AEDE/IS 539
China’s International Trade
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- Overview
- Background
- Process of trade reform
- Dualist trade regime
- Toward an open economy
- Outcomes
Overview

- By end of 2008, China had become world’s 2nd largest trading nation after US
- Total goods traded (imports + exports) reached 65% of GDP in 2007, compared to 20-25% for US, Japan, India and Brazil
- Before 1978, China a very closed economy, trade/GDP never exceeding 10%
- Trade liberalization an integral part of reform process, China joining WTO in 2001 – “reform and opening” – *gaige kaifang*
Figure 1 Exports and Imports (Share of GDP)

Source: China Customs Statistics
Background

- 1949-60, China somewhat open to trade – mostly with Soviet Union - 48% of total trade
- After GLF, China retreated into international economic isolation, trade with Soviet Union falling to 1% of total trade
- Early 1970s, low point of China’s relations with world economy – 1970/71, trade fell to 5% of GDP
- With failure of oil-field development in “leap outward”, not clear where foreign currency would come from to pay for imports
Process of Trade Reform

- Late-1970s, China’s economy separated from world market by “double air-lock”:
  - 12 foreign trade companies (FTCs) had monopoly control over imports/exports
  - currency (RMB) value set arbitrarily and non-convertible
  - FTCs bought and sold domestic goods at plan prices, and foreign goods at world prices – then re-priced at plan prices
  - Socialist price system insulated from world prices – extreme form of “import substitution industrialization” (ISI)
Process of Trade Reform

- **Initial reforms**: 1978-79, opened up new trade channels in Guangdong and Fujian provinces
- Hong Kong firms allowed to sign export processing (EP) contracts with firms in Pearl River Delta, e.g., fabric sewn into shirts
- Four SEZs then set up to allow expansion of EP trade – allowed imports duty-free as long as they were utilized in exports
- China able to selectively promote exports while maintaining ISI – Guangdong and Fujian eventually became crucial in global trade
Process of Trade Reform

- Liberalizing trade: mid-1980s, policymakers began to liberalize rest of trading system

(i) Devaluation of RMB – by 1986, currency had depreciated by about 60% against US$, exporting profitable, and imports constrained – did increase domestic price inflation

Dual exchange rate-regime – exporters outside plan could sell foreign-exchange in a secondary market – US$ went for a higher price, driving down the RMB

RMB depreciation in 1980s happened at same time as realignment of other currencies in SE Asia, e.g., Japanese yen appreciated
(ii) De-monopolization of trade - number of firms allowed to engage in trade expanded – 5,000 FTCs by 1988, local governments and SEZs set up trading firms

While exports were liberalized faster than imports, steady shift away from trade plan and direction of financial incentives

(iii) Change in pricing – exporting profitable, and FTCs became cost sensitive – sought cheap producers of labor-intensive goods, typically from TVEs whose share of exports increased

World price signals gradually transmitted to domestic economy
Process of Trade Reform

(iv) Tariffs and non-tariff barriers (NTBs) – as planned trade system was dismantled, erected high trade barriers to protect domestic market.

Policymakers afraid of import surges, trade deficits and hard currency debt.

1992, un-weighted mean tariff 43%, and key NTB was limited market access for imports, i.e., direct access reserved for FTCs who were state-owned.

Other firms kept from exploiting liberal terms of EP contracts.
Process of Trade Reform

- Import substitution and export promotion - mid-1980s, China had high tariffs, NTBs, and administrative discretion, i.e., typical of developing country ISI strategy.

Reforms had created some flexibility, allowing foreign trade system to harmonize with changes in domestic economy.

Not liberal enough to create later export success – net effect to discourage exports.

China then chose to create an export processing regime allowing exporters to bypass old foreign-trade monopoly.
Dualist Trade Regime

- After 1986, Chinese policymakers recognized opportunities in restructuring of Asian export production networks
- Supported “Coastal Development Strategy” – multiple firms allowed to engage in processing/assemblies contracts, including TVEs
- Foreign investors moved into coastal provinces, adopting more flexible EP contracts where they took ownership of tariff-free imported components and raw materials
- By 1987, essentially two trading regimes – EP vs. ordinary trade (OT)
Dualist Trade Regime

- EP trade had significant cost advantage (no tariffs) compared to slower growing OT trade
- Foreign invested enterprises (FIEs), able to avoid import controls – not required to go through FTCs to import
- While Chinese EP regime not unique, size unprecedented, i.e., whole coastal region
- Most FIEs from Hong Kong/Taiwan – able to transplant trade expertise to mainland
- Figure 2 shows relative contributions of EP vs. FIE to China’s total exports
Figure 2: Share of Exports from export-process regime and foreign-invested enterprises

Source: Naughton (2010)
Dualist Trade Regime

- EP share of exports rose to 56% in 1996, and then flattened out, while FIEs share of exports reached 54% in 2008
- Liberalization of foreign investment in China has clearly played a key role in globalizing its economy
- At same time, domestic exporters, especially SOEs, while increasing exports, have not been very successful at entering new markets globally
Towards An Open Economy

- In mid-1990s, with functioning trade regime, China began to move to truly open economy
- Preparing for membership of WTO was key, although mandated reforms were favored by Chinese policymakers

(i) Exchange rate: January 1, 1994, secondary “swap” market for foreign exchange was abolished - exchange rate unified at 8.3 RMB/US$, and access to foreign currency liberalized

Current account convertibility achieved – importers able to purchase foreign exchange
Towards An Open Economy

Hoped that China would move to a “managed float” of its currency, with removal of restrictions on its capital account

1997-98, Asian financial crisis put downward pressure on RMB, but not allowed to depreciate – *de facto*, RMB fixed to US$ (maintained until 2005)

After 2002, rapid export growth, lack of capital account convertibility, and low value of RMB – created tension in US/Chinese economic relations
Towards An Open Economy

(ii) WTO membership: China formally applied for membership of GATT in 1986 – took 15 years to gain entry to predecessor, the WTO

Shift in international attitude to China post-Tiananmen Square crisis, and after fall of Soviet Union in 1990

China a serious competitive challenge in export markets, but concerns/frustration with relatively closed domestic market

Following Uruguay Round of GATT, China faced with “grand bargain”, where its access to export markets would require broader and fairer access to its economy
Towards An Open Economy

China needed to open up its OT regime, thereby reducing the dualism of its trade – had to allow trading rights without restrictions.

By 2004, role of FTCs rolled back, except for state trading in case of a few agricultural commodities – subject to tariff-rate quotas (TRQs) ensuring market access.

China started lowering tariffs after 1994, average nominal tariffs falling to 17% by 1999, and WTO commitments have resulted in average industrial tariffs of 9.4% and average agricultural tariffs of 15%.
Towards An Open Economy

(iii) An open economy: share of imports is critical – measures openness to competition and access to low-cost supplies

Imports as share of GDP have risen, with pullback 1994-98, in addition, most growth in 1990s came from EP regime (Figure 3)

OT regime not liberalized that significantly until WTO membership in 2001 – imports having now surged to 13% of GDP

EP trade has also grown rapidly – mostly due to electronics sector
Figure 3  Openness Measures of Chinese Economy

Source: Naughton (2010)
Outcomes

- China now primarily exports medium-skill/labor-intensive finished goods (60% of exports) – miscellaneous manufactures, machinery and electronics

- Capital-intensive products account for 63% of imports – many serving as land substitutes, e.g., fertilizers, synthetic fibers, feed grains/oilseeds

- Chinese trade therefore fits basic trade model of comparative-advantage with associated gains

- Is China’s trade becoming more technology-oriented? Not really – production essentially concentrated in final assembly stage for electronic goods