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

- Our trade policy reform assessment remains neutral for 4Q2019. Rising imports and stable exports were consistent with reform goals, but improvement was temporary, driven by seasonal holiday effects. The COVID-19 crisis reshaped China's trade patterns in 1Q2020.

- Imports of consumer goods increased, and net exports of overcapacity goods remained stable or declined. China's overall goods trade surplus moderated, and its non-tourism service imports increased modestly.

- Policy developments included both trade opening and trade restrictions. China has taken steps to implement some provisions of the Phase One deal it signed with Washington on January 15, 2020, but the purchasing commitments it made are vanishingly unlikely to be met. The impact of COVID-19 and its political and economic fallout are prompting more trade restrictions as critical medical and protective equipment demand surges worldwide.

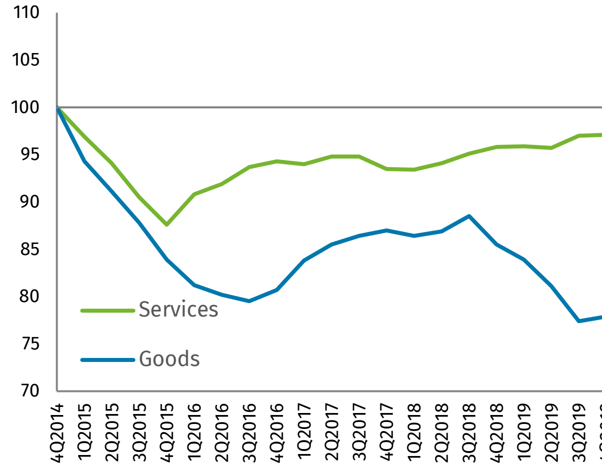
This Quarter's Numbers

China's import openness improved marginally in 4Q2019 from the previous quarter but remains below levels seen at the start of President Xi's reform era. Our **Composite Trade Liberalization Index** (CTLI) proxies goods imported into China for final consumption (excluding major commodities such as crude, iron ore, and integrated circuits) and services imports excluding tourism.

After falling throughout 2018 and 2019, goods imports stabilized in the fourth quarter. As our **External Trade** indicator shows, stronger imports and stable exports caused China's goods trade-to-GDP level to fall slightly in 4Q2019. At the same time, China's net exports of overcapacity goods (measured by volume) all declined or stabilized (see **Trade in Overcapacity Goods**). These patterns are consistent with greater trade liberalization but more likely reflect temporary conditions. An early Chinese New Year in January caused manufacturers to frontload activity in December (imports contracted throughout the first three quarters of 2019). Most of the import increase was driven by integrated circuits—a semiconductor component, indicating stockpiling amid U.S. trade tension—and soybeans, demonstrating trade war distortions.

Primary Indicator: Alternative Trade Liberalization Index

4qrs, 2014=100

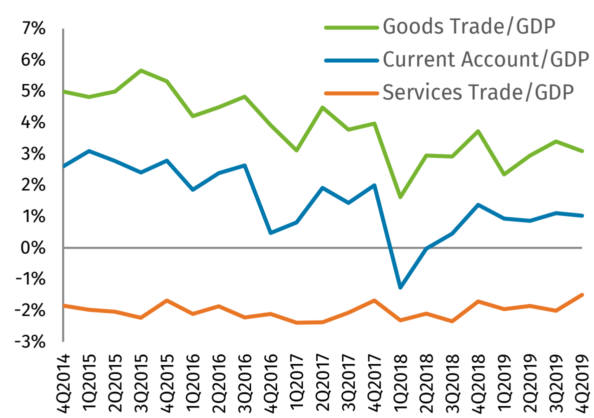


Source: General Administration of Customs, State Administration of Foreign Exchange, National Bureau of Statistics, Rhodium Group.

The CTLI services trade sub-indicator continued to improve through 2019. Outside of tourism, most services imports increased in 4Q2019 compared with 4Q2018, driven by "other commercial services" that include legal, consulting, engineering, and other professional services. The biggest shift has been China's growing services exports. Telecom and computer services and financial services exports rose, expanding China's surpluses in those categories (see **Services Trade Openness**). However, China's full-year 2019 services deficit got smaller: exports rose, and outside tourism imports (which contracted in 2019 for the first time since 2003), the remainder of non-tourism services imports rose by only 1%.

Supplemental 1: External Trade

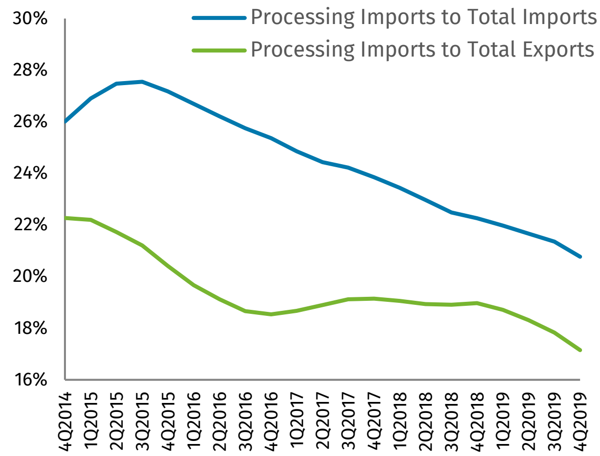
Percent



Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade

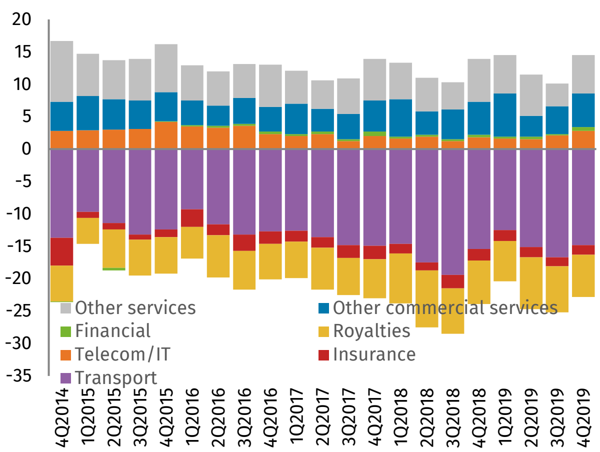
Percent



Source: General Administration of Customs.

Supplemental 3: Services Trade Openness

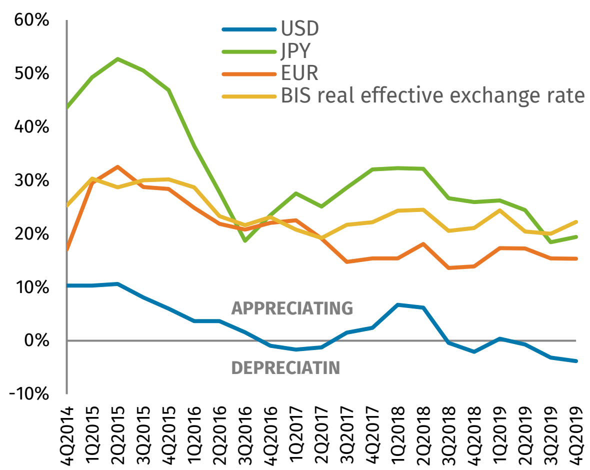
USD Billion



Source State Administration of Foreign Exchange.

Supplemental 4: Exchange Rate Fluctuation

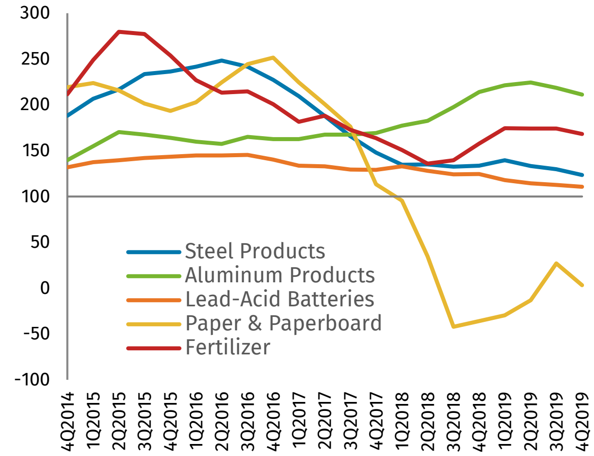
Percent



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

The key question for trade reform now is how China will respond to the exceptional circumstances created by the COVID-19 crisis. Policy developments in recent months included both trade opening and trade restrictions, but the fundamental factor at work is physical supply and demand realities around the world.

China has continued to reduce tariffs on U.S. products levied under the U.S. Section 301 case. In mid-February, the State Council Tariff Commission reduced September 2019 tariffs from 10% to 5% for 916 goods (including seafood, fruit, vegetables, cereals, edible oils, and leather), and from 5% to 2.5% for 801 goods (including dairy products, canned food, and mineral products). In May, China's Finance Ministry announced additional tariff reductions for 79 U.S. imports amounting to around $2 billion annually, most of which are chemicals and appear related to medical and protective equipment.

China has implemented a series of Phase One deal commitments according to the timetables specified in the agreement. In April 2020, China's supreme court published guidelines strengthening its intellectual property (IP) enforcement, enhancing trade secret protections, and increasing penalties for IP rights violations. In agriculture, China has implemented more than half the agreed-upon provisions to dismantle technical trade barriers, according to U.S. Agriculture Department officials, but its ability to meet purchase targets is questionable given the hit to domestic demand from COVID-19. The deal includes a provision mandating consultations in the event of "a natural disaster or other unforeseeable event," but as of late May, U.S. and Chinese officials said the deal remains intact and China plans to implement it. President Trump has indicated China's failure to meet targets could be met with more U.S. tariffs, withdrawal from the agreement, or cancelation of U.S. debt obligations with China, while also acknowledging limitations on China's ability to meet targets under coronavirus impacts. While the deal was unlikely to stabilize the bilateral relationship even pre-COVID, the pandemic and the heated back and forth between U.S and Chinese officials since its spread diminish that possibility even more.

Broader U.S. export controls and strong signals of mounting geoeconomic competition will limit any bilateral trade rebound. U.S. trade policy aggression also risks retaliation from China. In April, Beijing temporarily imposed export restrictions on critical medical equipment and protective gear. Official intentions were to ensure domestic supply and to control quality, after some governments reported receiving faulty ventilators and tests from China. China's Ministry of Commerce, the General Administration of Customs, and the State Administration for Market Regulation have since relaxed export certification requirements as spiking demand around the world has put supply chains under pressure. Several governments are advocating for re-shoring manufacturing activity to boost domestic production and reduce reliance on imports from China.

COVID-19 has reduced China's goods imports and exports by 2.4% and 11.3% year-on-year, respectively, which will complicate the reform outlook. China has proceeded with several waves of U.S. tariff reductions to reduce costs and has resumed some U.S. purchases. However, the coronavirus's shock to domestic activity caused goods exports and tourism imports to fall sharply. The political fallout from the virus outbreak is causing some governments and companies to reconsider their reliance upon supply chains from China. At the same time, China is ramping up domestic production capacity—likely to be in high demand in 2020—which could lead to overcapacity in the future. If these mitigation strategies become a reality, they will reshape China's trade patterns in the quarters to come.