China’s Gradual Opening to Trade (1978-1992)

The Starting Position (trade under planning)

The Pre-Reform Trade Regime

Up through the 1970s, Chinese trade took place within the context of a planned economy and therefore nearly all trade was subject to very exacting quantitative guidelines. The State Planning Commission’s import plan covered more than 90 percent of all imports. The export plan was similarly comprehensive, specifying the physical quantities of more than 3,000 individual commodities. Prior to 1978, a handful of foreign trade corporations owned and controlled by the Ministry of Foreign Trade were responsible for carrying out the import and export plans. In this context, neither exports nor imports were sensitive to exchange rates or relative prices. Furthermore, the composition of Chinese trade had little connection to Chinese comparative advantage, with capital-intensive goods, including refined petroleum products, playing a large role in Chinese exports well into the early 1980s. As a consequence, the volume of Chinese trade, relative to world trade, declined sharply from 1.5 percent in 1953 to 0.6 percent in 1977 (Lardy 1994, 2).
Potential Gains from Trade Opening

1. Productivity gains from specialization according to comparative advantage
   (switch workers from production of steel to the production of textiles)

2. Productivity gains from adoption of new technology and knowledge transfers
   (from foreign joint ventures)

3. Productivity gains from taking advantage of scale economies

4. Consumer gains from appearance of new products, greater product variety,
   and increased competition

Potential Dangers from Trade Opening

1. Losers from trade according to comparative advantage (recall Heckscher-Ohlin Theory and the Factor Price Equilization Theorem)

2. “Spiritual Pollution” from foreign ideology (e.g. Christians and Hollywood)

3. World Price shocks
Reasons for Opening

1. Lessons from the Great Leap Forward (losses from efforts to be self sufficient)

2. “Learning Truth from Facts” – Advances made by Singapore, Hong Kong, and Taiwan

3. Failure of PRC oil exports to earn sufficient foreign exchange to finance imports needed to supplement planned production
Early Moves to Open the Trade Sector

1. **Special Economic Zones (“One Country, Two Systems”)**

In 1979, Chinese government officials visited Singapore, an exported driven city state. Using the Singapore model, starting in 1980, China opened several SEZs in southern China close to Hong Kong (and Taiwan). Producers in these zones could import materials and components free of many regulations and tariffs. The Chinese government also provided substantial subsidies for infrastructure. In 1984, China established similar arrangements in 14 other coastal cities.
2. **1978-93: Dual exchange rate (FEC & RMB)**

The enterprises were permitted to retain a portion of their foreign exchange earnings. Domestic currency, RMB, was devalued in favor of exports. Various financial institutions were allowed to involve in foreign exchange business. Restrictions on domestic individuals' foreign exchange receipts were relaxed. The foreign exchange certificate (FEC) was introduced in order to encourage foreign exchange inflows and sales for RMB from overseas Chinese residents.

- Domestic residents were prohibited to possess FEC.
- The exchange rate of FEC was 20% higher than the value of RMB.
3. **Exchange Rate Devaluation**

Like most other planned “socialist” economies, the China’s exchange rate was overvalued at the beginning of the reform. The over valued exchange rate subsidized the importation of capital goods needed for the economic plan. It also led to an excess demand for foreign currency, a rigid system of controls, limitations on who could legally hold foreign exchange, and a vibrant black market.

During the 1980s, Exporters were helped by a substantial devaluation of the official exchange rate, from 1.5RMB/$ in 1981 to 8.3RMB/$ in 1995. While China did experience higher rates of inflation than the US, the IMF states that this represents a 70% devaluation in real terms.
4. The Double Air Lock (see Naughton around pages 380-381)

From 1986 to the mid 1990s, China used a dual currency system. Chinese could legally hold and transact only in RMB (people’s money). Foreigners and imported products could use Foreign Exchange Certificates. And, only state companies (12 FTCs) that were approved and part of the economic plan had the right to engage in trade. Domestic prices remained set by the government and were insulated from world prices.

   a. One Country – Two Currencies
   b. Monopolization of Trading Companies

Throughout the 1980s China continued to restrict the rights to engage in trade. Still, that was an increase in the number of firms allowed to conduct international firms, from 12 in 1978 to 5000 in 1988.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Companies</th>
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<tbody>
<tr>
<td>1978</td>
<td>12</td>
</tr>
<tr>
<td>1985</td>
<td>800</td>
</tr>
<tr>
<td>1986</td>
<td>&gt;1,200</td>
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<tr>
<td>1988</td>
<td>&gt;5,000</td>
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<tr>
<td>1996</td>
<td>12,000</td>
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<tr>
<td>1997</td>
<td>15,000</td>
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<tr>
<td>1998</td>
<td>23,000</td>
</tr>
<tr>
<td>1999</td>
<td>29,528</td>
</tr>
<tr>
<td>2000</td>
<td>31,000</td>
</tr>
<tr>
<td>2001</td>
<td>35,000</td>
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</tbody>
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5. Tariffs

Tariffs actually increased during the early 1980s. This was part of a longer term strategy of first turning non tariff barriers into tariff barriers, and then, reducing the tariffs en route to ultimate membership in the WTO (finished in 12/2003). While China’s tariffs were high in the early 1980s, they were not unusually high for a developing country.

Figure 1 Tariff Revenues as a Fraction of Import Value, 1978-2002

6. Corruption

While the gradual reforms can be said to have ushered in markets and trade to avoid unsustainable, short term shocks, the two track system opened the door to what is usually labeled as corrupt behavior.

In practice, it is clear that the authorities have never been able to separate China's two trade regimes as completely as the letter of the law would suggest. Substantial quantities of parts and components imported on a duty-free basis have been illegally sold in the domestic market, and there have been substantial illegal sales in the domestic market of goods embodying duty-free imports. In addition to "leakage" into the domestic market of goods imported under the export processing regime, there has been a significant degree of outright smuggling, much of it via Hong Kong.⁴

Hong Kong recorded by Chinese trade statistics.⁵ Hong Kong was America's fourth largest market for U.S. pork in 1999, but more than half of that product subsequently made its way into China.⁶ Fisman and Wei (2004) conduct an interesting systematic study of the discrepancies between Hong Kong and mainland Chinese trade statistics, which they term the "evasion gap." Their estimates suggest that an increase in the total import tax rate of 1 percent increases the evasion gap by 3 percent!⁷
Trade Outcomes

Trade in the late 1980s and early 1990s
Naughton concludes that by the late 1980s Chinese imports and exports had changed from the old “export oil so that we can buy heavy industrial technology”, to a system that “overwhelmingly” corresponds to trade according to comparative advantage as determined in the Heckscher Ohlin model. Chinese is abundant in labor and began exporting products of labor intensive industry (clothing, shoes, toys). Arable land is scarce in China and China began importing (in Naughton’s phrase), goods that were “land substitutes” (fertilizer, synthetic materials).

China’s Imports From the US (1989-1995)

Note the increase in Chinese imports of fertilizer.

China’s Exports to the US (1989-1995)

Note decline in petroleum exports and increase in clothing and toy related exports

Naughton quotes the following summary statistics

<table>
<thead>
<tr>
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<th>Extractive (ag. and oil)exports as % of total exports</th>
<th>Labor intensive exports as % or total exports</th>
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<tr>
<td>1984</td>
<td>49%</td>
<td>37%</td>
</tr>
<tr>
<td>1994</td>
<td>15%</td>
<td>54%</td>
</tr>
</tbody>
</table>
Recent Trade Trends

**China’s Imports From the US (1997-2007)**

Fun Trivia Question: During 2007 “aerospace products and parts” was the largest category of US exports to China. The (close) second largest category was
a. Oilseeds and grains
b. Resin and synthetic rubber
c. Computer equipment
d. Waste and scrap

Go through this table and identify areas where the US has a comparative advantage.

**China’s Exports to the US (1997-2007)**

One more trivia question:
In 1997 the top 5 categories of Chinese exports to the US were
1. Miscellaneous Manufactured equipment
2. Footwear
3. Apparel
4. Audio and Video Equipment
5. Computer Equipment
In 2007 which of the above was now #1?

Note that these numbers are not what you first think. Suppose China imported all the components of a Television from Japan, assembled TVs in one of its special economic zones, and then exported the assembled TV to the US. The trade numbers would show a big increase in both the imports and exports for China and a decrease in trade between Japan and the US.