1

Trade policy and economic development

Introduction

Since economic reform began in 1978 China has emerged as a major trading nation and foreign trade has begun to exert a greater influence on the domestic economy than at any other period in China's history. Its enhanced role in the world economy is evident both in China's participation in international economic organizations and its volume and pattern of trade. In the early 1980s China joined both the World Bank and the International Monetary Fund. In the mid-1980s China became a member of the Asian Development Bank and initiated the process of becoming what is called a contracting party of the General Agreement on Tariffs and Trade.[1]

Over the same years China's trade volume expanded dramatically. In 1978, on the eve of reform, China was the world's thirty-second ranked exporting country. By 1989 it was the world's thirteenth largest trading nation. In the process its share of world trade almost doubled. Moreover, more than 90 percent of China's trade was with market economies. In both its rapid trade growth and its orientation toward market economies, China poses a sharp contrast with the Soviet Union and the states of Eastern Europe. Despite their reforms, some of which significantly predate those of China, none of these states have become more important participants in the world economy. The foreign trade of the Soviet Union and the countries of Eastern Europe remains heavily skewed toward trade with one another and none of these states increased its hard currency exports substantially in the 1980s.

Equally significant as the increased importance of China's trade in the world economy is the greatly heightened influence of foreign trade on China's domestic economy. In both 1989 and 1990 trade turnover (imports plus exports valued at world prices) exceeded $110 billion.* China's imports,

*All references in dollars are to United States dollars.

which consist overwhelmingly of industrial goods, now contribute significantly to increased levels of technological sophistication and production capacity in a number of key domestic industries. And, at the same time, international markets are a growing source of demand for Chinese goods. China's textile industry, for example, is the world's largest and in 1990 exported products worth $13.5 billion, about one-third of its output. Because foreign trade has grown far more rapidly than the domestic economy over the past decade it is possible that in some sense trade has served as an engine of growth. According to Chinese data the rate of expansion of the domestic economy also has increased significantly to approximately 9 percent per annum in the first decade of reform compared to 6 percent prior to reform.

To what extent has China's shift toward a more open trade policy contributed to the growth acceleration observed in the first decade of reform? Economists have long argued that the shift away from a closed to a more open economy should improve the efficiency of resource allocation in developing economies and contribute to more rapid growth. This has been borne out by empirical studies showing trade liberalization tends to lead to an acceleration of economic growth, particularly in economies where severe prereform trade restrictions were countered with strong liberalization measures (Michaely, Papageorgiou, and Choksi, 85–92). What is sometimes overlooked is that the gains from trade liberalization are likely to be limited unless domestic economic policies are also liberalized. This linkage would appear to be even more important for a reforming socialist economy where various forms of government control have imposed more severe distortions in a larger number of domestic markets than in most developing countries.

In short, the issue is the extent to which reforms of China's domestic economy have been sufficient for trade liberalization to have improved the allocation of resources domestically and to have contributed to the faster growth of the Chinese economy since the late 1970s. Ultimately that focus will shed light on the sustainability of China's increasing participation in the world economy. Continued domestic economic distortions could limit the improvement in the allocation of domestic resources usually associated with increased openness and trade. Under these conditions expanding trade would fall short of its potential to increase the rate of growth of the economy and improve welfare. Trade liberalization and reform would likely be curtailed by a government weighing the limited positive economic benefits against the negative political effects of openness and trade expansion.

What are the lessons of the first decade or so of reforms in China for other economies seeking to alleviate the negative consequences of decades of cen-

tral planning? Many economists believe that the only hope of saving the Soviet economy from an utter collapse is a program of comprehensive reform instituted within a span of only a year or two. Key elements include slashing subsidies to loss-making enterprises and to consumers, freeing of prices, reducing the fiscal deficit, shrinking the monetary overhang, privatizing state assets, drastically devaluing the ruble, opening the economy to international competition, and so on. The economic challenge in Poland is similar but the demise of the Communist Party made it possible to initiate a radical reform strategy beginning in 1990, whereas Soviet reforms in many critical areas are still being debated.

China's economic reform program, begun cautiously in the late 1970s, seems almost quaint by comparison with either the dramatic reform blueprints advanced in the Soviet Union or Poland's "big bang" reform program instituted in 1990. Although the Chinese Communist Party over the first decade of reform approved dozens of major reform measures, no comprehensive reform blueprint with a specific timetable for implementation has ever been approved. Reform has been both incremental and ad hoc. Moreover, even prior to the tragedy of Tiananmen in June 1989, many observers felt that the impetus for economic reform in China had waned. A coalition of conservative party and state bureaucratic forces seemingly had undermined the reform process. China seemed to be following the Hungarian path, where the incremental reforms adopted under the rubric of the New Economic Mechanism in the later half of the 1960s had, within a decade, stalled out. The ascendency of political conservatives and the ouster of Zhao Ziyang in 1989 only deepened the pessimism felt in many quarters regarding the future of China's economic reform.

Yet China's foreign trade reforms by no means floundered after mid-1989. This study discusses several critical areas where reform continued in 1989 and 1990: a renewed devaluation of the official exchange rate to promote exports relative to imports; a further relaxation of exchange control, reflected in a continued rapid expansion in both 1989 and 1990 in the volume of transactions on the parallel, open market for foreign exchange; and further significant reforms in the domestic pricing of traded goods that more closely linked domestic and international prices for almost all imports and for a growing share of exports as well.

It is too soon to say that these reforms can be sustained. Indeed a principal argument in the concluding chapter is that China must soon deepen a broad range of domestic reforms, particularly in areas where elements of the traditional system of central planning seem least changed. Without these reforms it seems unlikely that further reforms in the foreign trade and exchange

control regimes would be warranted. However, it would be too soon to assert that China's more incremental approach to economic reform has or must fail.

Finally, to what extent is China's trade regime consistent with principles of the General Agreement on Tariffs and Trade? In early 1989 it appeared as if the working party appointed by the GATT Secretariat to examine the merits of China's request to participate in the world trade body would agree to an accession document setting forth the conditions under which that could be accomplished. But in the wake of the Tiananmen tragedy China's accession became a moot issue. To many participating countries, particularly major industrial states that imposed a variety of economic sanctions against China, accession was out of the question.

The official position of the Chinese government is that its economic and trade systems are already close to achieving "GATT compatibility" and that negotiations on China's accession should resume at an early date. Although serious negotiations may not resume for some time, when they do it is likely China will undergo a much closer scrutinity of its trade regime than it had received prior to June 1989. It probably will be expected to conform much more closely to GATT principles prior to its accession. Before mid-1989 China received a great deal of credit for the direction of its reform (Jacobson and Oksenberg 1990, 102–3). When negotiations resume the GATT working party likely will expect concrete evidence of compatibility rather than simply examine the trajectory of China's reforms. Thus the issue of GATT compatibility probably will be examined for some time. A thorough discussion of the degree to which China's trade regime is consistent with GATT principles is best left to someone better versed in the intricacies of the various codes and agreements negotiated in recent decades over several rounds of multilateral trade negotiations within the GATT. This study has the more modest aim of simply pointing out a few of the areas where China's trading system appears still to fall short of GATT expectations.

An analysis of the issues sketched in this introduction is best undertaken in a comparative framework. What were the central characteristics of the trade regimes adopted by most developing countries in the 1950s? How did these characteristics affect the allocation of resources and the patterns of growth and development?

Alternative trade regimes

In the years following World War II developing countries faced two basic alternatives as they shaped their international trade policies to support their broader development objectives. One alternative, the outwardly-oriented

strategy, sought to link the domestic economy to the world economy in order to foster industrialization. Regimes of this type generally offered only modest protection to domestic industries and imposed few controls on trade and foreign exchange. By contrast, the inwardly-oriented strategy sought to spur industrialization through policies that replaced imports with domestically produced manufactures. These regimes generally were characterized by high levels of protection for domestic manufacturing, direct controls on imports and investments, and overvalued exchange rates (World Bank 1987, 78–83).

The choice between these two strategies, while often not explicit, was shaped by assessments of both the nature of the international economic environment and the particular characteristics of individual economies (Little, 60–76). Many developing countries specialized in the production of agricultural and other primary commodities, which they exported in exchange for manufactured goods. Because of the widespread view in the 1940s and 1950s that world market prospects for the traditional exports of developing countries were dim, most developing countries' economic strategies focused on increasing the pace of industrial growth as the primary means of raising national income. For many that led to what came to be known as inwardly oriented or import substitution trade strategies.

The logic of import substitution was simple. If the prospects for traditional exports were limited, the foreign exchange available to import industrial goods would be limited, far less than necessary to satisfy the demand for the full range of industrial goods that could not be produced at home. It would thus be necessary to use the limited capability to earn foreign exchange to import the machinery and equipment required to produce a broad range of manufactured goods domestically. Thus the phrase import substitution: a strategy designed to develop the indigenous capacity to produce domestically the manufactured goods initially acquired through imports.

Import substitution regimes

The premises of the import substitution strategy dictated the character of government intervention in foreign trade. Above all, the prospect was for a shortage of foreign exchange. If the income elasticity of demand for traditional exports was low, rising incomes in the developed world could not be counted on to lead to rising demand for developing country exports. Moreover, technological innovations in developed countries were expected to reduce the demand for many raw materials, lowering the price the developing countries would receive for each unit of exports. On the other hand, the

expectation was that demand would push up the prices of manufactured goods and the machinery and equipment used to produce them. Thus, the expectation was for a secular unfavorable shift in the terms of trade of developing countries.

The expectation of a persistent "shortage" of foreign exchange led to a panoply of policy instruments to conserve foreign exchange and to insure its allocation to priority uses. These included import licenses and quotas, to influence the structure of imports; import tariffs, to restrict the import of goods that could be produced at home; domestic content requirements for industrial products, to encourage the replacement of imported parts and components; and frequently public ownership of firms in critical industries, to provide even more direct government control.

These policies on the trade side were complemented and reinforced by exchange rate policy. First, various forms of exchange control were common. These generally required exporters to relinquish some or all of their foreign exchange earnings to an agency of the state, typically a specialized state-owned bank. Foreign exchange thus gathered could then be allocated by the government to priority imports. Second, the government established an overvalued exchange rate as a mechanism to provide imported machinery and equipment to priority industries at a relatively lower domestic currency cost than would otherwise be possible. Because world prices of these goods could be assumed to be given to the developing country, when these prices were converted to domestic currency at the overvalued exchange rate (i.e., too few units of domestic currency per unit of foreign currency), the internal domestic currency price of imports would be less than the levels that would prevail at a more realistic exchange rate.

That overvaluation of the domestic currency invariably turned the internal terms of trade against producers of agricultural goods, raw materials, and other traditional export goods. Again prices for most of these goods would be established in the world market. Because the magnitude of exports of an individual country would not influence the world price, the developing country would usually be a price taker. Because the establishment of an exchange rate that overvalued the domestic currency would reduce the domestic currency earnings received by exporters, they, in turn, would be able to sustain exports only if they were able to purchase these goods at a lower domestic price than would prevail at a more realistic exchange rate. Thus the domestic market prices of all export goods tended to fall, turning the internal terms of trade against this sector and thus lowering the real incomes of individuals producing export goods.

Although advocates of import substitution strategies were aware that an

overvalued exchange rate would turn the internal terms of trade against producers of traditional exports, they did not regard this as a significant problem for three reasons. First, as already noted, they were pessimistic about the long-term prospects for the growth of traditional exports. They believed the income elasticity of demand for these products was low so rising incomes in the developed world would not increase the world market for these goods. Second, they did not believe that producers of traditional export goods, particularly agricultural goods, were very responsive to changes in relative domestic market prices. Declining relative farm prices, for example, would not necessarily lead to declining farm output because traditional peasants were believed not to be very responsive to price incentives (Little, 159–60).

Finally, advocates of import substitution strategies overwhelmingly represented the interests of urban elites. Policies that shifted the internal terms of trade against agriculture raised the relative real incomes of largely urban workers in manufacturing and other modern activities at the expense of the rural peasant class. Thus an antirural bias is one of the most salient characteristics of the import substitution development strategy.

The key features of the import substitution strategies adopted by many developing countries – a high degree of protectionism and an overvalued exchange rate – resulted in an inwardly-oriented development strategy in which trade and other incentives were biased in favor of production for the domestic market and against production for export. The bias against production for export arose because an overvalued exchange rate reduced the domestic currency earnings received by export producers and high tariffs increased the price of imported inputs and thus the cost of export goods that required such inputs.

Export promotion regimes

The alternative approach, an outwardly-oriented development strategy, is simply one in which trade and industrial policies are neutral and do not promote the production of goods for the domestic market at the expense of export goods or vice versa. Although the phrase export promotion strategy is sometimes used to describe this alternative, it obscures the key feature of the alternative regime which is to avoid discrimination either against or for exports.

Countries pursuing externally-oriented development strategies above all provide substantially lower protection of their domestic industries. Trade controls, such as quotas and import licensing arrangements, are minimal to

nonexistent. Tariff rates are relatively low and their structure relatively uniform to avoid the distorting effects of highly variable rates of protection across sectors. Moreover, in the case of the most strongly outwardly-oriented strategies whatever modest import barriers do exist as a result of tariffs and controls are more or less counterbalanced by export incentives (World Bank 1987, 82). The exchange rate is maintained at a reasonable level, so that exporters are not penalized, and the exchange controls required due to excess demand for foreign exchange that arises in the case of an overvalued domestic currency can be largely avoided.

A wide range of empirical studies supports the view that more outwardly-oriented economies in the 1960s, 1970s, and 1980s achieved significantly higher rates of real growth of gross domestic product. These studies show that this was because more open economies achieved both higher rates of saving and investment as well as more efficient use of investment resources. These efficiencies arise from greater utilization of existing plants, economies of scale that are sometimes achieved when production is not for the domestic market alone, and from the stimulus that competitive pressures from abroad provides for technological change and management efficiencies (Feder, 51). It is important to recognize that these efficiencies stem not only from substantially higher marginal factor productivities in export than in nonexport-oriented industries. In addition, the export sector confers positive effects on productivity in the nonexport sector through externalities that include the development of more efficient management, improved production techniques, training of higher quality labor, and an improved supply of imported inputs and so forth (Feder, 60–1). In one estimate based on a sample of developing countries, the positive effect of increased exports on productivity in the nonexport sector contributed more to higher growth than did the shift of resources into the higher productivity export sector (Feder, 69–70).

Thus even on the more narrow criterion of industrial development, as opposed to more broadly based growth, the import substitution strategy did not succeed. By several measures more outwardly oriented economies not only grew more rapidly overall but also were more successful in industrialization. Their growth of manufacturing output (measured in value-added terms) was more rapid; their shares of manufacturing in gross domestic product expanded more rapidly and finished at a higher level; and both their manufacturing employment and their shares of labor employed in industry grew more rapidly than in the countries where inwardly-oriented development strategies prevailed (World Bank 1987, 83–8; Balassa 1989).

Finally, there is even evidence, although less conclusive, that countries following outwardly-oriented strategies achieved more equitable growth

than countries following inwardly-oriented strategies. Put alternatively, the outwardly-oriented countries did not, on average, have to accept relatively inferior distributive outcomes to achieve higher rates of growth and more rapid industrialization (World Bank 1987, 85).

Although trade policy is only one of several influences on the dimensions of performance discussed above, there is a growing consensus that trade policies have a decisive influence both on the efficiency with which an economy employs its resources and on the distribution of income. Protection associated with inwardly-oriented regimes, by redistributing resources from more to less efficient sectors, imposed real efficiency costs which, in the aggregate, outweighed the benefits to the protected sector. Typically, as import substitution policies persisted and domestic production replaced an ever broader range of increasingly capital-intensive imported goods, incremental capital-output ratios for the economy as a whole rose more rapidly than one would have expected. This meant that an ever increasing rate of savings and investment was required to sustain growth at previous levels (Balassa 1989, 1,660; Krueger 1988, 359). Efficiency was further reduced because the distortions of the inwardly-oriented regime, such as an overvalued exchange rate, discouraged domestic producers from exporting. But without the export market, the scale of production was sometimes too small to reap advantages of scale economies, resulting in inefficient, high-cost production.

These sources of inefficiency reduced the real output of the economy and thus usually reduced savings and investment as well. Savings and investment were further discouraged under inwardly-oriented trade strategies. First, capital markets frequently were more distorted in countries pursuing import substitution policies. That often depressed real interest rates, discouraging savings. Second, the overvalued exchange rates common in these regimes discouraged foreign capital inflows in the form of direct investments (World Bank 1987, 91).

Even more serious, inwardly-oriented regimes appear to have discouraged innovation and thus productivity growth. Over time, this compounded the static inefficiency associated with import substitution. One major cause was that the high protection afforded by tariffs and other restrictive policies limited competition in the domestic market. Protection under import substitution regimes frequently increased the market power of domestic firms and sometimes converted domestic industries to monopolies. This increased static inefficiency, as these producers sought to increase their profits by cutting output and raising prices. Because these goods in turn were frequently used as inputs in the production of export goods, increased market

power raised the domestic cost of goods produced for the export market, compounding the initial bias of the trade regime against exports. Moreover, increased market power in these industries discouraged innovations that would increase productivity over time.

The linkages between trade policy and income distribution were also critical. Import substitution regimes, because they indirectly subsidized capital goods imports, encouraged more capital-intensive production, which meant lower levels of employment. Moreover, real wages tended to increase more rapidly in countries pursuing outwardly-oriented strategies where export growth tended to be more rapid (Balassa 1989, 1,679). Import substitution regimes also increased inequality because the import licenses and other instruments of trade control frequently generated economic rents that were captured by favorably positioned urban elites. But, most importantly, import substitution regimes had a strong antirural bias that reduced agricultural incomes relative to those of urban wage earners. The overvalued exchange rate reduced the real return to producing and exporting traditional agricultural goods and other primary products. As a result, these developing countries suffered sharp declines in their shares of world markets for these products (Balassa 1989, 1,669–70). That reduced the rate of growth of employment in rural areas, widening the gap between rural and urban incomes.

Given the accumulation over time of evidence of the advantages of an outwardly-oriented trade and development strategy, many developing countries have sought to reform their trade regimes and to introduce more realistic exchange rates as well. These liberalizations, begun in the 1960s, generally were successful in enhancing economic growth and employment. However, given the varying initial conditions and the differences in specific liberalization measures pursued, there are, of course, varying interpretations of the precise mechanisms through which changes in trade regimes affected macroeconomic performance (Krueger 1988, 360).

Part of the difficulty in reaching a consensus on these causal linkages stems from the fundamentally different approaches taken to trade liberalization. Broadly speaking, there were two alternatives. The first was to move toward free trade by dismantling the import substitution policies initiated decades earlier. Obvious measures of that type include reducing or eliminating import tariffs and quotas, reducing the degree of overvaluation of the domestic currency, and dismantling other measures protecting domestic industries.

An alternative strategy was to initially leave most of the protective measures in place but to add policies promoting exports to overcome, at least in part, the bias against exports that is characteristic of the import substitution regime. South Korea was one of the more notable examples of this latter