

# SOURCES OF CHINA'S HIGH-SUSTAINABLE GROWTH, PART III

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*How the “Open-Door” policy has transformed China*

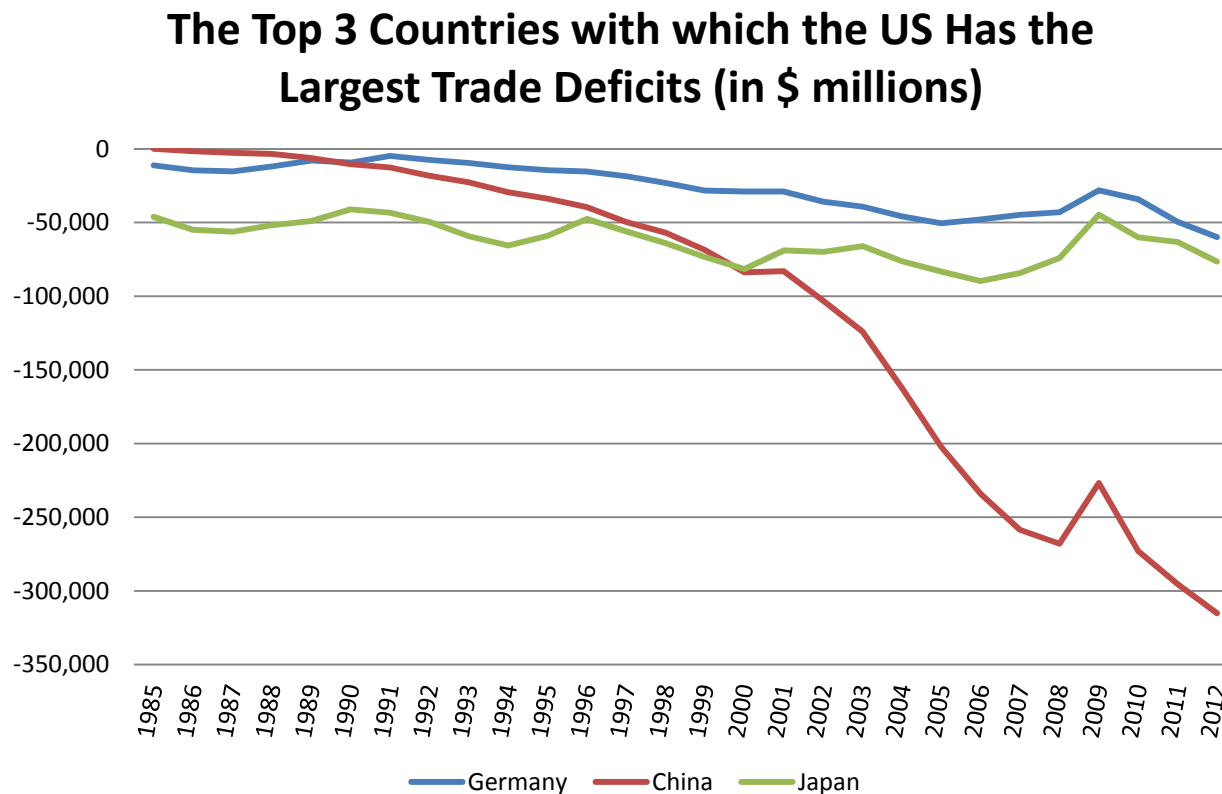
Paul Deng  
Nov. 5, 2013

# What's happening

- US fires on Germany, charging its trade policies “are dragging down the euro zone and global economy.”
- The U.S. put Germany ahead of China...and noted pointedly that in 2012 Germany's nominal current-account surplus was larger than that of China.

# What's happening

- US blasts Germany for running a huge trade surplus



Note: trade in goods only.

# Trade and Economic Growth

Michael Spence:

*“There are no examples of sustained high growth in the postwar period that do not involve integration into the global economy.”*

- in “Why China Grows So Fast”, *WSJ*, 2007



2001 Nobel Prize  
Winner in Economics

# China's Reform and Opening-up

- Reform (改革)
- Opening-up or “*open-door*” policy (开放)
  - Trade
  - FDIs
  - Cultural and educational exchanges
- Opening up in **three big waves**:
  - 1979, initial opening - special economic zones (SEZs)
  - 1987, coastal development strategy - “Open Cities”
  - 1992, after Deng Xiaoping's Southern Tour
  - 2013, another wave in the making?

## Major Events Timeline

- Late 1970s, foreign-trade was monopolized by the state; most trade took place with Soviet-bloc economies
- First SEZ was established in Shenzhen (深圳) in 1979/80
  - Three other SEZs approved around the same time: Zhuhai (珠海), Shantou (汕头), Xiamen (厦门)
- 1988, Hainan Province (海南) was established, also the largest SEZ
- Deng Xiaoping's *Southern Tour* in 1992 further boosted opening-up of China
  - In 1993, Shanghai Pudong New Area (or 浦东新区) was established
- China joined WTO on Dec. 11, 2001 (first applied membership in 1986; it took 15 years of tough negotiations)

## Deng's Southern Journey, 1992

- After 1989 Tian'anmen Incident, the conservative faction inside CCP wanted to reverse the reform policy. The SEZs were too capitalistic in their eyes: they wanted no “foreign exploitation of Chinese workers”.
- Then already retired Deng Xiaoping, who still held ultimate power inside CCP, sent a strong message to the wavering leadership led by Jiang: just shut up!
- Of course, Deng did not shout it out to his opponents. Instead, in a typical Chinese way of expressing his opinion indirectly, he chose to make a personal trip to Shenzhen Special Economic Zone.
- He made two famous comments during his visit:
  1. *No matter it's a yellow cat or a black cat, a cat that can catch a mouse is a good cat (referring to socialism vs. capitalism).*
  2. *Capitalism can have government planning; socialism can also embrace market.*

坚持党的基本路线一百年不动摇



Shenzhen Special Economic Zone  
30 Years



# Mapping China's SEZs



# China's Three Major Economic Clusters



## Trade used to be monopolized by the state, but no more....

**Table 1**      **Growth in Companies Authorized to Conduct Foreign Trade**

Year	Number of Companies
1978	12
1985	800
1986	>1,200
1988	>5,000
1996	12,000
1997	15,000
1998	23,000
1999	29,528
2000	31,000
2001	35,000

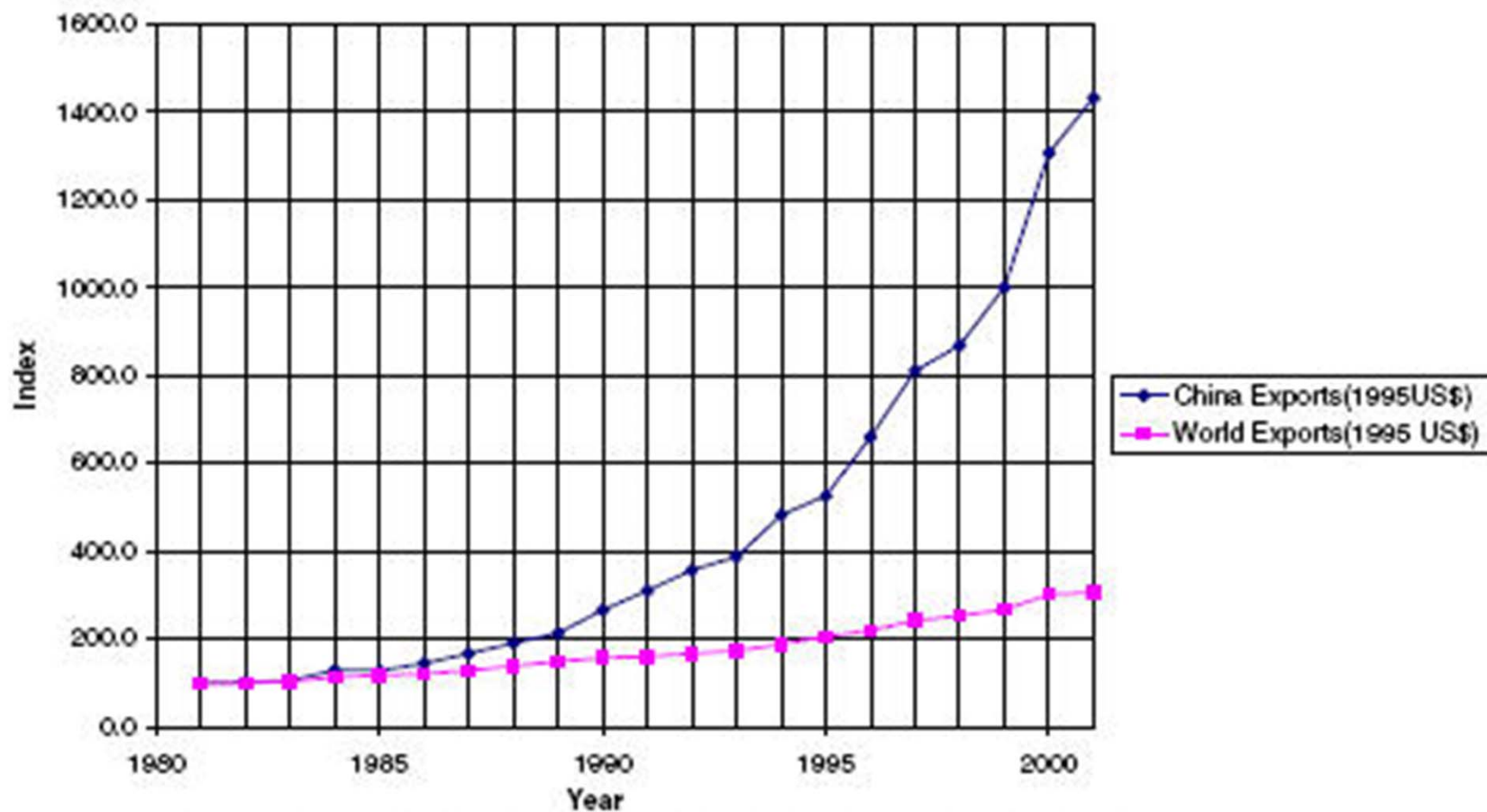
# Import tariffs were dramatically lowered

Table 1: China's import tariffs

	Unweighted average	Weighted average	Dispersion (st. dev)	Maximum
1982	55.6	..	..	..
1985	43.3	..	..	..
1988	43.7	..	..	..
1991	44.1	..	..	..
1992	42.9	40.6		220.0
1993	39.9	38.4	29.9	220.0
1994	36.2	35.5	27.9	..
1995	35.2	26.8	..	220.0
1996	23.6	22.6	17.4	121.6
1997	17.6	16.0	13.0	121.6
1998	17.5	15.7	13.0	121.6
2000	16.4	..	..	..
2001	15.3	9.1	12.1	121.6
2002	12.3	6.4	9.1	70.0

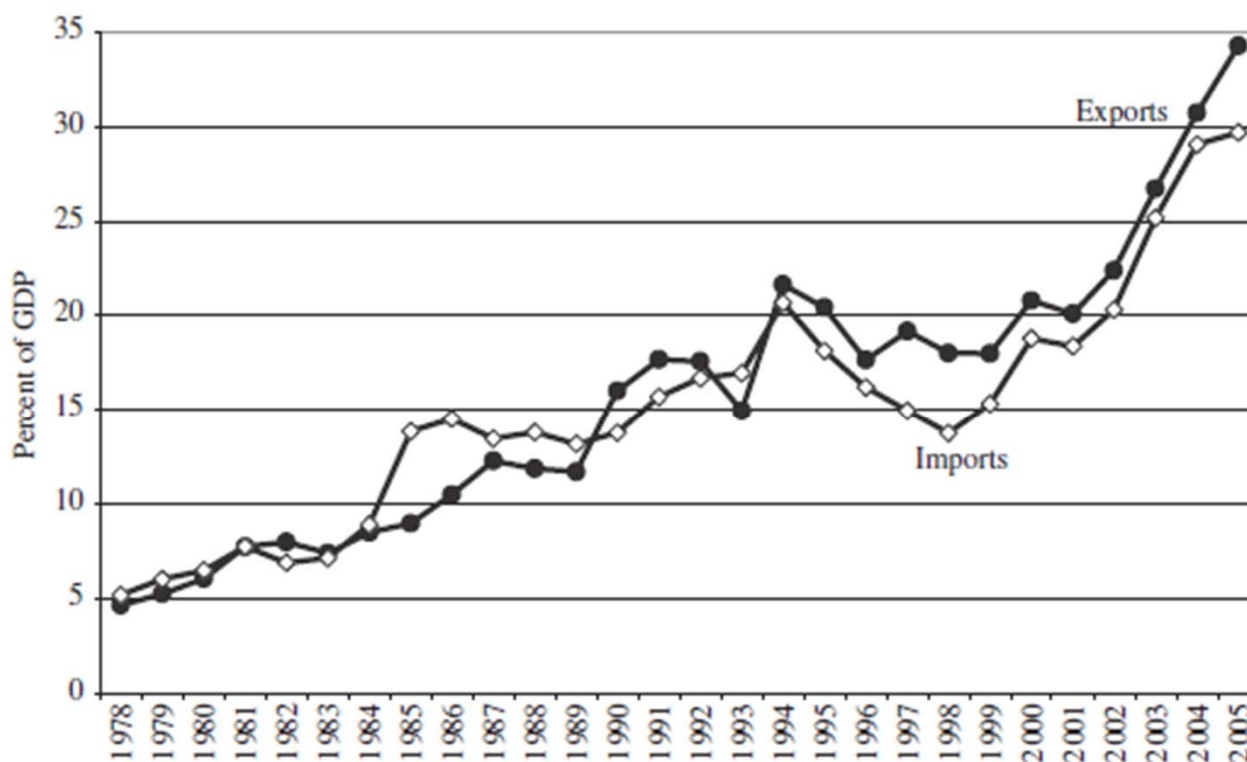
Source: Prasad (2004), p. 10.

## China's trade growth dwarfs the world average



\*International Monetary Fund (2002), International Financial Statistics, Washington,

## China has become remarkably open to trade



**Figure 16.1**  
Exports and imports (share of GDP)

In 2005, China's total goods trade (import+export) accounted for **65% of its GDP**; while the same ratio for the US and Japan is only around 20%. This ratio is unusually high for a large economy.

## Is China merchantilist?

- Merchantilist trade policy, or merchantilism, refers to the policy belief that a country can increase its welfare through expanding its exports, while limiting its imports.
- In the age of Gold Standard, merchantilism implies an accumulation of gold.
- It was the doctrine most major trading powers practiced in most part of the 19<sup>th</sup> century, before Adam Smith and David Ricardo argued forcefully it was flatly wrong.
- China was widely accused of practicing merchantilism in modern era by increasing its own welfare at the expense of others. But as one can easily see from the previous graph, China's imports always followed the trend growth of its export – for evidence of merchantilism, one would expect to see export growth diverges from import growth
- However, we indeed observed some elements of merchantilist-like trade policies in China, such as government's support of its export sector through various subsidies. But again, this is not unusual in most developed countries: e.g., EU's farm subsidies and US' sugar subsidies.

# Exports are geographically concentrated

*Link the following table to China's three major economic clusters*

Regional shares of China's exports (percent)

	1978	1994–1998	2005
Southeast	16	46	36
Lower Yangtze	34	21	38
Northeast and North Coast	39	23	19
Rest of China	11	10	7

Southeast: Guangdong, Fujian, and Hainan.

Lower Yangtze: Shanghai, Jiangsu, and Zhejiang.

Northeast and North Coast: Liaoning, Jilin, and Heilongjiang; Beijing, Tianjin, Hebei, and Shandong.



**What role has exchange rate played?**

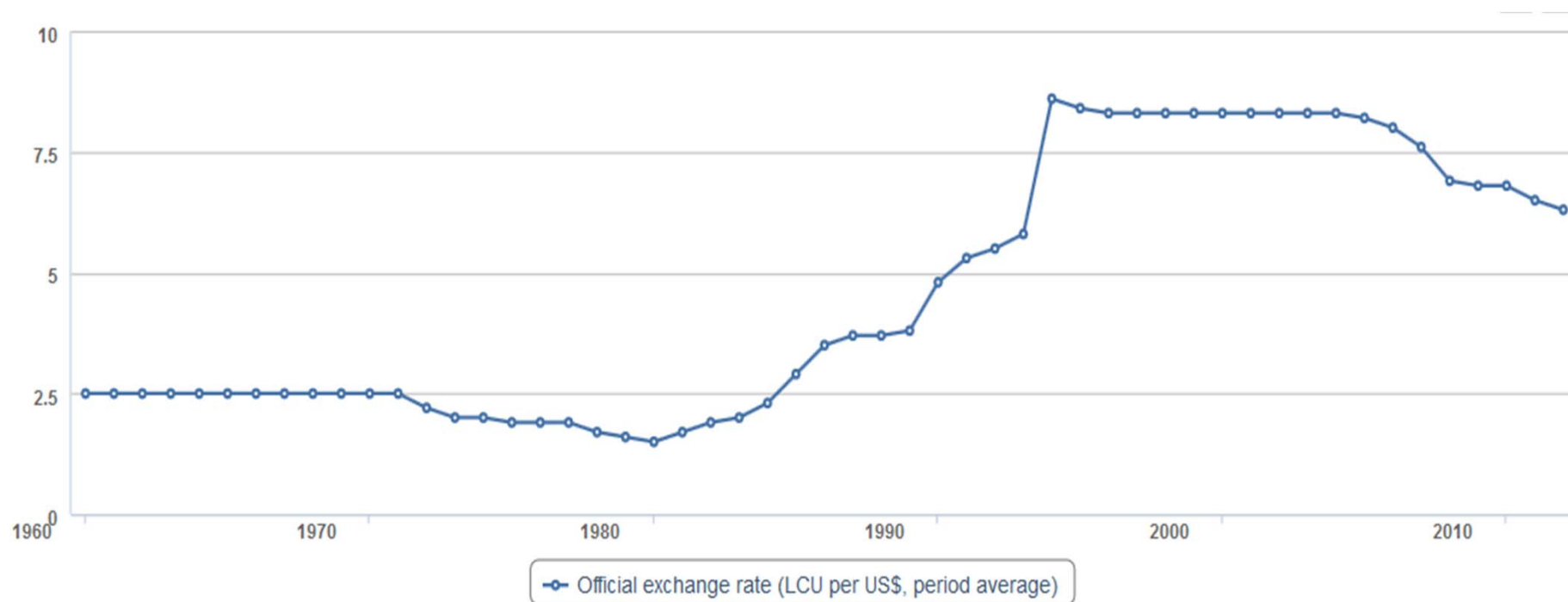
# The Role of Exchange Rate

- China's exchange rate was seriously overvalued before opening up: 1.68 Yuan in exchange for \$1 in 1978. As a closed economy with little export, there was a serious lack of foreign exchange reserves, such as US dollar. Currency blackmarket in 1980s was widespread.
- The currency overvaluation was a deliberate policy choice --- In order to import heavy machinery and equipment to support its heavy industry development in Mao's time, exchange rate had to be set high so to make imports cheaper. This policy persisted into 1980s.
- But heavy industry is capital-intensive by nature, which runs in conflict with China's comparative advantage: labor abundant (or labor intensive).
- Essentially, China's old industrial policy was import-substitution (versus export promotion). Like Latin American countries, it failed miserably.

# The Role of Exchange Rate

- With early experience in SEZs, China gradually learned the benefits of opening up to the world trade. In early 1990s, in the aftermath of *Tian'anmen Incident*, to spur its exports and reaffirm its open-door policy, Chinese policy makers allowed its currency to depreciate drastically
  - from 3.76 Yuan/\$ in 1989 to 8.62 Yuan/\$ in 1994, which represents a 56% depreciation against US \$ in 5 years
- In the next ten years, until 2005, China's exchange rate in terms of \$ barely moved, remaining above 8 Yuan/\$, despite the fact that its income had risen dramatically
  - this was the origin of the currency tension between the US and China
  - The US accused China of having an artificially undervalued currency
- Then from 2005, China started to appreciate its currency gradually. From 2005 to 2009, China had appreciated its currency by 22%
  - In Sept. 2013, the exchange rate stands at 6.12 Yuan per US\$.

# China's exchange rate: Yuan/\$



Source: World Development Indicators

# The Role of Exchange Rate

- China's devaluation of its currency in early 1990s contributed to the fast rising of the country's export. No doubt about it.
- But as we shall see, currency is not the fundamental reason for a country to run trade surplus. A simple math is sufficient to illustrate the point:
  - In 2010, Chinese manufacturing wage, on average, was only 10% of the US
  - In 2010, the exchange rate was at 6.8 Yuan per \$
  - Even if we allow Chinese currency to appreciate drastically by 50% against \$, i.e., from 6.8 Yuan to 4.5 Yuan per \$, Chinese wage will still be only 15% of the US wage --- a huge difference
- As we know, wages in developing countries are generally much lower than in developed countries. So even without currency devaluation, China's exports will still be very competitive in the world's market
- A trickier question is: why not just pay Chinese workers the same wage as the US workers?

# Ordinary vs. Processing Trade

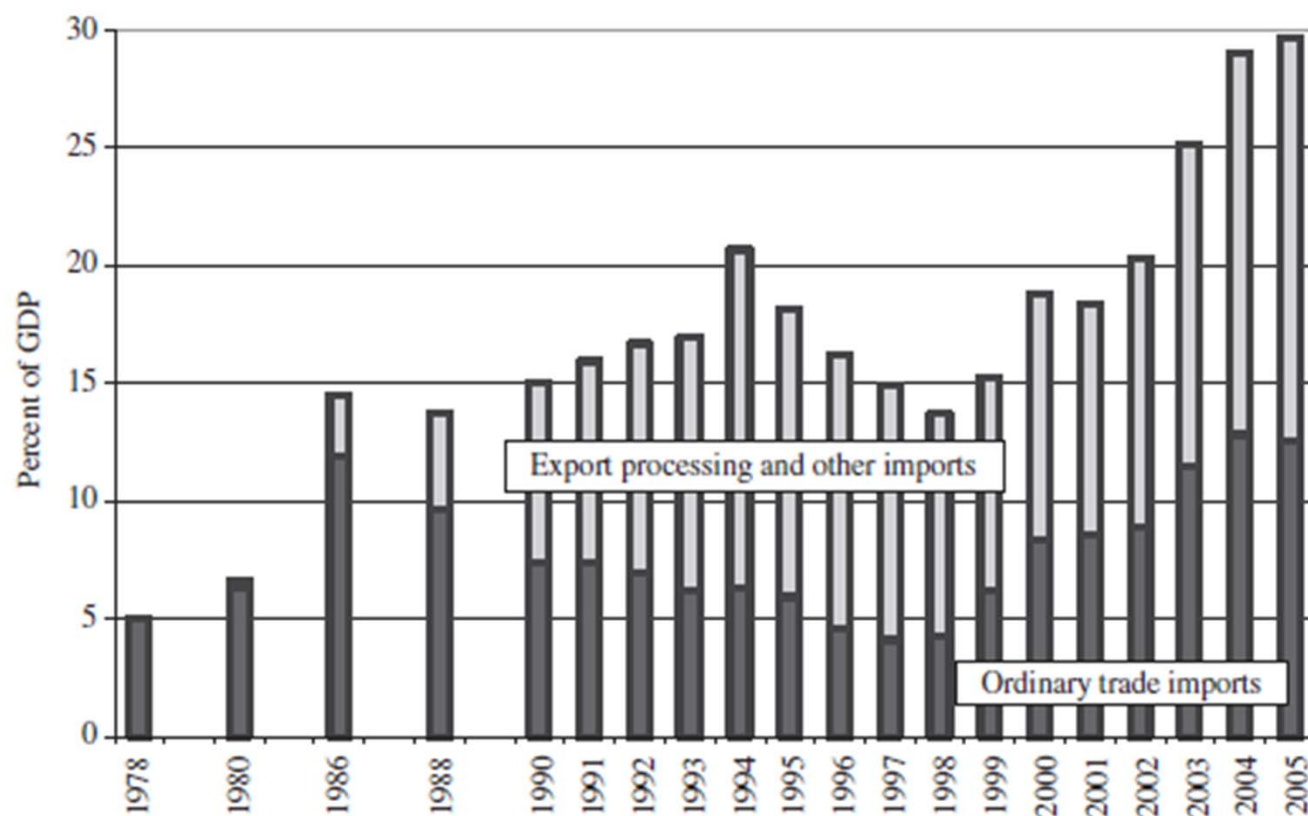
# Ordinary Trade vs. Processing Trade

**Table 1: China's Exports and Imports, By Ordinary and Processing Trade  
(Billions of U.S. dollars and Share of total value)**

Year	Billions of U.S. dollars				Share of total export or import value			
	Export		Import		Export		Import	
	Ordinary	Processing	Ordinary	Processing	Ordinary	Processing	Ordinary	Processing
1992	43.7	39.6	33.6	31.5	0.51	0.47	0.42	0.39
1993	43.2	44.2	38.0	36.4	0.47	0.48	0.37	0.35
1994	61.6	57.0	35.5	47.6	0.51	0.47	0.31	0.41
1995	71.4	73.7	43.4	58.4	0.48	0.50	0.33	0.44
1996	62.8	84.3	39.4	62.3	0.42	0.56	0.28	0.45
1997	78.1	99.7	39.0	70.2	0.43	0.55	0.27	0.49
1998	74.2	104.4	43.7	68.6	0.40	0.57	0.31	0.49
1999	79.2	110.9	67.0	73.6	0.41	0.57	0.40	0.44
2000	105.2	137.6	100.1	92.6	0.42	0.55	0.44	0.41
2001	111.9	147.4	113.5	94.0	0.42	0.55	0.47	0.39
2002	136.2	179.9	129.1	122.3	0.42	0.55	0.44	0.41
2003	182.0	241.8	187.7	162.9	0.42	0.55	0.45	0.39
2004	243.6	328.0	248.2	221.7	0.41	0.55	0.44	0.39
2005	315.1	416.5	279.7	274.0	0.41	0.55	0.42	0.42
2006	416.3	510.4	333.2	321.5	0.43	0.53	0.42	0.41

Source: China Customs Statistics (1992-2006)

## Evolution of China's Imports: Ordinary vs. Processing



**Figure 16.3**  
Openness measures of the Chinese economy



## Foreign firms have increasingly played a dominant role in processing trade

Share of export or import value in ordinary or processing trade								
Year	Export				Import			
	Ordinary		Processing		Ordinary		Processing	
	FIEs	Other	FIEs	Other	FIEs	Other	FIEs	Other
1992	0.05	0.95	0.39	0.61	0.05	0.95	0.45	0.55
1993	0.09	0.91	0.48	0.52	0.06	0.94	0.53	0.47
1994	0.07	0.93	0.54	0.46	0.05	0.95	0.59	0.41
1995	0.06	0.94	0.57	0.43	0.12	0.88	0.63	0.37
1996	0.12	0.88	0.63	0.37	0.17	0.83	0.67	0.33
1997	0.13	0.87	0.64	0.36	0.22	0.78	0.68	0.32
1998	0.14	0.86	0.66	0.34	0.22	0.78	0.70	0.30
1999	0.16	0.84	0.67	0.33	0.25	0.75	0.72	0.28
2000	0.19	0.81	0.71	0.29	0.26	0.74	0.74	0.26
2001	0.22	0.78	0.72	0.28	0.27	0.73	0.75	0.25
2002	0.23	0.77	0.75	0.25	0.27	0.73	0.77	0.23
2003	0.24	0.76	0.79	0.21	0.29	0.71	0.81	0.19
2004	0.26	0.74	0.81	0.19	0.29	0.71	0.83	0.17
2005	0.27	0.73	0.83	0.17	0.29	0.71	0.84	0.16
2006	0.28	0.72	0.84	0.16	0.32	0.68	0.85	0.15

Source: China Customs Statistics (1992-2006)

## FIEs and Processing Trade

- In 2006, around 55% of China's exports, and 40% of its imports are processing trade
- In the same year, FIEs account for almost 85% of processing trade for both export and imports
- In other words, over **45%** ( $=55\% \times 85\%$ ) of China's exports and nearly **35%** ( $=40\% \times 85\%$ ) of China's imports are processing trade done by foreign firms alone
- Remember this fact when you discuss trade imbalances in the future

## Ordinary Exports by Major Industries

**Table 4: Ordinary Exports By Major Industries (Share of Total Value)**

Year	Animals, Food	Minerals, Wood	Chemicals, Plastics	Textiles	Footwear, Headgear	Metals, Articles	Machinery, Electrical	Transport	Misc. Manufact.
1992	0.21	0.18	0.09	0.32	0.02	0.06	0.06	0.02	0.03
1993	0.18	0.16	0.10	0.35	0.03	0.06	0.07	0.01	0.04
1994	0.17	0.13	0.09	0.37	0.03	0.06	0.07	0.01	0.05
1995	0.14	0.16	0.11	0.31	0.03	0.08	0.09	0.02	0.06
1996	0.15	0.17	0.12	0.29	0.03	0.08	0.08	0.02	0.06
1997	0.13	0.16	0.11	0.32	0.03	0.08	0.08	0.01	0.07
1998	0.14	0.14	0.12	0.31	0.04	0.09	0.08	0.01	0.07
1999	0.12	0.13	0.12	0.30	0.04	0.09	0.11	0.02	0.07
2000	0.11	0.13	0.11	0.30	0.03	0.10	0.11	0.03	0.08
2001	0.11	0.14	0.11	0.29	0.04	0.09	0.13	0.03	0.08
2002	0.10	0.12	0.11	0.30	0.04	0.09	0.14	0.03	0.08
2003	0.09	0.12	0.10	0.30	0.04	0.09	0.15	0.03	0.08
2004	0.07	0.11	0.10	0.28	0.03	0.12	0.16	0.03	0.08
2005	0.06	0.11	0.10	0.27	0.03	0.13	0.17	0.04	0.08
2006	0.05	0.09	0.10	0.26	0.03	0.16	0.18	0.04	0.08

**Source:** China Customs Statistics (1992-2006)

## Processing Exports by Major Industries

**Table 6: Processing Exports By Major Industries (Share of Total Value)**

Year	Animals, Food	Minerals, Wood	Chemicals, Plastics	Textiles	Footwear, Headgear	Metals, Articles	Machinery, Electrical	Transport	Misc. Manufact.
1992	0.02	0.04	0.05	0.33	0.10	0.05	0.22	0.03	0.15
1993	0.02	0.04	0.05	0.30	0.11	0.05	0.24	0.03	0.16
1994	0.03	0.04	0.05	0.28	0.10	0.05	0.27	0.03	0.15
1995	0.03	0.04	0.06	0.26	0.08	0.08	0.28	0.04	0.14
1996	0.03	0.04	0.06	0.26	0.08	0.06	0.30	0.04	0.14
1997	0.03	0.04	0.06	0.24	0.07	0.07	0.31	0.04	0.14
1998	0.02	0.04	0.06	0.22	0.07	0.05	0.35	0.05	0.14
1999	0.02	0.04	0.06	0.20	0.06	0.05	0.39	0.04	0.14
2000	0.02	0.04	0.06	0.18	0.05	0.04	0.43	0.04	0.13
2001	0.02	0.04	0.06	0.17	0.05	0.04	0.47	0.04	0.12
2002	0.02	0.04	0.05	0.14	0.04	0.04	0.52	0.04	0.12
2003	0.02	0.03	0.05	0.11	0.03	0.04	0.58	0.04	0.10
2004	0.01	0.03	0.05	0.10	0.03	0.04	0.61	0.04	0.10
2005	0.01	0.03	0.05	0.08	0.02	0.03	0.62	0.04	0.11
2006	0.01	0.03	0.05	0.08	0.02	0.03	0.63	0.04	0.10

**Source:** China Customs Statistics (1992-2006)