Trade

The Story So Far

China is the world’s largest trader, and trade liberalization played a key role in its post-1978 economic success. Despite a history of reform, China runs a persistent trade surplus shaped by residual and newly created forms of protectionism, undermining trade relations abroad and consumer welfare at home. To sustain its growth potential, China needs to remove trade and investment barriers that are inefficient for its consumers and cause friction with trading partners.

- Beijing prioritized “trade facilitation reform” (simplification, harmonization, standardization, and transparency) when it ratified the WTO Trade Facilitation Agreement (TFA) in 2015. The government formed a national committee on trade facilitation in March 2016. After piloting reforms in the Shanghai Free Trade Zone in 2015, Beijing issued several policies to transition to a “single window” system nationwide to simplify trade inspections, declarations, taxes, and other procedures. China was ranked 46th by the World Bank in “Ease of Doing Business” in 2018, a significant improvement from 78th the prior year, in part due to lower trade-processing delays and costs. Beijing implemented multiple rounds of import tariff cuts starting in 2015 on a wide range of goods, with a focus on information technology and consumer goods. These tariff cuts reduced the normal, non-discriminatory (“most-favored nation”) simple average tariff to 7.5% in 2018 from more than 9% in 2013 and slightly reduced trade-weighted average tariffs to 4.4% in 2017 from 4.6% in 2013.

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- China’s leaders emphasize the importance of increasing imports to facilitate both internal and external rebalancing. To stimulate imports and consumption, Beijing tested a series of policies, starting in the Shanghai Free Trade Zone in 2015, to facilitate cross-border e-commerce trade. Key developments include gradually lifting equity caps for foreign e-commerce businesses in free trade zones and passing a new E-commerce Law in 2018, which aimed to reduce the sale of counterfeit goods and services. In January 2019, the State Council increased the scope for tax-free cross-border e-commerce imports across 22 pilot zones.

- China has expanded and sought new free trade agreements (FTAs). Since 2002, China has signed 16 FTAs with 24 countries or regions; in 2016, trade with FTA partners (including Taiwan, Hong Kong, and Macao) constituted nearly 40% of China’s total trade volume and saw import duties reduced by RMB 42.2 billion ($6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with Maldives in December 2017. Beijing is currently negotiating seven other FTAs.

Methodology

To gauge trade liberalization progress, we assess the change in China’s imports of a selection of highly protected goods and services using a composite trade liberalization index (CTLi). Scores higher than 100 indicate a growing role for these imports relative to gross domestic product (GDP) since 2013 (i.e., relative liberalization of these goods and services), while lower scores indicate a falling role. Supplemental gauges look at other variables in China’s trade picture: current account-to-GDP ratios for goods and services, whether goods imports are consumed in China or just reexported, the services trade balance by component, exchange rates, and trade trends in overcapacity sectors.
Quarterly Assessment and Outlook

Primary Indicator: Composite Trade Liberalization Index
4qma, 4Q2013=100

- We downgrade trade policy reform slightly this quarter, as our indicators show imbalances getting worse and import openness stalling.

- Our primary indicator cannot be updated because of missing data; its components show no net improvement. Rebalancing trade and moving up the value chain are taking a back seat as tariffs bite, while data suggest less openness to imports and more overcapacity shipped abroad.

- The domestic trade policy landscape remains basically unchanged this quarter. Trade talks offer Beijing the opportunity to liberalize more decisively but policymakers are more likely to focus on near-term offsets to the pain from tariffs and uncertainty rather than responding with reform.

This Quarter’s Numbers

For the fourth consecutive quarter, our quantitative analysis of China’s trade policy has been hindered by missing goods trade data, which officials attribute to technical problems with a vendor company. As a result, our primary indicator, the Composite Trade Liberalization Index (CTLI), remains incomplete.

Available CTLI data show no net improvement in trade opening. China’s Customs Administration partially updated missing data on nonsensitive but highly protected manufacturing imports in our sample, which have fallen significantly since 2013. Imports of protected agricultural goods increased in 1Q2019, but services imports remained at the same level relative to GDP as the previous quarter and still below 2013 levels. China’s nontourism services deficit shrunk because of smaller payments for royalties and transport services, and a stronger surplus in commercial services (see Services Trade Openness).

Reducing persistent external imbalances means relying more on domestic demand for economic growth. China’s current account surplus has receded significantly from its 2007 peak of 10% relative to GDP, reflecting some rebalancing of the economy. But the narrowing of the balance from its near-term high of 2.8% of GDP in 2015 to 0.4% in 2018 was driven by expansion of China’s services trade deficit and higher import prices, with less evidence of economic rebalancing showing up in trade flows. In 1Q2019, reduction of China’s current account paused, with new tariff distortions playing a role. China’s first quarter balance rose to $49 billion, the highest same-period level since 2015 and a sharp reversal from last year’s deficit (see External Trade). The elevated current account balance was driven by merchandise trade; our economic models and the observed trend both show that the consequences of trade wars for China so far are falling exports accompanied by even faster-falling imports.

Our Structural Change in Goods Trade indicator shows that more of China’s imports were for domestic consumption rather than processing for reexport in 1Q2019. This is positive; however, it is a result of trade squabbles rather than an organic transition to domestic consumption. Export weakness is attributable to declining processing trade exports to advanced markets including the United States, and as a result processing imports fell throughout the first quarter. Net exports of many overcapacity goods—aluminum products, fertilizer, and steel products—increased in 1Q2019 (see Trade and Overcapacity). Localities have loosened air quality and production curb enforcement to prop up production growth as the domestic economy slows (see Environment). Beijing announced localities will dictate output restrictions again this coming winter, meaning China’s beggar-thy-neighbor policies will likely worsen industrial overcapacity spillover abroad.
Policy Analysis

China’s trade policy agenda this year has been equal parts piecemeal reform and brinksmanship with Washington. As detailed in our Winter 2019 edition, in the first quarter, Chinese policymakers reduced import tariffs to support consumers, facilitate industrial upgrading, and offset trade war impacts. But changes in broader trade reforms have not struck other Organisation for Economic Co-operation and Development nations as decisive, and the situation with the United States has gone from bad to worse. U.S.-China trade talks broke down in May, with the United States accusing China of reneging on earlier commitments. As a result, the Trump administration raised tariffs on $200 billion in imports from China from 10% to 25%; Beijing responded by increasing tariffs on $60 billion in U.S. imports. A June State Council white paper on bilateral trade tensions blamed the United States for the breakdown and...
reiterated Beijing’s three “red lines”: that any trade deal requires Washington to remove all tariffs imposed since Trump took office; that U.S. expectations for purchases of U.S. goods be “realistic”; and that the agreement maintain a “proper balance” of commitments on both sides.

At the Trump–Xi Jinping bilateral meeting at the G20 summit in Osaka in June, the two leaders agreed to resume talks and President Trump agreed to delay raising tariffs on the remainder of imports from China while talks proceeded. For a time, China resumed occasional purchases of U.S. agricultural goods (sorghum, soybeans, and rice), suggesting that talks were back on track. But the post-G20 reprieve proved short-lived, and bilateral trade tensions now appear locked in a downward spiral. After a round of talks in Shanghai considered constructive by both sides, on August 1, President Trump tweeted that the United States would raise additional 10% duties on the remainder of imports from China not already subject to tariffs by 10% (around $267 billion) starting on September 1 because Beijing failed to deliver on promised U.S. agriculture purchases and crackdown on fentanyl sales. The U.S. Trade Representative later clarified that the new tariffs would proceed in two waves, on September 1 and December 15, to delay the impact on American consumers.

In reaction, the People’s Bank of China (PBOC) allowed the renminbi to fall through the 7.0 per U.S. dollar level, pointing to market forces produced by tariffs as driving the sudden depreciation. Market pressures were already pushing the currency weaker, but the change in the PBOC’s pattern of intervention to give into some of those pressures signals Beijing’s resignation that trade negotiations with the United States were not likely to produce any meaningful de-escalation or reduction in tariffs. The U.S. Department of Treasury labeled China a currency manipulator for the first time since 1994—a designation lacking economic rationale, but it may allow Washington to levy additional duties on imports under a U.S. Department of Commerce rule proposed in May providing trade protection against subsidization from currency undervaluation.

Beijing officially responded to the August 1 U.S. tariff increases on August 23 with two lists of proposed retaliatory tariffs on U.S. imports worth $75 billion. Calling Beijing’s retaliation “politically motivated,” President Trump immediately vowed to increase the existing 25% tariffs on $250 billion of imports from China to 30% on October 1 and to raise the September 1 tariff rate from 10% to 15%.

Trade tensions extend beyond tariffs. In May, the Commerce Department added Chinese telecom leader Huawei to its “Entity List”—a compendium of companies considered a threat U.S. national security—effectively restricting its access to key U.S. purchases. In response, China’s Ministry of Commerce announced plans to release its own “Unreliable Entity List.” On August 19, the Commerce Department extended temporary authorizations for some U.S. transactions with Huawei but also added nearly 50 more Huawei affiliates to the Entity List, further setting back the resumption of any substantive trade negotiations. These developments are part of a broader decoupling trend, which will risk further trade, investment, and technology balkanization if not mitigated.