



Policy effect on structural change: A case of Chinese intermediate goods trade



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ABSTRACT

We explain the dynamics of China's intra industry trade (IIT) development spanning over three decades from the perspective of institutional changes. We present two hypotheses after reviewing series of policy documents and related organizational adjustment descriptions. First, we argue that China's pro-liberal reform in trade and FDI institutions helped trade to take off. Second, China is ambitious in acquiring advanced technology and building up a sophisticated system to promote technological capability. An analysis of Grubel and Lloyd IIT index on intermediate goods trade belonging to SITC 7 and SITC 8- the key components of regional value chain in East Asia- suggests that the structural changes taking place in China's intermediate goods trade are in agreement with the stated hypotheses. China's institutional arrangements also help to explain the factor behind China's success in becoming a major player in the regional production network in East Asia.

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1. Introduction

Trade in intermediate goods that gives rise to regional production networks has been a hallmark of East Asia's trade pattern. This regional value chain in East Asia began in the 1990s, which is largely credited to Japanese Foreign Direct Investment (FDI). Dependence on this form of value chain in East Asian economies is relatively larger than elsewhere in the world (Athukorala, 2009) and the trade relations are more stable (Obashi, 2010). This is in line with the general equilibrium model proposed by Kojima (1973) whereby trade and FDI work as complements rather than substitutes. It is to be noted that most of this trade in intermediate goods took place among the members of East Asia and eventually produced the final goods whose market is determined externally. The majority of these final goods were exported to the United States (US) and Europe. China played an important role in building this network by engaging in high levels of trade with all key members involved.

In this paper, we look into the various aspects of Chinese government policies and their corresponding effects on China's trade. Particular attention was given to the industrial upgrading policies that the Chinese government implemented for her manufacturing sector starting from the 1980s. This paper has two important aspects. Firstly, we examined the policy changes relating to manufacturing industries and trade and linked them to specific industries. Secondly, data work was conducted to see if the impact of these policies were reflected in China's intermediate goods trade with ten of her Asian counterparts.

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Many economic variables have been nominated and tested to be the causes of trade patterns between countries. They include the size of a country (Amiti, 1998), technology transfer (Lemoine & Ünal-Kesenci, 2004), commercial policy (Falvey, 1981), regional economic integration (Khalifah, 1996), production differentiation, labor intensity of production, economies of scale, FDI (Aturupane et al., 1997a, 1997b; Markusen & Venables, 1999) and intra-firm trade (Becuwe & Mathieu, 1992). In line with those literatures, studies explain China's trade in intermediate goods typically from those conventional perspectives, such as China's economic development, comparative advantage and market sizes, the role of FDI, the technological gap and income disparity between China and her trading partners, regional division of labor, economic freedom and business environment, as well as credit constraints (Amiti & Freund, 2010; Chirathivat, 2002; Dean et al., 2009; Fung, 1996; Hu & Ma, 1999; Manova & Yu, 2012; Prime & Park, 1997; Xing, 2007). Those factors are important in explaining China's Intra-Industry Trade (IIT) to a certain extent. However, the role of institutional factors has been largely ignored, which results in a partial explanation of those variables above or a misinterpretation of the way by which China's trade pattern is affected. We argue that most of the above economic determinants, both country and industry-specific, could be the consequences of China's continuous institutional changes. In other words, China's intermediate goods trade could largely be interpreted as the result of institutional changes.

We employed the Grubel-Lloyd index (Grubel & Lloyd, 1971) to measure China's IIT in various disaggregated levels. Our data work was based on SITC 5-digit level (basic heading) wherein we identified 347 basic headings for intermediary goods after a careful examination of previous studies (Athukorala, 2003; Kimura & Obashi, 2010; Sturgeon & Memedovic, 2011). This basic heading IIT index was then narrowed down to SITC 2-digit level (division code) for the purpose of general analysis. We found that the Chinese government had undertaken two major policy shifts that have resulted in structural changes in China's intermediate goods trade. Firstly, during 1991 to 2011, there was an emphasis on moving away from low-technology-intensive industries to medium-technology-intensive manufacturing industries. Secondly, with the onset of the Global Financial Crisis (GFC) during 2007 to 2009, the Chinese government tried to reduce the dependence on external demand by increasing domestic demand and by pushing further for the upgrading of industries from medium technology-intensive to high technology-intensive.

The rest of this paper is organized as follows. In Section 2, in contrast with previous studies, we explain China's intermediate goods trade by focusing on the importance of institutions. In particular, we concentrate on certain fundamental institutional changes made in the 1980s and in the beginning of the 1990s, when key policy adjustments were made to provide stable incentives for foreign investment and trade and which accelerated China's technological progress. China's response in the aftermath of the GFC and its effect on her intermediate good trade is also reviewed in the section. Section 3 portrays the evolution of China's intermediate goods trade with 10 of her Asian partners over the past two decades using data work generated from the IIT index. In particular, we look at SITC section 7 and section 8 as these sections fall under the manufacturing sector and contain most of the goods involved in China's intermediate goods trade. Section 4 concludes with some remarks on policy consideration for the future development of regional value chains.

2. Policy effects on China's intermediate goods trade: An analysis of the institutional framework

A consensus among economists and policymakers has been reached that China's economic miracle was delivered by over three decades of market-oriented reforms, which can be viewed as a process of effective institutional changes or as a shift in economic development strategy (Lin et al., 2003; Qian, 2003; Xu, 2011). Correspondingly, China's foreign trade regime also underwent a remarkable transformation during this period. To this front, it is important to comprehend two underlying facts related to this

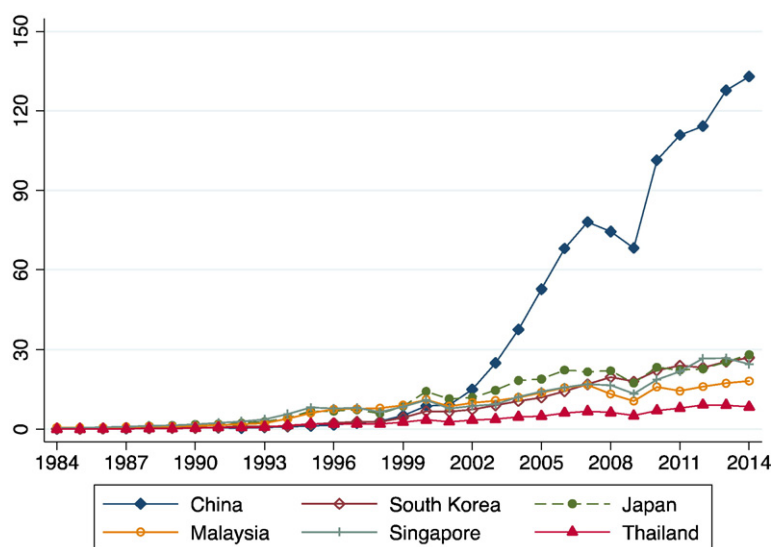


Fig. 1. Intermediate goods imports in Electronic and Automobile industries by selected East Asian economies from East Asia (USD billion). Source: CEPIL-CHELEM Database.

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