.70	—
	77	6.13	—
Nepal	78	—	7.35
	26	16.71	—
	65	—	17.29
	69	9.12	—
	72	20.76	—
	76	—	11.46
	77	9.76	—
	84	—	26.12
	85	—	8.68
89	6.54	6.50	
Samoa	76	—	26.77
	77	—	26.77
	64	18.33	—
	65	—	9.38
Tuvalu	33	—	15.05
	79	-	80.37
Vanuatu	33	—	13.17
	69	-	47.21

Source: United Nations Comtrade database and calculations by authors.

## 5. CHINA AND LEAST DEVELOPED COUNTRIES: EXPORTS TO THIRD MARKETS

Based on available third-market export data for the top five commodities, LDCs and China have only two key product categories in common: SITC Rev. 2 categories 84 (articles of apparel and clothing accessories) and 89 (miscellaneous manufactured articles). As miscellaneous manufactured goods account for a small portion of LDC exports, the ensuing discussion will focus on SITC Rev. 2 category 84 (articles of apparel and clothing accessories) and textiles, which are important to both China and LDCs.

Global trade in textiles and clothing, which amounted to \$530 billion in 2006, has become increasingly competitive following the phasing out of the Agreement on Textiles and Clothing on 1 January 2005 (World Trade Organization, 2007). With a well-established textile and clothing industry, a vertically integrated production structure and competitive prices, China is the dominant player in the textile and clothing market. Its exports of textiles and clothing to the United States were 76.7 per cent higher in 2006 than in 2004, while its market share in the sector rose from 17.2 per cent to 27.5 per cent in the same period, equivalent to a growth of 60 per cent. China's performance was less stellar in the European Union than in the United States, but it was still impressive, with 60.6 per cent growth and an increase in market share of 35.3 per cent (see tables 6 and 7). Note that China recorded this robust performance despite safeguard measures imposed by both the United States and the European Union in 2005.

**Table 6. United States market for textiles and clothing for six Asian countries**  
(Value in thousands of United States dollars;  
market share and export growth as a percentage)

Country	2004		2005		2006		2004-2006 Export growth	2004-2006 Market share growth
	Value	Market share	Value	Market share	Value	Market share		
<b>World</b>	<b>86 703 575</b>	<b>100.0</b>	<b>92 595 009</b>	<b>100.0</b>	<b>96 201 234</b>	<b>100.0</b>	<b>11.0</b>	<b>0.0</b>
China	14 948 476	17.2	22 445 458	24.2	26 418 449	27.5	76.6	59.9
Bangladesh	1 986 278	2.3	2 380 338	2.6	2 919 631	3.0	47.0	30.4
Cambodia	1 430 845	1.7	1 716 164	1.9	2 146 378	2.2	50.0	29.4
Nepal	132 563	0.2	98 422	0.1	88 724	0.1	-33.1	-50.0
Lao People's Democratic Republic	2 112	0.0	2 836	0.0	8 004	0.0	279.0	0.0
Maldives	81 052	0.1	4 720	0.0	1	0.0	-100.0	-100.0

Source: Based on Yumiko Yamamoto and Ratnakar Adhikari, *Textiles and Clothing Tracking Report*, UNDP Regional Centre in Colombo (forthcoming).

**Table 7. European Union market for textiles and clothing for six Asian countries**  
(Value in thousands of euros; market share and export growth as a percentage)

Country	2004		2005		2006		2004-2006 Export growth	2005-2006 Market share growth
	Value	Market share	Value	Market share	Value	Market share		
<b>European Union-Extra Trade</b>	<b>67 349 936</b>	<b>100.0</b>	<b>71 678 693</b>	<b>100.0</b>	<b>79 710 794</b>	<b>100.0</b>	<b>18.4</b>	<b>0.0</b>
China	14 661 418	21.8	20 836 111	29.1	23 541 345	29.5	60.6	35.3
Bangladesh	3 895 402	5.8	3 710 534	5.2	4 807 093	6.0	23.4	3.4
Cambodia	519 712	0.8	477 098	0.7	552 464	0.7	6.3	-12.5
Lao People's Democratic Republic	118 195	0.2	119 352	0.2	122 449	0.2	3.6	0.0
Nepal	77 787	0.1	73 088	0.1	68 503	0.1	-11.9	0.0
Maldives	255	0.0	55	0.0	2.7	0.0	-98.9	0.0

Source: Based on Yumiko Yamamoto and Ratnakar Adhikari, *Textiles and Clothing Tracking Report*, UNDP Regional Centre in Colombo (forthcoming).

Bangladesh is the largest LDC exporter of textiles and clothing, and export growth in the period 2005-2006 indicates that the country has benefited from the safeguards imposed on China by WTO. Textile and clothing exports from Bangladesh to the United States grew robustly, registering a cumulative growth of 47 per cent between 2004 and 2006. Despite a decline in exports to the European Union and a loss of market share in 2005, Bangladesh recovered with a strong performance in 2006. The net result is that exports to the European Union in 2006 were more than a fifth higher than in 2004, while market share expanded by 0.2 per cent.

Bangladesh specializes in the production and export of low-cost, high-volume, ready-made garments. This is evident from its revealed comparative advantage (RCA)<sup>13</sup> index (2005) of 27.31 for clothing compared with 3.60 for China. In the case of textiles, the opposite is true: with an RCA value of 2.69, China is more specialized than Bangladesh, which has an RCA value of 1.30 (James, 2008). A stronger specialization in clothing, duty-free access to the European Union market under the Everything But Arms (EBA) initiative and the safeguards imposed on China have all played a key role in helping Bangladesh to compete effectively with China (EmergingTextiles.com, 2007).

Cambodia developed a niche as an ethical clothing producer through high compliance with international labour standards and has managed to sustain its position in

<sup>13</sup> Revealed comparative advantage (RCA) is "a measure of relative *competitive performance* of a country's exporters of a particular product or class of goods" (Institute for Trade and Commercial Diplomacy, 2004).

the global textile and clothing trade after the Agreement on Textiles and Clothing was phased out. Its exports to the United States reached \$2.1 billion in 2006, which represents a 50 per cent expansion from 2004 and a 0.5 per cent gain in market share. Performance in the European Union market was less strong, with exports rising to €552 million in 2006, a tepid 6.3 per cent over 2004 exports. As a result, Cambodia's share of the European Union market contracted by 0.1 per cent.

The Lao People's Democratic Republic earned nearly \$143.2 million from textile and clothing exports in 2005. The productivity of both labour and capital there is low, but labour costs are considered to be one of the lowest among LDCs, which confers a competitive advantage on the country. Exports, which are concentrated in the European Union market owing to the tariff- and quota-free access provided under the European Union EBA initiative, increased from €119 million in 2005 to €122 million in 2006, which was just sufficient for the Lao People's Democratic Republic to maintain its 2004 European Union market share. The country is unable to fully utilize its duty-free access due to the stringent European Union rules of origin criterion: 42 per cent of the raw materials used in its clothing and textile sector are imported from countries that do not fall under the European Union rules of origin specifications.

While the textile and clothing industry in Maldives was adversely affected after the removal of quotas, the decline was not mainly a result of increased competition. The Maldivian textile and clothing industry was established by foreign investment during the period in which the Agreement on Textiles and Clothing was in force to take advantage of underutilized quotas. Once quotas were removed, the profit motive dictated relocation, which led to the decline of the industry. Exports to both the United States and the European Union collapsed after 2004.

The decline of Nepal's textile and clothing industry cannot be attributed solely to the phase-out of quotas. Other factors also played a role, including the preferential access to the United States market accorded to the sub-Saharan African countries through the African Growth and Opportunity Act (AGOA), the Maoist insurgency, labour unrest (Adhikari and Weeratunge, 2007) and the 12 per cent appreciation of the Nepalese currency against the United States dollar between July 2006 and June 2007.

Data on United States imports of the clothing items restricted by safeguards imposed on China give an indication of whether LDCs benefited from the measure. For example, between 2005 and 2006, exports of restricted categories by Bangladesh and Cambodia to the United States grew by 32.9 per cent and 42.2 per cent, respectively. The Lao People's Democratic Republic did not export these restricted categories to the United States in 2004 and 2005, but it exported nearly \$1.73 million worth in 2006. Nepal, which was unable to exploit the opportunity, experienced a 21.7 per cent reduction in exports of the restricted categories to the United States during the period 2005-2006.

There are essentially two types of barriers to textile and clothing exports from LDCs: domestic supply-side constraints and market access restrictions imposed by importing countries. The former includes political, structural and institutional barriers that constrain competitiveness. The lack of a vertically integrated supply chain, poor trade facilitation, high transaction costs, inadequate infrastructure, low labour productivity and the high cost of compliance with Customs procedures hinder the growth of the textile and clothing industry in LDCs. They will continue to constrain the ability of LDCs to compete effectively when quota restrictions on China are removed in 2009.

Even though the European Union provides duty-free access to the textile and clothing exports of LDCs, LDCs in Asia have low utilization rates because of a lack of production capacity for textiles and raw materials. The EBA rules of origin double transformation criterion specifies that the exporting country must undertake a minimum of two finishing operations. As this is not possible for many LDCs, they are unable to fully utilize the duty-free access provisions; they simply cannot meet the required rules of origin threshold. In 2004, the EBA utilization rate for clothing preferences was only 33.8 per cent for Bangladesh and 65.8 per cent for Nepal (World Trade Organization, 2005).

## **6. THE RISE OF CHINA AND IMPLICATIONS FOR FOREIGN DIRECT INVESTMENT IN THE LEAST DEVELOPED COUNTRIES**

China is a magnet for foreign direct investment (FDI). The country attracted \$685.8 billion in FDI inflows during the period 1990-2006. The nine LDCs included in the analysis<sup>14</sup> received \$9.7 billion in FDI during the 17-year period under study, which was less than 10 per cent of what China received in 1992, the year when the country witnessed a surge in FDI inflows. Bangladesh was the most important LDC as a destination for FDI, accounting for 53 per cent of FDI to all LDCs during that period; Cambodia ranked second with over a quarter of total FDI inflows. These two countries were the only LDCs to receive a cumulative sum of over \$1 billion each in FDI during the period and together they accounted for 82 per cent of total FDI to LDCs during 1990-2006. Bangladesh and Cambodia are the LDC giants in terms of domestic market, exports and imports, industrial supply capacity, strong textile sectors, labour market conditions and growth rates during 1995-2005.<sup>15</sup>

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<sup>14</sup> Kiribati, Solomon Islands, Timor-Leste, Myanmar and Tuvalu have been excluded from the discussion because of a lack of data.

<sup>15</sup> According to Shafaeddin (2008), Bangladesh and Cambodia have the highest industrial supply capacity among LDCs in the region (proxied by manufacturing value-added as a percentage of GDP—17.2 and 19.1, respectively), while their rates of growth were 5.13 and 7.10, respectively, during 1995-2005, two of the highest among LDCs in the region.

Does the “FDI haven” offered by China divert investment that would otherwise have gone to LDCs in the Asia-Pacific region? At first sight, this might seem to be the case, as the regional production networks that FDI has helped build emerged largely to supply parts and components to China, which is also a low-wage economy. No LDCs participate in any regional production network,<sup>16</sup> but it is crucial to note that inward FDI flows are a function of several factors. Standard determinants include market size variables (real GDP growth rates, growth rates of real per capita income and GDP), policy variables (the degree of openness, corporate tax rates, import duties and the quality of infrastructure), institutional characteristics (indices of corruption, the degree of Government stability and indices of the rule of law), labour market conditions (illiteracy rates and wage rates), standard gravity model variables (the size of the source country and destination countries and the distance between them) and the global supply of FDI.

Several of these variables have been found to have a significant effect on inward FDI. Chantasawat and others (2004), using two-stage least squares, estimated equations for FDI inflows to China and eight other Asian economies for the period 1985-2001.<sup>17</sup> While questions can be raised about their methodology, they found that the level of FDI inflows to China and the other eight economies are positively, not negatively, correlated. They concluded that “a 10 per cent increase in the FDI inflows to China would raise the level of FDI inflows to the East and South-East Asian countries by about 5 to 6 per cent, depending on the specifications”. In a later study, Chantasawat and others (2005), found that trade liberalization in the Asian countries is a strong force in attracting FDI. On the other hand, Mercereau (2005), using data for 14 countries for the period 1984-2002, concluded that inward FDI to China crowded out FDI to Singapore and Myanmar. Using a gravity model of bilateral flows to analyse FDI rather than trade, Eichengreen and Tong (2005, p. 23) found that China’s attractiveness as a destination for FDI had a positive effect in other Asian countries, “as would be the case if China and these other economies [we]re part of the same global production networks.”

Correlation coefficients for absolute levels of FDI, as well as associated growth rates, offer a rough indication of whether or not such inflows to China affected FDI inflows to the nine LDCs included in the analysis (see table 8).<sup>18</sup> Many macroeconomic time series are not stationary in their levels and can lead to spurious results. The level of such variables can become arbitrarily large or small with no tendency to revert to their mean level. Such variables are best represented by their first differences or growth rates.

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<sup>16</sup> Regional production networks are the supply chains that developed in East Asian countries to supply parts and components to the huge processing component of China’s export sector.

<sup>17</sup> The other eight economies are Hong Kong, China; Indonesia; Malaysia; the Philippines; the Republic of Korea; Singapore; Taiwan Province of China; and Thailand.

<sup>18</sup> Because of data gaps in country coverage, the correlation periods are not uniform. Data on FDI from China to LDCs, which would have added a more nuanced argument to this section, do not exist.

In general, the absolute *level* of inward FDI to these LDCs (together and individually), and to the Asia-Pacific region as a whole, continued to rise even as China attracted a larger inflow of FDI (see table 8). The correlation results between China and LDCs show: (a) a strong positive association between FDI inflows to China and to countries with a correlation coefficient higher than 0.5, including Afghanistan, Bangladesh, Bhutan, Cambodia and Maldives; (b) a positive but weaker association between FDI inflows to China and to countries with a correlation coefficient of less than 0.3, including Nepal and Vanuatu; and (c) a negative association, albeit weak, only for Samoa. If the growth rate of FDI, instead of its level, is examined, then a slightly different picture emerges. A strong positive association exists only for Afghanistan and Bhutan. Weaker associations exist for Bangladesh, Cambodia, the Lao People's Democratic Republic and Nepal; and a negative association is evident for Maldives, Vanuatu and Samoa. Even in the aggregate, the very strong absolute *level* association between FDI inflows to China and other Asia-Pacific economies, including LDCs, is degraded considerably when growth rates are used.

**Table 8. Foreign direct investment: correlation coefficient between China and LDCs, 1990-2006**

<i>Country or area</i>	<i>Coefficient (level)</i>	<i>Coefficient (growth rate)</i>
China and Afghanistan	0.56	0.61
China and Bangladesh	0.92	0.35
China and Bhutan	0.96	0.74
China and Cambodia	0.70	0.22
China and the Lao People's Democratic Republic	0.40	0.23
China and Maldives	0.73	-0.34
China and Vanuatu	0.14	-0.15
China and Nepal	0.06	0.08
China and Samoa	-0.17	-0.06
China and all nine LDCs	0.85	0.46
<i>Memo items</i>		
China and India	0.76	0.60
China and the Asia-Pacific region	0.89	0.55

*Source:* Authors' calculation based on UNCTAD, *Handbook of Statistics 2006-2007* (Geneva, 2007).

Why might these positive associations exist between FDI to China and FDI to LDCs? Two kinds of linkages are possible: production and resources. In manufacturing, especially in the region, firms tend to specialize in the context of a growing fragmentation of the production process. For example, an investor—a transnational corporation—establishes factories in both China and Bangladesh to take advantage of their respective

competitiveness in distinct stages of production. Parts and components are then traded between China and Bangladesh (and possibly other economies as well). In this scenario, an increase in FDI to China is positively associated with an increase in FDI to LDCs. A complementary argument is that, as China grows, its market size and appetite for raw materials increase. As a result, some transnational corporations will set up production facilities in China to take advantage of a growing market, while others will invest in LDCs (and other parts of Asia) to extract minerals and resources to feed China's rising demand for them. Once again, this argument predicts that FDI in China will lead to FDI in LDCs.

The general conclusion from this exploratory correlation analysis is that the *levels* of FDI inflows to China have two effects: they enhance investment in Asian LDCs, possibly through complementary inflows of FDI, but they also divert FDI inflows away from these LDCs. On balance, however, the result is a positive one: the investment-enhancing effect of FDI inflows to China dominates, so they have an uplifting effect on such flows to LDCs.<sup>19</sup>

## 7. CONCLUSIONS AND POLICY IMPLICATIONS

The 10 LDCs in Asia accounted for approximately 5 per cent of China's trade surplus during the period 1990-2006. LDC exports to China were concentrated by country and product; crude matter, a large fraction of which comprised forestry products, dominated by 2006. Imports from China to LDCs were dominated by two countries: 80.2 per cent went to Myanmar and Bangladesh in 1990, slightly less than in 2006. The combined shares of the top two SITC commodity groups imported by LDCs from China rose from 55 per cent to 59 per cent by the end of the period. LDCs and China do not compete in any significant way in third-country markets. A correlation analysis suggests that FDI flows to China have a positive effect on flows to LDCs.

An important policy implication is the need for more equalizing growth in the region and, in particular, between the emerging economies, such as China, and LDCs. Greater participation by LDCs in regional and global markets is hindered by supply-side constraints and limited market access for products for which they have a comparative advantage. Assistance could be provided in two ways:

- A regional fund could be established to find solutions to supply-side constraints.<sup>20</sup> Foreign exchange reserves have grown robustly during the last several years; China's foreign reserves alone surpassed \$1.6 trillion in March 2008 (Chinability, 2008). A regional fund, as proposed by Gampat (2007), could be set up to invest excess reserves in LDCs, providing resources for

<sup>19</sup> Chantasawat and others (2005, p. 37), using panel regression, examined the shares of FDI to developing countries and found that "the China effect is negative for both the East and South-East Asian economies..."

<sup>20</sup> This could complement the Aid for Trade initiative.

infrastructure projects—such as roads, port services, and information and communications technologies—to reduce the infrastructural bottlenecks and contributing investments in human capital—including technology transfers and skills development—to enable LDCs to diversify their products, move up the value chain and improve competitive capacity.

- Consistent with Target 13<sup>21</sup> of Millennium Development Goal 8 and the decision taken at the Sixth WTO Ministerial Conference held in Hong Kong, China in 2005 that “developed country members shall, and developing country members in a position to do so should provide duty-free and quota-free market access to LDCs” (United Nations Development Programme, 2008), China and other newly industrialized countries in the region should provide greater market access for Asia-Pacific LDC exports. This could be done by: (a) providing duty- and quota-free treatment for all LDC exports; and (b) strengthening market access preferences through improved special and differential treatment provisions, liberal rules of origin and flexible product standards for goods originating from LDCs (United Nations Development Programme, 2008). Additionally, the Global System of Trade Preferences among Developing Countries (GSTP) should be used as a mechanism for enhancing South-South trade among countries in the region, led by China and India, for example.

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<sup>21</sup> Target 13: Address the special needs of LDCs. “Includes: tariff- and quota-free access for Least Developed Countries’ exports; enhanced programme of debt relief for heavily indebted poor countries and cancellation of official bilateral debt; and more generous official development assistance for countries committed to poverty reduction” (United Nations Development Programme, 2005, p. 3).

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