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The rebalancing of China's foreign trade

China was a major player in the rise of global imbalances in the mid-2000s. If its overall trade surplus has decreased since 2007, its bilateral surpluses with the U.S. and Europe remain quite large. China's import demand has mainly benefited to its Asian neighbors and to raw material producing countries. However, Europe has also taken advantage of China's demand in consumption goods and increased its share in this market. The slowdown in international demand makes the rebalancing of China's domestic demand towards household consumption more necessary than ever for China's growth and is expected to benefit to European exporters[1].

Rise and fall of China's trade imbalances

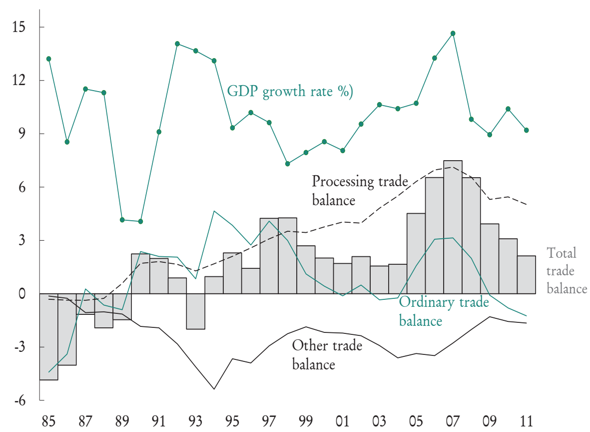
China's current account balance depends mainly on its merchandise trade. In the late 1980s, merchandise trade was showing a deficit and over the following fifteen years it recorded only relatively small surpluses (at most 4% of GDP in 1997 and 1998) (Figure 1). Only between 2005 and 2007 did China's foreign trade accumulate huge surpluses, contributing four-fifths to its current account surplus.

Merchandise trade balances are the result of both assembly (processing) trade, which tracks the activity of foreign capital firms using China as an export base and is therefore by construction in surplus, and of ordinary trade which balance fluctuates.

Between 2004 and 2007, China's trade surplus skyrocketed from 2% to 7% of GDP and external demand became an engine of economic growth. Assembly trade accounted for two-thirds of the increase in the trade surplus. Foreign investors were attracted by low entry costs in these activities and developed globalized production facilities in China, closely connected with the external demand boom, particularly in electronic goods. "Ordinary trade" has also contributed in the rise in the overall surplus as it shifted from a small deficit to a massive surplus.

This reversal was mainly due to Chinese companies building up large production capacities in two heavy industry sectors: "Machines" and "Base Metals". The international environment and the domestic policies aimed at import substitution have thus resulted in a swelling trade surplus.

Figure 1 – China's trade balance
(Trade in goods as% of GDP)



Source: China Statistical Yearbooks and China Customs Statistics.

1. The *Letter* is a short version of the CEPII Working Paper no 2012-14: "Scanning the Ups and Downs of China's Trade Imbalances", F. Lemoine & D. Ünal.

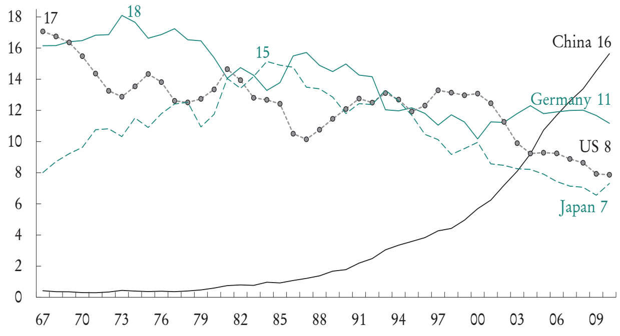
Since 2007, the overall surplus has decreased but bilateral imbalances remain large

Following the financial crisis shock in late 2007, the world trade collapsed in late 2008, only to resume in spring 2009. External demand ceased to drive China's economic growth and in autumn 2008 Beijing launched an ambitious program to boost domestic demand. Growth in China which had slowed down in late 2008 and early 2009, returned to a high pace in 2010 (10.3%) and 2011 (9.2%). The global crisis' impact on foreign trade, however, was severe. From 2007 to 2011, the share of exports in GDP fell from 36 to 28% and that of imports from 29 to 26%. In 2011 its trade surplus had returned to its 2004 level (2% of GDP).

This adjustment followed a pattern symmetrical to what occurred between 2004 and 2007: the assembly trade surplus narrowed while the ordinary trade balance turned into a deficit. On the export side, all trade regimes were hit by the global crisis but on the import side, trends have been heterogeneous. Assembly-related imports have durably stalled as a result of depressed global demand but ordinary imports rebounded quickly due to domestic demand upturn. Ordinary imports amounted to 14% of GDP in 2011, a higher ratio than before the crisis and comparable to that of the United States or Japan.

The terms of trade deterioration has accelerated trade rebalancing. Between 2007 and 2011, Chinese imports grew faster than exports not only in volume (respectively 40% and 34%) but even more in value (82% against 56%)[2]. In a depressed international environment, China has, thanks to its strong investment-driven economic growth, rebalanced its foreign trade and enlarged its presence in world markets. In 2010, the share of Chinese exports in global trade of manufactured goods reached 16%, a threshold close to that of leading exporters when they peaked (Figure 2).

Figure 2 – Major exporters of manufactured goods
(Share of world manufacturing trade, in%)

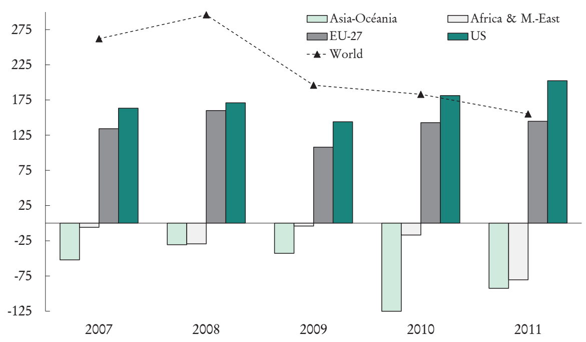


Source: CEPII database CHELEM-International trade.

However, strong bilateral imbalances persisted (Figure 3): on one hand, the trade surplus towards the United States was in 2011 back to its 2007 level and the trade surplus towards the European Union had remained almost unchanged, with the exception that China now runs a deficit towards Germany while increasing its surpluses towards most other European countries. On the other hand, deficits towards countries in Asia, the Middle East and Africa have deepened. The deficits towards Asia largely derive from the international division of labor in the region (in which China assembles components imported from its neighbors), but also from the progression of Asia's exports aimed at China's domestic demand.

Deficits towards Africa and the Middle East stem from China growing needs in imported raw materials as well as from higher prices.

Figure 3 – China's trade balance by area
(Trade in goods, in billions of dollars)



Source: China Statistical Yearbooks and data from China Customs.

How did household consumption evolve?

Since 2007, China's economy has weathered the crisis by relying on its domestic market but not on private consumption. Its weight in GDP has sharply fallen since 2000 and has declined further since 2007: it tumbled from 46% in 2000 to 36% in 2007 and further to 34% in 2010. This contraction is the result of the demographic and institutional factors which underlie the evolution of household income and savings behavior. Structural factors, such as the rapid growth (until 2010) of the working age population and the massive migration of workers from the countryside to the cities, have slowed the wage growth. Moreover, the institutional context and particularly the low level of social transfers and returns on savings (interest rate ceilings on bank deposits) have also contributed to reduce the weight of household income in the GDP[3]. The liberalization of factors of production's price remains incomplete: labor and capital

2. Import prices grew by 30%, and export prices by 16% (source: People's Bank of China, Monetary Policy Reports).
3. N. R. Lardy (2012), Sustaining China's Economic Growth After the Global Financial Crisis, Peterson Institute for International Economics, January.

prices have been kept low, at the expense of consumption. Finally, the rise of households' saving rate (up from 19% in the mid-1990s to 30% in 2009) can be traced to the decline in the dependency ratio as well as to the increase of job insecurity and income inequality. The low interest rates on savings have fostered household investment in real estate and contributed to raise prices.

However, China's national accounts statistics may underestimate the revenues and expenditures of the population. Indeed, official data do not include illegal or simply unreported income. They underestimate household expenditure, because the actual costs of services related to health, education and housing are higher than shown by the figures. Symmetrically, data overstate investment in fixed assets since they include, for example, the value of land transactions.

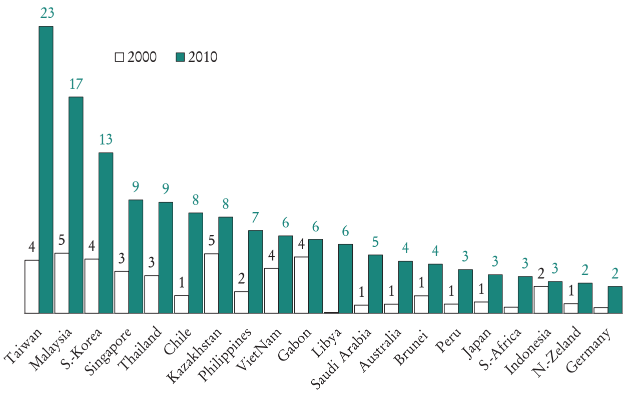
The reorientation of domestic demand toward household consumption is part of the priorities enshrined in the 12th plan (2011-2015) but it will not occur under the sole effect of demographic changes. Starting from 2010, the working age population ceases to increase and will decrease after 2015, which represent a fundamental change. According to some observers, China reached the point when its reserves of workforce are not "unlimited" anymore (Lewis turning point). Yet, others consider that China's reserves of labor are far from exhaustion because there are still a whole slew of potential migrants in the countryside (80 million). Local labor shortages would therefore originate from the fact that the center of economic growth has shifted to the inland provinces, which slows migration towards the coastal provinces. The transition to a more balanced development, making more room for private consumption, services and the quality of growth, could be hampered if it is not supported by policies promoting mass consumption (through urbanization, larger social public spending and higher return on savings, appreciation of the exchange rate). On average, the recent wage increases do not exceed labor productivity gains by a margin which challenges, in the short run, the competitiveness of the Chinese industry.

Which countries have benefit most from Chinese demand?

In Western countries, the global crisis has revived the concerns raised by the rising economic power of China but also the hopes that it could pull growth in the rest of the world. On the 2000-2010 period, China accounted for 20% of global growth when GDP is estimated in current dollars, but this figure rises to 30%, when considering purchasing power parity-based measures. Trade is the main transmission channel of the impact of China's growth on the rest of the world. With more than 9% of world imports in 2011 against 3.5% a decade ago, China is an increasingly significant source of international demand.

Figure 4 ranks countries according to the weight of exports to China in their GDP. It shows the countries which have benefited the most of China's import demand. The dependence of many emerging economies on China's market has increased significantly in the past decade. In 2010, exports to China amounted to 11% of GDP in East Asia excluding Japan (against 4% in 2000). The ratio reached 13% in Korea, 17% Malaysia, and 23% in Taiwan. China's role in the dynamics of regional integration cannot be overestimated. For some major exporters of raw materials in Central Asia (Kazakhstan), Latin America (Chile), Africa (Gabon) and Middle East (Libya, Saudi Arabia), the dependence on Chinese demand has also reached significant levels. China is now a major player influencing world trade in fuel, metals, and minerals prices. China pulls the Asian country growth through its demand for manufactured goods and that of Latin American and African countries through its imports of primary products. Although the orientation of Europe and the United States towards the Chinese market is on the rise, it remains low (less than 1% of GDP). Within the European Union, Germany is an exception with exports to China representing 2% of GDP.

Figure 4 – The share of merchandise exports to China
in the country's GDP (%)

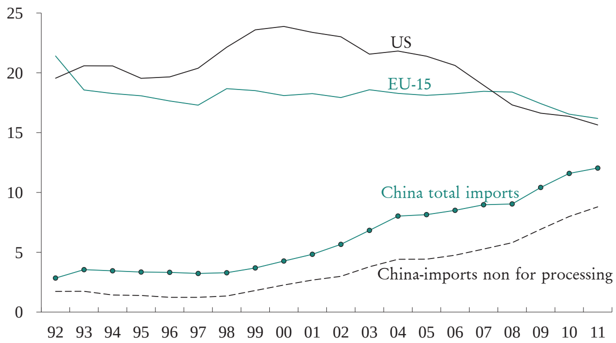


Source: CEPII database SLAM-International Trade-GDP.

Consumer goods: an already promising market:

China's imports are growing rapidly (Figure 5). If we consider only "ordinary" imports (excluding imports for assembly), their share rose from 2% of world imports in the early 1990s to 7-8% in 2010-2011. During the decade preceding the global crisis (1997-2007), the sectorial composition as well as the geography of China's imports for its domestic market changed significantly. The most remarkable change was that the share of primary products doubled from 20 to 40% between 2002 and 2007. This benefited to countries exporting energy and other raw materials.

Figure 5 – Share in world imports of manufactured goods
(excluding intra-EU trade, in percent)



Source : OMC et Statistiques de douanes chinoises.

In the case of China's ordinary imports of manufactured goods (Table 1), semi-finished products still occupy by far the leading position (43% of the total imports in 2007), although in relative decline. Parts and components have gained the second place (26% in 2007), ahead of equipment goods (22%). Consumer goods imports increased at an accelerated pace from a low level (reaching 9%), reflecting the increasing purchasing power of the Chinese wealthiest households.

Table 1 – China's ordinary imports of manufactured goods
by stage of production and by origin

	Semi finished products	Parts & components	Consumer goods	Capital goods	Total
Structure en 2007 (in percentage point)					
Asia	23.6	14.9	3.6	10.3	52.4
Europe	6.8	8.0	3.8	8.0	26.7
NAFTA	5.6	2.2	1.5	3.2	12.5
Others	7.3	0.4	0.5	0.2	8.4
World	43.3	25.6	9.3	21.8	100.0
Évolution 1997-2007 (in percentage point)					
Asia	+0.6	+7.6	+1.6	+4.5	+14.3
Europe	+1.3	+0.3	+2.6	-1.8	+2.3
NAFTA	-4.5	-2.4	+0.7	-2.7	-8.8
Others	-7.0	-0.3	+0.1	-0.5	-7.8
World	-9.6	+5.3	+5.0	-0.6	0.0

Source: China Customs Statistics.

Asian countries have significantly strengthened their position in the Chinese domestic market. Their share in ordinary imports of manufactured goods jumped 38% to 52% and this breakthrough occurred in intermediate products as well as in final goods (Table 1). China is not only an export base for Asian countries, but more and more a market for their finished products, and thus a growth engine for their economies.

The share of NAFTA (Canada, USA, Mexico) in ordinary imports of manufactured goods was almost halved in ten years, as North American exporters lost ground in all categories of products excepted consumption goods.

Despite competition from Asia, Europe has improved its position. In the supply of capital goods, European exporters lost in 2007 to Asian exporters the first rank they still held in 1997, but they achieved a better performance than Asia in consumer goods, especially in high-end goods.

Since 2007, consumer goods have gone on being the manufactured products' category which increased the fastest in China's imports and Europe has continuously enlarged its share in this market. The reorientation of domestic demand in favor of household consumption, could therefore have important positive implications for China's partners and especially for Europeans.

China's own growth depends to a significant extent on advanced economies (U.S., Japan and EU receive 44% of its exports) and is currently affected by their weak demand. In the first quarter of 2012, Chinese exports to the United States increased only slightly (13% in value, year on year) but declined to the European Union (-1.8%). The sharp deceleration in China's total exports expansion (7.6% against 26.5%in first quarter 2011) has contributed to slow down its economic growth, which fell to 8.1%. These frail external conditions make it more necessary than ever for China to boost domestic consumption. The next leaders will have to carry on this shift in the economic strategy.

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