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Lecture note 11: The "opening-up" of China, the role of FDI.

Opening up to the external world: 对 外 开 放 duì wài kāi fàng

11.1 Introduction

This lecture relates to Chapter 8 *Opening to the Outside World* in Wu (2005). The treatment is a little different, such the lecture note is a complement to the chapter rather than a summary.

The opening-up to the outside world became quickly the most visible side of China's economic reforms. China's international trade volume grew dramatically from the 1980s. Few people in the world can have remained unaware of China's enormous expansion in foreign trade, not least exports of consumption goods. The expansion in foreign trade took place while China attracted very large amounts of foreign direct investment (FYI) and borrowed actively in international financial markets.

Again we try to put our attention on the early part of China's by now long reform period, to understand more of how the reforms got underway. Let us remember at the outset that foreign trade also was a concept with strong political overtones. China's policy was self-reliance, which did not mean no trade, but certainly that China should avoid becoming dependant upon other countries through trade.

We first look at the three possible kinds of trade relations (11.2), then on how trade developed after the reform (11.3). In 11.4 we consider the role of FDI, and finally the policy of economic zones, singling out specific areas for conducting the trade with the outside world (11.5).

11.2 What kind of trade?

Foreign trade has since the reform grown more rapidly than the domestic economy, as was not the case earlier. It has been less obvious how the domestic economy accommodated and benefited from the expanding trade. What kinds of trade relations were developed? We can at the outset distinguish three models for trade:

- The planning regime's foreign trade was to acquire much needed imports through sales of Chinese produced commodities to the international market to finance the imports. The much needed imports could be strategically important goods not produced in China or for covering deficits in the domestic production. The exported commodities were typically selected without much consideration of China's comparative advantage. Thus this kind of trade contributed relatively little to economic growth.

  After the reform this strategy was continued but on a much larger scale. The Chinese leaders looked around the world, not least on the growth successes of a number of countries in Asia. There was a strong need to improve growth and productivity to offer the Chinese a better living standard and not to fall even more behind in the world. This led to the idea of expanding the state-driven export strategy for modernizing the economy, also by buying entire industrial plants and this technology, paying for it with whatever domestic goods available. This strategy was closely attached to the idea of exporting crude oil.

- Another kind of foreign trade which has played a very important role in China is the export processing, where foreign parts and components are brought in, assembled or processed using relatively low-cost Chinese labour, and then exported to world markets. This kind of trade capitalizes on China's comparative advantage in labour-intensive activities and thus contributes to economic growth. Typically in this trade the funding and management of these export-processing firms are foreign, and it is not obvious that even a very expansive and dynamic sector provides much stimulus to the indigenous manufacturing sector. This kind of trade played a very important role, and typically took place with special economic zones. This kind of trade is known from many places in the world, e.g. the production of American cars just across the border in Mexico.
- Then there is the general orientation towards foreign trade that we associate with an export-oriented strategy, which not only has direct demand effect on growth but influences the pace of structural and technical transformation of the domestic economy.

The opening-up may be related to the literature and long discussion among development economists on import substitution versus an externally oriented export-orientation as a development strategy. The dominating view in this discussion became that external orientation achieved higher rates of growth. Export-oriented economies were found to have higher investment and savings and more efficient use of scarce resources. Basically, growth rates became higher through export-orientation for two distinct reasons. Marginal factor productivities are typically in export than in non-export activities. As a larger share of the resources of the economy is shifted to the high-productivity export sector the overall efficiency of the economy increases.

But there is a second source of benefit from such a strategy, namely gains for the part of the economy not producing for export markets. In the export-oriented enclave of the economy the expansion and need for competitiveness lead to more efficient production and management techniques, better access to imported inputs etc. As these improvements spread to the non-tradable sector the gains can be very high, even higher than the direct gains from shifting resources. But these secondary gains may not come automatically.

Thus export-orientation beats import-substitution as a growth strategy, as many countries have found out. Countries which pursued import-substitution were more inward looking, which certainly may be said about the centrally-planned economy as well. The inwardly-looking trade regimes practiced a high degree of protection through tariffs and other forms of protection. The centrally-planned economy didn't really need tariff rates for protection as all trade was conducted by the state. A typical feature of a high-protection economy is an overvalued exchange rate, which serves as a tax on exports and a subsidy of imports. China also had this feature, in fact it practiced a dual foreign-exchange rate, and of course with a monopoly on foreign exchange.

11.3 The development of trade after the beginning of the reform period.

Wu (2005) states that the Chinese government started to "experiment with a new policy of opening up" already in the late 1970s and now is more open than other East Asian economies "were at the same level of development." Clearly, the opening up has been a success, but how did this “experiment” evolve. Looking back at the three trade models, we can tentatively state that these were emphasized successively and overlapping.

China’s foreign trade was stepped up sharply at the end of the 1970s to provide foreign exchange for imports within the logic of the planning regime. From 1980 to 1991 foreign trade growth (exports + imports) increased by 9.2 % p.a. according to data from the Ministry of Foreign Trade, and with 12.3 % p.a. according to customs data. China’s GNP growth in the same period was 8.8 % p.a. and the world trade growth was 5.5 % p.a. The trade balance shifted from an import surplus at the beginning of the 1980 to an export surplus at the end of the decade.

> Let us first explain the difference between the data from the two sources. The customs data measure the value of goods going in and out of the country. The Ministry treats the export processing trade differently, it includes in principle only the value added in such processing activities and imported parts and components are not included in the import figures. In this export processing arrangement machinery could be imported under compensation trade contracts, i.e. to be paid in kind a part of the exports produced with the machinery. Then the Ministry data does not include the machinery as imports and not the compensation as exports.

For the expansion of exports of after 1985 there was a strong rise in exports from rural enterprises from 3.9 B$ in 1985 to 12.5 B$ in 1990, and in exports from joint venture enterprises, which rose from 0.3 B$ in 1985 to 12.3 B$ in 1991. Another marked feature of this period was the rise of Guangdong province in exports while Shanghai was almost stagnant in comparison.

What was driving the foreign trade growth in this period? The overwhelming influence behind the surge in exports in the 1980s (there was also almost a doubling of exports and imports from 1978 to 1980) was state decisions. Deng Xiaoping had identified exports of petroleum as a key product to finance the imports to modernize China and make it more productive in the more outward looking strategy. China’s export of petroleum started in 1970s and grew from 11 million tonnes in 1977 to 36 million tonnes in 1985. As this was the period of the OPEC II price hike the value increased in the same period from 1B$ to 6.7 B$. Oil exports alone accounted for one third of China’s increased export earnings.

The role of oil in this period is a prime example of the state-driven trade that was pursued although China was experiencing energy shortages. It was also based on assumptions that China had considerably more petroleum resources than turned out to be the case.

1985 marks a change in the composition of exports. In the first half of the 1980s primary products (incl. oil) amounted to one half of exports and manufacturing products the other half. But from then until 1991 primary products decreased to less than a quarter of total exports and manufacturing product thus amounted to more than three quarters. This shift was caused by the fast expansion of manufacturing exports, mainly textiles and light manufacture goods.

Now we should note that primary products are essentially commodity exports, homogenous goods sold on international markets at world prices, little marketing knowledge is needed to sell them. For manufacturing products, e.g. consumption goods, the situation is vastly different, such good are more heterogeneous and to export such goods in large quantities require a more sophisticated understanding of consumer tastes, quality standards, etc.

The shift in export composition also reflected China’s comparative advantage the light manufactured products that dominated exports after 1985 were far more labour-intensive than the primary products.

The five most exported SITC group of commodities in 1985-90 were:

D84 Apparel
D65 Textile yarn and fabrics
D89 Miscellaneous manufactures
D76 Telecommunications and sound recording and reproducing equipment
D85 Footwear.

If we pursue why this shift occurred we may relate it to three developments in the 1980 reforms:

(1) the decentralization of decision-making in foreign trade;

In the pre-reform period planners use material balances to determine what was needed of imports and the exports sufficient to cover the imports were identified. But foreign trade was a complete monopoly of the central government. A handful of specialized foreign trade corporation was responsible for implementing the trade plan fro different kinds of commodities. The export plan specified 300 commodities that were procured by the government for export.

Reform on this field was part of the 1984 reforms. It was opened then for a large number of small and medium-sized import and export corporations. About 800 such corporations were established 1984-86, at the end of the 1980s there were 5000 such corporations. In fact this was an overexpansion and a number of these corporations were not able to handle such tasks and were close or forced to merge.

The decentralization of foreign trade was also reflected in reduced number of commodities in the foreign trade plan and smaller shares of overall exports and imports. The list of 3000 export commodities was reduced to only 112 at the end of the 1980s. The plan share of imports was 90 % at the beginning of the 1980s and less than 40 % at the end. The share of exports also fell to less than half.

(2) reforms in the pricing of traded goods; and

In the pre-reform trade regime the world market prices had little or no effect on the Chinese domestic prices of tradable goods. Producers received the same price whether goods were sold domestically or in the international market. Producers who delivered god for exports got none of the foreign exchange, nor could they claim to purchase goods abroad. Hence, there little economic incentive to sell on the international market nor to expand production of goods for which there was a strong international demand.

Also domestic prices of imported goods were to a considerable degree unconnected to the world market as the prices of 80 % of China’s imports were set at levels comparable to similar domestic goods. Naturally, this pre-reform practice distorted trade decisions. In some cases domestic production was unduly protected as imports at much lower cost were artificially priced up to match domestic prices. In other cases imported goods could be sold at prices significantly below world market prices, e.g. for grain which had highly subsidized prices.

Most of this flawed pricing of imports disappeared as the result of foreign trade reform and the proliferation of foreign trade corporations which priced imports in domestic currency at the official exchange rate and added shipping cost etc and commission. At the end of the 1980s this pricing principle covered about 90 % of the imports.

For exports the move to market-oriented prices went slower and the foreign trade corporations had a stronger position. The corporatiosn would negotiate prices with companies with little knowledge of world market prices. The export trade organizations could become very rich in this business until the competition among trade corporations became stronger.

(3) the abandonment of an over-valued exchange rate.

The exchange rate was highly over-valued in the pre-reform period. This had little effect on the volumes of exports and imports. In the beginning of the reform period the exchange rate became increasingly a problem. It took much of the profit out of exporting goods. The Ministry of Foreign Trade reallocated to some extent the profits in foreign trade among companies such the in reality the exchange rate differed from corporation to corporation or even from product to product.

The exchange rate in 1978 was 1.68 RMB Yuan per $. A devaluation took place throughout the 1980s until the rate in 1991 was 5.3 RMB Yuan per $. This gradual process took place without much instability as result. The change in exchange rate played limited role in the first half of the 1980s, but in the second half it had considerable impact and took away much of the bias against exports and also the subsidy of imports in the earlier regime.

The devaluation of the RMB reduced the excess demand for foreign exchange and the rigidity of the foreign exchange control could be relaxed in various ways. It was allowed to retain foreign exchange earnings and trade them in foreign exchange markets already from the middle of the 1980s. The market rate showed that the official exchange rate was still overvalued until the early 1990s.

11.4 The rise of FDI

The rise of FDI in the early part of the reform period was even more dramatic than the increase in foreign trade. The advantage of FDI is that it directly helps to relieve domestic capital supply bottlenecks and to promote employment and growth. Capital formation through imports of machinery and equipment can take place also through increased export earnings, but it is a slower process. What was the idea behind the FDI strategy?

China invited FDI into China through joint ventures shortly after the beginning of the reform. FDI was used also by other industrializing Asian countries, but they solicited manufacturing foreign direct investment for import substitution. China invited FDI for export-oriented production while at the same time China’s policy was still very much that of import substitution. FDI must politically have been viewed as difficult to accept, at least for the more dogmatic part of CPC. When it started under Zhao Ziyang it is most natural to consider it a san instrument simply for getting more foreign exchange for imports. Zhao Ziyang has been asserted to have used for the FDI strategy the expression:

Two heads outside 两 头 在 外 liang tóu zài wài, meaning that the use FDI meant that China relied on the outside world both for input supplies and for market outlet. Thus the immediate gain for China would primarily be foreign exchange. The use of geographical enclaves for locating the joint ventures and the FDI suggest that it was a way of insulating the activity form the rest of China.

If this was the original policy then China was very successful in adapting its policy towards benefiting from it in much more important ways. It was exploited by the Chinese for the import of technology and managerial skills. On the other hand FDI was invited to take part in more and more integrated ways of the Chinese economy that surely was not part of the original plan behind FDI. Perhaps an ultimate outcome of the FDI strategy is that China started to use FDI itself in other countries and now has become a very large FDI country. actor

11.5 The strategy of *econocoas*

China started to establish "economically opened coastal areas" (econocoas) immediately after the reform by opening the four Special Economic Zones (SEZs) in 1979/80: Shenzhen, Zhuhai, Shantou and Xiamen. Two of these were located in Guangdong and two in Fujian.

Then in 1984 14 opened coastal cities (OCCs) were declared from Dalian in Liaoning in the North to Beihai in Guangxi. In 1988 a government decree opened up coastal provinces (OCPs) from Liaoning to Guangxi and Hainan, altogether 288 counties. Between 1984 and 1988 the Pearl River Delta, the Yangzi River Delta and some other regional areas also got a special status. Even before that Fujian and Guangdong were given special privileges for shaping their own external relations.

11.6 Conclusion

References

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