

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. In November 2019, China and 14 other nations concluded negotiations on the Regional Comprehensive Economic Partnership (RCEP) to reduce regional trade barriers; the pact is scheduled to be signed in 2020.

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 this 2Q2019 edition, we are replacing the original Composite Trade Liberalization Index (CTLI) with an alternate indicator due to missing data.

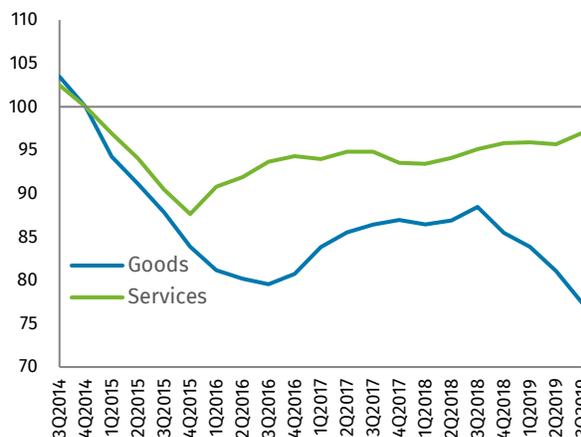
The indicator indexes the changes in the import/GDP ratios for selected goods and services relative to 2014. Our proxy line for goods trade measures ordinary trade imports—referring to imports that are not for processing, assembly, and reexport and are therefore a closer approximation of final import 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

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.

- Our trade policy reform assessment remains neutral, as our indicators are mixed and remain impacted by tariffs.
- Tariffs drove China's imports lower and its surplus higher in 3Q2019 but also led to less dependence on reexports and stable net exports of overcapacity goods.
- Phase 1 of the U.S.-China trade deal reduced uncertainty surrounding escalating tensions between the United States and China by pausing retaliatory tariff increases with some minimal tariff rollback and provisions to strengthen intellectual property protections, curtail forced technology transfer, and improve market access in financial services and agriculture. However, it does not comprehensively resolve structural reform issues at the heart of the U.S.-China dispute.

This Quarter's Numbers

Our **Composite Trade Liberalization Index (CTLI)** is designed to look past policy changes for outcomes that reflect greater openness to imports. For the third consecutive quarter, the CTLI – which proxies goods imported into China for final consumption (excluding major commodities such as crude, iron ore, and integrated circuits) – showed final goods imports continued to decline relative to economic growth.

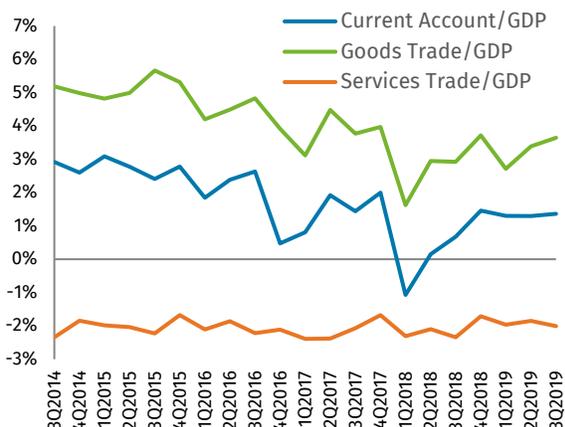
Services imports, excluding tourism, continued to expand relative to GDP in 2019, though they still remain below 2013 levels. However, **Services Trade Openness** shows in nominal terms (rather than against GDP) that China's non-tourism deficit actually shrank year-on-year for the third consecutive quarter led by falling transport service imports, likely related to weaker trade flows. Nevertheless, both imports and exports of two services categories – telecom and computer services and other commercial services – continued to increase.

The impact of tariffs obscures any clear read on trade liberalization; however, since the trade war began, China's imports have taken a hit. Relative to GDP, both China's goods surplus and services deficit expanded this quarter to 2017 levels, reaching 3.65% and 2.01% of GDP, respectively (see **External Trade**). The goods surplus rose more than the services deficit, causing the current account surplus as a whole to rise to 1.36% of GDP.

However, the same forces that drove China's external trade surplus higher drove improvement in other indicators. For one, processing trade imports, typically reflecting an export-intensive growth model, continued to fall relative to overall exports, suggesting that China's exports were less dependent on reexports (see **Structural Change in Goods Trade**). This is not just because tariffs reduced imports more than exports; processing imports were also a smaller share of total imports this quarter, compared with the same period in previous years. This dynamic also drove stabilization in **Exports of Overcapacity**. In 3Q2019, net exports of overcapacity goods remained roughly the same as in 2Q2019, relative to 2012 levels.

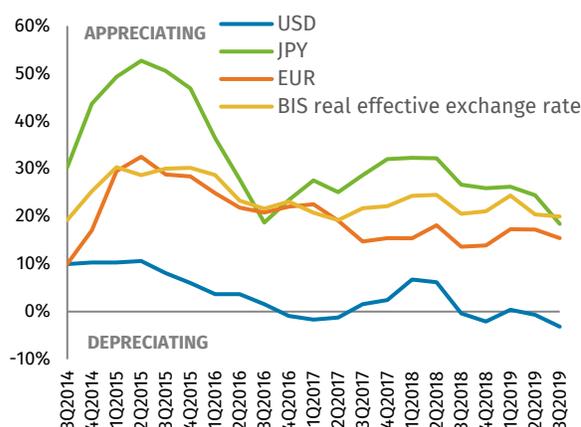
The yuan continued to depreciate against major currencies in the third quarter as uncertainty surrounding trade negotiations with Washington added downward pressure by souring the outlook (**Exchange Rate**). The move was consistent with the direction of market forces, and official data suggest the central bank did not intervene to weaken the currency further, even as export growth decelerated.

Supplemental 1: External Trade
Percent



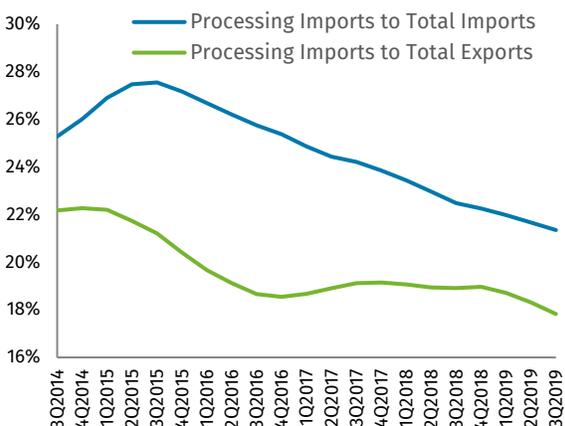
Source: State Administration for Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation
Percent



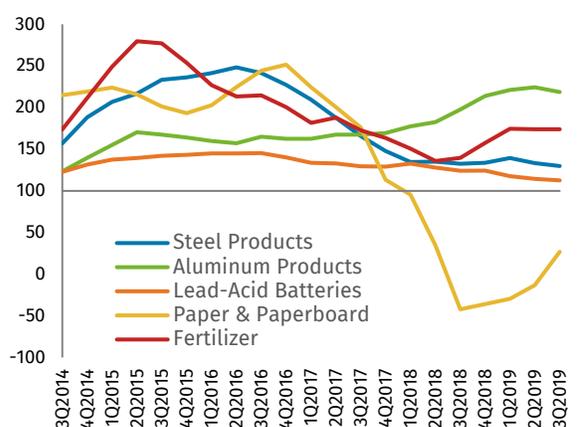
Source: People's Bank of China, National Bureau of Statistics.

Supplemental 2: Structural Change in Goods Trade
Percent



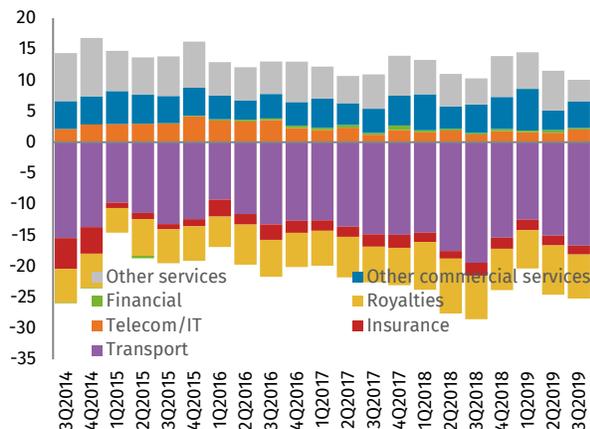
Source: General Administration of Customs.

Supplemental 5: Trade and Overcapacity
Index, 2012=100



Source: General Administration of Customs, Rhodium Group.

Supplemental 3: Services Trade Openness
USD Billion



Source State Administration of Foreign Exchange.

Policy Analysis

After nearly two years of tariffs escalation and negotiations, on January 15, 2020, the United States and China signed the Phase 1 economic and trade agreement. The deal consists of seven substantive chapters, covering intellectual property (IP) protection, tech transfer, food trade (including Chinese subsidies in these sectors), financial services market access, commitments to purchase U.S. products, macro and exchange rate management, and dispute resolution procedures. In effect, Phase 1 reduced the immediate uncertainty over possible further escalation in tariffs, achieved minor tariff rollback, and included provisions on a range of concerns but did little to resolve structural reform issues at the heart of U.S.-China tensions.

China's most concrete commitments are found in the "Chinese purchases" chapter, which outlines a managed trade program in which Beijing is to increase purchases of specified U.S. products from 2017 levels by \$77 billion in 2020 and \$123 billion in 2021 in four categories: manufacturing, agriculture, energy, and services. However, stronger U.S. imports may displace imports from other countries, casting doubt on whether the arrangement complies with international trade rules. Increased purchases of certain U.S. products could even come at the expense of other U.S. goods not subject to purchasing targets. The specificity and scale of China's purchasing targets only reinforce the state's role in managing trade, rather than letting the market play a more decisive role.

China's commitment to eliminate non-tariff measures in the agriculture and food sector is extensive. The agreement's annex details U.S. market access across many products, including beef and poultry. While agriculture market access barriers have been under discussion for years, the agreement takes many of these issues over the finish line and should promote longer-term improvement in U.S. agriculture exports to China.

Another significant outcome lies in China's IP protection commitments. While Beijing has promised to crack down on counterfeiting and piracy and improve trade secrets protections before, the deal also includes plans to monitor, publish, and evaluate implementation. More importantly, China agreed to shift the burden of proof in trade secrets theft cases to the defendant, forcing accused Chinese firms to prove they are not violating the plaintiff's IP rights, in line with its April 2019 revised Anti-unfair Competition Law. In theory, this could make IP protection less burdensome for plaintiffs, including foreign companies that have struggled to successfully defend their interests in China. Beijing also promised to increase specific IP protections in several product categories. However, doubts remain as to how this regime will work. Recent and ongoing legislative amendments enacted starting in 2019 outside the U.S.-China trade context may prove more fruitful in improving China's overall IPR regime (see **Innovation, Summer 2019 Edition**).

Besides concrete purchasing commitments, the agreement does not fully address fundamental areas of U.S.-China friction. Several provisions restate existing commitments, such as in financial services opening (see **Cross-Border Investment**). In the chapter on currency, both sides committed to not engage in "competitive devaluation." This reflects the belief that China continues to manipulate its exchange rate downward to support exports, which it is not; the central bank's recent interventions have mostly served to resist the yuan's depreciation. Other areas of

structural concern, particularly those related to industrial subsidies and the share of China's market dominated by SOEs, are largely absent from the deal.

Dispute resolution measures under the agreement include a multi-tiered consultation process. That process was formalized when the agreement came into force on February 14, 2020, with the formation of a new Bilateral Evaluation and Dispute Resolution Office to monitor China's implementation of Phase 1 commitments. Should consultation fail, the complaining side can unilaterally implement "remedial measures" or "suspend obligations under [the] Agreement," with the other party's response limited to withdrawal from the deal as an alternative to compliance.

Both sides have partially reduced tariffs. Before the Phase 1 deal was concluded, the United States dropped a planned tariff increase for December 15 and announced it would halve the 15% tariff rate on \$120 billion in Chinese goods in mid-February, but kept the 25% tariffs on imports worth \$250 billion in place. In effect, the deal slightly reduces average U.S. tariff rates on Chinese imports from 21% to 19.3%, versus only 3% in January 2018, according to the [Peterson Institute](#). On February 5, 2020, China's Ministry of Finance announced that Chinese tariff rates for \$75 billion of U.S. goods imports including crude oil and soybeans would be halved, which would facilitate increased purchases under Phase 1 commitments.

The prospects of a Phase 2 deal are not strong, as the challenging structural issues omitted so far grow more difficult by the month. With respect to timing, President Trump has made conflicting statements, indicating that negotiations would not begin until after the next U.S. presidential election and also claiming that they would begin following the Phase 1 signing ceremony. In January, China's lead negotiator Premier Liu He told state media that China was in no rush to start Phase 2 negotiations.

Meanwhile, the unanticipated novel coronavirus that spread from Wuhan in late 2019 has so severely depressed Chinese economic activity that the import targets will be very difficult to achieve. Projections of 1Q2020 headline GDP growth have been marked down significantly and are still falling. Price effects from weaker demand alone on many products slated for higher U.S. exports will also reduce the value of flows this year. With Chinese leadership focused on curtailing the spread of the virus, attending to the needs of its citizens, and taking measures to stabilize the economy, other areas of reform implementation may also suffer.