

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

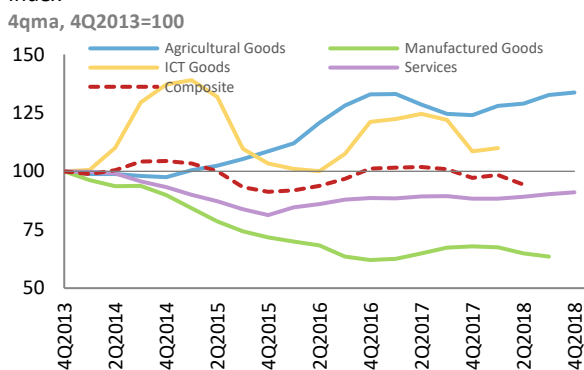
saw import duties reduced by RMB 42.2 billion (\$6 billion) that year. Most recently, China signed FTAs with Georgia in May 2017 and with the Maldives in December 2017. Beijing is currently negotiating seven other FTAs.

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



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

- We give trade policy reform a positive score this quarter, up from negative previously.
- Our data show a partial improvement in China’s openness to services trade, but no structural shift toward higher value-added and consumer-driven imports. Increased tariffs on trade with the United States started to reduce China’s trade flows in both directions in 4Q2018, complicating the analysis of broader trade patterns.
- Beijing cut tariffs and taxes to mitigate the effects of the trade war and support domestic economic recovery. While U.S.-China trade negotiations provide an opportunity for Beijing to converge with international trade rules, only piecemeal changes have been made so far and a recent escalation of bilateral tariff measures is not encouraging.

THIS QUARTER'S NUMBERS

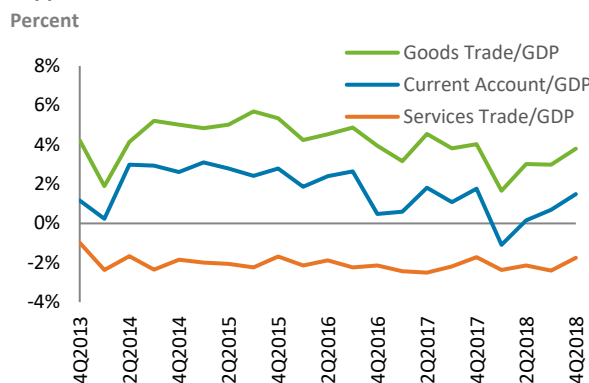
For the third consecutive quarter, our quantitative analysis of China's trade policy has been hindered by missing data concerning China's goods trade, which officials attribute to technical problems with a vendor company. As a result, our primary indicator, the **Composite Trade Liberalization Index (CTLI)**, cannot be fully updated. However, Chinese customs officials have indicated that missing data will become available again this June, meaning we should be able to analyze it later this year.

From the subset of data that was officially reported, we see partial improvement in opening of closed-off trade channels. The two sub-indicators we were able to update show China's protected agricultural imports rising, and services imports continuing to increase gradually (though they are still below the level of six years ago during the 2013 Third Plenum). Detailed services trade data also indicate China is becoming more open (see **Services Trade Openness**). Both services imports and exports rose steadily in 2018. Outside of tourism, which can disguise financial outflows from China, services imports rose 12.7% in the second half of 2018, while imports of telecom and other information services rose more than 20% year-on-year (yoy) each quarter in 2018. The "other business services" category led export growth, which includes research & development, consulting, architectural and engineering services, and other trade-related services.

While some progress on opening to services trade is apparent, structural adjustment toward higher value-added and consumer-driven import trade is still elusive. **External Trade** balances show China's current account-to-GDP ratio declined in 4Q2018, led by the smallest goods trade-to-GDP ratio for the fourth quarter of any year since 2011. The narrowing of China's current account surplus is not just a trade phenomenon; it is also aligned with financial liberalization as foreign capital plays a greater role in meeting China's capital needs. Indeed, China's current account has already shrunk considerably, from its near-term peak of 2.8% of GDP in 2015 to 0.4% in 2018, and capital inflows increased strongly in 2018 relative to the low levels in previous years.

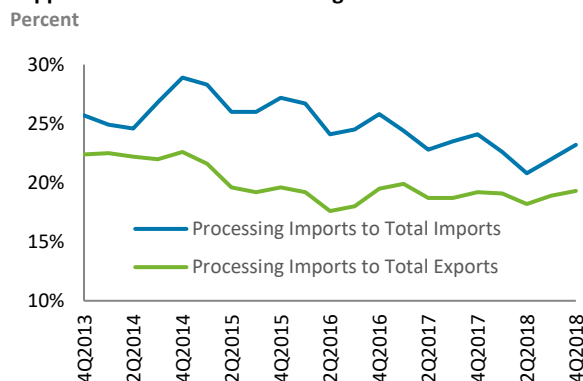
In the coming quarters, more immediate factors like trade war pressures and commodity prices will likely determine whether China's current account surplus fluctuates between a small surplus and a small deficit. This quarter, goods exports and imports rose by their smallest margin since 2016, with import growth driven by oil imports while export growth was powered by China's traditional manufacturing exports. In addition, China's imports and exports both suffered in November and December, likely related to the impact of bilateral tariffs imposed between China and the United States. **Structural Change in Goods Trade** shows that the shift to higher value-added trade — indicated by the level of imports processed in China relative to total exports — has not progressed meaningfully since 2016.

Supplemental 1: External Trade



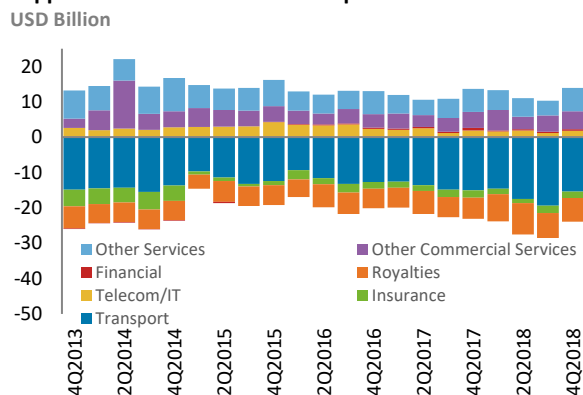
Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade



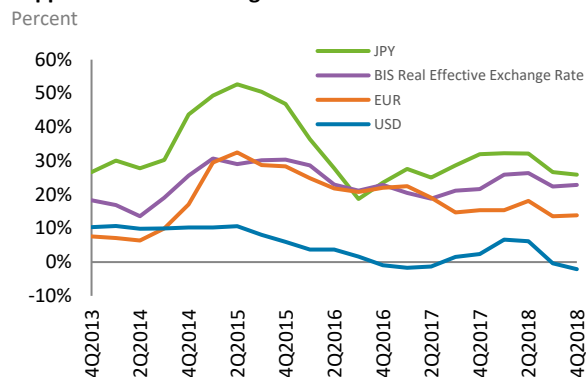
Source: General Administration of Customs.

Supplemental 3: Services Trade Openness



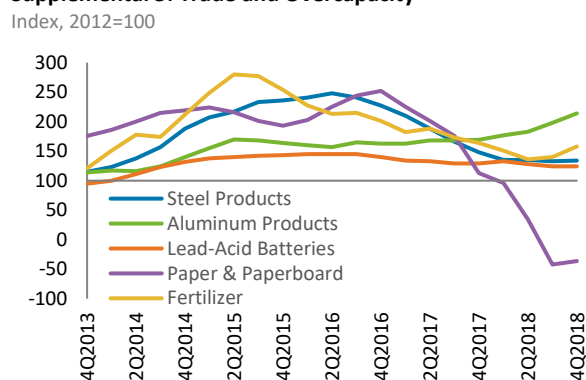
Source: State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation



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

Supplemental 5: Trade and Overcapacity



Source: General Administration of Customs, Rhodium Group.

POLICY ANALYSIS

Pressure from trade negotiations with the United States and growing complexity in the international trade environment elevated the importance of trade policy for China's leaders this period. At the National People's Congress (NPC) in March, Premier Li Keqiang named managing the "relationship between domestic and international issues" a top priority in achieving government goals and targets for the year, signaling growing attention to global pushback against China's trade and investment policies and practices.

For the most part, annual work reports released by Premier Li and the National Development Reform Commission at the NPC reiterated the same vague trade policy objectives of past years without specifying plans or timelines for implementation, indicating little movement toward more fundamental reforms. These goals — laudable in principle but lacking in implementation — include supporting the upgrading of processing trade; improving the import mix and actively expanding overall imports, especially in advanced technology and equipment and key resources; creating a fair and impartial environment for domestic and foreign companies; and facilitating WTO reform.

Beijing regularly tweaks tariff policy to support macroeconomic needs and industrial development goals, and the January 2019 round of tariff cuts was no exception. These reductions also support the stated reform goals of broadening trade openness and increasing imports, following earlier 2018 tariff cuts on 1,449 goods in May and 1,585 goods in September. But the growing costs from the trade war with the United States shaped the ways in which China opened its economy this quarter, likely accelerating some implementation. In late December, the Ministry of Finance (MoF) announced revisions to provisional tariff rates effective January 1, reducing or removing tariffs on 706 products to meet various policy goals. Import tariffs were reduced for textiles and pharmaceuticals as well as higher value-added industrial goods, including batteries for new energy vehicle engines, aircraft engines, and welding robots for auto manufacturing. Starting July 1, Beijing will push through the fourth round of most-favored nation (MFN) tariff rate cuts for information technology imports, covering 298 items. The MoF also implemented previously agreed-upon tariff reductions for a number of bilateral and multilateral FTA partners. Beijing's utilization of FTA mechanisms to reduce trade barriers is important in the long run for the trade reform agenda, but also serves to deepen links with alternative trade partners amid higher U.S. tariffs. Beijing also reduced tariffs on alternative feed imports, reflecting trade war pressures as U.S. soybean imports are subject to tariffs.

At least so far, U.S. pressure has not succeeded in achieving *fundamental* changes to China's trade policies; however, Beijing did make modest gestures in the context of ongoing negotiations. For example, Beijing extended its temporary suspension of retaliatory tariffs on U.S. autos and parts, after the White House delayed escalation to 25% tariffs on \$200 billion of imports from China (though it later took this action anyways, as discussed below). Chinese companies reportedly resumed occasional purchases of U.S. soybeans, sorghum, and oil throughout the first four months of 2019. Beijing addressed some of the core U.S. concerns within the Section 301 case — forced technology transfers and intellectual property theft — in late April when the NPC Standing Committee passed changes to the Trademark Law and Anti-Unfair Competition Law (see the **Competition** section). Beijing also passed a new Foreign Investment Law in early 2019, which will take effect in 2020 and which guarantees "pre-establishment national treatment" for foreign companies (see **Cross-Border Investment**). Ultimately, to be considered effective these developments will necessitate transparency around implementation and enforcement.

Will U.S. pressure ultimately lead Beijing to undertake more concerted trade policy changes? Bilateral negotiations do present an opportunity for reformers in China to advance their case for further liberalization, but whether they will succeed is still unclear. As of the drafting of this Dashboard edition, U.S. President Donald Trump raised tariffs on \$200 billion of U.S. imports from China already targeted under its

Section 301 case from 10% to 25%, and initiated the procedures to levy 25% tariffs on the remainder of U.S. imports from China if China retaliated. Beijing did so by increasing tariffs on \$60 billion in imports from the United States, prompting the Office of the U.S. Trade Representative to schedule a hearing and comment process in June to evaluate tariffs on approximately \$300 billion worth of additional imports from China. These actions make what was already a difficult negotiation more complicated, particularly as outstanding questions like how Beijing's reform commitments will be enforced, whether and how quickly bilateral tariffs will be reduced, and whether Washington can continue to use unilateral tools to respond to China's noncompliance cloud the outcome.