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 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.

- 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.

- 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. On November 15, 2020, China signed the Regional Comprehensive Economic Partnership (RCEP) with 14 other countries including Japan, South Korea, Australia, New Zealand, and the 10 Association of Southeast Asia Nations (ASEAN) member states.

Methodology

To gauge trade openness, we assess the change in China's imports using goods and services trade openness indexes. Scores higher than 100 indicate a growing role for 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. *Note: In 2Q2019, we replaced the original Composite Trade Liberalization Index (CTLI) with an alternate indicator due to missing data.*

The indicator indexes the changes in the import/GDP ratios for selected goods and services relative to 2014. Our proxy line for goods trade measures ordinary trade imports—referring to imports that are not for processing, assembly, and reexport and are therefore a closer approximation of final import demand—less three types of goods: crude oil, iron ore, and integrated circuits. We exclude these goods from our ordinary trade proxy as China's imports of these goods dwarf other imports in value and are highly sensitive to external price effects in such a way that they could distort this indicator. Ordinary imports face more tariffs and other trade barriers than processing imports, for which tariffs are typically low or zero, thereby favoring export growth above import openness; improvement in China's trade regime would rebalance toward more import growth catering to final demand.

For services, we included all subsectors except tourism and transportation, which are less reform sensitive given the longer-term trend of growing outbound Chinese tourism, overseas education, and resident spending abroad. The quarterly import/GDP ratio (four-quarter rolling sum) of each category was benchmarked to 2014 to coincide with the Third Plenum in November 2013. We attempt to isolate the trade liberalization variable by

screening goods and services whose import growth is most constrained by policy, and by measuring imports over nominal GDP; ultimately, however, other factors including prices and inflation, cyclical patterns, competitiveness conditions, and global trade conditions may impact the indicator.

Quarterly Assessment and Outlook

- Our trade reform assessment remains neutral: services trade openness improved (albeit to 2014 levels), while consumer goods trade openness declined.

- COVID-19–related exports of PPE and electronics products pushed the 2Q2020 goods trade surplus to its highest in history, inflaming foreign concerns.

- To hedge against risks from tensions abroad, Beijing is pursuing both trade deepening with pliant regional partners and reduced reliance on foreign suppliers in technology and strategic sectors.

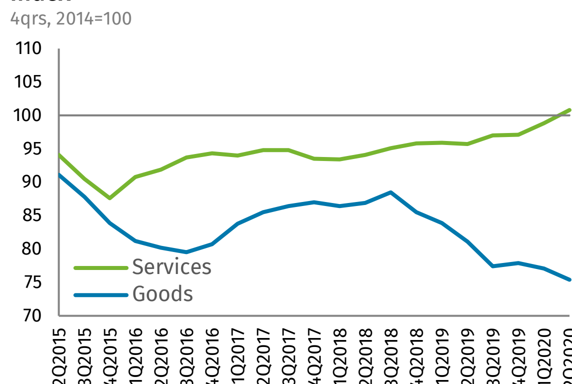
This Quarter's Numbers

Services trade saw opening in 2Q2020, while goods trade openness further declined. Our **Composite Trade Liberalization Index (CTLI)** showed the services proxy finally getting back to 2014 levels in terms of openness. Telecommunications, royalty payments, insurance and pension services all increased year-on-year (yoy) in 2Q2020 and 3Q2020 (see **Services Trade Openness**). However, consumer goods imports relative to GDP have continued to fall since 2018. The decline accelerated during COVID-19, as domestic demand slackened, reducing imports. This corresponded to China's new initiative to refocus its exporters on domestic market opportunities.

China's export sector rebounded in 2Q2020 as manufacturers resumed activity post–virus lockdown and demand for COVID-19–related goods in other economies surged. Authorities intervened to limit renminbi appreciation in 2Q2020, which helped to boost exports (see **Exchange Rate Fluctuation**). Strong exports, falling import prices, and weaker domestic demand pushed China's 2Q2020 goods trade surplus to $161.3 billion (4.6% of GDP)—the highest ever recorded—and drove the current account surplus to 3.1% of GDP, its highest since 2012 (see **External Trade**). Despite the export surge, net exports of steel and aluminum continued to decline, raising hopes that overcapacity in these products may be receding (see **Trade in Overcapacity Goods**).

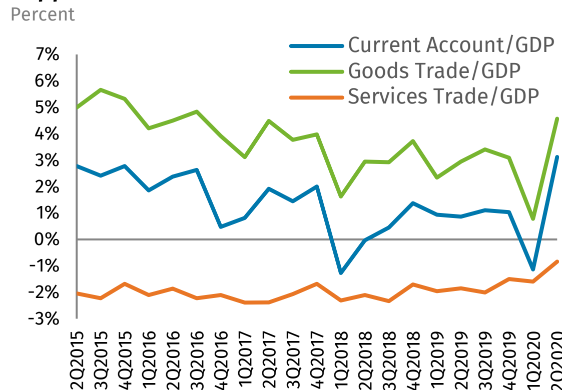
Ballooning imbalances will aggravate concerns about China's trade footprint: if trends persist, the 2020 current account surplus will surpass 2016 levels. Robust exports and weak imports have slowed China's intended shift away from the "import-for-export" model (see **Structural Change in Goods Trade**). With the new "dual circulation" strategy, Beijing has signaled the intent to boost consumption while reducing global reliance by substituting strategic imports with domestic production.

Primary Indicator: Alternative Trade Liberalization Index
4qrs, 2014=100



Source: General Administration of Customs, State Administration of Foreign Exchange, National Bureau of Statistics, Rhodium Group.

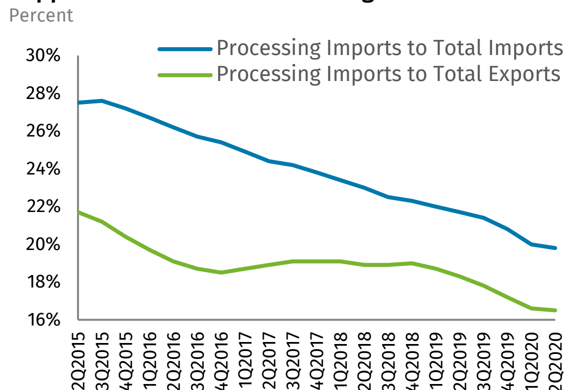
Supplemental 1: External Trade
Percent



Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

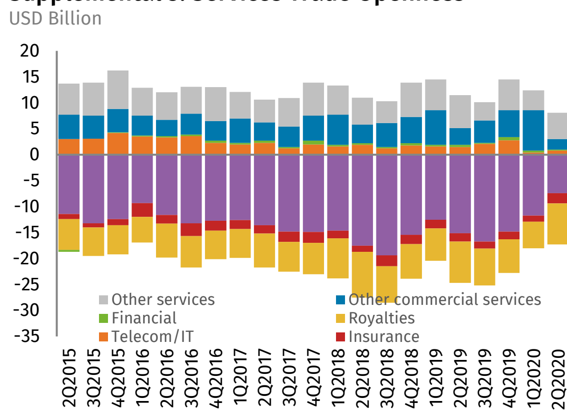
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

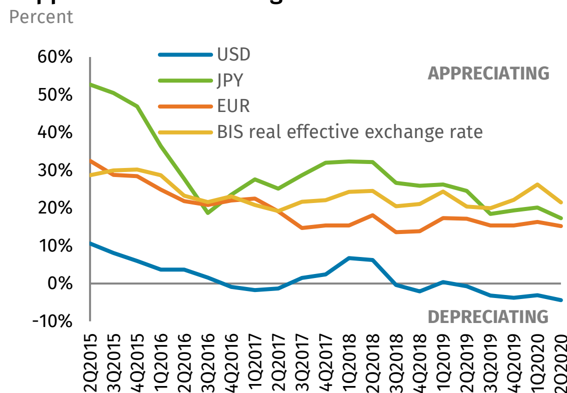
USD Billion



Source State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

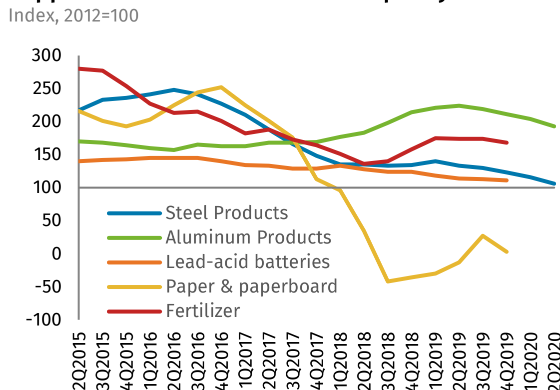
Percent



Source: People's Bank of China, National Bureau of Statistics.

Supplemental 5: Trade and Overcapacity

Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Policy Analysis

To hedge against risks from economic tensions abroad, Beijing is pursuing both trade deepening with pliant regional partners and targeted reduction of reliance on foreign suppliers in technology and strategic sectors. The new dual circulation strategy, which will be central to China's 14th Five Year Plan (FYP) for 2021–2025, calls for less reliance on foreign technology and trade and a greater focus on domestic consumption. It encompasses both "external circulation" (accessing global demand and foreign capital and technology) and "internal circulation" (stocking domestic demand and domestically developed technology). President Xi Jinping's explanation of the program emphasizes shifting growth momentum to domestic demand, domesticized supply chains, and indigenous innovation. While the net impact on China's trade balance is unclear, the import-substitution elements in the strategy do not auger well for reform. Import substitution in key technologies and critical supply chains will likely lead to measures protecting domestic manufacturer market shares and restricting foreign players.

Beijing continues to encourage trade opening in less technology-intensive sectors. At the November Shanghai Import Expo, President Xi announced a new "Negative List" on cross-border services trade to improve market access. He also said China would accelerate free trade agreement negotiations. On November 15, China signed the Regional Comprehensive Economic Partnership (RCEP) with 14 other countries including Japan, South Korea, Australia, New Zealand, and the 10 Association of Southeast Asia Nations (ASEAN) member states.

The deal is strategic for China, as it can strengthen regional economic ties to offset the prospect of U.S. decoupling. RCEP is far from comprehensive: it mostly codifies tariff reductions that already exist in other

agreements, with the important exception of China-Japan trade. Nevertheless, the agreement is an important signal of China's intent to expand and deepen regional economic integration, and it has prompted some soul searching in Washington and European capitals.

While RCEP is encouraging on paper, it is not stopping Beijing from using trade to bash Australia for unrelated, alleged affronts. China is impeding market access for Australian goods in retaliation for Canberra's "poisoning" bilateral relations with calls for an inquiry into the COVID-19 outbreak, charges about human rights and cybersecurity violations, reluctance to permit Huawei to sell 5G telecoms gear, and other non-trade issues. China has recently imposed tariffs exceeding 200% on Australian wine and restricted Australian coal, lumber, seafood, beef, and barley imports. There is no subtlety to these draconian measures, and they are leading U.S. allies and partners to voice concerns.

Final Dashboard Assessment

In trade, China remains a contradiction. It is the world's biggest trader in absolute terms; however, relative to its economic size, trade liberalization has not kept pace. Trade reform commitments set out in Beijing's 2013 Third Plenum program included two major tasks: promote trade openness and let the market play a decisive role in adjustment. China continuously reduced tariffs since our first Dashboard observation with cuts bringing simple average tariffs to 7.6% in 2019 from 9.9% in 2013, according to the World Trade Organization (WTO). However, Beijing raised tariffs on nearly all imports from the United States amid the tensions of the past two years, causing China's average tariff rate to rise to 9.8% in 2018. China has not made equivalent progress in reducing *non-tariff* barriers to trade and continues to use an unlimited array of administrative interventions as coercive, informal tools of statecraft. Despite China's claims to the mantle of trade liberalization leadership, our indicators show openness in non-strategic, highly protected goods categories has only decreased since 2013.

China's external trade imbalances, once expected to moderate, have surged back to dangerous levels over the past year. Unending financial enablement of already excessive production spilled directly and indirectly into China's exports in the early Xi years, fueling massive goods surpluses in 2015. The overcapacity problem caused global oversupply of industrial materials like steel and aluminum as well as in other subsidized output like solar panels, batteries, and fertilizer. Overcapacity exports have receded from peak levels after repeat campaigns consolidated industry players and tried to match supply with actual demand, though sheltering domestic manufacturers from real conditions and financial costs will cause the overcapacity problem to persist. After deleveraging the financial system and liberalizing some trade flows, that problem started to recede.

As recently as 2019, China was expected to move toward a structurally lower trade surplus, or even a trade deficit, as stronger domestic demand and services sector growth boosted imports. But the COVID-19 debacle seems to have altered that trajectory. The dual circulation strategy pledges to unleash domestic sources of demand but to curtail foreign suppliers from realizing their comparative advantages to satisfy it. Going forward, China's trade reform outlook looks like a closed-circuit liberalization that hoards the domestic dividends of competition, should they finally arrive, for home-team firms and selected foreign friends willing to play by authoritarian-friendly rules.