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. But 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, nondiscriminatory ("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 (FTZ) in 2015, to facilitate cross-border e-commerce trade. Key developments include gradually lifting equity caps for foreign e-commerce businesses in FTZs 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.

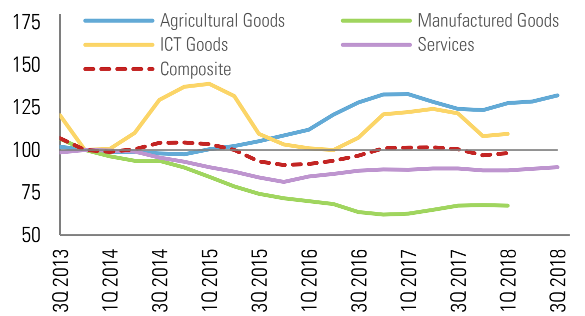
- China has expanded and sought new free trade agreements (FTAs). Since 2002, China has signed 16 FTAs with 24 countries or regions; in 2016, trade with FTA partners (including Taiwan, Hong Kong, and Macao) constituted nearly 40% of China's total trade volume and saw import duties reduced by RMB 42.2 billion ($6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with the 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 GDP since 2013; 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



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

- We slightly improve our assessment of trade reform but remain negative given the piecemeal nature of policy change and continued failure to report key data.

- Indicators show improvement in overall external balances but no progress in structural reform.

- Policy developments this period included pledges to increase imports and lower barriers, as well as a round of tariff cuts for some goods.

THIS QUARTER'S NUMBERS

For the second quarter in a row, our quantitative analysis of China's trade policy is 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), cannot be fully updated. Two subcomponents of the CTLI – agricultural goods trade and services trade – show a positive trend, with stronger improvement in imports of highly protected agricultural goods. Services imports increased only slightly and are still below 2013 levels, indicating backsliding since the Third Plenum reform program was announced. *If data remain unavailable, we may change our primary indicator of trade liberalization in the next edition.*

China's external trade rebalanced in the right direction this quarter but did not reflect opening of China's markets. China's $23.4 billion current account surplus in 3Q2018 was the lowest for a third quarter since 2004, driven by both goods and services trade. The goods trade surplus was 3% of GDP, the same level as in 2Q2018, while the services trade deficit expanded to 2.4% of GDP from 2.1% (see **External Trade**). Higher oil prices in 3Q2018 were the main reason China paid more for goods imports and the goods surplus did not rise further. China's exports remained resilient throughout 2018 despite the introduction of U.S. tariffs, and some exports were probably front-loaded ahead of tariff implementation, suggesting weaker Chinese shipments in 2019.

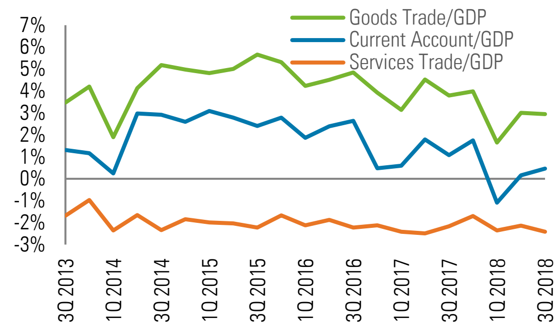
China's services trade deficit reached a new record of $82.2 billion, driven once again by tourism, not opening of domestic services markets. Outside of tourism, only transport services (freight and passenger transport) and to a lesser degree royalties (payments for the use of intellectual property) increased (see **Services Trade Openness**). For financial services, third-quarter imports were less than $0.5 billion, lower than imports of nearly every other commercial service.

Structural rebalancing toward higher value-added and consumption-driven trade did not progress this quarter. China imported less for domestic consumption and more for processing, or reexport, compared with last quarter (see **Structural Change in Goods Trade**). China's exports contributed more to global overcapacity in certain products. Net exports of aluminum products, coke, and fertilizer rose relative to 2012 levels, while net exports of steel products and lead-acid batteries remained basically stable (see **Trade and Overcapacity**). *Due to missing trade data, we had to slightly adjust our methodology for gauging overcapacity exports. We now focus on fertilizer trade, rather than a broader category of chemical products used in past updates. In addition, we look at rolling sums of net exports rather than quarterly average net exports, resulting in smoother lines, and changed the base year for comparing net exports from 2011 to 2012 due to data availability. The broad trends are consistent across methodologies.*

Notably, the renminbi (RMB) depreciated sharply against the dollar in July and August, falling 6.6% against the U.S. dollar on average from 2Q2018 to 3Q2018 (see **Exchange Rate Fluctuation**). This reflected greater central bank tolerance for RMB volatility in those months. Depreciation slowed in September, possibly because regulators intervened to avoid derailing trade negotiations with the United States. Monetary policy conditions support a weaker RMB, and the central bank remains concerned about the impact of capital outflows on domestic financial conditions, augmenting the instinct to stabilize the RMB. There is little evidence that China was driving the currency weaker in order to support exports.

Supplemental 1: External Trade

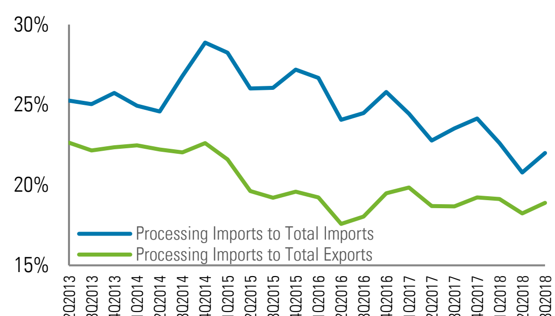
Percent



Source: State Administration for Foreign Exchange.

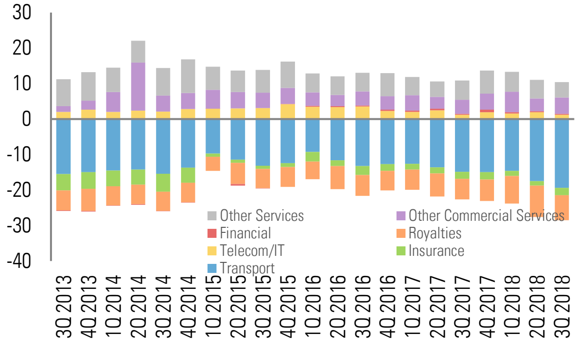
Supplemental 2: Structural Change in Goods Trade

Percent



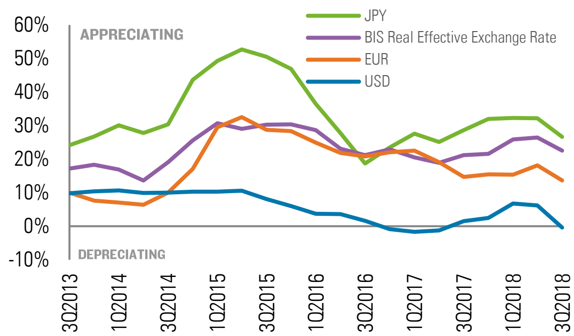
Source: General Administration of Customs.

Supplemental 3: Services Trade Openness
USD Billion



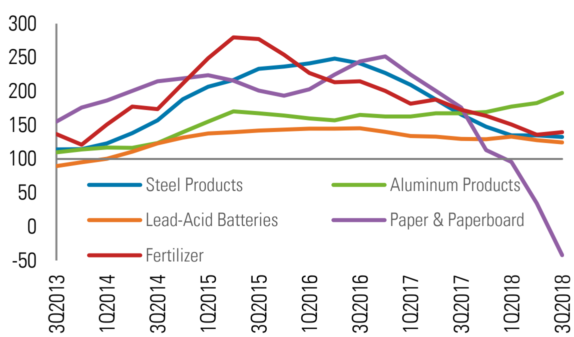
Source State Administration of Foreign Exchange.

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

Escalating talk of a trade war between the United States and China complicated Beijing's policy agenda throughout 2018. In 3Q2018 and 4Q2018, officials redoubled measures that appear reform oriented but are mostly targeted at offsetting the impact of U.S. tariffs.

For the most part, the policy direction in the second half of the year encouraged accelerated import growth in line with the needs of the domestic economy. In November, at China's first International Import Expo – an event meant to demonstrate that China's market is open to foreign products – President Xi promised that China would lower tariffs, expand market access, and increase imports. However, the expo generated more skepticism than confidence from audiences questioning the implementation of promised reforms.

Cutting import tariffs is an area where Beijing has made progress, with successive rounds of tariff cuts on highly protected goods picking up since 2015, but change has been gradual and piecemeal. On November 1, the State Council reduced tariffs on 1,585 line items to facilitate industrial upgrading, lower corporate costs, and meet domestic demand. Average tariff rates for electromechanical equipment fell from 12.2% to 8.8%, for textiles and building materials from 11.5% to 8.4%, and for resources and primary products from 6.6% to 5.4%. The State Council said the measures would reduce China's average effective tariff rate on goods imports to 7.5% in 2018 from 9.8% in 2017.

While trade policy reform has not been prioritized within Beijing's overall reform agenda since 2013, it has become more urgent as domestic and international pressures build; in this quarter, however, progress was not commensurate with the heightened urgency.

After Presidents Trump and Xi met at the G20 summit in Argentina on December 1, the United States and China agreed to suspend further tariff increases while engaging in trade negotiations with a new March 1 deadline for progress. Mid-level officials met in Beijing in January to pin down the framework and negotiating items, and Vice Premier Liu He visited Washington in late January for higher-level talks. U.S. negotiators are looking for increased Chinese purchases of key exports, improved market access, as well as structural reforms around state subsidies, industrial policies, forced technology transfer, and strengthened intellectual property protection and enforcement. Beijing seems serious about addressing certain U.S. requests, but a "grand bargain" will be difficult.

Since the summit, Beijing offered a few signs of reform intent. They include establishment of a national intellectual property rights court, reduction of retaliatory import tariffs on U.S. autos and parts to the rate charged on other countries' imports, allowing some purchases of U.S. soybeans and approvals of genetically modified crops, potentially revising the Made in China 2025 high-tech industrial policy to incorporate foreign firm participation, and revising guidelines governing foreign investment in China (see **Investment**).

Looking ahead to the end of the 90-day period, one key question for the outlook on China's trade policy is whether the trade war threat will compel Beijing to accelerate reform and opening up – and whether any measures addressing U.S. concerns are clearly verifiable. While a limited deal based on more Chinese purchases of U.S. goods and some additional market access is possible, a sustainable resolution still depends on fundamental reforms in China.