

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 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

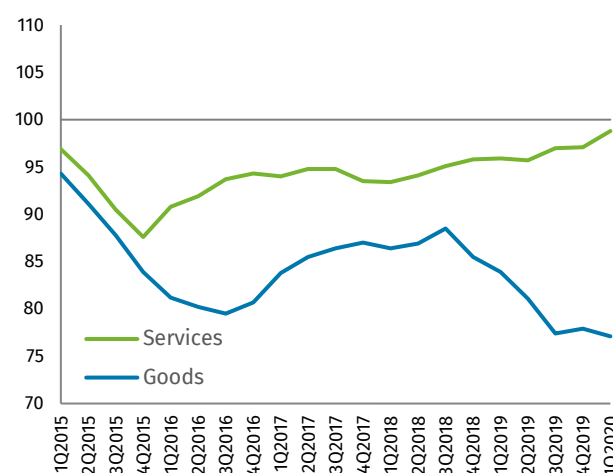
- Our assessment of trade policy reform in 1Q2020 is unchanged from the prior quarter. Imports for consumption declined even more than GDP growth, while services imports (excluding tourism) improved but remain below the 2014 level.
- The COVID-19 pandemic disrupted trade patterns significantly. Restrictions on workforce migration and activity reduced Chinese exports more than imports. As a result, China's current account surplus narrowed and overcapacity goods exports fell.
- China's trade policy focus shifted in 1H2020 away from implementation of its Phase One deal with the United States toward coping with the economic fallout from the COVID-19 crisis. A new focus on "internal circulation" suggests that domestic economic drivers are being prioritized in anticipation of weaker external demand.

This Quarter's Numbers

Trade was altered by COVID-19, making new conclusions about trade openness impossible. Our primary indicator, the **Composite Trade Liberalization Index (CTLI)**, shows increased openness in services trade but a continued decline in goods trade in 1Q2020. China's goods imports in 1Q2020 fell by 2% in value terms due to falling oil prices but rose by 6.7% in volume terms, led by rising imports of raw materials. Those aside, the CTLI (which excludes crude oil, iron ore, and integrated circuits) shows imports for consumption falling relative to GDP: a negative for trade reform.

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.

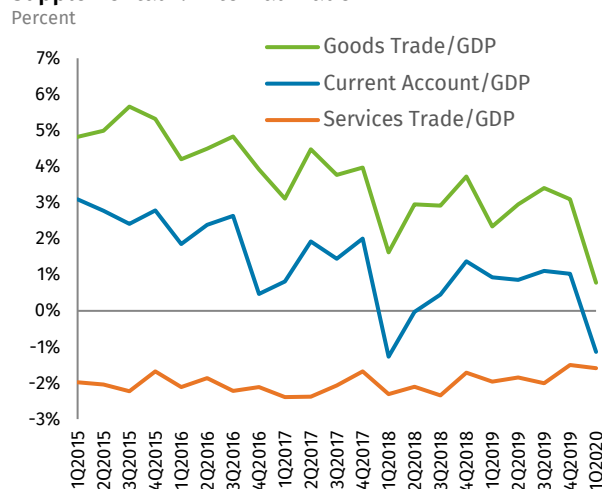
The COVID-19 crisis reduced China's exports more than its imports in 1Q2020. Restrictions on workforce migration and nonessential economic activities affected labor-intensive manufacturing, causing exports to decrease significantly, which led to a rare current account deficit of USD 34 billion in the first quarter. Weak exports reduced China's *goods* trade surplus to 0.8% of GDP in 1Q2020, down from 2.3% in 1Q2019 (see **External Trade**). This rebounded in the second quarter as production resumed and demand for medical and protective equipment abroad surged. A weaker renminbi helped (see **Exchange Rate Fluctuation**).

Services trade was also negatively affected by the pandemic. Fallout from the virus led to a 14.5% decline in the services trade deficit in 1Q2020, with exports falling 8.4% year-on-year (yoy) and imports by 17.6%. Tourism and transportation services accounted for most of the fall as people traveled much less, with Chinese travelers spending USD 19 billion less abroad on tourism in 1Q2020 than in 1Q2019. Our metrics of **Services Trade Openness** exclude tourism, which typically reflects some capital outflows in addition to tourism spending. While most service sectors saw imports fall in 1Q2020, telecommunications, computer, and other information services imports surged 34% yoy to USD 8 billion. Telecom exports have continued rising for 10 consecutive quarters.

Other indicators point to the improved structure of China's trade (meaning less reliance on export-oriented growth) but reflect COVID-19 distortions. Intermediate imports used as manufacturing inputs and reexported have continued to fall relative to total exports (see **Structural Change in Goods Trade**), which normally would indicate economic growth that is less export led and

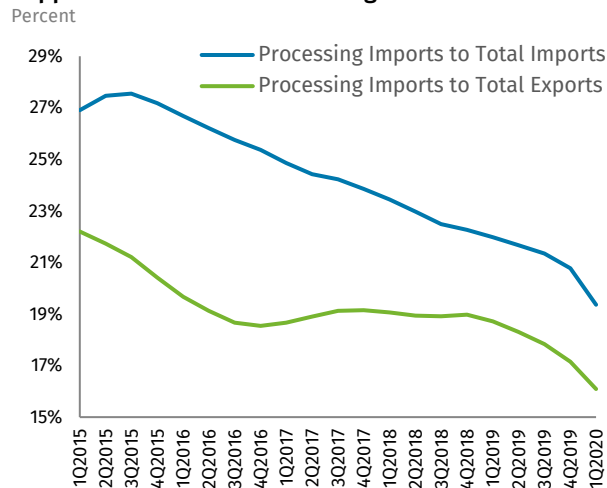
more consumption driven, but the CTLI indicates imports for consumption remain weak. Likewise, China's net exports of overcapacity goods like steel and aluminium products have fallen relative to previous quarters (see **Trade in Overcapacity Goods**), but this reflects the shock to external demand and reduced domestic activity from the pandemic, rather than a meaningful resolution of problems related to unproductive firms.

Supplemental 1: External Trade



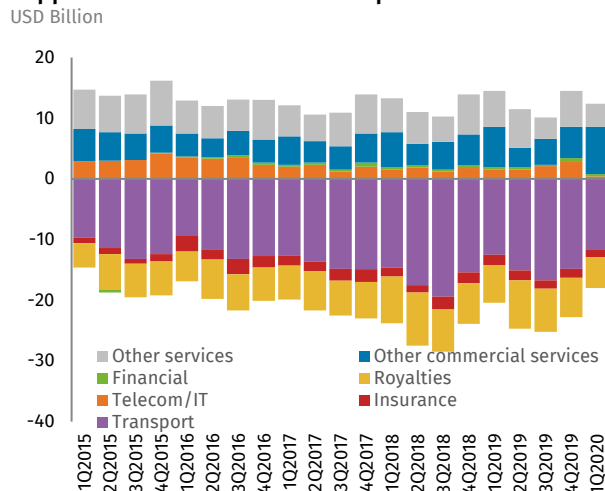
Source: State Administration for Foreign Exchange.

Supplemental 2: Structural Change in Goods Trade



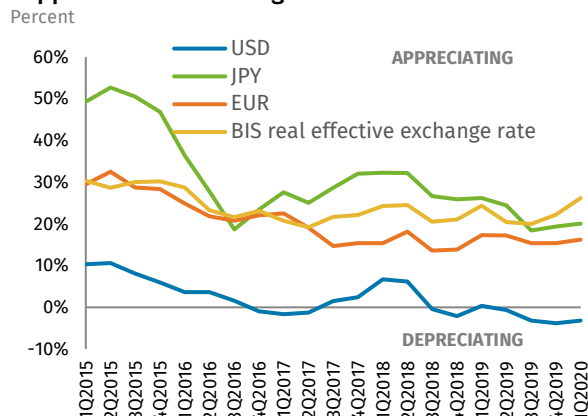
Source: General Administration of Customs.

Supplemental 3: Services Trade Openness



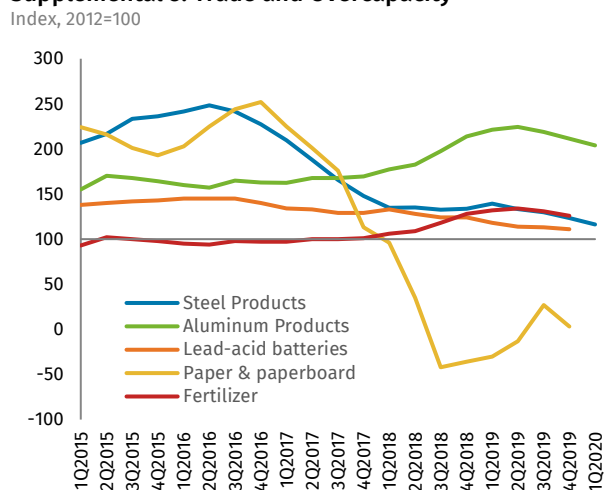
Source: State Administration of Foreign Exchange.

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

China's trade policy focus in 1H2020 shifted from managing the U.S. trade relationship and implementing the Phase One trade deal to responding to the economic fallout from the COVID-19 pandemic. Beijing has signaled that it plans to focus increasingly on domestic economic drivers, raising questions about its future trade openness.

Implementation of the purchasing targets contained in the Phase One deal has been slow at best. In the first six months of 2020, China met 57% of its full-year 2020 import target in manufacturing goods, 39% of agricultural products, and 22% of the target in covered energy products, according to the Peterson Institution for International Economics ([PIIE](#)). For other commodities (for which there are no targets), U.S. exports to China fell by 28%, compared with a 2017 baseline. These targets are increasingly unrealistic due—in addition to their questionable initial design—to the COVID-19 crisis and the mounting political tensions between the United States and China. The looming U.S. election could also be a factor in how China approaches its trade relationship with the United States for the remainder of 2020. China's implementation of the “rules” part of the Phase One deal, in such areas as intellectual property rights, financial services, and agriculture non-tariff measures, appears to be largely on track.

The COVID-19 outbreak transformed Beijing's thinking on trade policy. With employment a growing concern, China's government is doubling down on labor-intensive industries. In the past, policy had been aimed at shifting out of labor-intensive industries in the export sector, as they were seen as less innovative and less competitive. But a State Council Executive Meeting, held on July 22, prioritized the development of such industries. Mid-year data suggest a shift in exports to emerging markets (Africa, Latin America, ASEAN) from the United States and the European Union. Ultimately, an economic plan that reverts to polluting, investment-intensive exports is a step backward for reform.

Employment is also a focus of the new internal circulation strategy, which was discussed at Politburo meetings in May and July. The strategy aims to shift the economic balance toward China's vast domestic market, although China's leaders have stressed that they are not turning their back on international trade. In part, the approach reflects a new reality of weaker external demand tied to virus-induced economic slumps around the world combined with growing questions about economic engagement with China within the United States and other OECD countries. Elements of this new strategy are likely to feature in the 14th Five-Year Plan—China's most

important medium to long-term economic development strategy for 2021–2025, to be unveiled early next year. By elevating the focus on domestic market demand, Beijing is acknowledging a tougher and less predictable external environment.