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Economic Growth, International Trade and China

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SECTION I. Introduction

There is agreement in the literature that there is correlation between trade and economic growth.[1] Several studies throughout the years have found that an increase in international trade levels leads to an increase in GDP per capita.[2] Given that GDP per capita is our proxy for development (because it is highly correlated with other ways of measuring development), countries can indeed develop as a result of increasing their level of international trade.[3] However, there is no general agreement on whether fully open economies (free trade economies) outperform those that are more closed.[4]

Consequently, this begs the question of how can countries increase their levels of international trade and at the same time of economic output? The traditional theory of comparative advantages, conceived by David Ricardo more than two centuries ago, tried to answer this question by suggesting that countries should trade the products that they have an advantage in producing.[5] Adam Smith also heavily advocated for free trade and against protectionist instances on trade.[6] These theories consolidated themselves towards the end of the 19th century and gained momentum in the post-World War II era, where it was believed that free trade could promote economic development detering conflicts between nations.

[1] J. VENTURA, A GLOBAL VIEW OF ECONOMIC GROWTH. HANDBOOK OF ECONOMIC GROWTH 1419-1497 (2005).
[2] Id.
[3] One caveat is in order. The fact that there is correlation does not necessarily means that causation has been proven because there may be a problem of endogeneity. For instance, countries that do usually better in economic terms usually trade more and that may create econometric problems for regression models between trade and economic output. Some have tried to use proxy variables to deal with this potential endogeneity problem such as relying on geography for trade, given that it is a fixed factor see Jeffrey, A. *Frankel*, & David H. *Romer, Does Trade Cause Growth?*, AMERICAN ECONOMIC REVIEW 379 (1999). However, this does not fully prove that trade produces growth, in any case it could prove that geography is a good driver of growth.
[4] See *Trade and economic growth in developing countries: Evidence from sub-Saharan Afirca*, Journal of Afrinca Trade 41 (2016).
[5] For the description of the classical theory *see*, H. Myint, *The Classical Theory of International Trade and the Underdeveloped Countries*, THE ECO. J. 317 (1958).
[6] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

With this idea in mind, the GATT Agreement was concluded in 1947 with the strict purpose of reducing tariffs in order to foster international trade.[7] This then evolved into the World Trade Organization (WTO) in 1994, the beacon of international trade liberalization.

However, not all countries whose international trade has thrived have adopted the "no tariffs, no protection" prescription of neoliberal economics. Countries such as China, who has established itself as the leading country in terms of international trade, have adopted a deviation from this prescription and despite of that (or perhaps because of that) its international trade has boomed in the past four decades.

In 1980, Milton Friedman, the father of neoliberalism and a fervent proponent of free trade visited China.[8] The country had very recently started to pursue new "liberalization policies" under Den Xiaoping and the Chicago Economics Professor had recently published one of his most influential books: "Free to Choose".[9] In this work, Friedman advocated for minimal governmental intervention and wrote in favor of allowing Smith's Invisible Hand of the market to efficiently allocate goods and services.[10]

The Nobel laureate fervently defended free trade and the efficiency of unregulated markets, which gave rise to the policy recommendations contained in the Washington Consensus.[11] In this vein, Friedman's advice for China's integration to the world economy during his trip was straightforward: de-regulation, the elimination of tariffs and free-trade specialization.[12]

China, far from following Friedman's recommendations, has pursued a strong governmental intervention in a centrally-planned economy with tough tariffs on imports and

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[7] *See* K. Bagwell & R. W. Staiger, *Economic Theory and the Interpretation of GATT/WTO*, THE AM. ECONOMIST 3 (2002).
[8] *See* Mishra, Pankaj, The Rise of China and the Fall of the "Free Trade" Myth, New York Times Magazine, < https://www.nytimes.com/2018/02/07/magazine/the-rise-of-china-and-the-fall-of-the-free-trade-myth.html> (Feb. 7, 2008).
[9] MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT (1980).
[10] Id at 305-306.
[11] The Rise of China *supra note* 6.
[12] Id.

some anti-competitive or anti-free trade policies. The astonishment factor that Friedman's theory was not able to accurately describe is that, even departing itself from a fully free-trade agenda and with a strong governmental intervention, China today is the leading exporter and the second world importer. And indeed, much of its economic growth has been the result of a boom in international trade.[13] This undoubtedly begs the question on whether the free trade ideas of international trade is the correct or predominat path towards trade growth. Specially bearing in mind that some countries that have been good pupils of Milton Friedman's free-trade agenda, such as Mexico, have lagged behind in growth.[14]

Accordingly, the object of this paper will be to evaluate the international trade and development literature and then apply it to the Chinese model of international trade. With this in mind, this article will generally present the most salient literature on trade and development in the first section. Specifically, we will look at the historical development of the classical free-trade doctrine, show its consolidation as a dominant theory and present certain caveats that have been pointed out by different economists in Section II.[15] Section III will look at the Chinese case and how its policies have deviated from the dominant "free-trade" theory. It will also put forward certain explanations for its massive international trade growth.[16] Of course, one should be careful of not literally extrapolating the Chinese model into other countries, given the particularity of China.[17] But, there are surely certain lessons that can be drawn on a more general level.

SECTION II – Theory and history of international trade and development literature

[13] Peng Sun & Almas Heshmati, *International Trade and its Effects on Economic Growth in China*, IZA DP No.5151, Discussion Paper Series (Aug. 2010).
[14] See DANI RODRIK, STRAIGHT TALK ON TRADE 11 (2017)
[15] *See* for example Ricardo Hausman, et. al., What You Export Matters, J. OF ECO. GROWTH 1 (2007); R. FINDLAY, INTERNATIONAL TRADE AND DEVELOPMENT THEORY (1970).
[16] See Sheng Bin, *China's Trade Development Strategy and Trade Policy Reforms: Overview and Perspectives*, THE INSTITUTE OF INTERNATIONAL ECONOMICS, Nankai University, Tianjin, China.
[17] M. Guglielmo Caporale et. at, *Trade flows and trade specialization: The case of China,* CHINA ECO. REV., 261 (2015)

2.1. Classical thought on international trade

Trade is one of the oldest economic practices. But only in the seventeenth and the eighteenth century writers began to theorize about its relationship with economic growth and development. The mercantilist thought, present in the works of Jean Baptiste Colbert,[18] suggested that wealth acquisition was the result of trade surplus. However, already in 1752, David Hume criticized this theory by suggesting that trade surplus is a momentary fact given that money supply and prices adjustment as a consequence of the trade surplus would lead to balance of payments (BOP) equilibrium.[19]

Adam Smith also, in his famous book "The Wealth of Nations", severely attacked the mercantilists' tariff protection scheme.[20] In turn, he advocated for tree trade. He believed that trade allowed for large-scale production and more division of labor, which fostered productivity and consequently growth.[21] Moreover, international trade also permitted to allocate the surplus of goods produced in a certain economy.[22]

David Ricardo, another famously known economist, developed his "theory of comparative advantage". The latter suggests that all countries should specialize in producing commodities in which they possess a competitive advantage and then trade them for other goods that they are not good in producing.[23] For example, if a country is rich in land, they should produce and trade agricultural products.

The works of Smith and Ricardo established themselves as the majoritarian thought on international trade and economic growth in the 18th and 19th centuries in Europe.

Nevertheless, it was not unanimous. As early as Alexander Hamilton and the German economist Friedrich List, economists or political thinkers have advocated for the protection

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18 Victor-Lucien Tapié, Jean Baptiste Colbert, Encyclopædia Britannica, < https://www.britannica.com/biography/Jean-Baptiste-Colbert>.

19 RAJAT ACHARYYA, INTERNATIONAL TRADE AND ECONOMIC DEVELOPMENT 6 (2014).

20 ID. AT 8

21 P. 8

22 Id.

23 Id.

of infant industries.[24] List himself lived in the United States from 1825 and 1830, upon his return to Germany he published “Outlines of American Political Economy.” He heavily critized Britain’s position of relying on strong protectionist policies to develop its industries and then preaching against it in the rest of the world.[25] He didn’t oppose free trade, but rather he thought that the State should have a major role in nurturing incipient industries for them to be able to stand on their own.[26]

John Stuart Mill was also a proponent of the protection of infant industries idea with the caveat that protection should be temporary in order to allow the firm to be able to stand on its own feet.[27] Otherwise, the firm would become dependent on the State’s protection and have no incentives to produce efficient products.

Moreover, Mill had a profound criticism of the Ricardian doctrine based on the fact that it left out the notion of demand in the trade equation. Many years later, Marshall, modeled Mill’s idea in his concept of the “offer curve”.[28] Accordingly, Marshall presented the first price equilibrium model for international trade in terms of demand and offer curves.

The Austrian School of Economics refined the demand-supply notions developed by Marshall by incorporating the notion of “opportunity cost”, which provided the base for the Heckscher-Ohlin model of free trade.[29] This model, which instituted itself as the reigning economic model supporting free-trade almost until the 1980s, purported that a country’s exports depends on its endowments, particularly if the country is labor-intensive or capital-intensive.[30]

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[24] Marc J. Melitz, *When and how should infant industries be protected?*, J. OF INTERNATIONAL ECONOMICS 177 (2005) 177.
[25] The Rise of China *supra note* 6.
[26] *Id.*
[27] JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY (1848), in J.M. ROBSON, (ED.), COLLECTED WORKS OF JOHN STUART MILL, VOL. III. 918– 919 (1963).
[28] T. Negishi, *Marshall and Offer Curve*, Developments of International Trade Theory, in Research Monographs in Japan-U.S. Business & Economics 95(2001) 97.
[29] Tri-Dung Lam, *A Review of Modern International Trade Theories*, Am. J. of Eco., Finance and Management 604 (2015) 610.
[30] Id.

However, the HO endowment model was not fully corroborated empirically. Particularly in the United States during the 1950s, it was observed that exports were more labor intensive and despite of the availability of capital.[31]

2.2. Post World War II International Trade Theory in the developing world.

Neo-classical free trade ideas were very resonant in the post-war economic debate. The reminiscence of the Great Depression and tariff retaliation that had led to it was very recent and some scholars believed that those trade wars and race-to-the-bottom strategies pursued by the United States and Europe pre-WWII were highly detrimental to peace and economic prosperity.[32] With this idea in mind, the Western powers created the GATT in 1947, a treaty that promoted the progressive elimination of tariffs and the instauration of free trade as the ultimate objective.[33]

However, the neo-classical conceptions of trade started to be criticized during the 1960s from a developing world perspective. The leading economist on this regard was Jagdish Bhagwati with his theory of "immiserizing growth".[34] He proved that the terms of trade are a very important factor for growth rates of trading economies. Other economists such as Raul Prebisch[35] and Hans Singer[36] suggested that the terms of trade would harm those countries that produce primary products (such as developing countries) vis-à-vis more expansive capital products that were being imported from the developed world.

These economic theoretical criticisms lead to the development of "Dependency theory" school of thought with proponents such as Cardoso among others.[37] The core of their

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[31] L.W. Leontief, *Factor Proportions and the Structure of American Trade*, REV. OF ECONOMICS AND STATISTICS 38 (1956) 38-42.

[32] DOUGLAS A. IRWIN, PETROS C. MAVROIDIS & ALAN O. SYKES, THE GENESIS OF THE GATT 7-10 (2011).

[33] Id.

[34] Jagdish N. Bhagwati, Immiserizing Growth: A Geometric note, Rev. of Economic Studies, 201 (1958) 202-204.

[35] Raul Prebisch "Development Problems of the Peripheral Countries and the Terms of Trade." in J.D. Theberg (ed.) (1968) Economics of Trade and Development.

[36] Hans Singer. "The Distribution of Gains between Investing and Borrowing Countries.", American Economic Review, Papers and Proceedings (1950).

[37] Fernando Henrique Cardoso, *Dependência e desenvolvimento na América Latina* 34 (1970).

thesis established that international trade and international economic relationships are structured in such a way as to perpetrate the developing world's dependency on the developed world.[38] They challenged the idea that developing countries were destined to be the agricultural food providers of the developed world. Accordingly, many countries took this findings and adopted "import-substitution policies". This mechanism implied the protection of local industries from imports in order to substitute those goods that were bought from abroad.[39]

Now, although it served some countries to adopt strong import-substitution mechanisms based on high tariffs, there is ample evidence that import substitution did not lead to overall growth or development of efficient local industries.[40] Sometimes it even leads to protection of inefficient companies that sell their products at monopoly prices, generating dead weight loses and higher consumption prices.[41]

2.3. Export Base Theory

Another trade theory with origins in the 1950s and 1960s, and particularly popular in East Asian countries such as Japan, South Korea and Taiwan was the so-called "export base theory", a term coined by North in 1955.[42] An economic production of a certain country may focus on different kinds of goods: exporting goods and domestic consumption goods. Export base theory establishes that output and employment growth within a region depends on the demand for that region's exports. There is a strong assumption embedded in this theory, namely a perfect elasticity of input supply and demands for exports. That is to say, as soon as

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[38] Id.

[39] For a review of these types of policies and their application in Latin America see: Werner Baer, *Import Substitution and Industralization in Latin America: Experiences and Interpretations*, LATIN AM. RESEARCH REVIEW 95 (1972).

[40] The economist Anne Krueger stated: "It is generally believed that import substitution at a minimum outlived its usefulness and liberalization of trade is crucial both for industrialization and economic development." See Anne Krueger, *Trade Policy and Economic Development: How We Learn*, AM. ECO. REV. 1 (1997).

[41] See on the failures of import-substitution: Werner Baer, *Industrialization in Latin America: Successes and Failures*," J. OF ECO. EDUCATION 124 (1984).

[42] Tri-Dung Lam *supra note* 26 at 609.

the input supply gets minimally altered, it perfectly resonates in the demand for exports. Thus, economic output is a result of export of goods but also the theory implies a Keynesian income multiplier: growth in exports leads to income growth which leads to a greater demand of local goods (domestic consumption) and thus to further growth in the region's income.[43]

Although it is still a prevalent theory today, it is not immune to various criticisms. First, the theory seems to be shortsighted and limited to small regions, in larger regions, exports are not the only factor that drives growth.[44] Second, domestic markets determine the costs of factors of production for goods that are sold abroad; this is a feature that North's theory tends to miss.[45] Third, even if exports decrease, economic growth may be driven by a higher consumption of domestic goods,[46] especially in countries with huge populations such as Brazil or China.

Lastly, the most recent literature even suggests that what may matter is the composition of goods that a country exports instead of the amount of goods that it exports.[47] Thus, not any kind of export base model of international trade could lead to higher economic output but rather a high-value added goods basket is most likely to do the job.

2.4. Globalization and its impact on international trade and development

Towards the 1980s, there was a re-surge of neoliberalism supported by the work of Milton Friedman, amongst others, and the governments of Reagan in the United States and Thatcher in the United Kingdom. Simultaneously, the advent of globalization in the context of an informational technology revolution allowed closer interconnections between countries.

[43] R.M. Leichenko, *Exports, Employment and Production: A Causal Assessment of U.S States and Regions*, ECONOMIC GEOGRAPHY 303 (2000).
[44] Tri-Dung Lam *supra note* 26 at 609.
[45] Id.
[46] Id.
[47] Hausman, R., Hwang, J., and Rodrik, D. (2007). 'What You Export Matters'. Journal of Economic Growth 12(1): 1–25; Agosin, M. R. (2007). 'Export Diversification and Growth in Emerging Economies'. Working Paper No. 233, Departamento de Economía, Universidad de Chile.

With these ideas in mind and recurring to principles of the neo-classical trade theory, the World Trade Organization (WTO) was established in 1995 as a successor of the General Agreement on Trade and Tariffs (GATT).[48] The WTO's objective is quite straightforward: to promote and expand free trade by the progressive elimination of tariffs.[49] However, this international body has competence over services, agriculture, investments and other trade-related subjects, not only regarding trade in goods. In fact, the organization itself recognizes to be based on a liberal Ricardian theory of comparative advantage.[50]

Under the auspices of the WTO, many countries and regions have entered into Free-Trade Agreements, international treaties that have pursued the progressive elimination of tariffs in goods. In this way the WTO serves a coordination and centralization purpose: to conjunctly push towards trade liberalization preventing race-to-the-bottom strategies by single countries.[51]

While from 1994 to the early 2000s most free trade agreements were basically focused in the trade of goods, towards the second half of the 2000s and until recently, most free-trade agreements encompassed liberalization measures in a comprehensive set of disciplines. This was what Richard Baldwin denominated "Regionalism of the 21st Century".[52] Further, this International Economics Professor built on Michael Porter's value chains upon which each enterprise should integrate (and specialize) on those productive chain steps that may bring about the greater efficiency.[53] Baldwin takes this idea further and suggests that each step in the productive chain should be localized in such a country that

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[48] Understanding the WTO, who we are, < https://www.wto.org/english/thewto_e/whatis_e/who_we_are_e.htm> (May 5, 2018).

[49] Id.

[50] The WTO acknowledges that it is built around the idea of comparative advantages, attributable to David Ricardo, see Understanding the WTO, The Case for Open Trade, < https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm>.

[51] As the WTO itself recognizes: "There are a number of ways of looking at the World Trade Organization. It is an organization for trade opening" supra note 41.

[52] Richard Baldwin, *21st Century Regionalism: Filling the gap between 21st Century Trade and 20th century trade rules* (Staff Working Paper ERSD-2011-08, WTO: Economic Research and Statistics Division, 2011).

[53] Richard, Baldwin, "Global supply chains: Why they emerged, why they matter, and where they are going," CEPR Discussion Papers 9103, C.E.P.R. Discussion Papers (2012).

allows the producer to minimize costs.[54] These are global value chains, which create a productive transnational process in which each country, according to its comparative advantages, integrates in one part of the production chain.[55]

One of the problems with the whole concept of global value chains and 21st Century Regionalism relies on its extremely optimistic view on globalization, free trade and on its effects on economic growth. Further, there are two assumptions that are not always corroborated in the international trade. First, Baldwin's theory presupposes a high elasticity of price to exports. Thus, there is an expectation that as soon as tariffs and costs are reduced, there will be an immediate increase in production, a better insertion to global value chains and an immediate rise in exports. Second, there is no straightforward connection between reducing tariffs, an increase in exports and a consequent increase in the GDP. The inverse could also be the case. East-Asian countries that have thrived with export-oriented models such as Japan or South Korea, have at the same time sustained high import-tariffs to prevent a flood of intermediate goods.

However, Baldwin's enthusiasm with globalization was short-lived. With the upraise of nationalist movements in Europe and Donald Trump's victory in the United States, the momentum of mega-trade agreements such as the TPP were momentarily blocked. Moreover, discontent with globalization, which has been previously expressed in different scholarly works,[56] has started to flourish in the developed world[57] and those who have been left behind by this process have found the perfect scapegoat in the free movements of goods and people.[58] In this context, some leaders have taken advantage of this feeling and are pushing

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[54] Id.
[55]Gary Gerefii et. al, The governance of global value chains, Rev. of International Political Economy, 78 (2006).
[56] *See* STIGLITZ, JOSEPH, GLOBALIZATION AND ITS DISCONTENTS (2003)
[57] As we can observe in a poll printed in an article by The Economist, *What the world thinks about globalization* (18 Nov. 2016), < https://www.economist.com/blogs/graphicdetail/2016/11/daily-chart-12>, most people in different developed countries feel that globalization has benefited the wealthiest rather than the ordinary citizens
[58] As Douglas Irwin explains in his article *The Truth about Trade*, FOREIGN AFFAIRS (July/August 2016), <https://www.foreignaffairs.com/articles/2016-06-13/truth-about-trade>, most people tend to blame trade for the loss of jobs and growth. However, he points to the fact that according to the CBER (Center for Business and

anti-free trade and anti-migration agendas. Indeed, whilst technological advances are inevitable, one can always vote against Preferential Trade Agreements or immigration policy. Donald Trump for example, since taking office, has explicitly taken several protectionist policies such as the recent tariffs on trade and steel or the withdrawal from the TPP. Consequently, the future of free trade might look somewhat bleak.

2.5. A takeaway on the debate between free trade and protectionism and the future of international trade.

Economists on both sides of the aisle have tried to defend the costs and benefits of free trade in contrast to protectionism or vice-versa. However, it is usually the case that the best option for a country to adopt depends on its stage of development, productive matrix and economic policies that it pursues. Throughout history, there have been cases of increased and decreased economic growth for countries associated with protectionist and free trade policies. Furthermore, and recalling Bhagwati's findings portrayed above, export oriented growth may not be always be the most productive method to generate growth given that the terms of trade may deteriorate cancelling the initial GDP increase.[59]Additionally, as the benefits of free trade reside in very limited assumptions, the gains that a country may have from adopting such policy could not reach its full potential.[60]

On another note, the models that have been put forward to support free trade, usually do not take into account that free trade produces both losers and winners within the country itself.[61] This may exacerbate inequality within a determinate country.[62]

Economic Research) out of the 5.6 million jobs that were lost in the manufacturing industry between 2000 to 2010, only 13% was related to a change in trade patterns. The rest is due to technological changes that turned a lot of those jobs obsolete by increasing productivity.

[59] Bhagwati supra note 33

[60] RAJAT ACHARYYA supra note 19, at 10.

[61] *See* Leonardo Baccini, Pablo M. Pinto & Stephen Weymouth, *The Distributional Consequences of Preferential Trade Liberalization: Firm-Level Evidence,* INTERNATIONAL ORGANIZATION 373 (2017).

[62] Id.

On the other hand, some countries have also abused the Millian idea of trade protection of infant industries. Unlike many applications, infant industry protection does not equate to universal tariff protections. A strong tariff protection leads to the unwanted result of rents for economic agents, which are not always efficient.[63] For example, this was the case of the Tata automobile firm in India.

The other interesting argument against protectionism was brought up by Metzler in his 1949's model in which he proves that tariffs on imports may not in fact protect domestic industries givent that a higer price on imports will reduce world's demand (granted that it is a very large importing economy) and in turn it will decrease the imports' global price.[64] If this improvement in the terms of trade trumps the initial cost imposed by the tariff, the import is cheaper and we are in the same situation that we were before introducing it.[65] This may be an interesting finding for huge economies such as the United States or China, which are the leading world's importers.

Of course, the kind of international trade strategy that is appropriate for each country is highly dependent on its current development.[66] "The argument that an import-substitution development strategy will promote industrialization and growth is perhaps more relevant for more primitive countries that have little industrial base and are dependent heavily on primary and agricultural goods, such as the African countries. But for semi-industrialized countries like India, and many other Asian and Latin American countries at present levels of development, for which manufacturing constitutes a sizeable proportion of total exports,

[63] *See* Anne O. Krueger, The Political Economy of the Rent-Seeking Society, The American Economic Review 291 (1974); Bhagwati, J. N. (1982). 'Directly-Unproductive Profit-Seeking (DUP) Activities'. Journal of Political Economy 90: 988–1002.
[64] RAJAT ACHARYYA supra note 19, at 11.
[65] Id
[66] *See more generally* at JAGDISH N. BHAGWATI, PROTECTIONISM (1988).

import substitution development strategy is more likely to impede development and growth by encouraging inefficiencies."[67]

There is also an interesting recent development on international trade policies for middle-income countries. As Gregory Shaffer and Charles Sutton point out that a proper theory of international trade for middle-income countries could consider applying context-driven policies of either free trade or protectionism.[68] The key to this flexibility is having an institutional international system (such as the WTO) that permits this kind of policy space for them to experiment.[69]

Finally, it is worth mentioning that the most recent literature in international economics has found certain general conclusions on certain trade-affecting factors that could be used in analyzing future trends of international trade.

First, usually countries trade those goods, which they are good producing under autarky.[70] This is some form of confirmation of Ricardo's Comparative Advantage theory. Thus, generally you would expect to see countries trading those goods that they have more ease in producing.

Second, institutions also affect trade. For example, the access to private credit has a profound effect in the amount a country exports.[71] Usually, those countries that have the most dynamic credit markets export more than those who don't.[72] Another interesting finding by Melitz is that country-specific language knowledge is also important in promoting trade.[73] This means that there are a whole variety of non-economic institutional arrangements that

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[67] RAJAT ACHARYYA supra note 19 at 13-14.
[68] Gregory Shaffer & Charles Sutton, *The Rise of Middle-Income Countries in the International Trading System*, IN RANDALL PEERENBOOM & TOM GINSBURG (EDS.), LAW AND DEVELOPMENT FOR MIDDLE INCOME COUNTRIES 60-64 (2013).
[69] Id. at 64
[70] D. Bernhofen & J. Brown, *A Direct Test of the Theory of Comparative Advantage: The Case of Japan* J.OF POL. ECON., 48 (2004).
[71] Kalina, Malova, *Credit constraints, heterogeneous firms, and international trade,* THE REV. OF ECONOMIC STUDIES 711 (2013).
[72] Id.
[73] J. Melitz, *Language and foreign trade,* EUR. ECON. REV. 667 (2008).

may affect international trade. Some have even suggested that trade may have a positive effect on institutional development[74] and productivity.[75] But these are hypothesis worth of examining at further length.

2.6. Distributional effects of international trade

Regardless of the direct impact of trade on economic growth, there is a profound debate on whether trade leads to good or bad distributional outcomes. We have already mentioned that trade leads to winners and losers. The question now is whether this is necessarily good or bad for the poor and inequality?

First, there is a great deal of literature that deals with the impact of trade liberalization on income-effects on low-income people. For example, Topalova analyzed the impact of the 1990s trade liberalization on India. He discovered that it had had a negative effect on poverty reductions since those rural areas that were most heavily exposed to liberalization had a lower poverty reduction and consumption growth.[76] Other scholars have studied the impact of the Chinese imports on the US market and suggested that there is a strong correlation between the increase in Chinese imports in the period 1990-2007 to the increase in unemployment, lower labor-force participation, and reduced wages.[77] However, particularly on these kinds of studies, it is unclear whether the decrease in labor-intensive production of products was the result of imports or of technological advancement.

Moreover a greater criticism to both the Indian and US analysis lies on the fact that although they predict a higher income inequality as a result of trade, they do not analyze the overall effect on the Indian and American economy.

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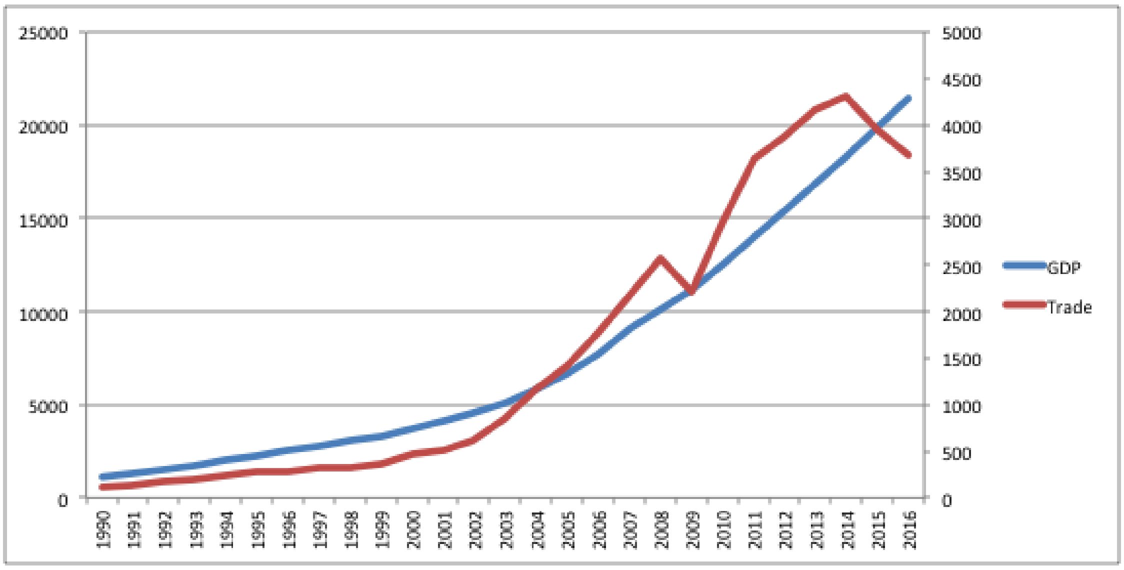
[74] Dani Rodrik et. al., *Institutions rule: the primacy of institutions over geography and integration in economic development*, J. OF ECONOMIC GROWTH, 131 (2004).
[75] F. Alcalá & A. Ciccone, A., *Trade and productivity*, QUART. J. OF ECON. 613 (2004).
[76] Petia Topalova, *Factor Immobility and Regional Impacts of Trade Liberalization: Evidence on Poverty from India*, AMERICAN ECONOMIC JOURNAL: APPLIED ECONOMICS 1 (2010).
[77] H. David et. al., *The China syndrome: Local labor market effects of import competition in the United States*, THE AMERICAN ECONOMIC REVIEW 2121 (2013).

On the other hand, there are other more optimistic findings on the impact of international trade on income distribution. For example, Fajgelbaum and Khandelwal suggest that an increase in trade liberalization reduces overall consumption prices of goods that are generally consumed by low-income people.[78]

<u>Section III: The Chinese model of international trade and development</u>

China has had an unparalleled economic growth over the past decades. In the last 20 years, the average growth has been of approximately 9% per year and great part of it is attributed to its international trade, particularly its exports.[79] As we can see in the graph below there is a parallel growth in international trade and GDP.

<u>Graph 1: Chinese GDP and trade growth since the 1990s (in billions of dollars)</u>



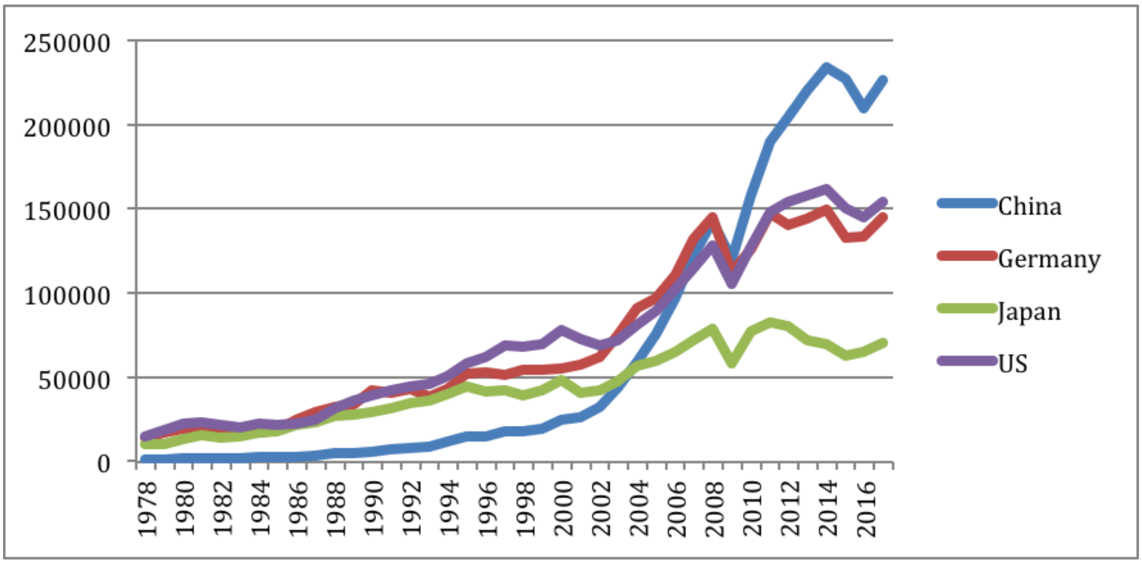
Source: World Bank data.

From 2007, China has surpassed the United States as the world's leading exporter country. China's boom in international trade followed from China's integration to the world economy after Den Xiaoping's reforms started to be enacted from 1978 onwards. In the graph below we can see how international trade actually flourished from this year onwards. Whilst China's exports

[78] Pablo D. Fajgelbaum and Amit K. Khandelwal, *Measuring the Unequal Gains from Trade*, THE QUARTERLY JOURNAL OF ECONOMICS (2016).
[79] *See* PENG SUN & ALMAS HESHMATI *supra note* 13.

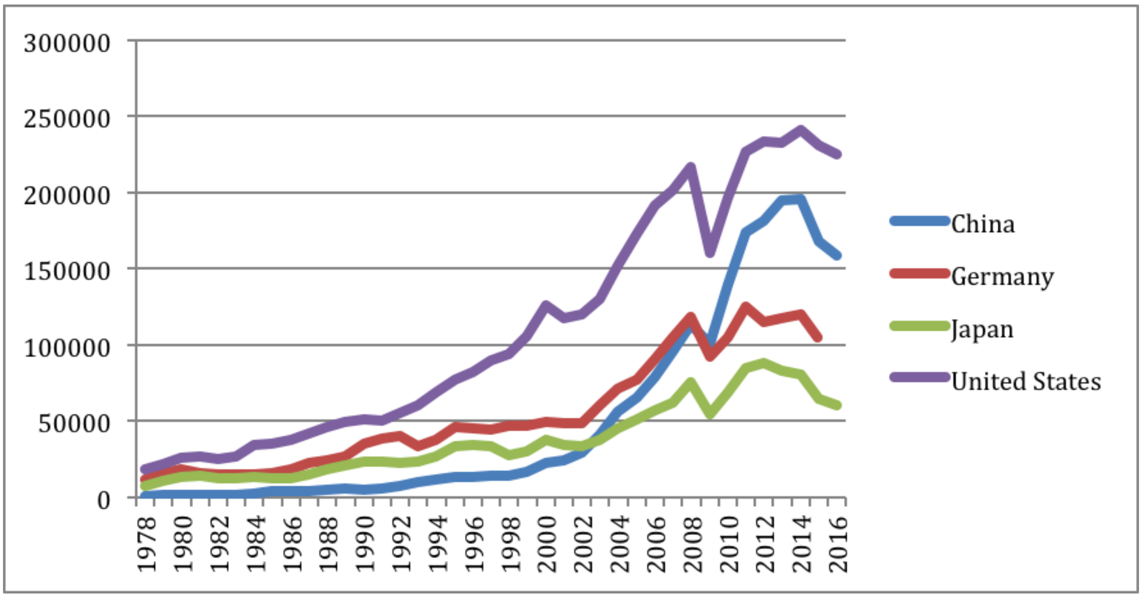
have grown exponentially, even surpassing that of United States, its imports have also grown but with a steadier rhythm and it still imports less products that the U.S.

<u>Graph 2: Chinese Exports (in billions of dollars):</u>



Source: Comtrade

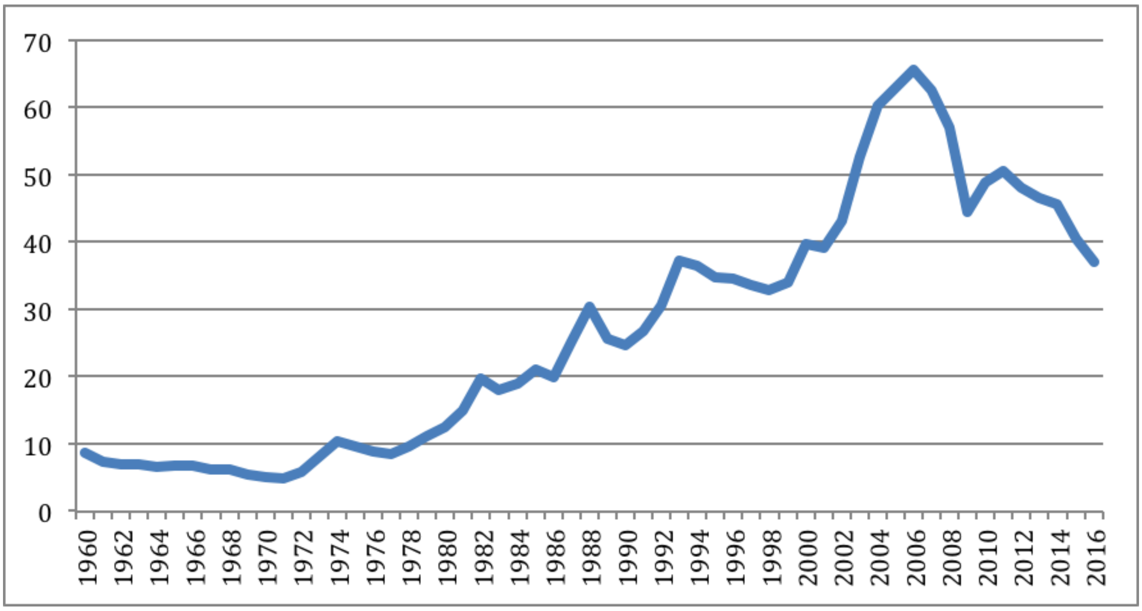
<u>Graph 3: Chinese imports (in billions of dollars):</u>



Source: Comtrade

Another interesting indicator to analyze the impact of international trade in the Chinese growth model is its representative GDP percentage. As we can see from the graph below, between the nineties eighties until 2006, China was heavily dependent on international trade as a percentage of its GDP. However, from that year onwards, the dependency on trade has decreased. The 2008 financial crisis was a turning point in terms of economic policies in China and since then, the economic growth relies much more consumption and investment than on trade.[80]

Graph 4: China's international trade as a percentage of its GDP (%).



Source: data retrieved from the World Bank

Despite China's successful integration to the World's economy and its increasingly successful international trade, it did not fully follow the liberal's "free-trade" prescriptions. China developed its successful international trade regime with strong governmental intervention. This Section will first explore the Chinese history of international trade from 1978 onwards. Then we will proceed to describe the Chinese model of international trade and finally we will compare and contrast it with the traditional international trade theories that we have described in the previous section.

[80] For an analysis on the role of consumption and investment in the Chinese economy *see* Issaku Harada, *China's new consumption-driven economy isn't what it seems,* Nikkei Asian Review, <https://asia.nikkei.com/Economy/China-s-new-consumption-driven-economy-isn-t-what-it-seems> (Dec. 26, 2017).

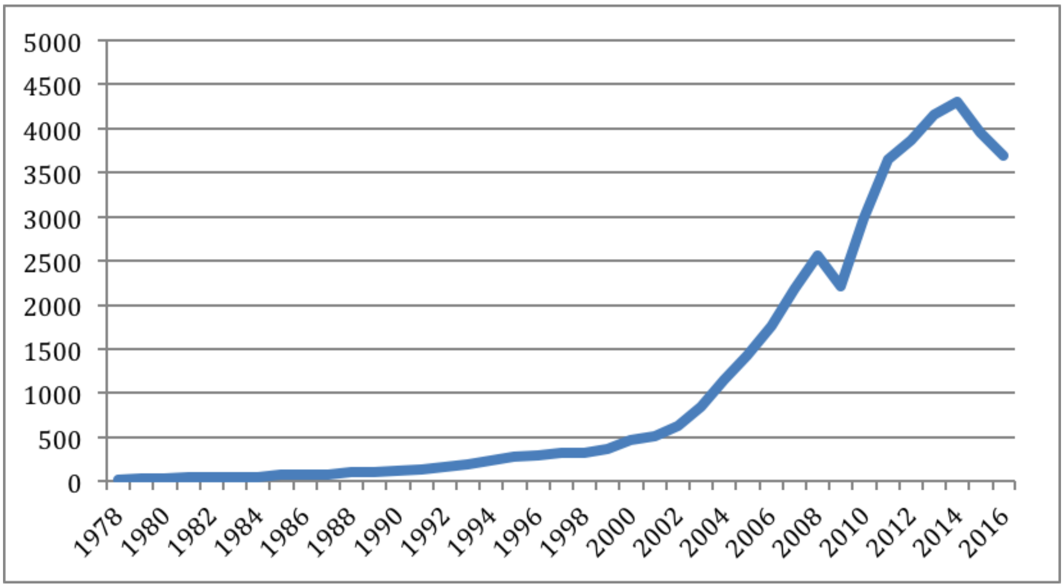
3.1. The Chinese international trade history

Prior to 1978, China was a centrally planned economy with virtually no interaction with the rest of the world's economy. China mainly traded with communist countries but apart from that it did not engage in economic activities with third parties. Trade was carried out by state-owned companies that had no competition and accordingly no incentive to act efficiently.[81] China was mainly an autarkic self-sufficient country with an import substitution policy until that year.

Shortly after Den Xiaoping started implementing his economic reforms in 1978, China experienced trade stagnation between 1981 and 1987 where exports increased 5.2% on average and imports doubled the export growth rate.[82] This was the result of the world recession and of the oil crisis.[83] From 1987 onwards (as evinced in the graph below) China's international trade (which has been a sum of its imports plus its exports) has increased exponentially. The two years in which the country's trade decreased were after the 2008-2009 crises and from 2014 onwards. Although the first entailed a major reduction of imports and exports, the latter is explained by a major decrease in China's imports, while the exports continued to rise.

Graph 5: China's international trade (in billions of dollars).

[81] Kyoji Fukao et. al, *China's Long-Term International Trade Statistics: By Commodity, 1952-1964 and 1981-2000*, Fukao, Kiyota, and Yue, Institute of Economic Research, Hitotsubashi University, < http://www.ier.hit-u.ac.jp/English/databases/china_trade.html> (2006).
[82] Id.
[83] Wolfgang Keller et. al., *China's Foreign Trade: Perspectives from the Past 150 years*, National Bureau of Economic Research, < http://www.nber.org/papers/w16550> at 33 (2010).



Source: Comtrade

However, there were clear stages of progressive liberalization combined with protectionist policies that account for this growth. From 1984 to 1990, China adopted various export promotion measures such as the elimination of the export tax, subsidizing exports, a foreign exchange retention quota and various exchange rates.[84] Simultaneously, import tariffs were still high during this period.[85] Furthermore, real exchange rate was overvalued 32% given the hyperinflation that occurred from 1986 to 1990.

From 1991 to 1993, much more ambitious trade liberalization polices were pursued and great efforts in the tariff reduction arena were made. However, the average import tariff still amounted to 43% and non-tariff barriers covered 51% of products.[86]

In fact in 1992, China Communist Party launched the "Socialism Market System with Chinese characteristics". This served as the framework to commit the country to market-oriented economic reforms in finance, banking, taxation, trade, state-owned enterprises among others.[87] Specifically in the international trade area, the Party instituted to start negotiations to join the GATT, which was later transformed to the WTO Chinese accession

[84] Id.
[85] Id.
[86] World Bank, *China Foreign Trade Reform: Meeting the Challenge of the 1990s.*Washington D. C., 1993.
[87] World Bank,*Globalization and China's Integration into the World Economy*. Washington D. C., 1997.

program. In accordance with this specific goal, in 1994 the government passed the Foreign Trade Law to reduce trade barriers.[88] Moreover, the Asian country completely eliminated foreign exchange controls in 1997 by liberalizing the current account.[89]

China finally joined the WTO in 2001 and since then, it started to adopt its commitments before this Organization. In these lines, China pursued a market-oriented and rule-based economic and trade liberalization among which the Foreign Trade Law was passed in December 2004.[90] The latter eliminated the "trade approval system" and thus all individuals and enterprises were eligible to export and import. Further, there was an integral review on all regulations regarding trade in order to make them consistent with what was required under the WTO accession protocol. Particularly, China established administrative actions and judicial reviews of administrative actions in order to allow private parties to question trade related administrative decisions.[91] In this vein, the Administrative Reconsideration Law was enacted to review administrative decisions and within that same law, it allowed the individual or enterprise to appeal to Courts if she was dissatisfied with the administrative action.[92]

China also took positive steps in complying with its market-access commitments. It reduced its import tariffs from an average rate of 15.6% in 2001 to 9.7% in 2005.[93] Many non-tariff barriers were also eliminated including import licenses, import quotas and conditional-tender requirements.[94] The Asian country also made huge efforts in the liberalization of services such as banking, securities, telecommunications, insurance, and retail, amongst others. China also took actions to comply with the requirements of TRIPs, the

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[88] Sheng Bin, *China's Trade Development Strategy and Trade Policy Reforms: Overview and Prospect*, International Institute for Sustainable Development, <*www.ipekpp.com/admin/upload_files/Report_3_54_Chinarsquos_2973653904.pdf* > (May 5, 2018) at 8
[89] Id.
[90] Sheng Bin supra note 88, at 9.
[91] Id.
[92] Id.
[93] Id.
[94] Id.

intellectual property treaty of the WTO. These included the revision of the copyrights, patents and trademarks laws.[95] The enforcement of intellectual property rights was also enhanced.[96]

These reforms were stalled since 2006 due to internal criticisms on China's role in the WTO negotiations but also the government was not fully convinced that market-oriented polices were an economic priority. Accordingly, import tariffs were not further reduced. Meanwhile, its accession to the WTO implied a lifting of exports barriers and so their exports grew rapidly.[97] Between 2007 and 2008, Chinese trade frictions with the rest of the world were exacerbated. China was the defendant State in 12 WTO dispute settlement panels mainly for subsidies related measures, IP infringement and tax incentives to domestic industries.[98] However, it accepted the recommendations of the panels and further escalation was avoided.

As a result of the 2008-2009 financial crisis, Chinese exports and imports fell (see graphs above). In order to cope with this situation, the government adopted a series of export-promotion measures that involved financing exports, tax incentives and the loosening of export controls.[99] Simultaneously, it took temporary import restrictions such as the cancelling of preferential tariffs and enlarged the amount of products to be subjected to automatic licenses.[100] These were all policies aimed at increasing the costs of importing and they worked in curving them upwards even after the crisis.

With the revitalization of the world's trade since 2010 and 2011, China's exports are almost reaching pre-financial crisis levels, however its imports have not fully recuperated. This has lead to a higher trade balance surplus for the Chinese economy.

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[95] Id.
[96] Id.
[97] Id.
[98] Bin at 10.
[99] Bin at 11.
[100] Id.

Additionally, China is currently pursuing more aggressive geopolitical strategies to promote its international trade. For example, China has adopted a leading role in the Regional Comprehensive Economic Strategy, a free-trade agreement pushed by the ASEAN States alongside Japan, India and China. Further, it is actively promoting other initiatives such as the One Belt One Road and the Asian Infrastructure Investment Bank to develop trading and investment partnerships.[101] This policy has also including the signature of Free Trade Agreements with mostly Asian countries. Currently, China has a total of 14 free trade agreements mainly with developing countries with the exception of Switzerland, New Zealand and Australia.[102]

In spite of the massive growth in Chinese international trade over the last decades, it was only in 1994 that China regained the same amount of world's trade share that it had in 1994 (2.3%).[103] Thus, the Chinese trade story could be more related to a catching-up story rather than a miracle phenomena in trade growth. However, it must be pointed out that by 2016 China accounted for around 11.5% of the world trade and there is a strong possibility that this share will continue to grow in the years to come. So the catching up hypothesis is soon to be tested.

3.2. China's international trade today and an appraisal of its success

Currently, China is the largest exporter of goods in the world and the second importer after the United States. It has the largest trade surplus that accounted for $551 billions in 2016. This represents 50% of the American trade deficit. Moreover, overall imports from China in the world economy grew from 3% in 1996 to 19% in 2016 as a result of their

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[101] Dian, Matteo, *The strategic value of the Trans-Pacific Partnership and the consequences of abandoning it for the US role in Asia*, 54 INT. POLIT. 583 (2017) 593.
[102] China-Trade Agreements, <http://fta.mofcom.gov.cn/english/fta_qianshu.shtml> (May 5, 2018).
[103] Keller, *supra note* 83, at 32.

industrial potential. This has been accompanied with a steady average growth of the Chinese economy of 9% over the last 40 years.[104]

China's manufacturing profile went from textiles, toys, footwear and consumption goods in the eighties and nineties to other products with a higher added value and technology based products from 2000 onwards. In fact, the imported percentage of Chinese exports rises to 32% while the OCDE countries' average is 24%. This clearly shows how China has successfully inserted itself into global supply chains, in accordance with Balwin's language. Indeed, Chinese machinery exports, as evinced in the table below, abruptly increased and while labor-intensive products were the majoritarian exports of the years that followed 1978, capital intensive products have consolidated themselves as the leading exported goods in the last years.[105]

This is consistent with Ricardo Hausman and Dani Rodrik's article *What you exports matter*, in which they describe that it is not sufficient to have many exports but rather, those should be high value added exports to make a difference in economic output.[106] This change in the type of goods that China exported, from primary labor-intensive to technological capital-intensive export baskets is a clear example of how the basket of goods that a country exports makes a huge difference in the overall trade and output.

Main Exports from China in 2016
(billion dollars)

Product	Amount
Cellphones	124.902
Computers	90.457
Phone parts	49.585
TV parts	32.437
Other liquid crystal appliances	31.191
Processors and controllers	30.662
Computer parts and accessories	28.107

[104] See China at the World Bank Group Data, <https://data.worldbank.org/country/china> (May 5, 2018).
[105] Maria Guglielmo Capore et. al., *Trade flows and trade specialization: The case of China*, CHINA REVIEW 261 (2014) 263.
[106] *See supra note* 15.

Memories	21.567

Source: Own from data retrieved from Comtrade

Main imports to China in 2016
(Billion dollars)

Product	Amount
Crude petrol oil	134.341
Processors and controllers	108.221
Memories	61.463
Iron minerals and concentrates	55.691
Other integrated electronic circuits	49.437
Other crystal liquid appliances	40.152
Cellphones and cellphone parts	39.920
Vehicles for people –cylindrical between 1.500 y 3.000 cc	36.112

Source: Own from data retrieved from Comtrade

Another salient feature the Chinese international trade case-study is that although there have been clear winners within the Chinese entrepreneurial class, the government did an enormous effort in distributing the gains from trade and economic growth in order to lift more than 200 million people from poverty.[107]

There is also evidence within China, that the higher the city's exposure to international trade, the higher its growth rate.[108] However, the distributional effects of trade have not been as positive as those of growth as Shang-Jin Wei and Yi Wu give account for.[109] Consequently, whilst China has been able to fight poverty, inequality has been on the rise greatly due to the results of international trade.[110]

3.3. China's model of international trade and development

[107] See Jean C. Oi, *Development Strategies and Poverty Reduction in China*, in Developmental Pathways to Poverty Reduction Series book series 230 (2007).
[108] Wei, Shang-Jin, *The Open Door Policy and China's Rapid Growth: Evidence from City-level Data*, in TAKATOSHI ITO AND ANNE O. KRUEGER (EDS.) GROWTH THEORIES IN LIGHT OF EAST ASIAN EXPERIENCE (1995).
[109] Shang-Jin Wei & Yi Wu, *Globalization and Inequality: Evidence from Within China* (2002).
[110] For an analysis of the different trends between the decrease of poverty and the rise of inequality see Guobao Wu, *Ending poverty in China: What explains great poverty reduction and a simultaneous increase in inequality in rural areas?*, The World Bank blog (Oct. 19, 2016) <http://blogs.worldbank.org/eastasiapacific/ending-poverty-in-china-what-explains-great-poverty-reduction-and-a-simultaneous-increase-in-inequality-in-rural-areas>.

In his article "Put Globalization work for Democracies", Professor Dani Rodrik narrates a description by a Chinese student of his on the engagement of China with the world economy: "China…opened a window to the world economy, but placed a screen on it. The country got the fresh air it needed nearly 700 million people have been lifted from extreme poverty since the early 1980s — but kept mosquitoes out".[111] And then he continues: "Look closely at the economies that converged with richer counterparts — Japan, South Korea, China — and you see that each engaged globally in a selective, strategic manner. China pushed exports, but it also placed barriers on imports to protect employment in state enterprises and required foreign investors to transfer know-how to domestic companies."[112]

As we can observe from going through Chinese trade history, the Asian country had a lot to gain from adopting a series of liberalizing trade and market-oriented policies since 1978. However, it was not the case that China went from an autarkical country to a full-fledge free trade country, quite to the contrary, China still heavily protects domestic industries by adopting high import tariffs and non-trade barriers. Furthermore, it still engages in anti-free-trade practices such as dumping and subsidies.

The role the Chinese government in paving the way towards economic growth was very much involved in crafting and developing the "screen" that Rodrik mentions and yet it has become the undisputed leading country in the international trade arena. This, consequently, There are two questions that ought to be discussed. First, what were the main reasons for China's success and second are there any other countries that have actually benefited from the "free-trade agenda"?

In answering the first question, we need to recall the Chinese model of international trade that was explained in this Section's first subsection heavily relied on governmental intervention. The government used tariffs to prevent goods from getting into the Chinese

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[111] Dani Rodrik, *Put Globalization to Work for Democracies*, New York Times (Sept. 17, 2016), <https://www.nytimes.com/2016/09/18/opinion/sunday/put-globalization-to-work-for-democracies.html>.
[112] *Id.*

market. According to the World Economic Forum, it still ranks today number 121 out of 136 countries in terms of domestic market access with average applied tariffs of 11.1%.[113]

The Chinese model is consistent with other Asian and non-Asian countries' models of international trade and development. Japan and South Korea also adopted various similar models in developing their domestic industries.[114] The export base theory that we have discussed in subsection 2.4 has proven to be effective for the Chinese experience. Although, from 2008 onwards, probably as a result of the financial crises, consumption has been one of the major drivers of economic growth in China over the last 6 years.[115]

Moreover, other international trade models that have closely followed the "free-trade" recipes have not done so well. For example, as we have already mentioned, Mexico tried to integrate fondly into the world economy through NAFTA and liberal trade and financial policies.[116] However, its economic growth has been meager compared to other Latin-American countries.[117]

Another interesting comparison is with Russia, another country that has moved from a centrally-planned to a market-economy. While Russia has adopted more polices in favor of trade liberalization and privatization plans, its international trade has not thrived as much as the latter.[118] On the other side of the spectrum, some countries that have heavily relied on import substitutions and high tariffs, were not able to grow either. Accordingly, China challenged Friedman's recipes on full-fleshed free-trade and yet thrived by opening up the screen a little bit while maintaining high import restrictions strategically. The Chinese model has allowed liberalization to revitalize its international trade while preventing imports'

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[113] 5 things to know about China's approach to free trade, World Economic Forum, <https://www.weforum.org/agenda/2016/12/china-approach-to-free-trade/> (Dec. 9, 2016).

[114] DANI RODRIK supra note 14, at

[115] As page 4 of the IMF's 2017 Article IV report on China points out: "consumption firmed amid still-tight labor market and accounted for nearly two-thirds of total gowth." See People's Republic of China, 2017 Article IV Consultation, International Monetary Fund (August 2017).

[116] DANI RODRIK supra note 14, at 11.

[117] Id.

[118] Yingyi Qian, *How Reform Worked in China*, in DANI RODRIK (ED.), IN SEARCH OF PROSPERITY: ANALYTIC NARRATIVES ON ECONOMIC GROWTH 323 (2003).

flooding. Consequently, we can see how China has wisely used the tools of available to middle-income countries, in accordance to Shaffer and Sutton's recommendations, to successfully develop its international trade model.

Of course China is still facing several challenges resulting from unfair trade practices that could exacerbate as a result of Trump's administration willingness to penalize it with retaliations as the steel and aluminum tariffs. Between 2006 and 2015, China has been either a complainant or a respondent State in 45 cases before the Dispute Settlement Mechanism of the WTO.[119] As a result, China should look out for possible reputational effects of unfair trade conducts that may exacerbate the incipient nationalist sentiments in the US and Europe because this may hamper its ability to continue profiting on international trade.

<u>IV. Conclusion</u>

After reviewing the literature on international trade and development, we can see that there is no silver bullet that can make a country's international trade boost. Further, the Chinese case shows that there is no "one-size-fits-all" model. China by adopting a mixture of liberalizing and protectionist polices was able to become the leading exporter and the second importer in the world. This, in turn, has fostered its economic growth.

However, we should not lose track that: "China's phenomenal growth is not just another successful growth story because China is not a "typical" country, although in cross-country regressions China can only represent one data point, same as Singapore or Botswana."[120] Indeed, China may be a deviation of trational free-trade and pro-markets economics but at the same time it has incorporated a lot of liberalization policies which bolstered its trade and growth.

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[119] Marc Wu, *The "China, Inc." Challenge to Global Trade Governance*, Harvard International Law Journal (2016).

[120] Yingyi Qian, *supra note* 117 at 297.