

## **China's Export Strategy: What Can We Learn From It?**

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*As much as by luck as by design, China stumbled onto an export and foreign investment strategy that has proved remarkably successful, helping the economy move quickly to a market-based system. But can the Chinese experience serve as a model for other countries?*

After three decades of inward-oriented trade and foreign investment policies, in 1979, China switched course and launched an "open-door" policy.

During the 15 years that have elapsed since then, the country has persistently, albeit gradually, liberalized its trade and foreign investment regime. This has been accompanied by a spectacular growth in GDP and foreign trade. During 1980-90, GDP grew annually at an impressive rate of 9.5 percent. Over the same period, exports grew at an annual rate of 11 percent--more than twice as fast as world trade--and imports 9.8 percent. More recently, in 1992 and 1993, GDP has shown annual growth rates exceeding 13 percent. The annual growth in exports and imports during these two years has been 13 percent and 27 percent, respectively.

What are the key trade and foreign investment policies that have led to this dramatic growth in China's foreign trade and GDP? And what lessons can we derive from China's experience for other economies in transition? (see box)? In the following, we examine the nature of reforms and why they worked well or poorly in particular cases. Though this study focuses on external economic policies, it is important to remember that the promotion of non-state enterprises has closely complemented China's outward-oriented

strategy. These enterprises, owned collectively by local authorities in urban areas, townships or villages, enjoy a high degree of autonomy in their operations. Consequently, they have been most successful in taking advantage of the outward-oriented strategy.

**Promoting an "export culture"**

On the external front, three factors combined to give rise to China's success: adoption of an aggressive pro-export strategy by central authorities, active participation of local authorities and the presence of Hong Kong and Taiwanese investors looking for a source of cheap labor. With the beginning of the open-door policy, the central authorities began sending clear signals in favor of an export-oriented trade regime. A variety of instruments were employed to promote what may be called an "export culture": geographical targeting, sectoral targeting, a liberal foreign investment regime, and liberal provision of export financing.

**Geographical targeting.** China set up the so-called Special Economic Zones (SEZs) and Open Cities within which economic activities-- manufacturing, banking, exporting and importing, and foreign investment-- took place in a more liberal environment than is available in the rest of the economy. These zones helped to serve as focal points for investment from both domestic and foreign sources and to allow China to develop links with the world market, brought in part, by Hong Kong and Taiwanese entrepreneurs.

Originally there were only a handful of such zones, all in Guangdong and Fujian provinces. Over time, many features of SEZs were extended to other cities. Two features of SEZs distinguish them from the rest of the country. First, the SEZs enjoy considerable *administrative autonomy* in the

areas of investment, pricing, taxation, housing, and labor and land management policies. Most foreign investments can be approved locally and require virtually no central clearance. Second, the SEZs offer many *economic incentives* to investors not available in the inland provinces. The corporate income tax, normally 33 percent for foreign funded enterprises and 55 percent for state owned enterprises, is 15 percent for *all* enterprises in the SEZs. All imported inputs used in exports or sold within the Zones are free of import duty and other indirect taxes. In addition, tax holidays available to foreign funded enterprises are more generous in the SEZs than those available under the national tax legislation. Depending on the amount of investment, nature of the technology, and duration of the project, tax holidays of up to five years are available.

The SEZs and open cities exhibited spectacular economic performance. In 1979, the three SEZs in Guangdong were small fishing villages with virtually no industrial activity. By the end of 1980s, they had been transformed into modern cities. In 1990, the SEZs and open cities accounted for 52% of total realized investment and more than half of total exports. During 1985-90, industrial output in Guangdong and Fujian grew at annual rates of 16% and 14.7% compared with 6.9% in the rest of the economy.

**Sectoral targeting.** Side by side with geographical targeting, China has also engaged in sectoral targeting for exports. Targeted sectors, chosen at a broad level, have included light industrial products, textiles, and machinery and electronic goods. The most important instruments of targeting were production networks for exports (PNEs) and higher exchange retention rights to targeted sectors.

The Seventh Five Year Plan (1986-90) provided for the creation of PNEs. The idea was to bring the leading factories within the targeted sector into a network and support them through subsidies for technological upgrading, guaranteed supplies of raw materials and power, preferential access to transportation, attractive purchase prices for their goods, and higher exchange-retention rights than other enterprises in the same industry. The aim of the networks was to expand both the quality and quantity of exports of the participating factories. The first industry group to benefit from this scheme was machinery and electronic goods. PNEs have also been created in light industrial products and textiles, and farm and sideline products.

Rights to foreign exchange generated by exports are shared between the central and provincial governments. For targeted sectors, the allocation of retention rights was more favorable to the province and the foreign trade corporations (FTCs), which procure and export more than 80 percent of China's exports. In the case of light industries, arts & craft, and knitwear, foreign exchange was divided in the ratio of 20:80 between the center and province. Similarly, in machinery and electronic goods, for within-quota exports, the split between the center and provinces was 35:65.

Though the retention rights have been revised recently, the bias in favor of FTCs has been retained.

From the available data, it is difficult to judge the impact of sectoral targeting primarily because it was broad based. The share of textiles and light industrial products in total exports did expand significantly after 1985. But the effect on machinery sector is less clear.

Overall, one thing which is clear, however, is that the export share of labor intensive sector has gone up in the latter half of 1980s. In 1982, export shares of heavy and light industries were 47.5% and 37.6%, respectively, in 1982. By 1989, these shares had changed to 31.9% and 52.9%.

**Liberal foreign investment regime.** China's striking export performance is related to the size of foreign direct investment flows into the country (see table). Foreign investors have been lured to the Chinese market for three reasons.

First, both policies and procedures have been designed to facilitate foreign investment. A 25 percent foreign investment gives an enterprise the status of a joint venture and qualifies it for various tax incentives. At the same time, foreign equity investment can rise all the way up to 100 percent. Restrictions on the choice of sectors are minimal; any preferences, sectoral or otherwise, take the form of extra incentives. As a result, joint ventures have been established in sectors ranging from high-technology to consumer goods, services, and raw materials. There is no lower or upper limit on the amount of foreign investment. In large open cities such as Shanghai, foreign investment projects up to \$30 million can be approved by local authorities. The limit in smaller open cities is \$10 million while that in unopened cities is \$3 million. This autonomy has greatly simplified the approval procedures.

Second, employment, wage and pricing policies for joint ventures are flexible. Joint ventures are free to employ any required personnel on a contractual basis. Employees are subject to warnings, wage cuts and

dismissal. Except for a few product categories for which prices are set by the state, joint ventures are free to set their prices both domestically and abroad. Products or services for which prices are fixed are of two types. In the first category, prices are completely fixed (e.g., products such as grain, oil, and fuel; and services such as electricity and rent). In the second category, prices are allowed to fluctuate within prespecified bands usually ranging from 10 to 30 percent (e.g., steel, cement, timber, coal and other major capital goods).

Finally, China has given extra incentives to joint ventures. As already discussed, these incentives are particularly generous in the SEZs and open cities. Since 1986, additional preferential treatment has been available to export-oriented or technologically advanced projects. The incentives include:

- o Exemption from state subsidies paid to employees to cover the benefits provided by the government of China;
- o Priority in obtaining Bank of China loans;
- o Tax exemption on profits remitted abroad;
- o Longer tax holidays from corporate income tax;
- o Extra tax benefits on profits reinvested in export-oriented or technologically advanced projects; and
- o Further reduced land-use fees, priority in obtaining utilities, transport, and communication facilities.

**Duty exemptions.** China has also instituted an elaborate system of duty exemptions on imported inputs used in exports. Under these schemes, the concessional share of imports was 35 percent in 1988 and rose to 50

percent in 1991. The schemes, introduced in 1984 or later, seem to have played an important role in expanding China's exports. Total exports associated with concessional import arrangements account for 64 percent of China's manufactured exports. These exports doubled between 1988 and 1991.

The domestic value added of these exports is, of course, lower than of other exports.

**Export financing.** Ready access to export credits is believed to contribute favorably to export performance. The Bank of China, which is the primary bank dealing in foreign exchange, provides trade credits. Credit, offered in domestic currency, is available for working capital as well as fixed investment for the production of exports and import substitutes. The main beneficiaries of these credits are FTCs. They accounted for 85 percent of total trade credits in 1991. The Bank of China also offers loans in terms of foreign exchange, primarily to enterprises in which foreigners have invested, for working capital and fixed investment.

Though contributing favorably to exports, the liberal credit policy has led to a rapid expansion of outstanding loans. The total volume of outstanding trade loans at the end of 1991 was more than three times that at the end of 1985. In part, this expansion was due to the growth of exports.

But perhaps it also reflects a rising ratio of export credit to total exports. According to one calculation, this ratio was 150 percent in 1988.

#### **The Hong Kong connection**

A key element in China's success in the world markets has been the so-called "Hong Kong connection". In the mid-1980s, Hong Kong entrepreneurs began shifting manufacturing facilities to China, attracted by lower labor

costs as wages rose rapidly at home. This link with Hong Kong has not only brought much needed capital to China but also supplied new technology, modern management practices and critical links to the world market. Today more than half of China's exports to the rest of the world are handled by Hong Kong. Of the \$45 billion in cumulative foreign investment commitments to China through 1992, 70 percent came from Hong Kong. This investment went mainly to export-oriented joint ventures. A large proportion of Guangdong's export production is supervised under contract by firms in Hong Kong. Processing activity for exports in Guangdong is also carried out largely in collaboration with partners in Hong Kong who supply materials. Many items, particularly in the toy and clothing sectors, which were previously exported by Hong Kong are now exported by Guangdong.

#### **Local policies**

China's economic system is highly decentralized now and the implementation of policy is largely under the control of provinces. Hence, in the fast-growing provinces, provincial and local officials have been deeply involved in the development process in general and export promotion in particular. The role of local authorities in facilitating foreign investment has been described earlier. In addition, there are a number of ways in which local authorities promote exports.

First, the center gives mandatory targets or export quotas for only a limited number of items or in limited volumes. But in some provinces, for example Jiangsu, the export-quota-system is far more elaborate. Moreover, taking advantage of their monopsony power, FTCs are able to buy goods from enterprises at prices well below the corresponding domestic prices. Though

the economic desirability of "exports at any cost" has been questioned, the FTCs have certainly been able to operate profitably on account of the monopsony power.

Second, operating within the center's guidelines, provincial authorities have been expanding Direct Export Rights (DERs) to enterprises.

Because the criteria for obtaining such rights are stringent, the DERs have not expanded as rapidly as would have been desirable, however. Enterprises with DERs account for only 5% of China's exports.

Third, within the State's guidelines, provincial and city governments decide the allocation of raw materials imported by using locally retained foreign exchange earnings among enterprises, collectives and TVEs and across different sectors. Provinces and cities also provide indirect export subsidies through the provision of critical inputs such as electric power to export oriented enterprises. Further incentives are provided in the form of higher bonuses for managers and employees on the basis of export performance. Within the guidelines laid down by the State, provinces can confer rights to trade directly upon enterprises and enterprise groups.

Finally, local authorities establish joint ventures between FTCs and enterprises to promote exports. During the Seventh Plan, Wuxi City alone established 160 of these ventures. In the Eighth Plan, the city intended to establish another 200 such ventures.

#### **The central lesson**

Perhaps the most important lesson, also consistent with the experience of other East Asian countries such as Korea, Taiwan Province of China,

Singapore and now Thailand, is that the key to high GDP growth rates is export orientation and eventual success in the world market. The success in export expansion, in turn, depends on the policy package, which conveys a message in no uncertain terms that, rather than shelter import competing industries, the country will give priority to export oriented activities.

China benefitted greatly from the clarity of signals sent by its policy reforms. Once the reform process began, there was rarely any doubt about its direction. Despite occasional policy reversals, provincial and city governments, which implemented policies and enterprises, both state and nonstate, were convinced that the country was headed towards an export oriented regime. In terms of static efficiency, virtually all policies--geographical targeting, preferential treatment of foreign investment in general and in export sectors in particular, and discriminatory exchange retention rights--were highly distortionary. Yet, they combined to give a loud and clear signal that the government was determined to change the economy's orientation away from import substitution to export promotion.

**Box**

**Can India benefit from China's experience?**

Operationally, the Chinese model is not very applicable to the economies of Eastern Europe or the former Soviet Union. These countries have largely rejected the planning model, which has remained an integral part of the Chinese development strategy. The countries in Eastern Europe have already evolved far closer to the market model than China. The countries emerging out of the former Soviet Union, on the other hand, are still struggling with the problem of macroeconomic stabilization.

The country for which the Chinese experience is most relevant is India. Both are highly populous and, by developing-country standards, large economies. They began their development process approximately at the same time and stressed self-reliance. Both relied increasingly heavily on import substitution policies and ended up with a highly capital intensive production structure. China changed course in 1979 while India continued (with modest liberalization) on the old course. In 1991, in many ways, India stood where China stood in 1979. The trade-to-GDP ratio was the same as China's in 1979. Import and investment controls were rampant and the domestic currency was overvalued.

Despite these similarities, even in India's case, lessons from China are limited. In addition to the obvious differences in political systems which lead to very different political-economy processes in the two countries, there are three reasons for this. First, the Chinese approach has been highly interventionist. This approach can be successful--as it has been in China and elsewhere in East Asia--provided the government can

implement "right" interventions judiciously. India's experience during the last four decades in this respect has not been encouraging. Second, India's economy has already evolved far closer to a market economy than that of China. For instance, export targets and foreign exchange contracts, which have arguably helped create a pro-exports ethos in China are neither desirable nor feasible in India. Similarly, private sector plays a far greater role in India than in China. Finally, India has already carried out many reforms that China is still contemplating. For example, in the area of exchange rate, China has a multiple exchange rate system and its exchange market is not organized along the lines of market economies. India has achieved virtual current account convertibility and its foreign exchange market is organized along modern lines.

Of the lessons that have general relevance to India, the following points would seem to be the most pertinent.

- o First, creating a liberal and flexible economic environment along the lines of SEZs in China would stimulate greater foreign investment. The country can begin with a small number of cities--e.g., Bombay, Bangalore, Cochin, and Madras--and, as in China, local governments may be given full authority to approve foreign investment up to a certain limit. Most important, rules of entry and exit in the zones can be made more flexible. Because these zones will be introduced in limited areas with a high growth potential, political consensus may be easier, even if this requires new legislation. Eventual success in the open zones may open the way for political consensus on a wider scale. Currently, India does have export processing zones. But the geographical area over which such zones operate

is far too limited to allow for the full play of liberal policies and make them focal points of investment activity.

o Second, provision of infrastructure facilities through active participation of local authorities in the reform process is critical. In the fast growing provinces in China, local authorities--especially mayors of the cities--have been deeply involved in the process of development. They try to ensure that investors get speedy clearance with respect to land use, supply of electricity, water and other facilities. In India, so far, it seems that the enthusiasm for reforms has not filtered to state governments and the center may well have to take a lead in this regard, offering both carrot and stick. All incentives and reforms at the central level can be rendered ineffective if the state and local authorities, which must provide land, power, communications facilities, and environmental clearance, do not cooperate. There is an urgent need to study caefully how such bottlenecks can be removed.

o Third, there is a need for a shift in the production structure towards more labor intensive industries. The share of capital goods imports in total imports is rather small in India when compared with China and other fast-growing countries in East Asia. This, combined with the fact that India's import-to-GDP ratio is small, suggests that India is far more deeply into the production of capital goods than China and other comparator countries.

In late 1970s and early 1980s, China also suffered from this problem and adopted policies to change the structure of production in favor of labor intensive goods. An important part of this strategy was targeting of a few

sectors, especially for exports. For India, it is perhaps unwise to follow this route. Given the country's generally neutral and rules-based approach to reforms, it is perhaps best to rely on the standard trade policy tools, particularly the structure of tariffs. Recent reduction in tariffs on capital goods should help move the economy towards more labor intensive goods. What is needed is resistance to policies that reverse the impact of this policy change. In particular, there is need for labor-market reforms. The country will not be able to take advantage of low wages of skilled and unskilled labor unless potential investors are sure that they can operate factories around the year without fears of recurrent labor disputes. This fear has been behind the highly capital intensive technologies chosen by investors in recent years.

o Fourth, duty exemptions for assembly type operations combined with rapid processing of imported inputs and materials by customs authorities made a significant contribution to China's export growth. In India, duty exemptions for exporters exist but an improvement in their administration and simplification of procedures leading to speedy processing by customs will help boost exports. Also, for small exporters who rely on duty drawbacks, delay in getting the drawback as well as in obtaining inputs from abroad are common. An improvement in this direction is also desirable.

o Fifth, it is important to note that China was welcoming of foreign investment for both domestic and foreign markets. Most of the incentives-- tax holidays, lower fees on land use, flexibility in the employment of labor etc.,--were available to all foreign investors. For export-oriented joint ventures, some extra incentives were provided. The lesson here is that

fears of tariff-jumping type of foreign investment should not lead to *erection of barriers*. Instead, if the regime is to be tilted in favor of export-oriented foreign investments, it should be done through *positive incentives*. Imposition of barriers to foreign investment will only add noise to signals of openness that India has been sending.

A final point concerns the importance of a "Hong Kong" connection. In India's case, there are no geographic neighbors that are as economically dynamic as Hong Kong or Taiwan, Province of China. But through cultural ties, the most India can do is to attract investments from Indians in Hong Kong and Non Resident Indians (NRIs) elsewhere in the world. While this is obviously worth doing, India has to rely on a more diversified base of foreign investors. It may be argued that to meet the East Asian challenge, investors in the United States and Europe will be increasingly looking for sources of cheap labor. With its vast pool of cheap unskilled to middle-level skilled labor, India clearly fulfills this requirement. Moreover, India's economic and political institutions are also familiar to western investors. What is needed is more open policies, transparency, and infrastructure. If this can be accomplished, India may well become the primary export base for the United States and European Community in the 21st century.

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Direct foreign investment into China

(billion dollars)

	Commitment	Actual
1988	5.3	n.a.
1989	5.6	3.4
1990	6.6	3.5
1991	12.0	4.4
1992 (first half)	14.5	3.4
Cumulative, end 1991	48.9	20.3

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Sources: China Statistics Yearbook 1990, 1991, Ministry of Foreign Economic Relations and Trade, China.