



# THE BROOKINGS INSTITUTION

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FOREIGN POLICY STUDIES PROGRAM

## NICHOLAS R. LARDY

Nicholas R. Lardy is a Senior Fellow in the Foreign Policy Studies program at the Brookings Institution, having joined the staff in September 1995. Lardy came to Brookings from the University of Washington, where he was the director of the Henry M. Jackson School of international Studies since 1991. Beginning in the fall of 1997, he is also the Frederick Frank Adjunct Professor of International Trade and Finance at the Yale University School of Management. He is an expert in Asia, especially the Chinese economy.

Before his directorship, Lardy had been a professor of international studies at the University of Washington since 1985 and an associate professor from 1983-1985. He was the chair of the China Program from 1984-1989. He was an assistant and associate professor of economics at Yale University from 1975-1983.

Lardy has written numerous articles and books on the Chinese economy. His current project at Brookings, *Integrating China in the Global Economy*, explores whether reforms of China's economy and its foreign trade and exchange rate systems will be sufficient to integrate it much more deeply in the world economy. The result of his previous project, *China's Unfinished Economic Revolution*, was published in September 1998. The study evaluates the reform of China's banking system and measures the economic consequences of deferring reform in the state-owned sector. Some of his other publications include: "China and the Asian Contagion." *Foreign Affairs*, Vol. 77, No. 4, (July/August 1998); "The Role of Foreign Trade and Investment in China's Economic Transformation." *The China Quarterly*, No. 144 (December 1995); *China in the World Economy* (Institute for International Economics, 1994); "Chinese Foreign Trade" *The China Quarterly*, No. 131 (September 1992); *Foreign Trade and Economic Reform in China, 1978-1990* (Cambridge University Press, 1992, paperback, 1993); *Agriculture in China's Modern Economic Development* (Cambridge University Press, 1983) and *Economic Growth and Distribution in China* (Cambridge University Press, 1978).

Lardy serves on the Board of Directors and Executive Committee of the National Committee on United States-China Relations, is a member of the Council on Foreign Relations; and is a member of the Editorial Board of *The China Quarterly*, the *Journal of Asian Business*, and the *China Economic Review*.

He received his B.A. from the University of Wisconsin in 1968 and his Ph.D. from the University of Michigan in 1975. both in economics.

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## **Is China a “Closed” Economy?**

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The rapid growth of China's foreign trade over a period of more than two decades is unprecedented. As shown in diagram 1, the growth of China's trade since 1978 has been four and a half times that of world trade. Indeed, in the post-war period no other country has increased its share of international trade so rapidly in a period of only two decades. China's share of world trade quintupled from 0.6 percent on the eve of reform in 1977 to 3.0 percent in 1998. This expanding trade is one of the major sources of China's economic growth, which also has been the most rapid of any country in the world over the past two decades. Rapid growth, in turn, has more than quadrupled per capita income and lifted approximately two hundred million Chinese out of abject poverty since 1978. China may be the best example ever of the linkage between expanding trade, accelerating growth, rising living standards, and poverty alleviation.

Some have argued that China has focused on promoting its exports while remaining largely closed to foreign goods. While China's trade system still has important protectionist elements, those who argue that "China is a closed economy" fundamentally misunderstand the dramatic transformation that has occurred in China since the late 1970s. Most important, China has become more open to foreign direct investment than any other country in East Asia. Indeed if judged by the magnitude of these inflows it is one of the most open emerging market economies in the world. Diagram 2 shows that annual foreign direct investment inflows grew from under \$1 billion annually in 1983 to more than \$45 billion in both 1997 and 1998 before declining to \$40 billion in 1999. For most of the 1990s China was far and away the largest emerging market recipient of foreign direct investment and from 1993 through 1997 it was the second largest global recipient of foreign direct investment, following only the United States.

As shown in diagram 3, by the end of the 1990s the total stock of foreign direct investment in China was well over \$300 billion. Foreign direct investment in China now

accounts for almost a third of the cumulative foreign direct investment in all developing countries combined and far exceeds the total stock of foreign direct investment in other large economies such as Mexico and Brazil, which began to open their doors to foreign direct investment decades before China.

The stock of foreign capital now is so large that it has come to have an unusually large influence on China's trade. As foreign firms have invested ever larger amounts of capital in China, China has become increasingly integrated into global production networks for a broad range of goods, particularly labor-intensive manufactures. As diagram 4 shows, this integration is very obvious on the export side. Foreign invested firms in China last year accounted for almost half of China's total exports, up from 1 percent in 1985. The vast majority of these exports are labor intensive manufactures. Production of these goods has migrated on a wholesale basis to China, primarily from higher wage locations elsewhere in Asia. Foreign invested firms also account for an unusually large share of imports—over 50 percent last year. Imports of foreign invested firms includes both capital goods and tens of billions of dollars of parts and components that are shipped to China to be assembled into final goods and exported to the international market. In short, the pattern of China's imports and exports increasingly reflects the decisions of foreign companies.

The "China is a closed economy" view also misunderstands the extent to which barriers to the import of goods into China have declined, particularly in the 1990s. As shown in diagram 5, import tariffs averaged well over 50 percent in the early 1980s but by 1998 were only 17 percent. Most of the reduction in rates occurred since 1993. China's import **tariffs are** now about half those of India and roughly equivalent to those of Brazil and Mexico. Equally important, because China exempts so many goods entirely from import tariffs and because a

significant share of the imports of goods subject to high tariffs are imported illegally. actual tariff collections as a percent of total import value have been much lower than the nominal average tariff level would suggest. Even at its peak in the mid-1980s tariff revenue was only about 16 percent of the value of imports. In the last five years the collection rate has fallen to about 3 percent.

There also has been an impressive reduction in the use of nontariff barriers to restrict imports. Today the number of tariff lines subject to licenses and quotas has been reduced by 80 percent in comparison with 1992. These restrictions now apply to less than 4 percent of all import tariff lines.

The reduction in trade barriers has led to a significant growth in US exports to China over the past decade. In 1998 sales of U.S. firms to China were \$19 billion, more than three times the level of 1990.<sup>1</sup> In the 1980s China was not a significant market for U.S. firms. By 1998 it was the sixth largest destination for US exports. As shown in diagram 6, from 1990 through 1998 the growth of exports of U.S. firms to China far exceeded that to any other of our largest export markets, including Canada and Mexico. The contrast with Japan, where U.S. sales have been declining in absolute terms since 1996, is particularly striking.

Despite the rapid growth of sales of US goods to China, our bilateral deficit has grown continuously since the mid-1980s. In my judgment this growing deficit largely reflects the migration of labor-intensive manufacturing to China from other locations in Asia, notably Hong Kong, Taiwan, and Korea. As wages in these countries rose and China introduced an increasingly liberal environment for foreign direct investment, Asian entrepreneurs moved a growing share of their labor intensive production to China. The two largest categories of goods

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<sup>1</sup> These numbers take into account the reexport of US goods From Hong Kong to China, which are recorded by the US Department of Commerce as exports to Hong Kong.

the United States currently imports from China are baby carriages, toys, games, and sporting goods, followed closely by footwear. Goods in both these categories are extremely labor intensive and produced predominantly in foreign-invested enterprises or under processing contracts in which a foreign firm supplies to a Chinese firm a significant portion of the inputs needed to produce the final good. These two categories account for more than a quarter of all U.S. imports from China. The rapid growth of these imports from China in large part reflects the displacement of alternative sources of supply in Asia, notably Hong Kong, Taiwan, and South Korea. For example, in 1986 and 1987 an average of about 60 percent of U.S. imports of footwear were from Taiwan and South Korea; China was the source of only 1.5 percent. By 1998 the share of U.S. footwear imports originating in Taiwan and South Korea was only 4 percent and the share originating in China was almost 60 percent. The story is similar in the case of toys and sporting goods. Hong Kong, South Korea, and Taiwan supplied an average of about 60 percent of our imports in 1986 and 1987; China was the source of only 7 percent of U.S. imports. By the late 1990s these shares were reversed. China supplied about 60 percent of U.S. imports, all the rest of Asia only 10 percent. Obviously the United States has and will continue benefit enormously from this shift of production within Asia since it holds down the prices of important consumer goods in the United States.

The bilateral agreement reached between the United States and China in November 1999 on China's accession to the World Trade Organization promises to enhance the flow of U.S. exports to China. China will further reduce import tariffs and phase out import quotas and licensing requirements entirely over a five year period. For industrial products, for example, average tariff rates are scheduled to drop from 17.4 percent in 1998 to 9.4 percent by 2005. Despite these liberalizing measures, the increase in total U.S. exports to China is likely to be

modest since on average existing tariff and nontariff barriers to merchandise imports in China already are relatively low. There is, of course, the potential for significantly higher levels of export of selected U.S. goods that are currently subject to high tariff and nontariff barriers. But these gains, while of potential great importance to a few producers in the United States, are not likely to reduce significantly the magnitude of the U.S. merchandise trade deficit with China.

The largest U.S. gains are likely to be achieved in services, where the current degree of protection is much higher than for goods. Further liberalization in financial services, telecommunications, and distribution is likely to lead to a significant additional direct investment in these sectors by U.S. firms. It is important to note that these service sector gains will be reflected not in the merchandise trade account but in the services account. The United States has had a growing surplus in its services trade with China in the 1990s. That trend is likely to accelerate considerably over the next five to ten years.

However, the case for China's entry into the World Trade Organization and for congressional approval of China's permanent normal trade relations (most-favored-nation status) in the United States market depends not on the likely effect on the bilateral United States-China trade balance, but on whether it serves to deepen further China's integration into the global economy. There can be little doubt that the answer to this is positive. China's bilateral agreement with the United States, which is extraordinarily far reaching, reflects the belief of China's leadership that over time the benefits of increased participation in the international economy will far outweigh the short-term adjustment costs deeper integration will inevitably entail. The United States should welcome China's commitment to further open its market by providing permanent normal trade status in the United States.

Diagram 1  
The Growth of China Trade vs. World Trade, 1977-1998

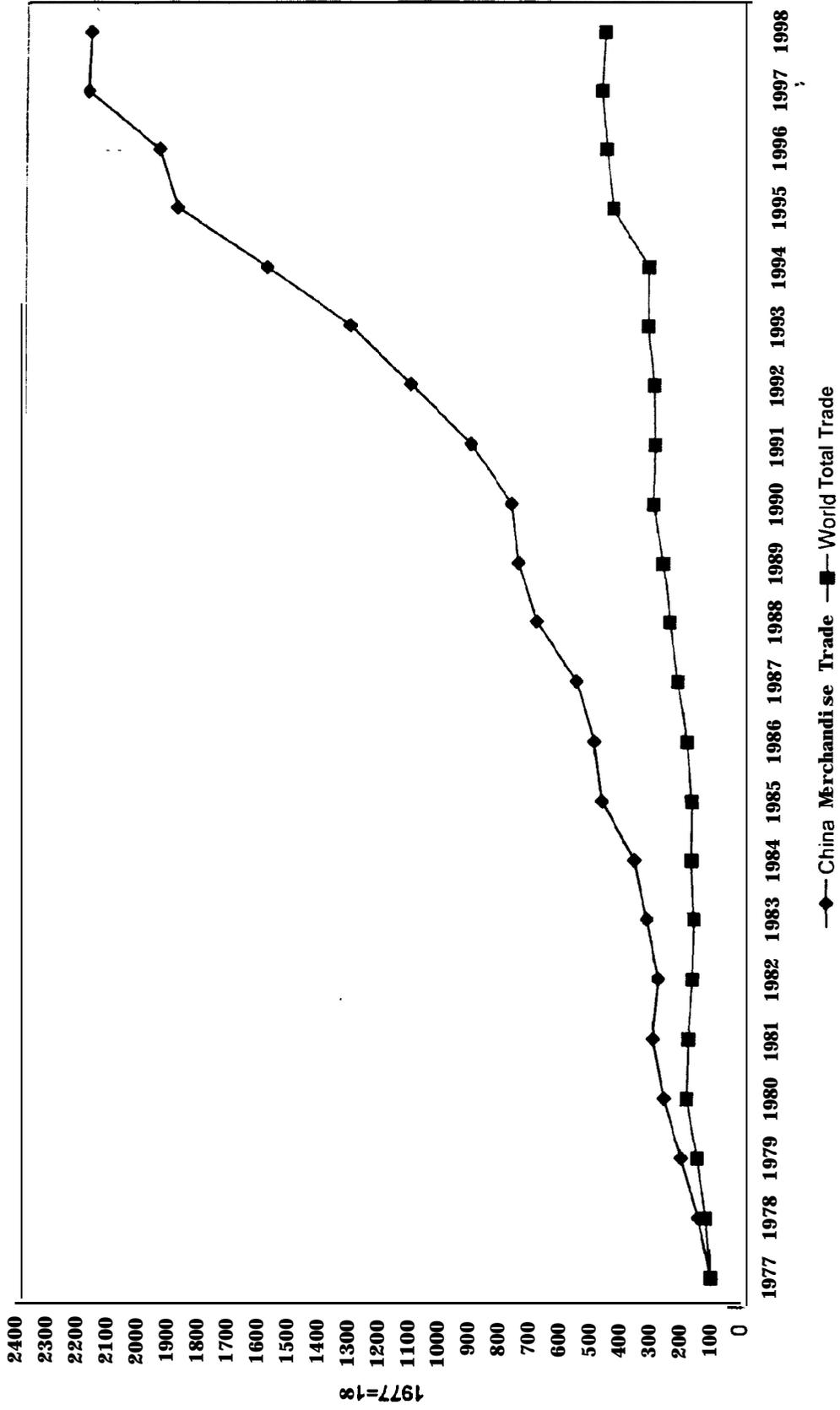


Diagram 2  
Annual Inflows of Utilized FDI in China, 1983-1999

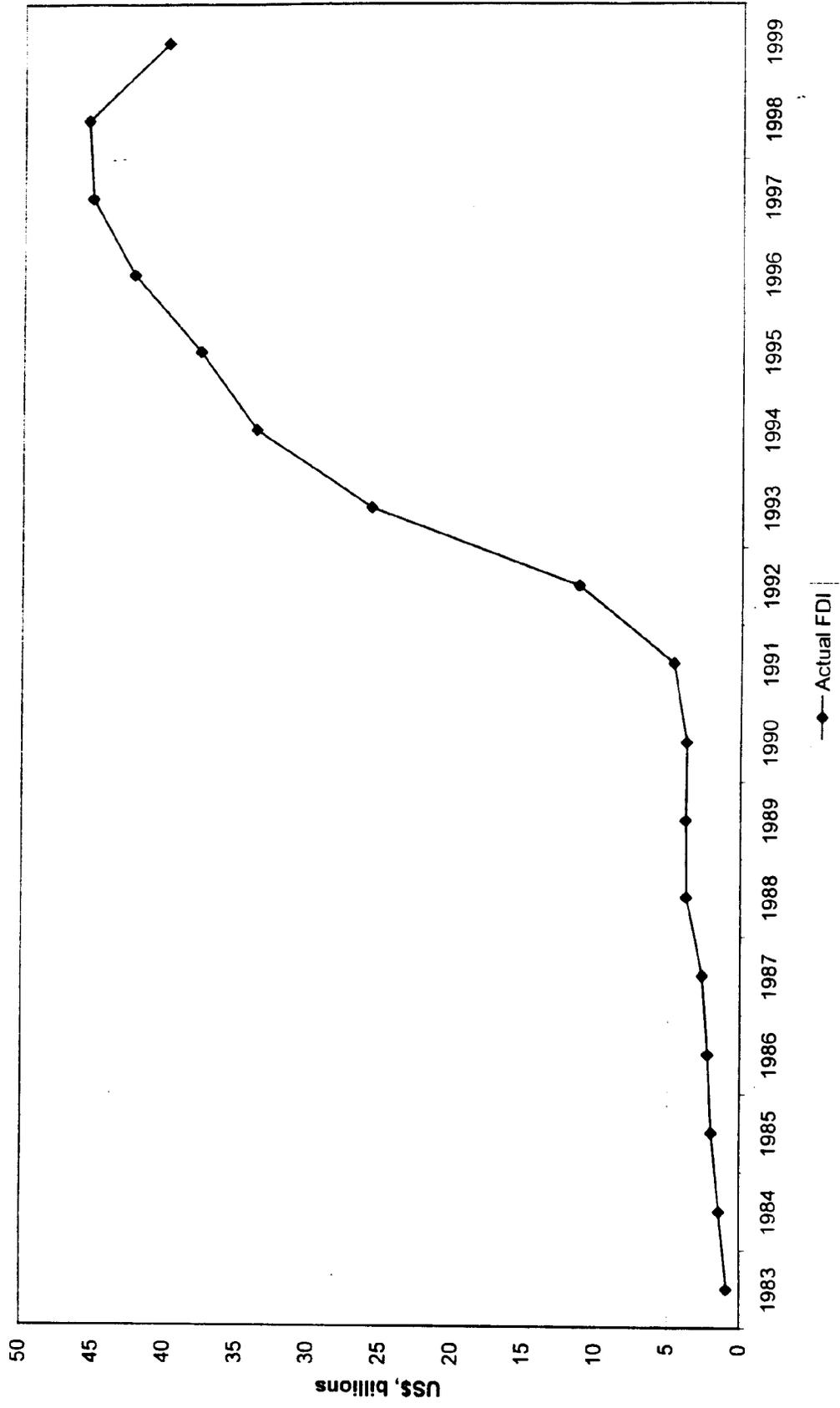


Diagram 3  
Cumulative FDI in China, 1982-1999

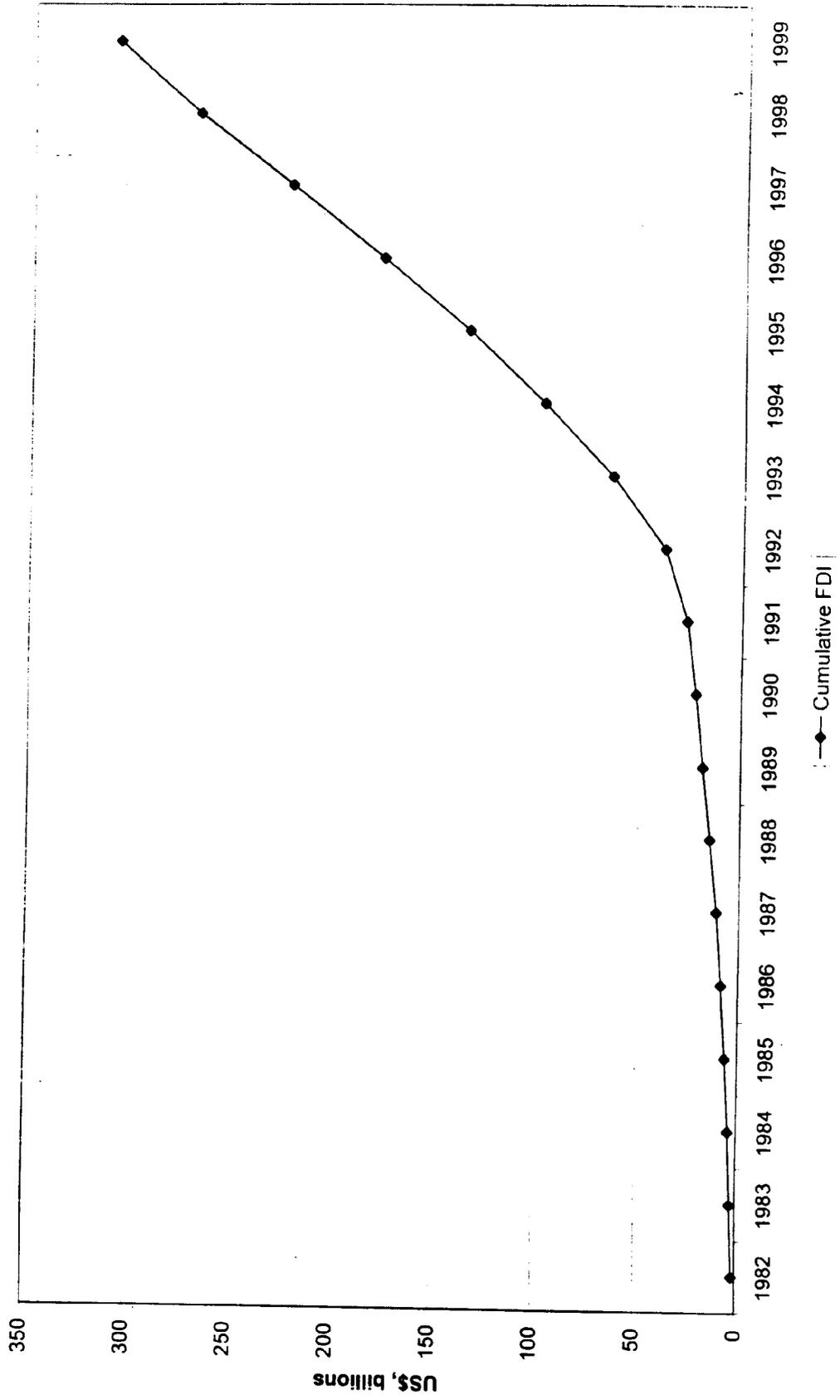


Diagram 4  
Foreign Enterprise Share of China's Exports (1985-1999)

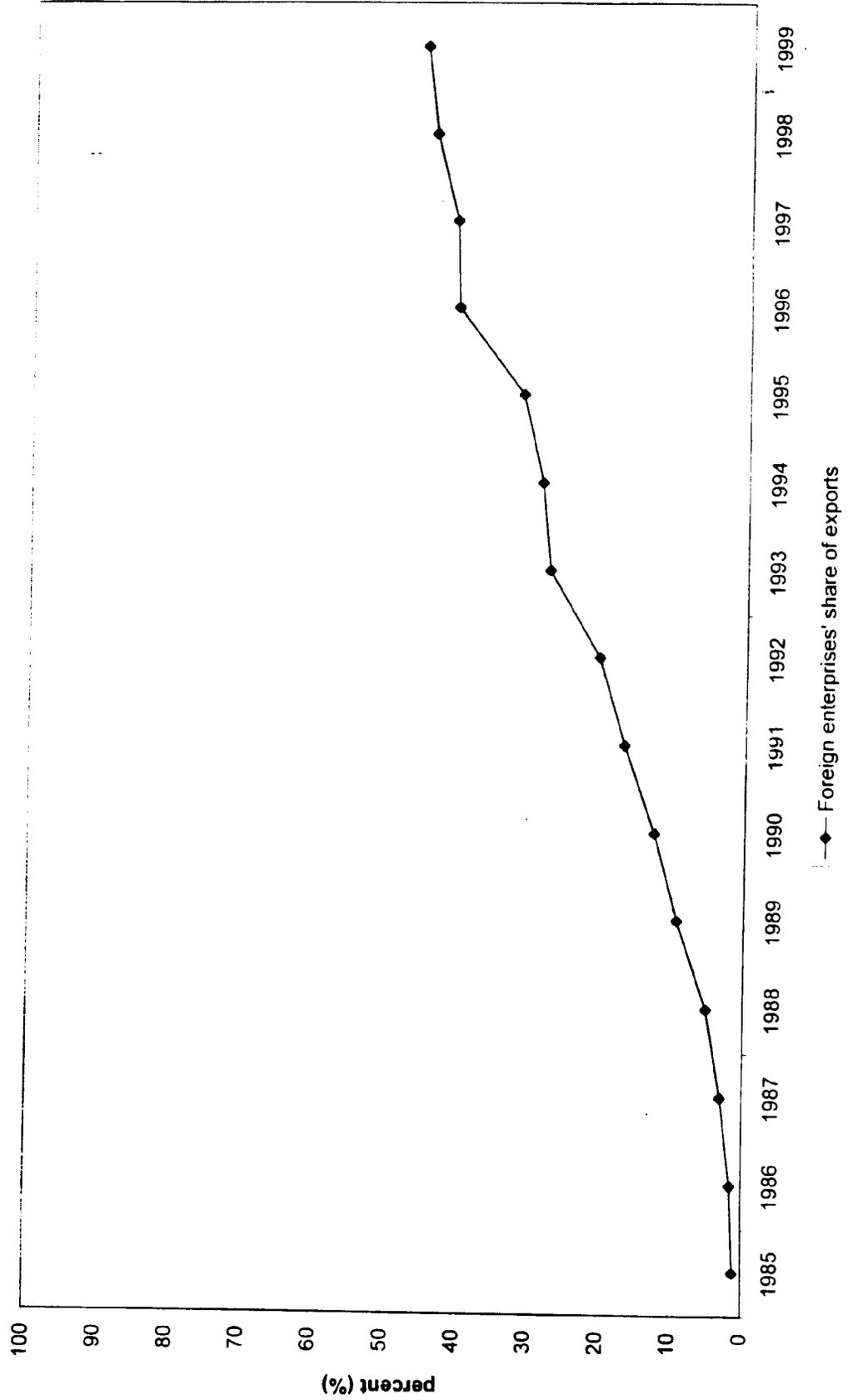


Diagram 5  
 China's Import Tariffs vs. Tariff Collections, 1982-1999

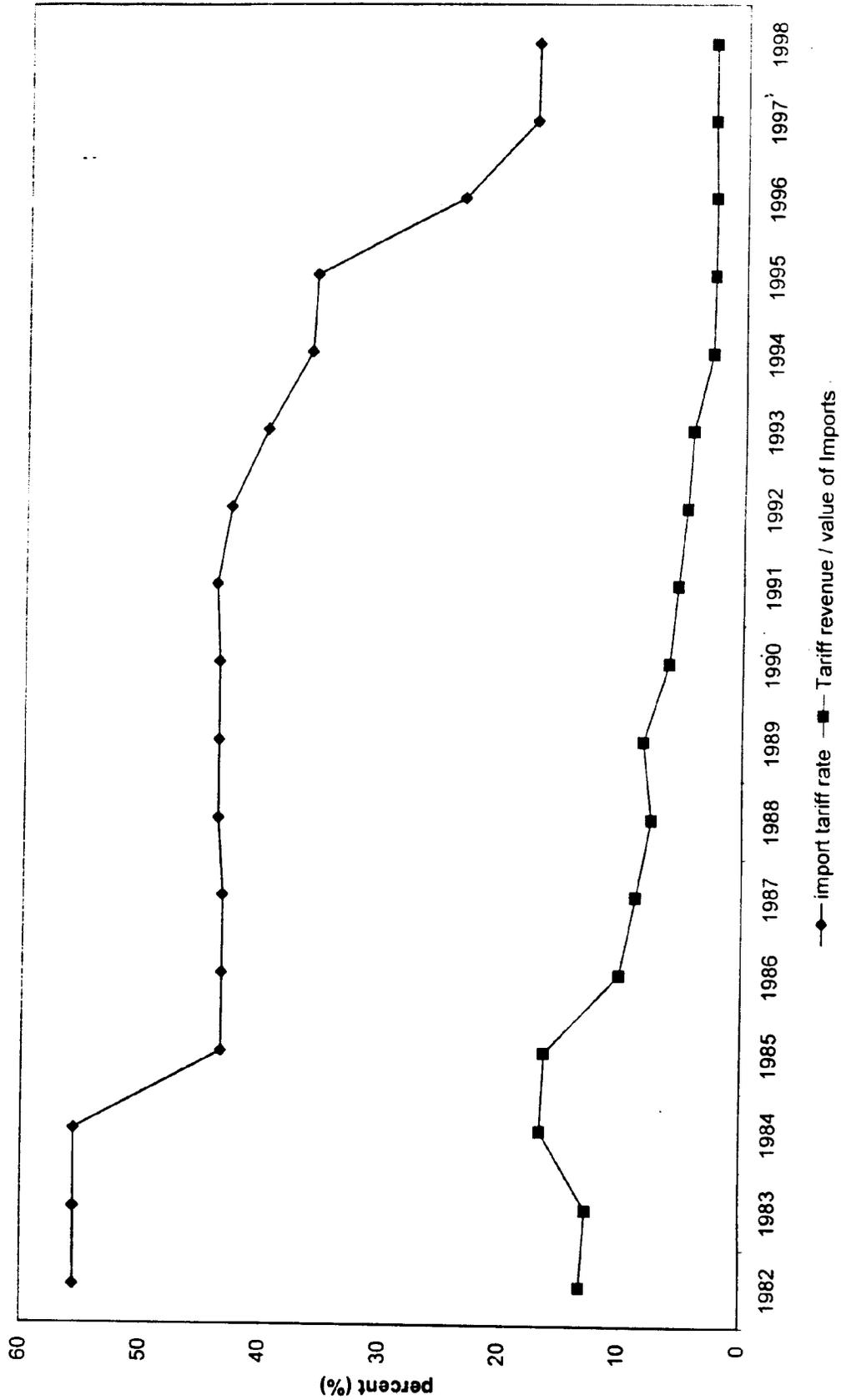
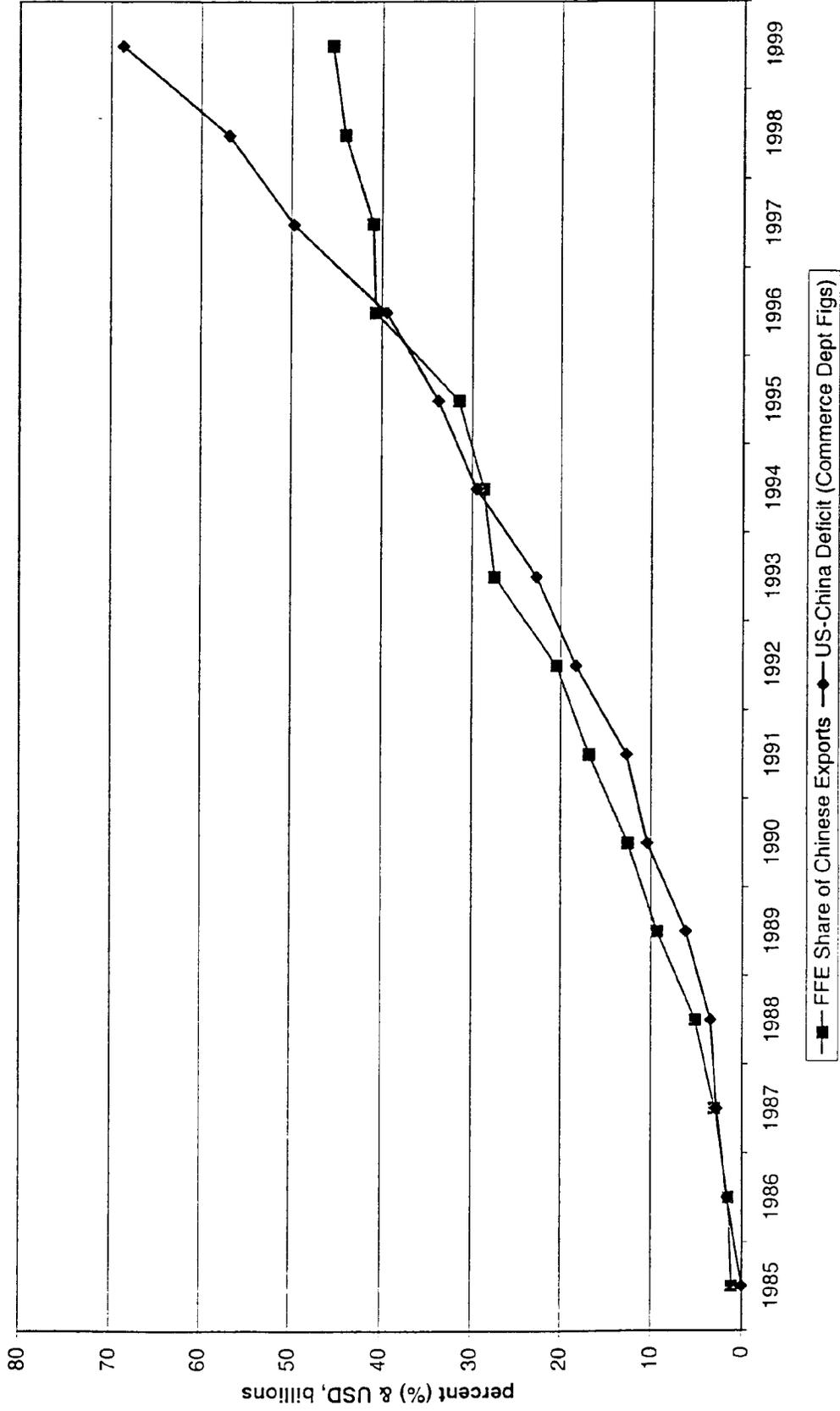


Diagram 6  
The Growth of US Exports to Our Largest Markets



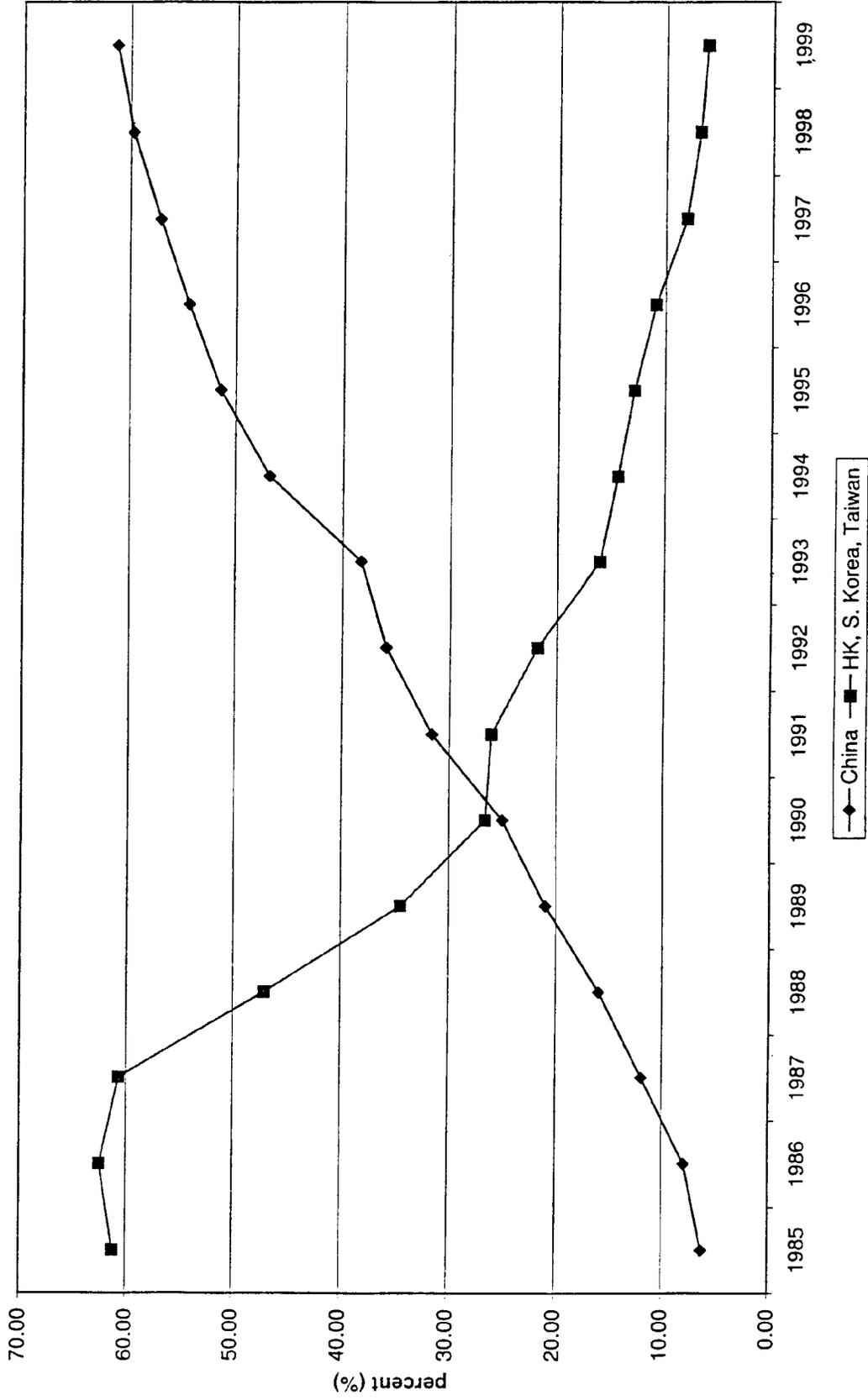
\*Exports to China include US goods reexported to China from Hong Kong

# Foreign Invested Enterprises' Share of Chinese Exports and the US-China Trade Deficit, 1985-1999



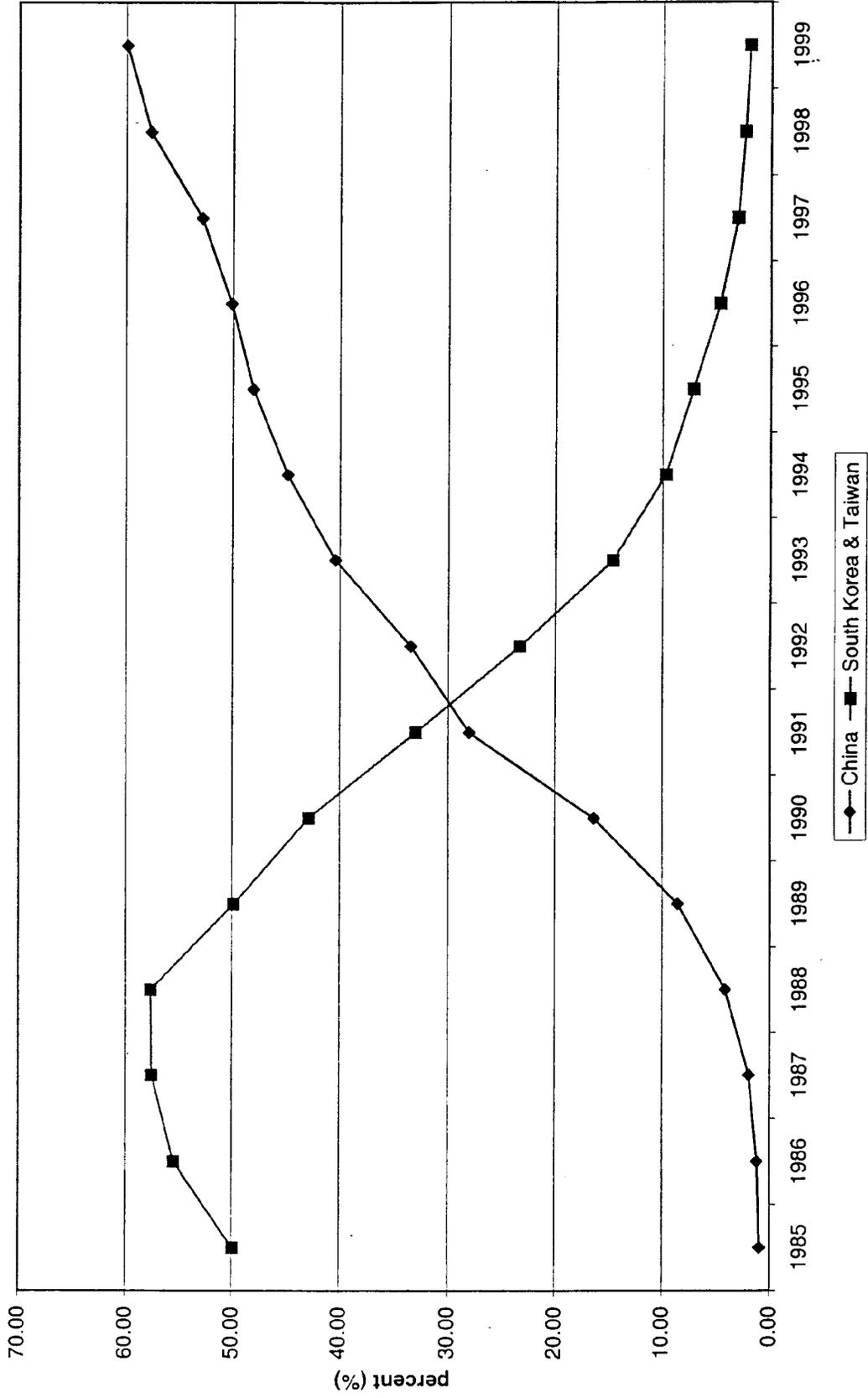
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Share of US Imports of Toys, Games, and Sporting Goods, 1985-1999



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Share of US Footwear Imports, 1985-1999



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