

# China's Trade Policy

**Yu Yongding**  
**Director and Senior Fellow**  
**Institute of World Economics and Politics**  
**Chinese Academy of Social Sciences**  
July 31, 2004

## China's trade expansion

Since the reform and opening up in the later 1970s, China has achieved amazing success in trade expansion. Just for two decades, China has completed the transformation from an autarky economy to the sixth biggest trading nation in the world. In 2003, China's total trade volume surpassed 851.2 billion US dollars, an increase by 37% percent over the previous year. The exports and imports in the year were 434.8 billion US dollars and 412.8 billion US dollars, respectively. The corresponding increases over the previous year were 34.6% and 39.9%, respectively. According to the WTO (on April 6, 2004), in 2003 China overtook France to become the fourth largest trading nation in the world. By import value, it outstripped Japan, Britain and France and climbed from the sixth to the third place, only after the United States and Germany. Over the past decades, China's trade has been consistently outperformed the world average (table 1).

With the total trade over GDP ratio being as high as 60 percent, China's openness has already surpassed almost all the major trading nations. China has become one of the most open economies in the world. While having benefited from the integration with the global economy, China has contributed to global growth significantly as the second most important locomotive of global growth since 2001.

According to General Administration of Customs, in the first quarter 2004, China's import and export value totaled US\$239.85 billion, up 38.2 per cent over the same period of 2003. The import value was US\$124.14 billion, an increase by 42.3 per cent. As a result, China has registered a cumulated trade deficit of US\$8.43 billion in a quarter for the first time in many years.

Table 1 China's economic performance since 2000

	2000	2001	2002	2003	2004e
Growth of GDP					
world	2.5%	-1.2%	3.0%	3.2%	4.1%
<b>China</b>	<b>8.0%</b>	<b>7.3%</b>	<b>7.8%</b>	<b>8.5%</b>	<b>8%</b>
Growth of international trade					
world	12.6%	-0.1%	3%	3-5%	5-6%
<b>China (in value terms)</b>	<b>32%</b>	<b>7.5%</b>	<b>22%</b>	<b>37.1%</b>	<b>20%</b>

Growth of FDI					
World	29%	-41%	-21%	-10%	10%
Total flows, billion \$	1392.9	823.8	651.2	560-600	600
China billion \$	40.7	46.8	52.7	53.5	60

### China's export structures

China's exports by region is characterized by heavy dependence on OECD countries. China's exports to Japan, the US and the EU account for over 60% percent of its total exports. Japan has been China's most important trade partner for 11 consecutive years. The US has been China's most important export market for many years. The NIEs as a group are China's second important trade partner account for less than 20 %. The ASEAN follows as the third leagion accounted for more than 5 % of China's total exports. China's imports by region are characterized by a similar pattern (table 2). Imports from the US, EU and Japan and the rest of OECD countries account for around 50% of the total. The NIEs account for approximately 30% and the ASEAN nations around 6% of the total.

China has succeeded in upgrading its export structure by raising the share of high value-added capital and technology- intensive products vis-à-vis low value-added labor-intensive products. In addition to the traditionally strong items, such as fabrics and handcrafted goods, there has been noticeable growth in exports of machines and electronic products of a relatively low technological level, such as color televisions, telephones, video equipment, etc. China's exports of machinery and electronic goods have exceeded those of fabrics, and accounted for more than 30% of the total. China's imports of machinery and electronics account for 40% of the total, around half of them are capital goods. In addition to its huge demand for imported machinery and equipment, one of the most important changes in China's trade structure in recent years is the dramatical increase in China's demand for energy sources and raw materials. For instance, China imported more than 90 million tons of crude oil in 2003; in the first two months in 2004, the import volume of crude oil already topped 20 million tons.

Table 2

China' major trade partners, 2002-2004 (billion. USD)

	Top ten import economies	Jan-May 2004	2003	2002
1	Japan	36.66	74.15	53.47
2	EU	27.10	53.06	38.54

3	Chinese TW	25.07	49.36	38.06
4	ASEAN	23.90	47.33	31.2
5	Korea	23.95	43.13	28.57
6	US	19.13	33.86	27.23
7	Hong Kong	4.44	11.12	10.74
8	Russia	4.89	9.73	8.41
9	Australia	4.25	7.3	5.85
10	Brazil		5.84	
11	India	3.58		
12	Canada			3.63
	Top ten export economies			
1	US	43.23	92.47	69.95
2	Hong Kong	34.79	76.29	58.47
3	EU	38.62	72.15	48.21
4	Japan	27.43	59.42	48.44
5	ASEAN	14.70	30.93	23.57
6	Korea	9.76	20.1	15.50
7	Chinese TW	4.78	9.0	6.59
8	Australia	3.02	6.26	4.59
9	Canada	2.80	6.03	4.30
10	Russia	2.75	5.63	3.52

Sources: MoC website.

One of the most important features of China's trade structure is the domination of processing trade vis-à-vis general trade. The share of processing trade in China's total export has been around 70% since 1995. In 2003 the share of processing trade in total export was 55%. The share of processing trade-related imports in the total import was 40 %.

### **China's trade promotion policy**

Since the early 1980s China has adopted export-oriented strategy of development. The aim is to gradually integrate the Chinese economy with the global economy on the basis of comparative advantages. As a result, both China's export/GDP ratio and import/GDP ratio have increased dramatically. China's trade/GDP ratio has rose from a negligible small figure in the early 1980s to as high as 60.4% in 2003.

For many years in the past, there were two major considerations that shaped China's trade promotion policy: the need to maintain the balance of trade account and the need to maintain a relatively independent economy vis-à-vis a colony-like specialized economy. As a result, in combination with industrial policy, China used variety of policies such as multi-tier exchange rates, subsidies, tariffs and various none tariff barriers (NTBs), to encourage exports, protect domestic markets, and maintain foreign exchanges balance. However, following the deepening of China's reform and trade liberalization, all policies that are inconsistent with the WTO rules have been abandoned or in the process of being abandoned. Some of the policies were already abandoned long before China's entry into the WTO.

It is worth mentioning that the public opinion on tariff and other protectionist measures has changed significantly. For example, in the early 1980s, a major Chinese state-owned carmaker in Shanghai established joint venture with Volkswagon. The calculation was that, with foreign direct investment, the Chinese producers can learn advanced technology, then with local content requirement, local parts would replace imports gradually, and finally with high tariff, domestic markets are guaranteed for the cars thus domestically produced. It was expected that an advanced national automobile industry eventually would emerge. However, due to the government over-protection against competitions, especially in the form of high tariff, and enterprises' over-reliance on multinationals in technology transfers, the carmaker has lost interests in and ability of conducting R and D.<sup>1</sup> Volkswagon and its Chinese partner have gained huge profits at the expense of Chinese consumers. A twenty to thirty year old model was kept churning out from assembly lines for more than two decades. Only the tariff cuts and the dismantling of the barriers to new entries by other carmakers have succeeded in forcing the joint venture to bring out some new models with much lower prices.

One of the most important trade promotion policies, which is still relevant, is the policy of the tax rebate for export products. Tax rebate was adopted in 1985 in China. Since 1996 the rebate rate was 3% on the value of the purchased input of export products. After the Asian financial crisis the

---

<sup>1</sup> Lu Feng: On the Policy Alternatives for the Development of China's Automobile Industry with Indigenous Property Rights, 2004. (Internal Document).

average rebate rate was raised from 6% before the crisis to 17%. Although the VAT tax rebate per se is not a trade promotion policy and perfect legal in the WTO. The policy of tax rebate has significant stimulating effect on exports. However, the VAT tax rebate, which means that while VAT on exports is zero-rated, the government has to reimburse exporters VAT tax included in the prices of the inputs they purchased, soon became a heavy burden for the government budget. Following the trade expansion, the cumulated arrear of rebate increased rapidly and reached to 300 billion RMB by the end of 2003, which accounted for 12% of total government expenditures in 2003. To reduce the pressure on the government budget as well as on the appreciation of RMB, the government decided to reduce the average rebate rate by 3% as of January of 2004<sup>2</sup>.

Some foreign commentators accuse China of practicing mercantilism. One cannot entirely deny the fact that there is the fear of trade deficit in China. But the most fundamental reason for China's trade surplus is Chinese households' high saving propensity vis-à-vis Chinese firms' inability of finding investment opportunities. China's excess saving has to be resulted in the trade surplus. China's goal is to integrate fully with the rest of the world economy and to deepen its participation in the international division of labor, according to comparative advantages. Some times it runs trade surplus and some times deficit. The sun rises and falls. There should be no fear of China's trade surplus in the rest of the world, just as there should be no fear of trade deficit in China.

### **China's commitment to trade liberalization**

China's main obligations as a WTO member consist of tariff reduction, the removal of quotas, dismantling NTB, opening up telecommunication and financial service and other sectors.

Compared with other developing countries, China's tariff rate has been low. According to JP Morgan, in 1999 China's effective tariff rate was 4.5%. According to Chinese scholars, before the entry, China's real average tariff rate was 11% (taking smuggling into consideration). China's committed tariff cut is very deep and fast after the WTO entry. From 2001 to the end of transition period (in 10 years) the average tariff rate will fall from 23.7 percent to 5.7%. The cuts are especially deep for those previously heavily protected products (agricultural products, motor vehicle and parts, clothing and textile). Although the transition period is 10 years, the bulk of the tariff reduction will be completed within the first five years. Many of China's tariff cuts are implemented ahead of the schedule. As of January First, 2004, China's average tariff has dropped from 11% to 10.4%. The average tariff on agricultural goods was lowered from 16.8% to 15.6% and that of industrial products from 10.3% to 9.5%. This is the third round of tariff cut since China's entry into the WTO in December of 2001. In this round, tariffs on 2414 items of imports were reduced.<sup>3</sup>

China is committed to remove most quotas and other quantitative restrictions on agricultural as well as industrial products before 2006. So far quota for automobiles has been increased by 15%. "Tariff-rate quotas" for many imports, especially agricultural imports, were increased. Tariffs on the part of some imports that are above "tariff-rate quota" were reduced. Imports that fall into

---

<sup>2</sup> Blue book of China's economy (Spring), 2004, p190.

<sup>3</sup> Blue book of China's economy (Spring), 2004, pp192-193.

these categories include wheat, corn, rice, cotton, sugar, soybean oil, palm oil, and vegetable oil. Quotas on 39 tariff codes in 4 categories of products including oil products, rubber products, automobiles and cranes and parts, motorcycles and parts were eliminated. Special requirements for 44 tariff codes in 7 categories of products including electricity generators, bulldozers, transformers, offset printing machines, mechanical device, TV receivers and ships were abolished. China already started to open up its service sectors and this process will also be completed before 2006.

China's commitment for removing other non-tariff barriers (NTB) includes phasing out restrictions in a broad range of services, removing subsidies on loss-making state-owned-enterprises (SOEs), stopping interfere in trade flows by favouring a particular suppliers and restricting quantities imported or exported, no subsidizing exports or fixing prices. China has almost removed all the above-mentioned NTBs. China has already begun to open up its service sectors that include telecommunication, insurance, banking services, professional services including law firms, consultancy, accountancy and so on.

China has eliminated all restrictions on FDI. There are no longer requirements for technology transfers, foreign exchange balance and local contents for FDI.

No one, even the most picky American trade officials, can accuse China of not being serious about its commitments. However, in contrast, some of China's trade partners are abusing the Safeguard measures and anti-dumping rules against China's exports. Different from general safeguard measures, the safeguard measures specially designed for China are stronger than America's article 201, the most sever measure of all. The condition for initiating the measures is "material injury", instead of "serious injury". The specific safeguard measures will be in place for 12 years after China's joining the WTO. China has also accepted the anti-dumping rules that were based on denying China's status as a market economy for the purpose of trade protection. After the WTO entry, China will be treated as a non-market economy for 15 years. This in fact gives the American government (and other like-minded governments) the arbitrary power in deciding whether a given Chinese product is priced below the cost. Chinese exports are entirely at the mercy of American government and interest groups. Recently, an American enterprise that almost nobody knows suit Chinese TV exporters for injury, and the Chinese duly lost the case with losses worth hundred million US dollars. Funny thing is that America virtually stopped producing TV long time ago, and the enterprise that suit Chinese TV exporters does not produce TV at all. The EU perhaps is worse in practicing protectionism.

So far Chinese enterprises have been implicated in more than 600 cases of anti-dumping suits, which accounted for 15% of world total. China has lost 70% of its cases. The key for China's lose in regal battles is China's non-market economy status. This is an uttermost unfair characterization of the Chinese economy. However, there is no body but Chinese themselves should be blamed. It is the Chinese delegation raring to go that accepted the characterization in the first place in.

Despite the fact that Chinese public are sick and tired of the disputes, China will stick to its WTO commitments, no matter how resentful the Chinese public opinions are for the concessions made by the Chinese delegation during the negotiation for the WTO entry. However, on the other hand, China will contest any unjustified charges of injury and dumping vigorously. The Chinese government officials are calling for Chinese enterprises to accept the challenges by foreign

enterprises. In retaliation, Chinese enterprises are encouraged to use all means available within the WTO to suit foreign exporters who are deemed to be involved in dumping and causing Chinese enterprises serious injury. It is possible that there will be more tit for tat trade disputes in the future, and the trade war is going to be nastier. On the other hand, faced with inevitability of more serious trade frictions, China should have second thought about its export drive and important adjustment should be made.

### **China's policy towards Doha round**

Doha round is supposed to aim to boost the global economy by cutting tariffs, subsidies and other barriers to international trade. The changes would affect farm goods as well as manufactured goods and services such as telecommunications and banking. From developing countries' point of view, Doha round is about agriculture and development. Development concerns are supposed to be at the heart of the Doha program. Developing countries emphasize the principle that Doha mandate is explicit on less than full reciprocity and there is no mandate for harmonization of tariffs. With regard to agriculture issue, developing countries complain that distortions are permitted to continue, since there are no commitments for developed countries to reduce the overall support. Developing countries demand developed countries to cut the high Northern subsidies. On the other hand, they do not want to be subjected to further tariff reduction in food products and reductions for all agriculture products in which developed countries are providing domestic or export subsidies.

The problems facing China are not entirely the same as those facing other developing countries and China wishes that agreements can be reached in an amicable atmosphere in Doha round so that the momentum of trade liberalization can be maintained. However, China is sympathetic with the demand of developing countries. China's position is that in the past the distortion in agricultural trade has been serious, which is reflected mainly in the high tariffs and high subsidies by some developed countries. The high tariffs block the entry of agricultural products from developing countries into the market of developed countries. The high subsidies enable agricultural products from developed countries to flood the market of developing countries. The protection of the interests of farmers in developed countries who constitute only a very small proportion of the population of developed countries with measures that distort market at the expense of livelihood of hundreds of million farmers in the developing countries is entirely unacceptable. China appeals the US, Japan and European countries to take more positive attitude to lower agricultural tariff and cut agricultural subsidy substantially and eventually eliminate the market distortion in agricultural trade. As regard with Singapore issues, China's position is that the issue of trade facilitation may be relatively easy to solve. But to reach agreements on issues of investment and competitive policy is difficult and most developing countries are not ready yet. To set a high standard on competition policy also needs time. There is a related development: the Chinese government has adopted much severe methods to deal with property rights infringement. There is still long way to go, but significant progress has been made.

### **China's policy towards regional trade liberalization**

China will actively participate and even take lead in promoting regional economic cooperation in the form of FTAs. The creation of FTA is inconsistent with the principle of a multilateral trading system. The popularity of creating new regional trading blocs is a natural response to the failure of the multilateral approach towards trade liberalization.

Over the past two decades, East Asia has created the Asian Miracle. In addition to domestic factors and social and economic policies adopted by the governments of East Asian economies,<sup>4</sup> regional economic cooperation based on the regional division of labor characterized by the so-called “flying geese formation” was also an indispensable contributing factor to the miracle. Despite the changes in the global situation, certain foundation is still there in East Asia for a closer cooperation among countries and economic entities.

It is hypercritical to deny the fact that the impact of China’s export drive on its neighbors is multi-dimensional. In labor-intensive products, Chinese exports’ displacement dominates with regard to the ASEAN countries, but the complementary effect dominates with regard to the NIEs. In capital/technology intensive products, Chinese competitive pressure on the ASEAN countries and the NIEs is increasing. With regard to Japan, China’s exports are largely complementary, and to a large extent are results of Japanese companies’ design of overseas production and export plans.

After the Asian financial crisis, East Asian countries suddenly realized that they needed to redefine their identity and reshape their economic alliances. China has initiated the process of China + ASEAN 10 FTA. China will redouble its efforts in negotiating with its neighboring countries (economic entities) and the countries that are more sympathetic with China’s positions to form various regional groupings to achieve trade liberalization. Many Chinese economists hope that, as an ultimate goal, a strong East Asian Economic Union can be established, shoulder-to-shoulder with the EU and NAFTA.

The key for an East Asian FTA is the relationship between China and Japan. The importance of Sino-Japanese relationship to East Asian FTA is as important as that of German-Franco relationship to the EU. China and Japan are economically highly complementary. Unfortunately, historical problems have become a stumbling block for a closer relationship. Politicians in both countries should look ahead and redouble their efforts in guiding two peoples to have a better understanding with each other to pave the way for the establishment of An East Asian FTA.

### **Trade imbalance needs to be addressed**

China is worried about the sustainability of current global trade patterns. Global trade patterns can be partitioned into three spheres: China, the rest of East Asia, and the rest of the world (with the OECD countries at the core). Currently, both of China and the rest of East Asia are running substantial trade surpluses vis-à-vis the rest of the world. To maintain the circulation of global trade flows, China has to suffer corresponding trade deficits against the rest of East Asia. And this

---

<sup>4</sup> World Bank, The Asian Miracle, 1993.

is happening. According to some economists (Roland-Holst), in 2020, China will sustain and even increase its structural trade surplus with OECD, while at the same time developing a structural deficit of about equal magnitude with the rest of East Asia (and some resource rich developed and developing countries in other part of the world). The more China's neighboring countries are gaining from exports to China, the more China will bear the blunt of the bashing of trade protectionism from the EU and the US. What China can do? I think, the three parties must sit and figure out a joint solution. Otherwise, China must rethink its strategy of development.

### **FDI and processing trade**

China's attraction of FDI is as successful as its trade expansion. China's success in attracting FDI can be attributed to the following factors: abundant supply of low-cost skilled labor, highly developed Infrastructures, preferential policy towards FDI, huge potential domestic market, stable macroeconomic environment. The following are a few comments on the above-mentioned Chinese virtues. Low cost labor undoubtedly is the most important attraction for multinationals. This comparative advantage will not go away for long time to come. As for infrastructures, in some areas, zero prices for land use for twenty years are in offer by zealous local governments that are competing with each other for FDI. Where could you find more favorable terms for FDI? Preferential policy? Chinese entrepreneurs are crying for national treatment not for foreign investors but for themselves.

FDI's contribution to China's trade expansion is most significant. China's trade is dominant by processing trade. This is why the Chairman of American chamber of commerce deplored the stupidity of American congresspersons that are plotting trade wars against imports made in China. Yes, those products are made in China. But it is the American multinationals that, as owners of capital, are pocketing the profits.

China's trade growth rate during the reform period has been about 4.5 times the world average, and foreign-funded enterprises have played a key role in this achievement. Their share in exports has risen from 1 percent in 1985 to between 45 and 50 percent recently. In 1991, foreign funded enterprises' export was USD 12 billion, accounted for 16.75 percent of China's total export. In 2002, foreign-financed enterprises export was USD 275 billion, accounted for about half of China's total export.

Owing to China's policy in favor of processing trade, China's export is dominated by processing trade. In 1980, China's total value of processing trade was USD 1.66 billion. By 2001, it rose to USD 241.4 billion, a 145-fold increase. The share of processing trade in China's total trade increased from 4.4 percent in 1980 to 47.4 percent in 2001. In the 1990s, China's foreign trade expansion relied mainly on processing trade. Since the second half of the 1990s, processing trade has already accounted for more than half of China's export.

The close relationship between processing trade and FDI inflows is evident when looking at the changes in China's trade structure. Fastest growth of exports came from machinery and electrical machinery, other transportation equipment and instruments, which are sectors dominated by

foreign funded enterprises. Correspondingly, imports of capital goods, semi-finished goods and materials for processing exports are also growing very fast. The fact that China runs trade surplus primarily with the United States and deficits with the East and South East Asian Economies suggests that East Asian investors are using China as an export platform for the Western markets. China became one of the most important participants of the international production network. The domination of processing activities in foreign trade activities shows that for multinationals that are increasingly rely on outsourcing, China's attractiveness as a production base for exports is strong. As a result, more and more foreign enterprises from advanced countries are boosting investment in China and importing cheap Chinese goods back home as a way to cut costs and boost profits.

In the near future, China's comparative advantage in processing trade will not disappear. However, China will not satisfied with being the "manufacturer of world", the share of processing trade in China's trade probably could fall. Chinese government may phase out the policy in favor of processing trade. More incentives may be given to the products "made by China" rather "made in China".

### **China's exchange rate policy**

In 1980s, China's exchange rate regime was characterized by multi-tier exchange rates based on the real cost of exports. In 1994, after the realization of the fusion of official and swap exchange markets, China adopted the exchange rate regime of managed floating. In 1995 and 1996 the Chinese currency, RMB, appreciated by 1-2% respectively. The 1997 Asian financial crisis forced the Chinese government to adopt the policy of no devaluation aimed at financial stability. After the crisis, the policy become de facto peg to the US dollar.

Owing to the fact that China has run current account surplus and capital account surplus for more than a decade, it is argued that the RMB is under-valued. In 2002, the then minister of finance of Japan started to accuse China of exporting deflation by keeping RMB under-valued. Later on the Americans joined the chorus calling for the revaluation of RMB.

The Chinese government resists the pressure for RMB revaluation. The Chinese government fears that the revaluation will create negative impacts on net export and on employment via the impact on net export. The government also fears that a small change in RMB exchange rate will strengthen appreciation expectations and short-term capital inflows aimed at exchange rate arbitraging will increase and in turn will put more appreciation pressure on RMB. At time another important argument against revaluation is that an appreciation will worsen China's deflation. Now pressure on RMB appreciation has been abating. It is worth mentioning that some American politician argued that the intervention into FX market means that the Chinese economy is not a market economy. This argument is ridicules. According to this logic, before 1973 there was no market economy in the world, because under Breton Wood system all exchange rates were fixed. Furthermore, according to the same logic, Hong Kong should not be regarded a market economy, because the Hong Kong Monetary Authorities have maintained currency the board system, the most inflexible exchange rate regime. Following the change of economic situation, China may allow market to play a more important role in determining the exchange rate. China is faced with

variety choices. Among them, the most likely choice is soft peg. For foreign competitors, to concentrate attention on RMB exchange rate is misguided. Exchange rate is just one of many factors that will influence a country's trade performance. Even if RMB appreciates by 15%, would it have any impact on Sino-American trade balance? The answer must be no, if taking into consideration the fact that the wage level of Chinese workers' is just a fortieth of that of American workers'. For the sake of a more balanced development and that of macroeconomic stability, I think that RMB exchange rate can be more flexible. The most likely timing for the RMB adjustment is when nobody is paying attention to the adjustment. It seems that the possibility for a more flexible RMB regime is looming.

### **Concluding remarks**

In summary, the key message that I wish to convey: over the past two decades, foreign trade and FDI have played significant positive roles in China's economic development. In the short run, the success of China's trade and FDI policy is beyond doubt. However, compared with Japan, Korea and Chinese Taiwan's experience, China perhaps may have paid a cost too high, and the long-term impact of China's current success has yet to be seen. Now, it seems time for China to make necessary adjustments to gear to a more balanced and sustainable strategy of development. Thank you very much for your patience.