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# Effect of Intra-Industry Trade on Skill Premium in Manufacturing China

Xiaohua Feng<sup>1</sup>

## ABSTRACT

In making use of the panel data in 27 manufacturing industries, this paper examines the recent increase in skill premium in manufacturing in China. The paper argues that the recent increase in skill premium in Chinese manufacturing can be partly attributed to the decline in intra-industry trade. A reasonable explanation on this is that the decline in intra-industry trade occurred in the period studied is associated with a decrease in output. This led to a reduction in relative demand of low-skilled workers, which supports the hypothesis of the output-skill substitutability, and finally an increase in skill premium. Further, this paper finds that the negative effect of intra-industry trade on skill premium is larger for high-skilled manufacturing than low-skilled manufacturing. One more result in this paper is that the increase in capital input reduced the skill premium in Chinese manufacturing. The empirical evidence is consistent with a modified model of intra-industry trade with differentiated products and three factor inputs: high-skilled labour, low-skilled labour and capital.

## KEYWORDS

Intra-industry Trade; Skill Premium; Output Elasticity of Substitution; Manufacturing; China

## 1. Introduction

Over the past two decades, China has experienced a large increase in income inequality due to increase in returns to skills and education and increases in regional wage disparities (OECD, 2012, Park et al. 2003). Over that same period, China's international trade as percent of gross domestic product (GDP) increased, particularly after 2001 when China joined the World Trade Organization (WTO). The dramatic increase in China's international trade was largely driven by the increase in inter-industry trade. The intra-industry trade actually declined in the recent years. The trend in rising skill premium and declined intra-industry trade over the recent years may indicate a negative relationship. The main objective of this paper is to examine the hypothesis that changes in intra-industry trade are related to changes in skill premium, and the recent increase in skill premium is partly explained by the decline in intra-industry trade in Chinese manufacturing industries.

The relationship between trade and skill premium can be derived from the theories of international trade. Samuelson and Stolper (1941) pointed out that the skill premium increased in

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