

**Does Comparative Advantage Make  
Countries Competitive?  
A Comparison of China and Mexico**

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# Does Comparative Advantage Make Countries Competitive? A Comparison of China and Mexico

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## Abstract

Latin American countries have lost competitiveness in world markets in comparison to China over the last two decades. The main purpose of this study is to examine the causes of this development. To this end an augmented Dornbusch-type “Ricardian” model is estimated using panel data. The explanatory variables considered are productivity, unit labor costs, unit values, trade costs, price levels, and real exchange rates; all variables are evaluated in relative terms. Due to data restrictions, China’s relative exports (to the US, Argentina, Japan, Korea, the UK, Germany, and Spain) will be compared to Mexico’s exports for a number of sectors over a limited period of eleven years. Panel and pooled estimation techniques (SUR estimation, panel Feasible Generalized Least Squares (panel/pooled FGLS)) will be utilized to better control for country-specific effects and correlation over time. A simulation underlines the positive impact of relative real exchange rate advantages on relative exports for the textile sector. Standardized  $\beta$ -coefficients identify relative real exchange rates, relative cost levels, and relative unit values as the drivers of competitive advantage in the textile sector.

*Keywords:* “Ricardian” model of trade; panel data models; panel Feasible Generalized Least Squares; Seemingly Unrelated (SUR) estimation.

*JEL classification:* C23, F11, F14

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# **Does Comparative Advantage Make Countries Competitive? A Comparison of China and Mexico**

## **1. Introduction**

Latin American countries have lost competitiveness in world markets in comparison to China for the last two decades. The economic opening up of China, which was strategic and well planned, included the attraction of foreign companies and their know-how through special incentives such as tax exemptions, and through the creation of export-processing zones. Latin American countries, in contrast, tried to pursue unilateral<sup>1</sup> and regional trade liberalization (creation of MERCOSUR, CAN, CACM). Their attempts to form Free Trade Agreements (FTAs) with the European Union (EU) and the US have not yet yielded results. In the end, Latin America's strategic planning of exports aimed more towards signing bilateral trade agreements (Mexico-EU, NAFTA, Chile-EU, Chile-US, etc.) with the objective to gain better mutual market access and was less focused on foreign direct investment (FDI).

Due to China's trade strategy, industrial development in the country has been rapid in contrast to development in the farm sector. China's top export sectors are automatic data-processing machines, telecommunication equipment, baby carriages, toys, games, sporting goods, footwear, and textiles. The best performing Chinese products in terms of export shares are television cameras, video recording/ reproduction equipment, furniture, footwear, jerseys, and pullovers (International Trade Center (ITC), based on COMTRADE statistics). China's main export markets are the US, Hong Kong, Japan, Republic of Korea, and Germany (UN COMTRADE statistics database, 2006). In comparison with China, Latin American countries, which are still strong in the agricultural and food-related sectors, lost influence in the manufacturing, machinery, and transport equipment sectors between 1995 and 2000 (TradeCAN, 2002 Edition). Latin American countries export mainly to the US, Germany, the

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<sup>1</sup> Chile started to liberalize its trade in the mid seventies of the last century. Most other Latin American countries opened up trade after the big debt crisis in the mid eighties of the last century to comply with structural adjustment programs.

Netherlands, France, Spain, and Portugal, according to UN COMTRADE statistics database, 2006.

The main purpose of this study is to examine the causes of this loss of Latin American trade share and to measure the effects of relative productivity, changes in relative unit labor costs, changes in relative unit values, and changes in the overall price level (in constant US dollar terms) on relative export strength. If we find that the loss of Latin America's competitiveness is more the result of China's exchange rate management, than any failure on the part of Latin America, then Latin America would have less reason for concern. If, however, the loss of competitiveness were more the result of China's increase in productivity, then Latin America should be concerned about its future standing in world markets.

There are few empirical studies attempting to disentangle the concepts of comparative and competitive advantage when examining export success. This distinction, however, is crucial for evaluating the development of market shares in certain sectors and certain markets, as well as examining their determining factors. We build on a study by Golub and Hsieh (2000) who empirically test a "Ricardian model"<sup>2</sup>, explaining "comparative advantage"<sup>3</sup> by differences in productivity and labor costs. There is little empirical evidence based on Ricardo-type models, except for analyses by MacDougall (1951), Stern (1962), and Balassa (1963). Competitive advantage, which is empirically studied, is the key concept of the newer trade theories and of strategic-trade policy and continues to be a much-debated issue in developed and developing countries. After all, it is costs (labor costs, trade costs--transport costs, tariff and non-tariff barriers, insurance costs)), prices and exchange rates that matter in trade and, together, they are an important factor in determining the success of a product even where product differentiation exists.

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<sup>2</sup> It is not a "true" Ricardian model that derives comparative advantage from differences in opportunity costs in a two-sector model. What Golub and Hsieh (2000) mean by Ricardian model is a model which gives importance to differences in labor productivity and labor costs in a one-sector model.

<sup>3</sup> Authors in this field actually mean competitive advantage based on production cost advantages when talking about "comparative advantage".

We try to extend the study of Golub and Hsieh (2000) by testing competitive advantage and by giving unit labor costs and prices (unit export values) adequate importance and by including trade costs and real exchange rates. We furthermore aim to identify sectors where success is driven more by product quality than by product prices (in terms of export unit values). An optimal model will therefore contain relative labor productivity, relative labor costs, relative export unit values, differences in trade costs, and relative real exchange rates. Our study will build on a set of panel data and use panel and pooled-estimation techniques (SUR-estimation, panel Feasible Generalized Least Squares (panel/pooled FGLS)). In this panel data framework, we are able to control for unobserved country-heterogeneity and also for time-driven effects.

In our analysis, we will limit ourselves to comparing China with a Latin American country having a very strong manufacturing industry, namely Mexico, in selected single markets (the US, Japan, Korea, Germany, the UK, Spain, and Argentina)<sup>4</sup>, thereby extending a study by Iranzo and Ma (2006) on the effect of China's trade on that of Mexico, which study focused on the US market only. The relevance of a comparison of China and Mexico is supported by Hanson and Robertson (2006). They found that high competition existed in manufacturing between China and Mexico as the sectors in which Mexico has a relatively strong export-supply capacity tend to be sectors in which China's export capacity is also strong.

The paper is organized as follows. Section 2 explains the concept of "comparative" and competitive advantage and how these concepts are interlinked. Section 3 discusses the empirical implementation (data issues, model specification, and estimation techniques). In Section 4 the empirical results for eleven sectors are presented placing emphasis on the textile sector, and the most important determinants of competitiveness (in terms of export success)

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4 A comparison between China and Brazil was impaired by data problems (lack of comparable productivity and labor compensation data) with respect to Brazil. Nonetheless, common to China and Mexico is the influence of multinationals and foreign direct investment (FDI).

are identified. Section 5 contains a simulation of the role played by the relative real exchange rate and Section 6 concludes.

## **2. “Comparative Advantage”, Competitive Advantage and Relative Export Strength**

We utilize an eclectic Dornbusch-type model to explain relative export strength. Relative export strength is determined by factors influencing competitive advantage. To simplify, competitive advantage contains four components: relative unit labor costs (the ratio of labor costs and labor productivity) as a rough indicator of a production advantage, relative product prices (as measured by unit export values), relative trade costs, and relative real exchange rates. As to the first component, production advantage<sup>5</sup>, we build on the “Ricardian model of trade and payments” (Dornbusch, 1980), in which labor is the only factor of production and where home (nontraded) goods and traded goods are produced with constant returns, (fixed coefficient production functions of the Leontieff-Walras type). Technology and hence unit labor requirements differ across countries.

Following Dornbusch (1977, 1980), production advantage in this model is determined by unit labor requirements,

$$a = L / Q \quad (1)$$

where  $a$  is the number of units of labor required to produce a unit of value added ( $Q$ ), and  $L$  is labor employed when producing a product in the home country. The  $a$ , the inverse of labor productivity, can be obtained from input-output tables.

The relative unit labor requirement  $A$ , our measure of comparative advantage, compares technical efficiency at home and abroad<sup>6</sup> (\*) and is defined as

$$A \equiv a^* / a. \quad (2)$$

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<sup>5</sup> This production advantage is called comparative advantage by Dornbusch and Golub and Hsieh..

<sup>6</sup> In our empirical analysis, China stands for abroad and Mexico stands for home country.

In a two-country, multi-good “Ricardian” model, production advantage (“comparative advantage”) can be determined by ranking domestic and foreign labor productivity by sector ( $i=1, \dots, n$ ).

$$a_1^* / a_1 > a_2^* / a_2 > \dots > a_i^* / a_i > \dots > a_n^* / a_n. \quad (3)$$

To make fair comparisons of competitiveness between the foreign and home markets, the price of labor has to be viewed in a common currency since countries with low labor productivity are well able to compete if their wages are sufficiently low and/or their exchange rate is depreciated; analogously, countries with high labor productivity might be unable to compete in international markets due to (excessively) high labor costs and/or an appreciated exchange rate.

Relative unit labor costs  $c_i$ , therefore, relate to cost/price competitiveness, our alternative first component.

$$c_i = w_i^* a_i^* e / w_i a_i \quad (4)$$

where  $c_i$  stands for relative labor unit costs and is a measure of *competitive advantage*.  $w_i^*$  and  $w_i$  are labor costs (labor compensation) abroad and at home and  $e$  is the bilateral nominal exchange rate between abroad and at home.

Sector  $i$  has a competitive advantage in the home country if

$$c_i > 1 \quad (5a)$$

$$\text{or } a_i w_i < a_i^* w_i^* e. \quad (5b)$$

Under the assumption that the wage and price setting behavior at home and abroad is similar (similar power of labor unions and similar profit margins, etc.), the ratio of relative unit values<sup>7</sup>  $uv = UV_{it}^* / UV_{it}$  could serve both as an indicator of product quality<sup>8</sup> and price advantage, our second component.

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<sup>7</sup>  $UV$ 's are normally in US dollars. If not, they must be converted to a common currency.

Following Deardorff (2004), we extend the concept of competitive advantage and control for trade costs  $tc_i$ , our third component, that arise when serving a certain market  $m$  ( $tc_{m_i}$ ). Taking into account trade costs, the home country will export a good to market  $m$  if unit export values (including trade costs) are lower/less than abroad. To control for differences in trade costs,<sup>9</sup> we utilize the variable  $TCM_i = (tc_{m_i}^*e) - tc_{m_i}$  as an indicator for a trade cost advantage/disadvantage. In the empirical analysis, we will use  $TCM_i$  as a separate variable and do not include it into the term  $UV_i^* / UV_i$ .

We also accept that the market exchange rate  $e$  differs from the PPP exchange rate ( $e_{PPP}$ ) in the short-to-medium term and that the short-to-medium term real exchange rate ( $RER$ ) will also differ from  $RER_{PPP}$ . Thus the real exchange rate, our fourth component, also determines competitive advantage and can reflect the impact of exchange-rate management over the short and medium term.

Differing expenditure levels/cost of living levels at home ( $EXP$ ) and abroad ( $EXP^*$ ), our substitute for relative labor costs<sup>10</sup>, determine competitive advantage in the short-to-medium term. According to the purchasing power theory (PPP), over the long run, price levels (in a common currency) for traded goods at home and abroad should be the same in the absence of tariffs, transport costs, and the absence of spatial arbitrage. In the short-to-medium time period, however, a relatively lower expenditure/cost of living level is expected to promote trade.

### 3. Empirical Implementation

#### 3.1 Data and Variables

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<sup>8</sup> It could incorporate the aspects of differentiated products having variable quality standards and diverse product characteristics.

<sup>9</sup> Trade costs can comprise tariffs, transport costs, insurance costs, and the like.

<sup>10</sup> As to China, sectoral labor cost data lacked for most of the years in the period of 1980 to 1986..



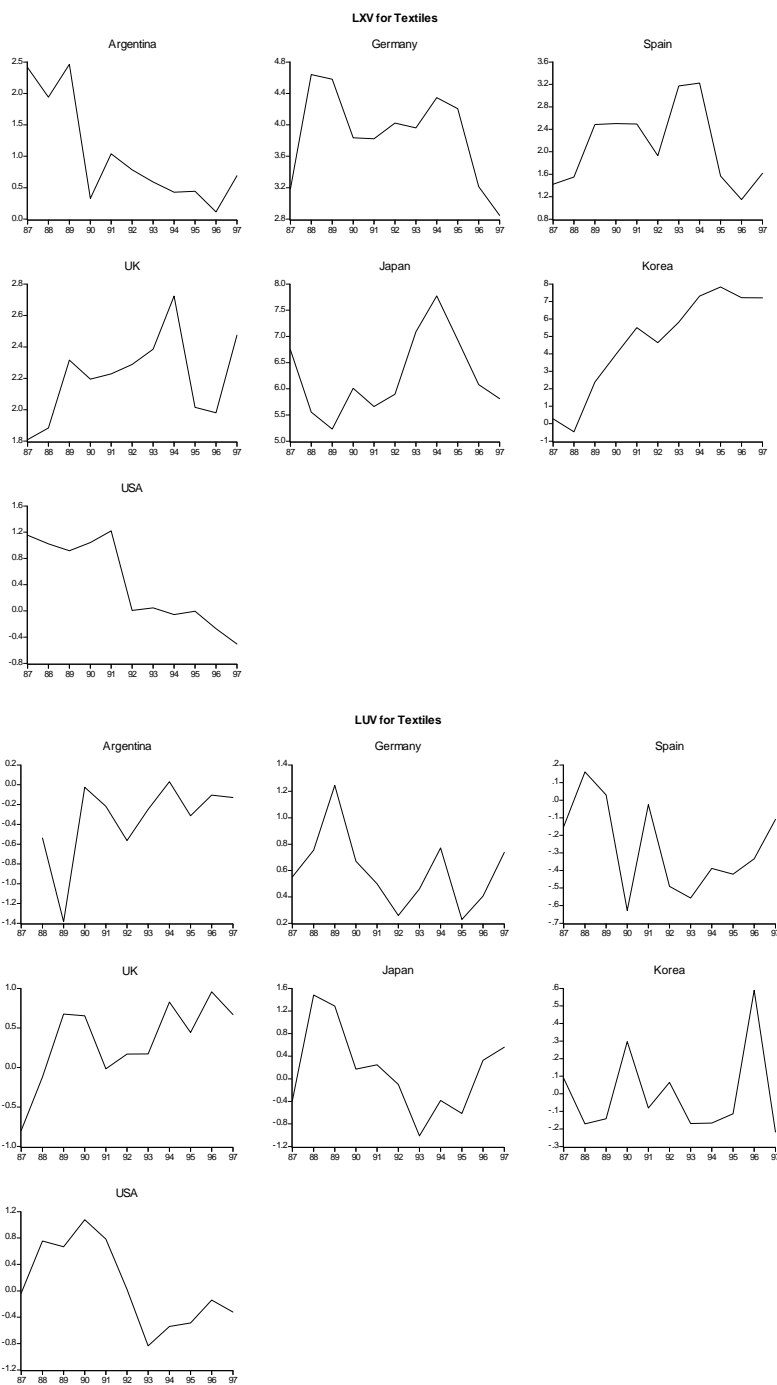
The main data source employed is World Bank's database (<http://www.worldbank.org/trade>) for sectoral exports in value and volume (1987-2004), export unit values (1987-2004), and value added per employee (1980-1997).<sup>11</sup> Sectoral data are organized according to the ISIC classification which unites trade and production data. Macro data were taken from the World Development Indicators of 2006. We used household final consumption expenditures per capita (in constant 2000 US dollars) as a proxy for labor costs (1980-2004) and computed bilateral real exchange rates (1980-2004) from WDI, 2006. The relative Chinese to Mexican export values and unit values for the different destination markets are displayed in Figure 1 in the example of the textiles sector.

Distances were taken from <http://www.maritimeChain.com/> and freight costs (based on Hufbauer, 1991, and Busse, 2003) were available from 1980 to 2004. A trade-cost variable is computed by multiplying the freight-cost index with the difference in actual nautical miles (the actual sea route that captains take) between the Chinese port and the Mexican port that is used by ships going to a certain market, e.g., the US.

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11 Labor cost per employee (1980-1986) and unit labor costs (1980-1986) had too many missing values to include them in the pooled analysis.

**Figure 1** Development of relative<sup>12</sup> export values (lxv) and relative<sup>13</sup> unit values (luv) for textiles to all destination markets, in logs



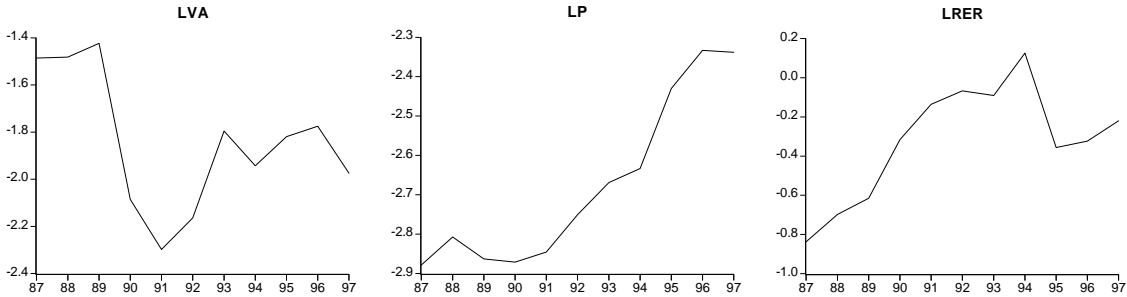
We have the unfortunate situation of having data for relative productivity (LVA) from 1980 to 1997 and having relative export values (LXV) and relative unit values (LUV) from 1987 to

<sup>12</sup> Relative implies that *China* stands in the numerator and *Mexico* stands in the denominator.

<sup>13</sup> Relative implies that *China* stands in the numerator and *Mexico* stands in the denominator.

2004. The relevant sample period thus shrinks to 1987 to 1997. This is not long enough to use some specific estimation techniques examining all sectors (e.g., system-of-equation techniques (such as SUR) cannot be utilized in some sectors due to a lack of observations).

**Figure 2** Development of relative<sup>14</sup> value added (lva), relative<sup>15</sup> household expenditures (lexp=lp=lw) and relative<sup>16</sup> real exchange rates (lrer), in logs



We try to capture the impact of relative labor costs by utilizing relative household expenditures (lexp=lw). The argument that the relative real exchange rate (lrer) and Lexp are both measures of relative real exchanges is true in general terms as both variables measure relative prices or costs. The argument is less true in the sense that relative household expenditures are a price measure for (only) private consumption, whereas the GDP-deflators that enter the LRER measure prices of private and public consumption, of private and public investment, and of exported and imported goods. Note that the correlation between both variables is quite low for the period observed (0.32). Furthermore, checking the impact of correlation between LP and LRER by leaving out either one of the variables did not change the significance, the amounts, or the signs of the coefficients. Both coefficients remained significant in the regression when both variables were in the regression, and the size stayed practically unaltered. The development of these dependent variables is displayed in Figure 2.

<sup>14</sup> Relative implies that *China* stands in the numerator and *Mexico* stands in the denominator.  
<sup>15</sup> Relative implies that *China* stands in the numerator and *Mexico* stands in the denominator.  
<sup>16</sup> Relative implies that *China* stands in the numerator and *Mexico* stands in the denominator.

### 3.2 Selection of Destination Markets

We examine relative exports of China and Mexico to a total of seven destination markets. The destination markets were determined by means of the UN COMTRADE database (2007) according to the export value of 2005. Even though 2005 is not in the sample period, it gives us an idea of the markets that will be of relevance in the future. For both China and Mexico, the five most important export markets were selected. This yielded some overlap of countries (The US, the UK, and Germany are important export markets for both China and Mexico.) and some mutually excluding destination markets due to language/cultural ties and geographical distance (e.g., Argentina and Spain are interesting markets for Mexico, and Japan and Korea are the main export markets of China). Accordingly, the US, the UK, Germany, Japan, and Korea have been selected as China's most important export markets, whereas the US, Argentina, Spain, Germany, and the UK have been identified as Mexico's export markets of relevance. Germany and the UK are of utmost importance both for China and Mexico; Spain and Argentina are critically important for Mexico; Japan and Korea are China's predominant export outlets. However, Asian countries are becoming increasingly interesting, particularly for Latin American countries.

### 3.3 Model Specification

To test for the role of comparative and competitive advantage in our eclectic, Dornbusch "Ricardian" model, we perform a panel regression analysis of the dynamics of Chinese and Mexican sectoral trade patterns over the period from 1987 until 1997. Export ratios (dependent variable) are considered a measure of trade following MacDougall (1951, 1952), Stern (1962), and Balassa (1963).<sup>17</sup> In contrast to the above-mentioned studies, we look at the ratio of exports of Chinese and Mexican exports to certain markets (Argentina, US, Japan,

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<sup>17</sup> These authors used the ratio of US to UK world exports as the dependent variable.

Korea, Germany, and Spain) and not to the world as a whole. The use of trade data (value and quantities) and of unit values is only justified when bilateral exports are considered.

Unfortunately, data restrictions concerning China, in particular, are severe (labor costs and, consequently, unit labor costs, are available only for the short time span of 1980 through 1986, whereas export volumes and values are only available from 1987 onwards).

In a *second best data world* we can set up the following model to explain relative export success (export ratios) of China (marked by a \*; in the numerator) and of Mexico (in the denominator).

$$\ln(X_{ijt}^* / X_{ijt}) = \alpha + \beta \cdot \ln(VA_{it}^* / VA_{it}) + \gamma \ln(EXP_{jt}^* / EXP_{jt}) + \delta \ln(UV_{ijt}^* / UV_{ijt}) + \varepsilon \ln(TC_{ijt}^* / TC_{ijt}) + \phi \ln(RER_{jt}^* / RER_{jt}) + u_{ijt} \quad (6)$$

i stands for sector (in our case textiles); j stands for destination market<sup>18</sup> (j); t stands for time.

The simplified version of the model reads as:

$$lxv_{ijt} = \alpha_j + \beta \cdot lva_{it} + \gamma \cdot lw_t + \delta \cdot luv_{ijt} + \varepsilon \cdot TCM_{jt} + \phi \cdot lrer_{jt} + u_{ijt} \quad (7)$$

where all variables except for TCM (the difference in transport costs<sup>19</sup>) are in logs. The dependent variable is  $lxv_{ijt} = \ln\left(X_{ijt}^* / X_{ijt}\right)$  = relative exports to market j in millions of US dollars (USD) (in logs). We consider relative export strength to be determined by five explanatory variables. The first right-hand side variable is relative labor productivity ( $va=VA^*/VA$ ) abroad (\*) and at home. We expect a positive sign. The second right-hand side variable is relative labor costs in a common currency ( $w=W^*e/W$ ), e being the bilateral nominal exchange rate. Since labor costs are not available for equal spans of time in China

<sup>18</sup> The destination markets include: Argentina, Germany, Spain, UK, Japan, Korea and the USA. Germany, UK and the USA are the intersection markets of China and Mexico, Argentina and Spain are Mexico-specific and Japan and Korea are China-specific markets.

<sup>19</sup> We assumed freight costs to depend on the distance but to be the same otherwise. Depending on the destination market the term can become negative. For this reason we did not take logs. The ratio of Chinese and Mexican transport costs, in contrast, would not vary over time and would therefore not be applicable in the panel context..

and Mexico, they will be proxied by relative cost of living levels abroad and at home ( $\text{exp}=\text{EXP}^*/\text{EXP}$  = relative household consumption expenditure per capita (constant 2000 USD))<sup>20</sup>. The expected sign is negative. Relative unit export values ( $\text{uv}=\text{UV}^*/\text{UV}$ ) are our third right-hand side variable. The expected sign is negative if price competitiveness prevails and positive if product quality is emphasized<sup>21</sup>. Our fourth right-hand side variable is relative trade costs ( $\text{tc}=\text{TC}^*/\text{TC}$ ) or the difference in trade costs  $TCM_i = (tcm_i^*e) - tcm_i$  as an indicator for a trade cost advantage/disadvantage<sup>22</sup>. Given that the market exchange rate  $e$  differs from the PPP exchange rate ( $e_{PPP}$ ) in the short-to-medium term, the relative real exchange rate ( $\text{rer}=\text{RER}^*/\text{RER}$ ), our fifth right-hand side variable, also determines competitive advantage<sup>23</sup> and can reflect the impact of exchange-rate management over the short and medium term. The expected sign is positive.

### 3.4 Estimation Procedure

The estimation procedure can be described as follows: In the first step, a pooled regression is run to get an overview of the relevant variables in each sector. This model-setup is estimated by Feasible Generalized Least Squares (FGLS), thus controlling for autocorrelation and non-stationarity of the series.

In the second step, a system of equations is built around the seven destination markets (Argentina, US, Germany, Spain, UK, Japan, and Korea). We control for correlation of the disturbances between the cross-sections (the above-mentioned seven countries) via Seemingly Unrelated Regression (SUR). By means of this method, correlation between the seven destination markets is considered. The system approach adds supplementary information to

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<sup>20</sup> According to the purchasing power theory (PPP), over the long run, prices (in a common currency) for traded goods at home and abroad should be the same in the absence of tariffs, transport costs, and the absence of spatial arbitrage. In the short-to-medium time period, however, a relatively lower price (or cost) level is expected to promote trade.

<sup>21</sup> See also Rodrik (2006) and Schott (2006).

<sup>22</sup> In the empirical analysis, we will use  $TCM_i$  as a separate variable. It is not included in the term  $UV_i^*/UV_i$ .

<sup>23</sup> Dullien (2006) computed a unit-labor cost based real effective exchange rate for China.

the non-system approach which was initially tested. The seven regressions (over the twenty-eight sectors for each destination market) yielded quite poor results.

In the third step, the system of equations is estimated with cross-section specific (country-specific) coefficients. However, it is only possible to use this method when sufficient data are available. As SUR with cross-section specific coefficients would be our estimation method of choice we present the results for the textile sector even though the sample size is insufficient.

#### 4. Empirical Results: The Determinants of Competitiveness at the Sectoral Level

We present estimated results starting with a sector of utmost importance, namely textiles, where our data on export values and unit values were relatively more complete. Equation (7) was estimated with cross-section specific intercepts (country-fixed effects) and autocorrelation was controlled for with an AR(1) term. Adjusted  $R^2$  was 0.92 and the Durbin-Watson statistic was 1.96 (see Table 1).

**Table 1** Determinants of competitiveness in the textile sector (pooled analysis with fixed effects; FGLS estimation)

Dependent Variable: l <sub>xv</sub>					
Method: Pooled Least Squares					
Sample (adjusted): 1988-1997					
Included observations: 10 after adjustments					
Cross-sections included: 7					
Total pool (unbalanced) observations: 69					
Convergence achieved after 15 iterations					
VARIABLE	COEFF.	STD. ERROR	T-STATISTIC	PROB.	St. $\beta$ -coeff.
intercept	1.97	2.63	0.75	0.46	
l <sub>va</sub>	0.54	0.44	1.24	0.22	0.065
l <sub>w</sub>	-0.22	1.07	-0.21	0.84	-0.020
l <sub>uv</sub>	-0.34	0.18	-1.87	0.07	-0.080
l <sub>rer</sub>	1.07	0.65	1.65	0.10	0.129
t <sub>cm</sub>	0.00	0.00	2.49	0.02	0.000
AR(1)	0.65	0.10	6.70	0.00	
Fixed Effects (Cross)			China/Mex:		
1--C	-6.10	Argentina	TC-disadv.		
2--C	-2.70	Germany	TC-disadv.		
3--C	-2.95	Spain	TC-disadv.		

4--C	-4.28	UK	TC-disadv.
5--C	9.90	Japan	TC-advant.
6--C	11.45	Korea	TC-advant.
7--C	-5.92	USA	TC-disadv.
Cross-section fixed (dummy variables)			
R-squared	0.94	Mean-dependent var.	3.01
Adjusted R-squared	0.92	S.D. dependent var.	2.33
S.E. of regression	0.66	Akaike info. criterion	2.18
Sum-squared resid	24.60	Schwarz criterion	2.60
Log likelihood	-62.32	F-statistic	65.29
Durbin-Watson stat.	1.96	Prob. (F-statistic)	0.00

The signs of the coefficients are as expected, except for the variable TCM (transport cost disadvantage). This coefficient was supposed to be negative but it turned out to be zero, indicating that transport costs do not influence the Chinese-Mexican relationship in competitiveness.<sup>24</sup> We observed that the transport cost effect was very well reflected in the cross-section-specific intercepts. The intercepts were negative for the destination markets: the US, Argentina, Germany, Spain, and UK, where China has a transport cost disadvantage, and were positive for the destination markets Japan and Korea, where China has a transport cost advantage. Relative productivity (*lva*) and our proxy for labor costs (*lw*) were insignificant but show the correct sign. Relative unit values (*luv*) had a significant negative impact on relative exports, implying that an increase in Chinese relative unit prices leads to a decrease in Chinese relative exports. A depreciation of the relative real exchange rate (*lrer*) had a positive impact on relative Chinese exports.

In terms of standardized  $\beta$ -coefficients, relative real exchange rates (*lrer*) contribute most (0.129) to relative exports (*lxv*), followed by relative unit values with an impact of -0.080 and *lva* with an impact of 0.065 and *lw* with an impact of -0.020. The impact of the difference in transport cost was 0.00.

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24 In fact, transport costs were zero or very close to zero for all twenty-eight ISIC sectors. Therefore, transportation costs were removed from the regression equations. The “zero”-impact might be due to the fact that we were forced to use to sector-unspecific transport costs due to unavailability of the data.



In the second step, we built a system of seven equations (one equation for each destination market) and estimated the model by SUR. This procedure is less restrictive and yielded fairly good results. Relative productivity (lva) and relative real exchange rates (lrer) had a positive significant impact and relative costs and relative unit values had a negative impact on Chinese relative exports, as expected. Table 2 shows the SUR results for all seven destination markets together.

**Table 2** Determinants of competitiveness in the textile sector (dependent variable lxy; SUR estimation with fixed effects and common slope coefficients)

VARIABLE	COEFFICIENT	T-STATISTIC	P-VALUE	ST.β-COEF
lva	0.52*	1.81	0.08	0.062
lw	-1.20*	-1.93	0.06	-0.107
luv	-0.14	-1.34	0.19	-0.034
lrer	0.78*	1.81	0.07	0.090
FE-USA	-1.90	-1.08	0.28	
FE-ARG	-1.37	-0.77	0.44	
FE-ESP	0.26	0.14	0.88	
FE-UK	0.57	0.33	0.74	
FE-DEU	2.07	1.16	0.25	
FE-JPN	4.14	2.35	0.02	
FE-KOR	4.59	2.28	0.03	
Total system obs: 69	1 weight matrix	$R^2 = 0.39$		
Sample: 1988-1997	21 total iterations	coef. DW=1.54		

Note: An AR(1) term was added. The coefficient was 0.78 and significant.

The standardized SUR estimates ( $\beta$ -coefficients) show the highest values for relative labor costs (lw) with an impact of -0.107, followed by relative real exchange rates (lrer) with a value of 0.090. The  $\beta$ -coefficients were 0.062 for lva and -0.034 for luv.

In the third step, a SUR was estimated with country-specific coefficients. luv was removed from the variable list, since it was statistically insignificant. Table 3 shows the SUR results for each of the seven countries.

We observe in Table 3 that almost all variables are significant (at conventional confidence levels). Furthermore, the Durbin-Watson statistics are now closer to two and the explanatory power of the regression equations has improved. The main message of Tables 1 to 3 is that the impact of transport costs is captured by the intercept of the pooled regression (see Table 1, Fixed Effects). China's transport cost disadvantage is reflected in the negative intercept of Argentina, Germany, Spain, UK, and the US, and China's transport cost advantage is reflected in the positive intercept of Japan and Korea. Low unit values (proxy for prices) of a textile product enhance textile exports,  $\alpha$  being twenty percent (Table 2). In summary, for most countries, productivity, low costs, and a depreciated real exchange rate positively influence competitiveness in the textile sector. Although, a seemingly unrelated regression with country specific coefficients would be our model of choice, we have to admit that the results have to be handled very carefully due to the data limitations discussed before. For this reason we do without computing the standardized  $\beta$ -coefficients.

**Table 3** Determinants of competitiveness in the textile sector at the country level (dependent variable  $lxv$ ; SUR estimation with fixed effects (suppressed) and cross-section-specific coefficients)

VARIABLE	COEFFICIENT	T-STATISTIC	P-VALUE
<b>Argentina</b>			
lva	0.94**	2.86	0.01
lw	-1.99***	-6.52	0.00
lrer	-1.00***	-3.05	0.00
R <sup>2</sup> =0.80	DW=2.38		
<b>Germany</b>			
lva	1.40**	2.87	0.01
lw	-1.86***	-4.36	0.00
lrer	0.90*	1.67	0.10
R <sup>2</sup> = 0.70	DW=1.75		
<b>Spain</b>			
lva	1.78***	5.89	0.00
lw	-2.47***	-8.72	0.00
lrer	3.34***	10.75	0.00
R <sup>2</sup> =0.84	DW=1.86		
<b>UK</b>			
lva	0.49**	2.38	0.02
lp	-0.30*	-1.87	0.07

lrer	1.13***	5.24	0.00
R <sup>2</sup> =0.69	DW=1.93		
<b>Japan</b>			
lva	2.49***	3.80	0.00
lw	0.34	0.52	0.60
lrer	3.95***	5.53	0.00
R <sup>2</sup> =0.66	DW=2.31		
<b>Korea</b>			
lva	-1.10	-0.72	0.47
lw	8.01***	6.48	0.00
lrer	5.25***	3.41	0.00
R <sup>2</sup> =0.86	DW=1.66		
<b>USA</b>			
lva	-0.79***	-2.98	0.01
lw	-2.10***	-9.52	0.00
lrer	-1.50***	-5.40	0.00
R <sup>2</sup> =0.90	DW=2.25		

Equation (7) was estimated for the remaining ISIC sectors. The results are presented in the Appendix (Tables A1 and A2). Estimations are primarily based on the SUR technique. SUR is estimated with common coefficients for the system of seven equations. Due to data restrictions some variables had to be dropped from the regressions. The main results were:

In **furniture** trade lower relative costs and a more depreciated real exchange rate influenced Chinese exports positively. With respect to trade in **iron and steel and non-ferrous metals**, lower unit values and a depreciated real exchange rate had a positive impact on China's exports. Product quality (as reflected by higher unit values) was rewarded by an increase in Chinese **fabricated metal** exports as was a depreciated real exchange rate. Unit values did not play a significant role in China's exports of **electric and non-electric machinery**. A depreciated real exchange helped to some extent. Concerning **food** exports, low unit values determine export success. Consumers look for cheap nutrition. This may explain the success of low price supermarkets. In the trade of **wearing apparel**, in contrast, only a depreciated real exchange rate matters. Trade in **industrial chemicals** is positively determined by high productivity, low unit prices and a favorable real exchange rate, whereas trade in **beverages** profits from low costs in the production countries.

## 5. Simulating the Effect of a Revaluation of the Chinese Yuan

The Institute for International Economics (IIE) found that the Yuan was 15-25% undervalued in 2003. Preeg (2003) estimated that the Yuan was undervalued by 40% in 2003. These estimates are not the product of econometrically estimated economic models, rather they are “back of the envelope” estimates based on a few simple “rule of thumb” assumptions that take into account current account surpluses, net foreign direct investment flows, increase in foreign exchange reserves (Morrison, 2007). We therefore assume the Chinese Yuan to be undervalued by 20 to 40 percent in our simulation. By basing the simulations for the textiles sector on the SUR results of Table 1, we compute the effect of a Chinese currency appreciation/revaluation against the currencies of the destination markets<sup>25</sup> on China’s relative export position. In the simulation we consider only the first-round effect of a currency appreciation and leave all other explanatory variables in the model unchanged. Simulating a 20-percent appreciation or a 40-percent appreciation, we obtain noticeable declines in the relative export ratios when comparing the “before” and “after” export ratios. Depending on the destination market we can also observe huge differences in Chinese-Mexican export ratios in textiles, the ratio being smallest in the US-American and Argentine market and being highest in the Japanese and Korean market (Table 4).

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<sup>25</sup> We assume a similar undervaluation of the Chinese Yuan in the non-\$ destination markets.

**Table 4 Impact of a 20% and a 40% revaluation of the Yuan on the Chinese-Mexican export ratios in textiles in important destination markets**

Years	Ratio before Revaluation USA	After 20% Revaluation USA	After 40% Revaluation USA	Before Revaluation ARG	After 20% Revaluation ARG	After 40% Revaluation ARG	Before Revaluation ESP	After 20% Revaluation ESP	After 40% Revaluation ESP
1988	1.05	0.88	0.70	2.14	1.80	1.43	9.89	8.31	6.64
1989	1.25	1.05	0.84	2.83	2.38	1.90	11.84	9.95	7.95
1990	1.07	0.90	0.72	2.11	1.78	1.42	11.73	9.86	7.88
1991	1.11	0.93	0.74	2.17	1.82	1.46	10.77	9.05	7.23
1992	1.25	1.05	0.84	2.30	1.93	1.54	11.61	9.75	7.79
1993	1.52	1.27	1.02	2.37	1.99	1.59	12.63	10.61	8.48
1994	1.53	1.28	1.03	2.39	2.01	1.61	12.96	10.89	8.70
1995	0.87	0.73	0.58	1.44	1.21	0.96	7.47	6.28	5.01
1996	0.77	0.65	0.52	1.31	1.10	0.88	6.90	5.79	4.63
1997	0.78	0.66	0.52	1.29	1.09	0.87	6.58	5.52	4.42
Years	Ratio before Revaluation UK	After 20% Revaluation UK	After 40% Revaluation UK	Before Revaluation DEU	After 20% Revaluation DEU	After 40% Revaluation DEU	Before Revaluation JPN	After 20% Revaluation JPN	After 40% Revaluation JPN
1988	14.03	11.79	9.42	55.63	46.74	37.35	398.16	334.55	267.31
1989	14.75	12.40	9.91	61.05	51.30	40.99	481.12	404.27	323.01
1990	13.37	11.23	8.98	59.78	50.23	40.13	507.98	426.83	341.04
1991	14.66	12.32	9.85	61.15	51.38	41.05	501.99	421.80	337.02
1992	14.43	12.13	9.69	63.86	53.66	42.88	532.41	447.36	357.44
1993	15.55	13.07	10.44	66.96	56.27	44.96	652.08	547.91	437.78
1994	14.91	12.53	10.01	67.34	56.58	45.21	627.45	527.21	421.25
1995	9.03	7.59	6.06	41.69	35.03	27.99	371.76	312.37	249.58
1996	7.85	6.59	5.27	37.99	31.93	25.51	304.42	255.79	204.38
1997	8.04	6.75	5.40	35.70	30.00	23.97	290.11	243.77	194.77
Years	Ratio before Revaluation KOR	After 20% Revaluation KOR	After 40% Revaluation KOR						
1988	786.96	661.24	528.33						
1989	921.45	774.25	618.63						
1990	782.76	657.73	525.52						
1991	824.23	692.56	553.36						
1992	815.52	685.24	547.51						
1993	908.83	763.65	610.16						
1994	954.24	801.80	640.64						
1995	543.54	456.71	364.91						
1996	460.19	386.68	308.96						
1997	507.04	426.04	340.41						

\* Figures have been rounded to second decimal place.

Performing the simulation with data from 1988 to 1997 and revaluing the Chinese currency by 20 percent, we obtain a mean decline in the relative Chinese-Mexican export ratio of 16 percent for the time period under study. The mean decrease in the relative Chinese-Mexican export ratio is 33 percent in the 40-percent- appreciation scenario .

## **6. Conclusions**

Almost all trade sectors do benefit from competitive real exchange rates, which makes exchange rate management a quite attractive policy option. Even though the results reflect the heterogeneity of the ISIC sectors under examination, they do show that “comparative advantage” of the Ricardo type is relevant in some sectors (textiles and industrial chemicals). It also becomes evident that low-cost countries do have a competitive advantage, at least in some export sectors (textiles, furniture, beverages). Low unit prices are important for export success in non-ferrous metals and food but they are unimportant in the majority of the other sectors under investigation. In this study the impact of transport costs seems to be captured in the cross-section fixed effects (in the country fixed effects). Using a common intercept, transport costs are significant and carry the correct sign<sup>26</sup>.

A simulation study for the textile sector indicates a 16-percent decline in relative export ratios in the scenario of a 20-percent revaluation of the Chinese Yuan and a 33-percent decline in relative exports in the scenario of a 40-percent revaluation of the Chinese currency.

Further research would be desirable on the cost side (labor costs, unit labor costs) of the analysis. We would have especially appreciated having data for longer time periods, thus making our estimation results more reliable.

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26 In preliminary estimations with a common intercept for all seven countries the transport cost coefficient was significant, but the fixed effect model is better able to control for all sorts of country-specific characteristics.

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## Appendix

In Tables A1 and A2, we present our estimation results for some ISIC sectors with a sufficient number of observations. Table A1 shows the estimation results that were obtained using SUR and Table A2 contains the estimation results using Iterative Least Squares (ILS) or Weighted Least Squares (WLS). Insignificant variables were left out from the regression analysis. Autocorrelation was always controlled for. The inserted AR(1) was significant, but is not listed in Tables A1 and A2.

**Table A1** Estimations based on SUR (dependent variable l<sub>xv</sub>)

VARIABLES	COEFFICIENTS	T-RATIOS	P-VALUES
<b>Furniture (ISIC 332)</b>			
Lva	-0.06	-1.52	0.13
Lw	-3.02***	-5.48	0.00
Lrer	0.75**	2.07	0.04
<b>Iron and steel (ISIC 371)</b>			
Luv	-0.67***	-4.59	0.00
Lrer	1.54**	1.98	0.05
<b>Non-ferrous metals (ISIC 372)</b>			
Luv	-0.17**	-2.42	0.02
Lrer	1.32***	3.22	0.00
<b>Fabricated metal products (ISIC 381)</b>			
Luv	0.12***(quality?)	4.23	0.00
Lrer	0.91***	3.24	0.00
<b>Non-electric machinery (ISIC 382)</b>			
Luv	0.03 n.s.	1.14	0.26
Lrer	1.04**	2.42	0.02
<b>Electric machinery (ISIC 383)</b>			
Luv	-0.01 n.s.	-0.14	0.88
Lrer	0.86	1.43	0.16
<b>Wearing apparel (ISIC 322)</b>			
Luv	0.11** (quality?)	2.04	0.05
Lrer	1.47***	4.10	0.00
<b>Food (ISIC 311)</b>			
Luv	-0.21***	-4.68	0.00

**Table A2** Estimation results based on ILS or WLS (dependent variable lxx)

VARIABLES	COEFFICIENTS	T-RATIOS	P-VALUES
<b>Industrial chemicals (ISIC 351)</b>		<b>WLS</b>	
lva	1.51***	3.66	0.00
luv	-0.18**	-2.55	0.02
lrer	2.68***	3.36	0.00
<b>Beverages (ISIC 313)</b>		<b>ILS</b>	
lva	0.47	0.56	0.58
lw	-1.30	-1.40	0.17

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