

9. Foreign Trade and Investment

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Topics

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1 Issues of foreign trade and investment

Issues of foreign trade and investment

- Theories of international trade
- The process of globalization
- What has been accomplished?

Why is foreign trade beneficial?

- Comparative advantage
 - Ricardian theory
 - Heckscher-Ohlin theory
- New trade theories
 - Increasing returns
 - More varieties of goods and services

What is export-led growth?

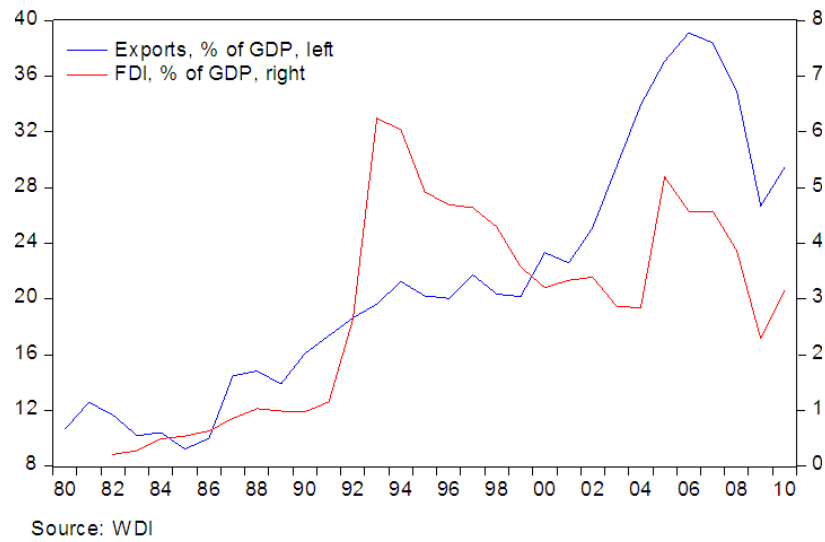
- Industrialization may be achieved through import substitution or export promotion
- Export-led growth is a common feature in Asia
- In Japan and Korea, assisting domestic companies in their exporting is the key policy measure
- In China and other emerging Asian economies, attracting foreign companies to produce exports is a key policy

The process of globalization

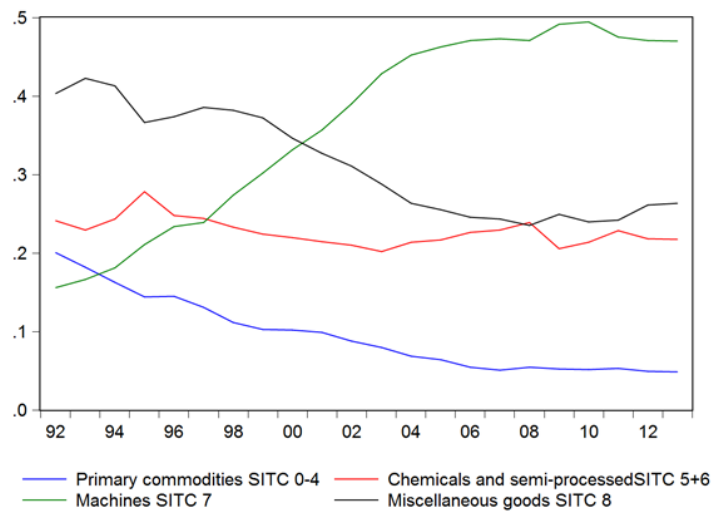
- General Agreement on Tariffs and Trade: successive rounds after WWII to negotiate down tariffs on manufactures
 - Most favored nation principle
 - Outlaw export subsidies
- World Trade Organization (WTO) came into being in 1995 to replace the GATT
 - Dispute settlement mechanism
- Post-WTO developments
 - Doha Round that has failed and progress has been made in numerous regional free trade/economic partnership agreements
 - Major issues are:
 - * trade in agricultural products
 - * national treatment of investment
 - * protection of intellectual properties
 - * labor and environmental standards
 - * state-owned enterprises and government procurement

Opening the Chinese economy

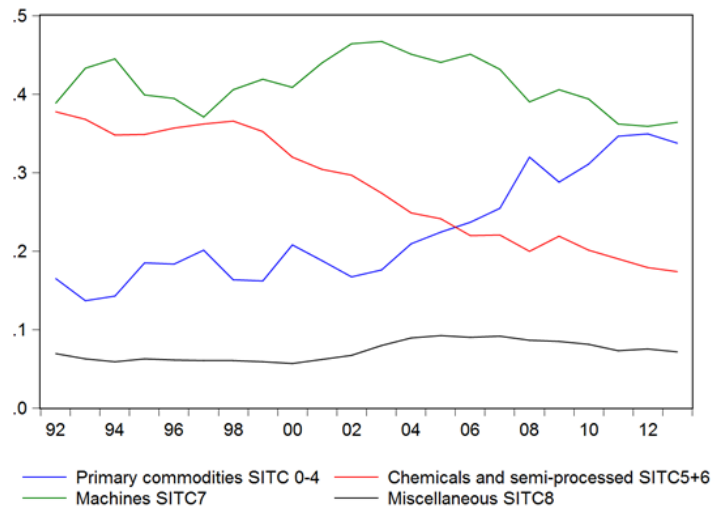
Opening the Chinese Economy



The structure of China's exports



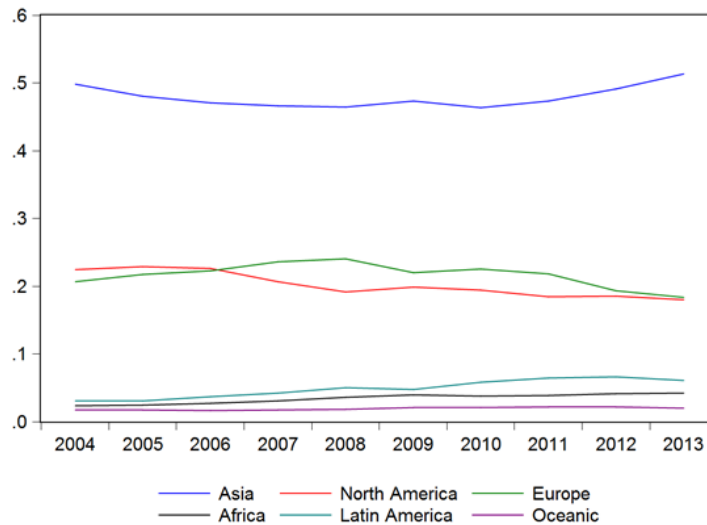
The structure of China's imports



China's trade performance

- Export demand has been a major growth engine, especially since 1994
- Export expansion started with low-tech and labor-intensive goods. Export processing and FDI have played a significant role
- Export upgrading has moved along two fronts:
 - move up the value chain with productivity improvement
 - start to export heavy industrial goods (machines and ships)

The geographical mix of China's exports



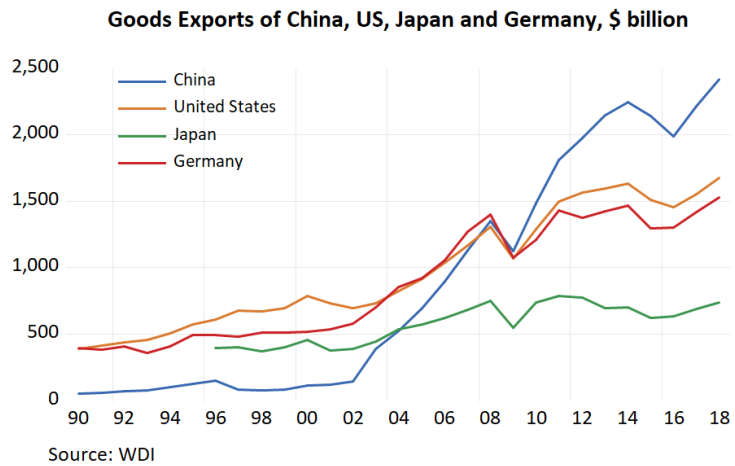
Where does export demand come from?

- Europe and North America used to be the main destinations. However, their relative position have waned markedly in recent years, roughly equal, 18% in 2013
- Close of half of China's exports go to Asia, 51.3% in 2013. China has signed free trade agreement with ASEAN and South Korea. (Hong Kong accounts for roughly 1/3 of total)
- In recent years, Africa, Latin America and Oceania are the most dynamic regions for China's exports

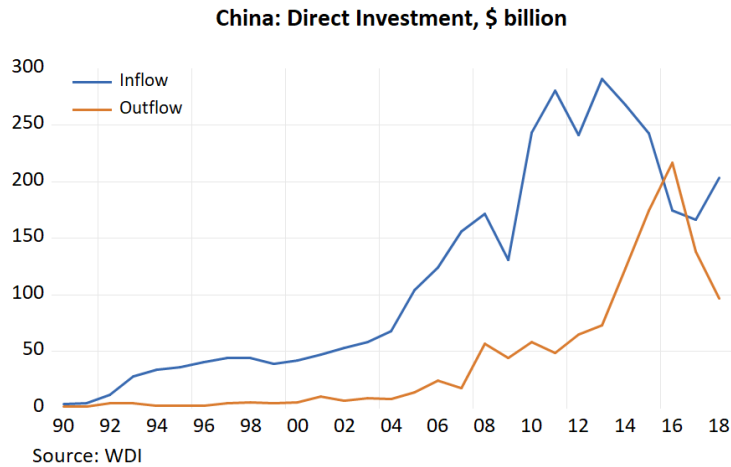
Export-led growth is running of steam



Goods exports of China and other major exporters



China: direct investment



Key points

- In general, more foreign trade is beneficial because it improves efficiency and enriches consumption
- In theory, free trade is the best, though in practice, few economies implement free trade
- Export-led growth is a common experience in East and Southeast Asia
- Export-led growth is not the same as free trade, for it is based on export promotion and attraction of foreign investment
- China exports manufactures, half of which are machines, while imports technology, machines and raw materials
- China sells about half of exports to Asia, 40% to North America and Europe

2 The open-door policy

Opening the Chinese economy

- Break the state monopoly of foreign trade in the 1980s
- Converge towards the WTO threshold in the 1990s
- Hesitate over the path to a true open market economy

The trade system in 1978

- Foreign trade was conducted by a state monopoly
- There was no foreign exchanges market
- Domestic prices were disconnected with world prices, so there was no need for a system of tariffs and quotas
- Foreign trade was kept to minimum and import substitution at the maximum

What does it take to open the door?

- Expand trade according to China's comparative advantage
- Turn state monopoly to a market-based system that relies on profit-motivated enterprises
- Develop a national foreign exchange market
- Re-shape the set of trade taxes and quotas to guide the evolution of trade structure. Import substitution and export promotion

China's comparative advantage

The Ricardian theory: China's comparative advantage lies in those goods where China's productivity gaps with its trading partners are at the low end, basically, they are low-tech goods such as clothing

The Heckscher-Ohlin theory: China's comparative advantage lies in labor-intensive goods because of cheap labor supply there

The Chinese advantage: The biggest economy has the largest potential for economy of scale, especially with the current big data technology

Decentralization

- State monopoly of foreign trade was broken by allowing other central ministries and local governments to set up their own foreign trade companies
- By late 1980s, there were too many foreign trade companies, resulting in excessive internal competition to the benefit of foreign buyers
- In late 1980s, most large producers could trade directly, while SMEs typically relied on foreign-trade companies for imports and exports

FDI and export processing

- Special economic zones in coastal provinces were set up to attract FDI that was engaged in export processing
- Imports of equipment and intermediate inputs were exempt from import tariffs
- Since early 1990s, export processing accounted for 50+% of total exports
- Policy measures include: tax incentives, cheap land and utilities, cheap labor, and a friendly government

A national foreign exchange market

- As foreign trade became decentralized, the exchange rate assumed a new critical role to guide import and export decisions
- Over-valuation of the yuan in 1978 necessitated devaluation, which occurred through 1994
- Local swap centers appeared in late 1980s, eventually, a national foreign exchange market was formed in 1994
- By 1996, China attained current-account convertibility
- The next yardstick should be capital-account convertibility, which has not been attained

Tariffs and quotas

- As foreign trade became decentralized, it was necessary to influence trade decisions with tariffs and quotas, in addition to a market exchange rate
- A system of tariffs and quotas was implemented to protect key domestic industries
- Average tariff rate peaked at 50%, but was cut down steadily to about 20% in 1998, and to 10% after joining the WTO
- Import protection played a critical role to induce foreign direct investment

China's import tariffs

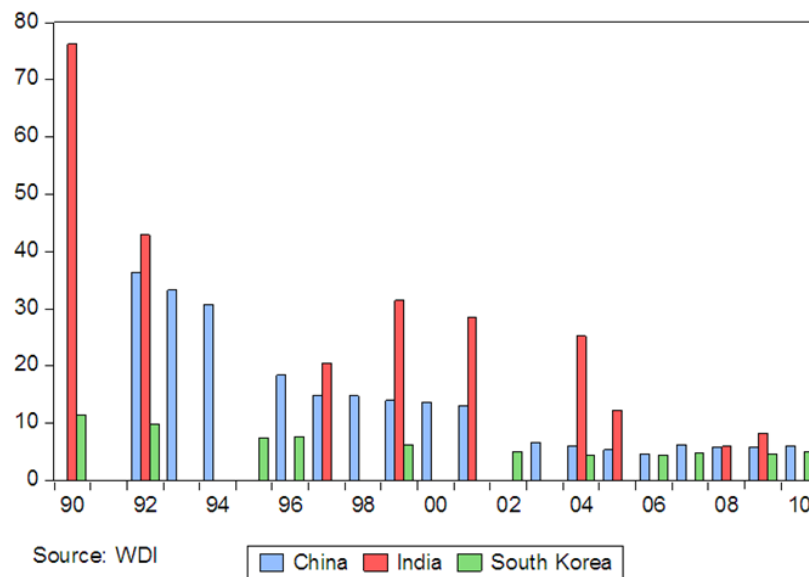
Table 1: China's import tariffs

	Unweighted average	Weighted average	Dispersion (st. dev)	Maximum
1982	55.6	..	..	..
1985	43.3	..	..	..
1988	43.7	..	..	..
1991	44.1	..	..	..
1992	42.9	40.6	..	220.0
1993	39.9	38.4	29.9	220.0
1994	36.2	35.5	27.9	..
1995	35.2	26.8	..	220.0
1996	23.6	22.6	17.4	121.6
1997	17.6	16.0	13.0	121.6
1998	17.5	15.7	13.0	121.6
2000	16.4	..	..	..
2001	15.3	9.1	12.1	121.6
2002	12.3	6.4	9.1	70.0

Source: Prasad (2004), p. 10.

Compared with Asian neighbors

Tariff Rate, Applied, Weighted Mean, Manufactured Products (%)



China as champion of free trade

- No longer being suspicious of free trade, China now actively pursues it, though in a manner with Chinese characteristics
- China has already signed and implemented 12 FTAs, with 8 more under negotiation

- China's pursuit of FTAs focuses more on manufactures, is open on selective farm products, flexible on opening of service sectors
- Shanghai's pilot free trade zone illustrates how far China is willing to go

The rise of China

- The quest for natural resources
 - The demand from China and India has been behind the rise of commodities prices
 - China has expanded overseas investment for resources.
- An expanding role as a world factory
 - The range of Chinese manufactures has expanded from consumer goods to heavy industrial machines.
 - So far, low prices of Chinese exports have benefited consumers everywhere.
 - Foreign investors have captured the largest share of value added in profits.

What it means for the rest of the world

- Does more Chinese demand mean less consumption for us in the West?
- Does more Chinese investment for resources in other developing countries threaten the security of developed economies?
- Is Chinese investment in Africa a new kind of colonialism or a promoter for local economic development?

Key points

- A gradual approach to develop a decentralized market-based foreign trade system
- A dual-track system that promotes exports and protects domestic industries inherited from the past
- Foreign direct investment was attracted to bring in technology and management skills
- Exchange domestic market for technology, sometimes in a forced way
- However, Chinese production has remained to be largely at the low end of the global value-added chain
- Joining the WTO in 2001 as a developing economy
- In pushing forward into high-tech products, China reverts back to government support, especially through state-owned enterprises

3 Current issues

Current issues

- Climb the global supply chains
- Post-WTO liberalization
- One Belt One Road (OBOR) initiative

Does China produce and export too much?

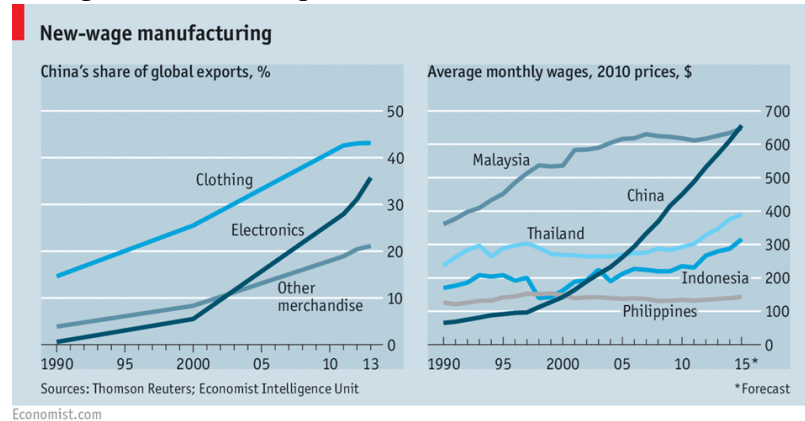
- Some thoughts on China as a global factory
- Is China in the trap of immiserizing growth resulting from deteriorating terms of trade?
- Are Chinese workers underpaid (labor standard)?
- As many of Chinese industries are dirty polluters, does it make sense to export such dirty goods (environmental protection)?
- As the US dollar depreciated in 2002-2008, the debt China holds against the US lost value significantly
- Is it wise for poor Chinese migrant workers to subsidize rich American consumers?

Global shares of manufacturing



Economist.com

New-wage manufacturing



Re-orient the export-led growth model

- The past export-led growth based on cheap labor, land, and lax environmental regulations has brought glory to China, but it may have benefited more foreigners than Chinese themselves
- A better alternative is to export *less* but get a *higher* price for your exports
- Therefore, it makes sense to appreciate the Chinese yuan, to allow faster wage rises, to beef up environmental regulations, even if it slows down China's export growth
- As a result, it is inevitable that many factories may be relocated out of China
- And it is essential that China moves up global supply chains, but how?

Will manufacturing disappear in China?

- Rising wages, a strong RMB, reinforced environmental control and the current anti-corruption campaign are forcing China's manufacturing to upgrade
- This restructuring may benefit from a better educated labor force
- Another advantage is established industrial clustering and modern infrastructure
- China may continue to play the role of the hub for Factory Asia
- Therefore, the size of China's manufacturing may shrink, but the quality and value added of manufacturing may rise

Is there a role for industrial policy?

- Industrial policy refers to government policy to assist some sectors or companies through measures such as:
 - SOEs
 - Subsidies and tax incentives
 - Subsidized credit and land
 - Subsidies for research and product development
- The recent example is *Made in China 2025*
- Subsidies violate the WTO rules, and invite “safeguards” tariffs
- Is the Party-control feature a Chinese characteristic, or something incompatible with a true market economy?

How to acquire cutting-edge technology?

- In-house research and development: Huawei?
- Government assistance through industrial policy: the opposite of the post-WTO liberalization
- Buy high-tech companies in the west: apparent favorite to many Chinese businesses
- The “one-thousand talents” plan to poach talents and technologies: easy and quick?
- stealing and internet hacking: how low can it go?

Regional integration

- The current global trade rules are set by the WTO. The world is moving forward with WTO+ initiatives.
- The Doha Round of the WTO negotiation is stuck. So parties of the willing are moving forward with their own initiatives.
- In Asia, China has concluded the ASEAN+1 FTA, also with Korea and Australia. China is promoting Regional RCEP/FTAAP to counter the US-led TPP.

Should China join the TPP?

- The negative list of foreign investment, especially in services.
- Trade liberalization in agricultural products.
- Strengthening the protection of intellectual products, especially drug patents.
- Labor standard and environmental protection.
- Dispute settlement mechanism, especially for the disputes between companies and the host government.

A Chinese approach for the post-WTO globalization?

- China has signed up free-trade agreements with the ASEAN 10, South Korea, Austria and New Zealand, and may negotiate with Canada for a FTA
- In general, China's FTAs are regarded as low-end, in contrast to the TPP agreement
- China's main interest lies in pushing for markets for its manufactured exports and outward investment in natural resources and technology
- Concessions sought after by trading partners are a shorter negative list of foreign investment, protection of intellectual properties, and higher labor standard and environmental protection
- But government subsidies and SOEs are a contentious issue

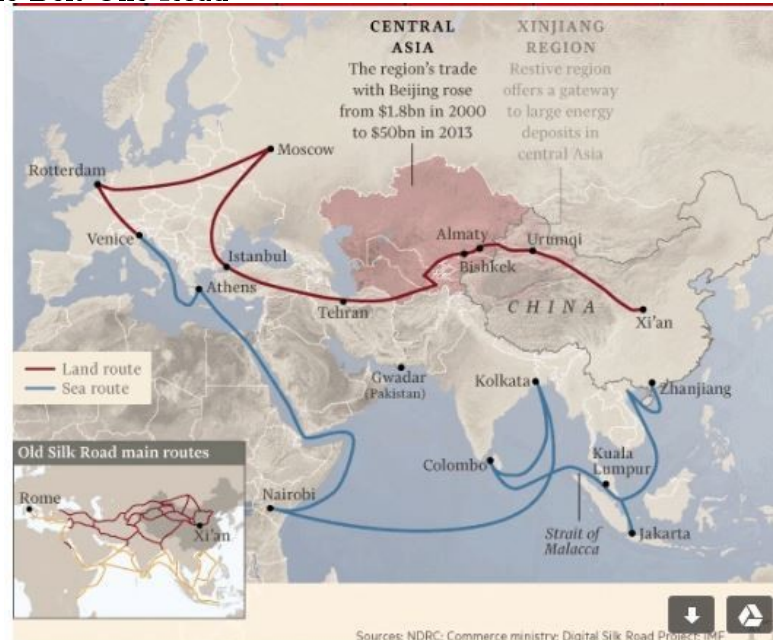
China-US trade war

- Cuts in tariffs, especially for agricultural products
- Opening more sectors to foreign investment, even with wholly-owned subsidiaries
- No forced technology transfers
- Stop stealing technology and stronger protection of intellectual properties
- Reduce subsidies to SOEs
- A more enforcement mechanism

China's Belt and Road Initiative

- The belt: the Silk Road economic belt that links China with Europe through the central Asia land routes
- The Road: the 21st century maritime Silk Road that links China with Europe through sea routes
- The infrastructure investment initiative: China will help to fund and build railway and ports and other projects, both on its own and in partnership with new multilateral infrastructure investment banks that it will lead

One Belt One Road



What motivates the OBOR initiative?

- Find external markets for China's excess capacity of infrastructure construction
- Nostalgia for the Asian Silk Road
- Geopolitical strategy for a sphere of China's influence
- Or more cynically, grab profits and move private assets overseas in the name of the OBOR initiative at the expense of piling up dubious debt for the country

Key points

- How to move up the global supply chain is a challenge: private enterprises v. government involvement via industrial policy
- How much more open and globalized is another critical issue for China and the world
- Canada and the European Union are probably close to the idealized vision of opening and globalization
- The US-China trade war is about pushing China beyond the WTO
- RCEP is a low-grade FTA, while TPP (CPTPP) is a high-grade FTA
- OBOR is a Chinese alternative to a current world order or the west version of post-WTO globalization

Review questions

- How has export-led growth performed in the past?
- What role has the government played in expanding trade and attracting foreign investment?
- What would be the future for China's export machine? And what should be the new role for the government?