

Trade Liberalization and Its Role in Chinese Economic Growth

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In terms of their participation in the international economy it would be difficult to envision two more contrasting cases than China and India. Whether the base line is 1947/49, the time of Indian independence and of the founding of the People’s Republic of China, the beginning of Chinese economic reforms in the late 1970s, or the initiation of Indian economic reforms in 1991, China’s trade performance has been distinctly superior. Even after a decade of economic reform beginning in 1991, India’s share of global trade in 2000 was only 0.7 percent, two-thirds less than in 1948.¹ By contrast, China’s share of global trade is now more than three times that of 1953 and six times that of India.² Most of the increase in China’s share of global trade has occurred in the twenty-five years since reform and opening began in 1978.

Chinese and Indian Shares of Global Trade in the Last Half Century

	19xx	2002
China	1.5	4.8
India	2.2	0.8

Note: The base year data for China is 1953, for India 1948.

Source: World Trade Organization, *World Trade Report 2003*, Appendix Table 1A.1

The contrast is also evident in the trade rankings of the two countries. Consistent with its declining share of global trade, India’s rank as a global trader has fallen steadily over the past half century. By 2002 there were 25 countries with total trade exceeding that of India.³ By contrast China’s rank has risen steadily from the thirtieth largest

¹ T.N.Srinivasan and Suresh D. Tendulkar, *Reintegrating India with the World Economy* (Washington: Institute for International Economics, 2003), p. 11.

² The comparison is even more striking if one uses, as do Srinivasan and Tendulkar, Chinese data from the late 1940s. At that time China's trade, only 0.9 percent of global trade, was acutely depressed by the civil war between the Nationalist and Communist Parties.

³ World Trade Organization, *World Trade Report 2003*, Appendix Table 1A.1

trading country in 1977, on the eve of economic reform, to the seventh largest trader in 2000.⁴ Since that time China's trade performance has become even more robust, even as global trade expansion has slowed markedly. In 2001 and 2002 China's trade first surpassed that of Canada and then that of the UK to become the 6th and then the 5th largest trading country. In 2003 China's trade growth has been so rapid that it will easily surpass that of France, which ranked fourth in global trade in 2002. China's import growth this year has been so rapid (40 percent in the first nine months) that its imports for the year as a whole will substantially exceed those of Japan for the first time ever. There is a reasonable prospect that this year China's total trade will surpass that of Japan, making China the world's third largest trading economy.⁵

One final comparison of India and China. This year China's trade turnover will EXPAND by over \$200 billion, roughly twice the LEVEL of India's trade turnover last year.

This paper consists of two parts. The first provides a brief summary of the unilateral trade liberalization that China undertook during the reform period, even prior to its accession to the World Trade Organization. By a number of measures China transformed its economy from one of the most protected to perhaps the most open among emerging market economies. The second part of the paper analyzes the implications of increased openness for economic growth. The central theme is that increased openness dramatically increased competition in the domestic market and that competition has

⁴ Nicholas R. Lardy, *China in the World Economy* (Washington, D.C.: Institute for International Economics, 1994, p. 1. Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, D.C.: Brookings Institution Press, 2002), p. 4.

⁵ In the first half of 2003 China's imports slightly exceeded those of Japan while Japan, because of its large current account surplus had exports that were well ahead of those of China. But the margin by which China's import growth exceeds Japan, 40 percent versus 7 percent, as well as the 32 percent rate of growth of Chinese exports in the first nine months of 2003 makes it possible that China's total trade in 2003 will exceed that of Japan.

contributed to a substantial transformation of the economy, particularly in the state-owned sector.

Trade Liberalization in China

Prior to the late 1970s China's commodity trade was determined almost entirely by economic planning. The State Planning Commission's import plan covered more than 90 percent of all imports. The Commission designed the import plan to increase the supplies of machinery and equipment, industrial raw materials, and intermediate goods that were in short supply and needed to meet physical production targets for high priority final goods. The export plan was similarly comprehensive, specifying the physical quantities of more than 3,000 individual commodities.

A handful of foreign trade corporations owned and controlled by the Ministry of Foreign Trade was responsible for carrying out the trade plan prior to 1978. Each of these corporations typically dealt in a narrow range of commodities for which it was the sole authorized trading company.

Since the planning process was carried out in physical terms, the exchange rate and relative prices played little role in determining the magnitude and commodity composition of China's foreign trade.

The consequences of these policies for both the volume and the commodity composition of foreign trade were quite adverse for the efficiency of domestic resource allocation and economic growth. A significant share of China's exports consisted of goods for which China did not enjoy a comparative advantage in production. And producers of export goods had no economic incentive to expand their international sales.

That, in turn, impaired China's ability to finance imports embodying advanced technology that could have contributed to productivity growth and economic expansion.

There were several manifestations of these inefficiencies. Most obviously, the volume of China's trade grew relatively slowly. China's share of world trade dropped markedly, from 1.5 percent in 1953 to only 0.6 percent in 1977.⁶ Not only did this system depress the overall volume of trade, it distorted the commodity composition of foreign trade, particularly on the export side. Rather than concentrating on labor-intensive goods, China exported significant quantities of capital-intensive goods.⁷

The system of physical planning of foreign trade, which was responsible for a relatively irrational pattern of exports, was gradually dismantled in the 1980s and by the end of the 1990s was largely abandoned. While the government, through its foreign trade companies, continued to maintain direct control of a handful of important commodities, most trade was decentralized and increasingly market determined. This was made possible by a dramatic expansion in the number and type of firms authorized to engage in foreign trade; reforms of pricing of traded goods so that international prices of traded goods were increasingly transmitted to the domestic market; and the adoption of exchange rate policies that did not discriminate against exports. As direct trade controls were phased out, the regime developed a foreign trade system relying much more on indirect instruments, such as tariffs and non-tariff barriers, to regulate the flow of imports and exports.

On the import side, in the early years of the reform era China maintained an extraordinarily complex and highly restrictive system of controls including not only the

⁶ Nicholas R. Lardy, *China in the World Economy*, p. 1.

⁷ Nicholas R. Lardy, "Chinese Foreign Trade," *The China Quarterly*, No. 131 (September 1992), pp. 695-700.

usual policy instruments, such as tariffs, quotas, and licensing requirements, but also an array of other tools. These tools included limiting the number of companies authorized to carry out trade transactions and restricting the range of goods that each of these companies was allowed to trade, import substitution lists, a system of registration for selected imports, and commodity inspection requirements.

By the time China entered the World Trade Organization in 2001 the import regime had been almost entirely transformed. As reflected in diagram one, the average statutory tariff, which stood at the relatively high level of 56 percent in 1982, was reduced to 15 percent by 2001. The share of all imports subject to licensing requirements fell from a peak of 46 percent in the late 1980s to fewer than 4 percent of all commodities by the time China entered the WTO.⁸ The state abolished import substitution lists and authorized tens of thousands of companies to engage in foreign trade transactions, undermining the monopoly powers of state trading companies for all but a handful of commodities.

The transformation was similarly far reaching on the export side. At their peak in 1991, for example, two-thirds of all exports were subject to export licensing and quotas. But by 1999 only 8 percent of all exports were so encumbered.

Three other policies were critical to the rapid expansion of China's foreign trade over the past two and a half decades. The first is the reform of the pricing and allocation of foreign exchange. In the pre-reform era the state fixed the exchange rate at an overvalued level to implicitly subsidize the import of high priority capital goods that could not be produced domestically. Overvaluation of the domestic currency, naturally, led to excess demand for foreign exchange relative to supply, necessitating a rigid system

⁸ Nicholas R. Lardy, *Integrating China into the Global Economy*, pp. 33, 39.

of exchange control. The key elements of this control system were the requirement that exporters surrender 100 percent of their foreign exchange earnings to the government; rigid limitations on the rights of individuals to hold foreign currency; and strict controls on the outflow of capital.

Beginning in the early 1980s the state gradually modified these features of the foreign exchange system. Exporters were allowed to retain a share of their foreign exchange earnings. That gave them the ability to finance imports without the need to seek permission to purchase foreign exchange, which was a substantial incentive to sell into the international market. And, perhaps most importantly in the long run, over time the government substantially devalued the domestic currency from a nominal exchange rate of RMB1.5 to the dollar at the outset of reform to RMB8.7 in 1994 when the prevailing dual exchange rate system was ended by fixing the official exchange rate at the rate then prevailing in the parallel foreign exchange market.⁹ In real terms China's currency lost just over 70 percent of its value between 1980 and 1995. But the adoption of the market-clearing rate, however, suggested that the cumulative change in the official exchange rate up to that time was necessary to eliminate the historic overvaluation of the currency. Less than two years later the Chinese authorities announced that the currency was convertible on current account transactions, meaning that importers could purchase foreign exchange without restriction.

Another second policy supporting the rapid growth of China's foreign trade was the decision of the State Council in 1984 to rebate the indirect taxes that reduced the profitability of exporting. This reform, which is allowed under the rules of the World

⁹ Just prior to the unification of the two rates at the market rate 80 percent of all foreign exchange trading was on the parallel, unrestricted market.

Trade Organization, allowed China, which relies heavily on indirect taxes such as the value-added tax, to compete fairly with firms in countries that rely primarily on direct taxes, such as the corporate and individual income tax.

A third policy that helps to explain the rapid expansion of China's exports over the past two decades is the duty drawback system that supports China's export processing program. This system, which was formalized in the second half of the 1980s, rebates import duties on raw materials, parts and components, and so forth used for export processing, allowing export processing to take place at world prices, free from tariff or domestic pricing distortions. The rapidly increasing share of total exports contributed by processing suggests the importance of this initiative. By 2002 processed exports reached \$180 billion and accounted for 55 percent of China's total exports.

The dramatic affect of these reforms on the volume of China's foreign trade is reflected in the summary data presented at the outset of this paper. Equally important have been the changes in the commodity composition of China's trade, particularly on the export side. As the reforms took hold, export growth became increasingly concentrated in labor-intensive products in which China has a relatively strong comparative advantage. In the early years of reform, China exported primarily agricultural products, petroleum, and petroleum products. Later China shifted increasingly into manufactured goods, particularly light manufactures. Thus the share of primary product exports fell by almost four-fifths, from an average of 45 percent of total exports in the first half of the 1980s to only 10 percent by 1999.¹⁰

China's fastest growing exports have been labor-intensive manufacturers—textiles, apparel, footwear, and toys. Between 1980 and 1998 exports of these items rose more

¹⁰ National Bureau of Statistics, *China Statistical Yearbook 2002* (Beijing: Statistics Press, 2002), p. 613.

than ten-fold, from \$4.3 billion to \$53.5 billion. The share of China's total exports accounted for by these four product categories soared from 6.9 percent in 1980 to 29.1 percent by 1998. For each of these products China captured a rapidly rising share of total world exports. In textiles China's share almost doubled, from 4.6 percent in 1980 to 8.5 percent in 1998. The increase was even faster for apparel where China's share of global exports more than quadrupled, from 4.0 percent to 16.7 percent over the same period. Faster yet was the expansion in the world market share for toys--from 2.3 percent in 1980 to 17.9 percent in 1998. China's share of the world market for footwear rose the fastest of all, soaring from 1.9 percent in 1980 to 20.7 percent in 1998.¹¹

More recently China has become an important location for the assembly of consumer electronics, computers and other information technology products. While some of these goods have a high tech appearance, the high value parts and components are still mostly sourced off shore and the assembly of the final goods in China is relatively labor intensive. The growing importance of these goods is reflected in the U.S. market where imports from China rose by more than a third, from \$26 billion in 2000 to \$35 billion in 2002. In that two-year period China displaced the European Union, Mexico, and Japan to become the largest supplier of high tech goods to the United States.¹²

The Competitiveness Effects of Openness

China's substantial trade growth has introduced substantial new competition into its domestic market. One measure of the potential competitive effect of trade for any

¹¹ Nicholas R. Lardy, *Integrating China into the Global Economy*, p. 56.

¹² American Electronics Association, *Tech Trade Update 2003(insert space)* (Washington, D.C.: 2003), p. 5.

country is the ratio of its imports to gross domestic product, sometimes called the import ratio. As reflected in the diagram two, China's import ratio increased from under 15 percent in 1990 to almost 25 percent last year. This year the ratio likely will reach 30 percent. Thirty percent is almost four times Japan's import ratio of 8 percent, two and one half times India's 2002 import ratio of 12 percent, and twice the likely 14 percent import ratio for the US this year.

In addition to imports, competition is enhanced through the domestic sale of goods produced by foreign affiliates located in China. This is particularly important in China since by the end of June 2003 cumulative inward foreign direct investment was about \$480 billion, far and away the largest of any emerging market economy. Over half of inward foreign direct investment has gone into the manufacturing sector, where there are very few restrictions on foreign ownership. The economic importance of foreign affiliates in China is reflected in their contribution to manufactured goods output, which in 2002 stood at almost 30 percent. Contrary to the impression that foreign affiliates have invested in China mostly as a manufacturing platform for sales into the global market, about 60 percent of the output of joint ventures and wholly foreign-owned firms is sold on the domestic market.¹³ From the point of view of local firms without foreign ownership the competitive effects of imports and of goods produced by foreign affiliates but sold on the domestic market are similar. In both cases the goods will reflect whatever advantages of foreign technology, finance, and marketing can be brought to bear. The sum of imports plus the domestic sales of foreign affiliates relative to gross domestic

¹³ For the years 1994 through 2002 the share of output of foreign manufacturing affiliates sold on the domestic market has ranged between 55.0 and 63.5 percent.

product, shown in the top line of diagram 2, grew from just under 30 percent in 1994 to over 40 percent in 2002. This ratio is likely to exceed 45 percent in 2003.

Three indicators suggest that increased competition is having a transforming influence on China's domestic economy. The three are the decline in employment in the state sector; the dramatic shrinkage in the rate of inventory accumulation; and the upturn in profitability of China's state-owned manufacturing firms.

Even as China's economic transformation was gathering speed in the 1980s and early 1990s, the number of people employed in the state sector continued to go up. As is reflected in the top line of diagram 3, by 1995 the number employed in the state sector exceeded 109 million, an increase of 35 million or almost one-half compared to the 75 million workers in the state sector as reform was getting under way in 1978.

That situation has dramatically reversed since the mid-1990s. Between 1995 and the end of 2002 the number of people employed in the state sector declined by a third, or 38 million. The shrinkage of employment in the state sector has been very large and very compressed.

In manufacturing the story is similar through the early 1990s. But, as is reflected in the steep slope of the bottom line in diagram 3, the decline since then has been even more abrupt. In the 1980s and early 1990s the share of manufactured goods output produced in the state sector was shrinking, as the share of the private sector and foreign affiliates grew. Nonetheless employment in state-owned manufacturing establishments increased by more than 10 million, reaching a peak of more than 35 million in 1992. But by the end of 2002 state-owned manufacturing establishments employed fewer than 10 million people. Through a combination of management and worker buyouts that

converted firms from public to private, some bankruptcies, and substantial workforce downsizing in firms that remain state-owned, manufacturing jobs in the state sector have declined by almost three-quarters from their peak.

Declining inventory accumulation is a second indicator of how competition is transforming China's economy. Inventory accumulation as a percent of gross domestic product, shown in diagram 4, averaged a breathtakingly high 6 percent in the run-up to the Asian financial crisis in 1997. Economic growth in this period averaged 11 percent in real terms, but 6 percent of output every year went into inventories that were never sold. In the five years 1998 through 2002 inventory accumulation has come down to an average of only 0.9 percent of gross domestic product. The improvement reflects the combined effect of two changes. First, the main objective of state enterprises is no longer to provide employment; rather profitability is the main indicator for evaluating firm performance. Enterprise managers in recent years have had the authority to reduce the number of workers, so production for inventory has gone down. Secondly, the banks, under pressure to increase the return on the funds that they lend, are apparently less willing to provide state-owned companies with seemingly unlimited lines of working capital credit. Thus firms are both less willing and less able to finance the build up of inventories.

As a consequence of the ability of state-owned manufacturing firms to lay off excess workers and a reduction of the rate at which they accumulate unsold inventories, profitability in China's state-owned sector has actually improved since 1997. Diagram 5 shows that return on assets of state-owned manufacturing companies, which had declined continuously for 20 years, has risen significantly since reaching a low in 1998. By 2002

the return on assets, defined as pre-tax profits divided by the sum of the depreciated value of fixed assets plus working capital, had risen to 9.1 percent compared to only 5.0 percent in 1998.

Conclusion

China is perhaps the best example of the positive connection between openness and economic growth. Reforms in China transformed it from a highly protected market to perhaps the most open emerging market economy by the time it came into the World Trade Organization at the end of 2001. The focus of this paper has been on manufacturing, but China's WTO commitments are also leading to a very significant opening in services. For example, the chief U.S. negotiator on China's WTO accession has characterized China's commitment to liberalize its distribution system as "broader actually than any World Trade Organization member has made."¹⁴ Thus the positive stimulus that international competition provides for technical change and managerial efficiencies will not be limited to manufacturing but will extend increasingly to the services sector as well, where China's commitments to increased openness go beyond those made by most other members of the World Trade Organization.

¹⁴ Charlene Barshefsky, "U.S. Trade Policy in China," Hearings before the Senate Finance Committee on the Status of China's Application to Join the World Trade Organization, April 13, 1999 (www.fnsg.com).

Diagrams

Diagram 1: China's Average Import Tariff Rate, 1982-2005

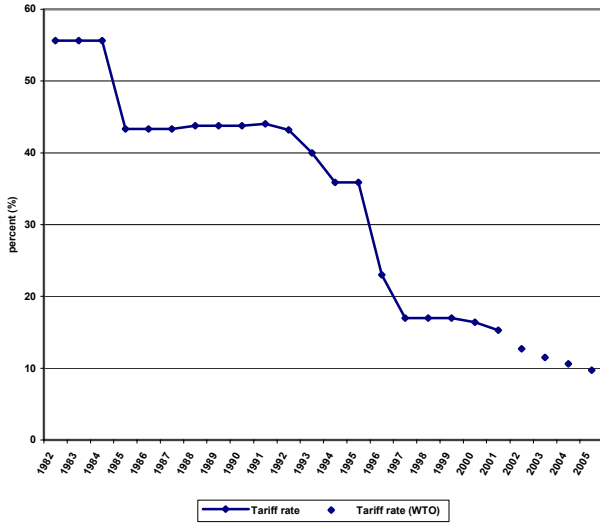


Diagram 2: Openness of the Chinese Economy: Imports as a Share of GDP, 1990 - 2003E

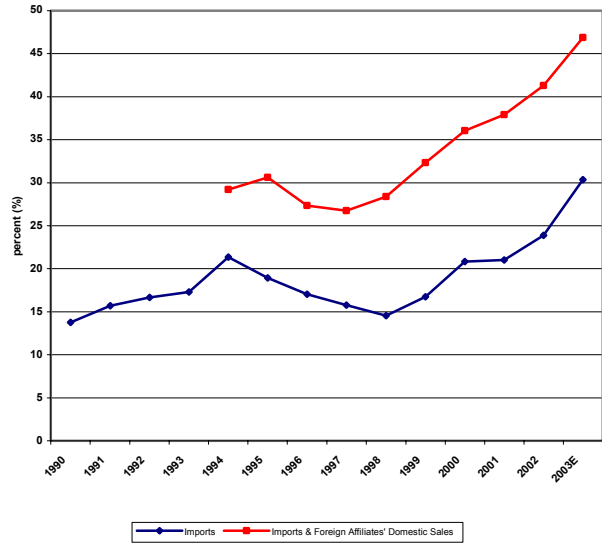


Diagram 3: State Employment, 1978-2002

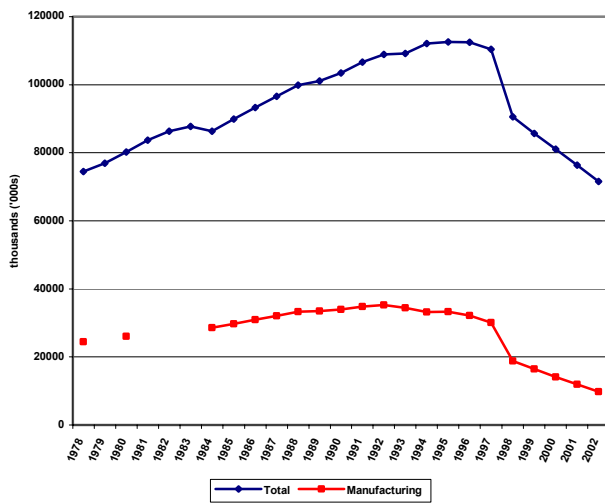
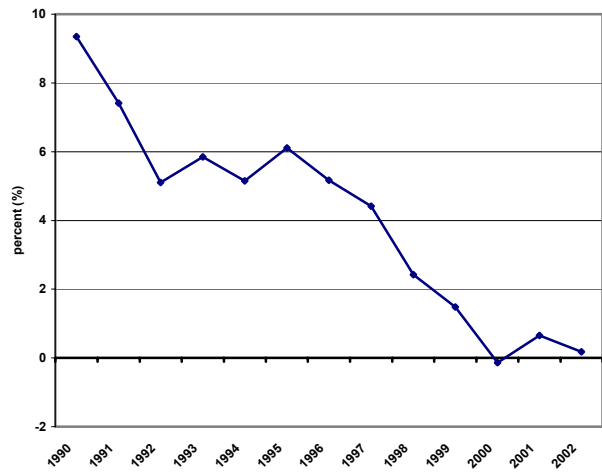


Diagram 4: Inventory Accumulation as a Percentage of GDP, 1990-2002



Diagrams (cont.)

