



*Explaining China's Export Drive
The Only Success Among Command
Economies*

Yun-Wing Sung

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Abstract

Given the cumbersome controls on China's external sector, many China specialists, including those from the World Bank, have argued that China's export success could not last. However, China's stunning export performance in the reform era of 1978-1990 has repeatedly defied the skeptics. Though China's external sector is heavily regulated, there are also significant elements of flexibility, including special freedoms for foreign investors, special economic zones and open areas, free-wheeling rural enterprises, and a widespread grey market in foreign exchange. Moreover, cumbersome controls can be circumvented through the rampant black market in foreign exchange and covert Hong Kong connections. This study quantifies the contributions of the above factors to China's export drive. It appears that China has been able to capitalize on the above elements of flexibility through its Hong Kong connections, facilitating the synergy of foreign know-how and capital with China's cheap labour into a potent force to penetrate the world market.

1. Introduction

Since China's adoption of economic reforms in late 1978, China's real GDP per capita and volume of exports have grown at more than 6 and 10 percent per year respectively. Such rates are on a par with East Asia's Newly Industrializing Countries (NICs), and are roughly treble that of other developing countries and for the world as a whole. China's achievements are especially dramatic in comparison with other command economies. From 1978-89, China's real export growth rate was roughly six times that of the USSR and Eastern Europe. In fact, China had the only sustained successful export drive among command economies.

China's successful export drive is difficult to explain because it contradicts the conventional wisdom in the trade liberalization literature

which stresses that a realistic exchange rate and a flexible, marketized economic system are the preconditions for export success. For instance, a World Bank mission visiting China in late 1986 argued in its report that China's export growth would slow down because China's trade regime was still inward looking. The mission concluded that 'without further changes, it is quite possible that foreign trade growth will slow down, as the high rates of recent years reflect primarily the transitional effect in moving from almost complete insulation to a partly open, but by international standards still relatively inefficient foreign trade system.' (World Bank, 1988:viii)

The mission's assessment is mistaken. China's exports continued to grow rapidly after 1986 (Table 1). The growth rates in 1987 and 1988 in terms of the US dollar were 27.7 percent and 20.4 percent respectively. Even after the *Tiananmen* incident, China exports continued to grow at double digit rates. The growth rates for 1989 and 1990 were 10.5 percent and 18.3 percent respectively.

China's external sector is a mixture of planned and marketized elements. As emphasized by the World Bank mission, China's external sector seems to be quite rigid as 'It continues to place heavy reliance on administrative import and export decisions, including mandatory planning; it restricts imports and some exports through licensing and other quantitative restrictions, it imposes high (and highly variable) tariffs on imported goods to protect domestic industry from foreign competition; it limits direct contacts between domestic enterprises and foreign buyers and suppliers through the intermediation of monopolistic Foreign Trade Corporations; and it uses a cumbersome administrative foreign exchange allocation system.' (World Bank, 1988:ix)

However, there are also significant elements of flexibility in China's external sector. Foreign investors face roughly international prices because they can import their inputs tariff-free. This is especially important in processing operations producing labour-intensive manufactures for export. The official exchange rate is highly over-valued, but the effective exchange rate is quite realistic due to substantial subsidies on export and the operation of 'foreign exchange adjustment centres' which are grey markets for foreign exchange. The 'open areas' (special economic zones, open cities and regions) are more marketized and flexible than other

areas. Rural industries are highly marketized. They have grown extremely fast, and they played an important role in exports. Moreover, Hong Kong lowers the transaction cost of China's trade and facilitates China's interaction with the external world by acting as a middleman. The proportion of China's goods re-exported via Hong Kong increased from 6.5 percent in 1978 to 42 percent in 1990. There are also numerous ways of getting around cumbersome administrative controls in the external sector. For example, many Chinese enterprises have been able to trade covertly with the outside world through their Hong Kong connections. There is also a widespread black market in foreign exchange. The 1986 World Bank mission had underestimated the above elements of flexibility which have a decisive impact on China's export drive.

The history of command economies suggests that, without economic reforms, the promotion of exports through administrative means cannot lead to lasting success. Hungary and Poland had tried to increase their participation in world trade in the 1970s, but they failed to achieve any lasting success. Under Hua Guofeng's era of 1977-78, China had also mounted an export drive to finance massive plant imports to support a Stalinist strategy of imbalanced and extensive growth characterized by neglect of efficiency. The rates of export growth in 1977-78 were high (Table 1) but such rates only represented the once-for-all effect of a policy switch. Hua's modernization drive soon faltered due to severe bottlenecks and balance of payment problems. Hua's failure led to a fundamental re-orientation of China's developmental strategy in late 1978. A strategy of intensive growth was adopted. Economic reforms and marketization were initiated to improve economic efficiency. The year 1978 is taken as the base year in this study because it marks the beginning of economic reforms. Taking 1978 as the base year has the advantage that exports by then had recovered from the 1975-76 setback which stemmed from the political struggle between Deng Xiaoping and the 'Gang of Four.' Exports were at an all-time high after two years of export promotion under Hua Guofeng, and there is no danger in overstating China's export growth in using 1978 as the base.

Table 1. Value of China's Trade

	Exports		Percentage of		Imports	Trade Bal.
	US\$m.	Growth rate (%)	China's GDP	World Exports	US\$m.	US\$m.
1970	2260	2.5	2.55	0.72	2326	-66
1971	2636	16.6	2.85	0.75	2205	431
1972	3443	30.6	3.35	0.83	2858	585
1973	5819	69.0	4.36	1.01	5157	662
1974	6949	19.4	5.13	0.83	7619	-670
1975	7264	4.5	4.94	0.83	7487	-223
1976	6855	-5.6	4.80	0.69	6578	277
1977	7590	10.7	4.57	0.67	7214	376
1978	9745	28.4	4.81	0.75	10893	-1148
1979	13658	40.2	5.46	0.83	15675	-2017
1980	18272	33.8	6.25	0.92	19550	-1278
1980	18120	—	6.20	0.91	20020	-1900
1981	22007	21.5	7.94	1.11	22015	-8
1982	22321	1.5	8.22	1.20	19285	3036
1983	22226	-0.5	7.79	1.22	21390	836
1984	26139	17.6	8.59	1.34	27410	1271
1985	27350	4.7	9.71	1.40	42252	-14902
1986	30942	13.1	11.44	1.46	42904	-11962
1987	39437	27.7	13.33	1.62	43216	-3779
1988	47540	20.4	12.94	1.70	55251	-7711
1989	52486	10.5	12.48	1.74	59142	-6656
1990	62070	18.3	16.98	—	53360	8710

Source: Data since 1980 are obtained from *China Customs Statistics*.
1950-80 data are obtained from the Ministry of Foreign Economic Relations and Trade.

This paper is divided into eight sections. Besides the introductory section, section two compares China's export performance with other command economies and with India, which is comparable to China in size and level of development. Section three surveys the market and

commodity composition of China's exports. Section four estimates the effective exchange rate for China's exports. Section five examines the middleman role of Hong Kong in facilitating China's exports. Section six studies the various channels available to circumvent the cumbersome controls on China's external sector. Section seven examines the role of the foreign investor. Section eight concludes the study and quantifies the contribution of various factors to China's export growth.

2. An International Comparison

Table 2 compares China's export growth with that of other centrally planned economies in the period 1980-89. China's export growth is compared with that of the USSR, Hungary, and the USSR and East Europe as a whole. The USSR is the classic case of a command economy, and Hungary is regarded as the most successful case of marketized reforms in East Europe. It is clear that China's export growth exceeded that of other centrally planned economies by a wide margin. Moreover, over half of the trade of the Comecon bloc were with bloc members themselves. Such trade tended to be of low quality items not usually accepted in the international market. Over 90 percent of China's exports were with market economies, and comparison in terms of exports to market economies would be a more meaningful indicator of export performance.

For China, the growth of exports to market economies was faster than total exports, whereas the reverse was true for the USSR. By 1989, the absolute volume of China's exports to market economies were nearly on a par with that of the USSR. This is surprising as the USSR has a much bigger economy than China. Though figures were not yet available for 1990, it is clear that China's exports to market economies have surpassed that of the USSR in 1990 given the rapid growth of China's export and stagnation in the exports of the USSR. From 1980-89, the increase in exports to market economies was US\$32 billion for China and only US\$18 billion for the USSR and East Europe as a whole. Among centrally planned economies, China's export performance is stunning.

Table 2. Exports of Centrally Planned Economies (US\$mn)

	Total Exports				Exports to Market Economies			
	China	USSR	Hungary	USSR & East Europe	China	USSR	Hungary	USSR & East Europe
1980	18120	76449	8677	156509	16647	41724	4199	75000
1985	27350	87201	8555	174821	25035	41813	3924	76720
1987	39437	107772	9571	212391	36387	46898	4611	84009
1988	47540	110541	9972	221591	44184	48959	5260	90015
1989	52486	109212	9584	195998	49082	51419	5491	93271
Average annual growth rate (%)	(12.5)	(4.0)	(1.1)	(2.5)	(12.8)	(2.3)	(3.0)	(2.5)
1980-89								

Source: UN Monthly Digest of Statistics.

Table 3. Ratio of Exports and Imports to GDP in China and India (%)

	China		India	
	Exports	Imports	Exports	Imports
1978	4.8	5.4	5.6	6.6
1979	5.5	6.3	5.9	7.5
1980	6.3 (9.7)	6.9	5.3	9.2
1981	7.9 (11.8)	7.9	4.5	8.4
1982	8.2 (11.8)	7.1	5.0	7.5
1983	7.8 (12.1)	7.5	4.5	6.7
1984	8.6 (10.8)	9.2	4.9	6.2
1985	9.7 (10.6)	15.1	4.4	6.2
1986	11.4 (13.9)	15.8	4.1	6.6
1987	13.3 (16.6)	14.6	4.4	6.5
1988	12.8 (15.6)	14.9	4.7	6.8
1989	12.5 (17.4)	14.0	—	—
1990	17.0 —	14.6	—	—

Figures in brackets represent the ratio obtained from using the true value of exports instead of the official data. The true value of exports is obtained by multiplying the value of exports in US dollars by the average cost of earning foreign exchange.

Source: China's exports and GDP are obtained from the *Statistical Yearbook of China*, and India's export and GDP are obtained from the IMF *International Financial Statistics*, the average cost of earning foreign exchange is obtained from Table 7.

The ratio of China's exports to its GDP has risen rapidly since 1978 (Table 1). Table 3 compares the openness of China and India in terms of the ratios of exports to the GDP. India is chosen for comparison because the ratio is usually lower for large economies and higher for more developed economies, and India is comparable to China in size and level of development. In the twelve years of reform and open-door policy from 1978-90, China's ratio of exports to GDP rose sharply from 5 to 17 percent, according to official data, while the same ratio for India declined from 6 percent in 1978 to 5 percent in 1988. Chinese data in fact understate the openness of the Chinese economy because the official data of the *Renminbi* value of exports were biased downwards to avoid

charges of dumping. The Chinese data are obtained by converting the US dollar value of exports at the official exchange rate which is substantially lower than the true cost of exports. Data on the effective exchange rate of Chinese exports (Table 7) can be used to estimate the true *Renminbi* cost of exports, and the adjusted data give a ratio that is appreciably higher than the official ratio. In 1988, India's ratio was only 4.7 percent whereas China's adjusted ratio was 17.4 percent in 1989. China's economy is thus much more open than that of India, and China's export drive has been remarkably successful.

Though China's official data on exports and imports are seriously biased downwards, they have been used in numerous research projects and policy papers and might have misguided policy makers.

3. The Market and Commodity Composition of China's Exports

The commodity composition of China's exports is shown in Table 4. Before 1981, Chinese statistics on the commodity composition of exports were not available, and data from the US Central Intelligence Agency (CIA), which were estimated from statistics provided by China's trading partners, were used instead. From 1981 onwards, *China Customs Statistics* were used. From 1985 onwards, data from China classified its substantial exports from processing/assembling operations in division 9 (commodities not classified elsewhere). The bulk of these exports consists of textiles, clothing, electronic products and toys. To obtain the true commodity composition of China's exports, we have to distribute the exports from processing/assembling operations into their respective SITC (Standard International Trade Classification) categories. However, data on the breakdown of such exports were not published before 1989, though they can be purchased from China's State Statistical Bureau. We have been able to purchase such data for 1985-87 and thereby distribute processing/assembling exports into their respective SITC categories. The distributions so obtained were very close to those obtained from USCIA data. Since USCIA data were obtained from China's trading partners, China's processing/assembling exports were already distributed into

Table 4. Commodity Composition of China's Exports (%)

	Food		Crude Materials (2, 3, 4)			Manufactures (5, 6, 7, 8, 9)					Total	
	(0, 1)	(26)	Textile fibre	Fuels	Subtotal	Chemical	Textile fabric	Machinery electrical	Clothing	Others	Subtotal	(1-9)
1970	31.6	4.9	2.7	21.3	5.4	18.2	0.9	4.7	0.1	47.0	100.0	
1975	29.7	3.3	14.3	26.6	4.8	14.5	1.1	5.1	0.3	43.6	100.0	
1977	24.9	3.9	14.2	27.4	4.9	15.2	1.4	7.2	0.3	47.8	100.0	
1979	20.1	3.7	17.9	30.1	5.7	16.6	1.4	7.7	0.3	49.9	100.0	
1981	13.6	2.1	23.8	33.0	6.1	12.2	1.3	8.5	4.1	53.4	100.0	
1983	13.3	3.0	21.0	30.0	5.6	13.1	1.7	9.3	8.8	56.7	100.0	
1984	12.8	3.5	23.0	32.7	5.2	14.1	2.1	10.2	6.1	54.3	100.0	
1985	14.5	4.3	25.9	36.3	5.0	12.3	1.5	11.9	6.8	49.3	100.0	
1986	14.8	3.9	11.7	21.6	5.6	14.1	3.1	14.6	12.3	63.6	100.0	
1987	12.6	4.0	11.5	21.2	5.7	15.0	4.3	14.5	11.3	66.2	100.0	
1989	12.5	3.1	8.1	16.5	6.1	13.6	8.2	15.4	7.6	71.0	100.0	

Figures in brackets represent SITC categories.

Source: 1970-79 data came from USCIA, National Foreign Assessment Centre, *China: International Trade*, various issues. Data since 1981 came from *China Customs Statistics*, various issues.

their respective SITC categories. However, the latest published USCIA data were only for the year 1987, as there was a considerable time lag in obtaining data from China's many trading partners. This study thus used China's customs statistics to compute China's commodity composition of exports from 1981 onwards.

Table 4 shows that the share of food in China's exports has declined while the share of manufactures has risen. The share of fuels (mainly oil) has risen rapidly since 1970 and reached a peak of 26 percent in 1985. However, falling oil prices and supply bottlenecks have led to a drastic decline of the share of oil to 8 percent in 1989. The share of manufactures declined from 1970 to 1975 due to the rapid increase in oil exports, but increased thereafter up until 1983. The share of manufactures declined again from 1983 to 1985. This was partly due to the rapid rise in oil exports and partly due to a rapid increase in exports of food and textile fibres as a result of the success in agricultural reforms of the early eighties. From 1985 onwards, however, oil prices collapsed and exports of manufactures increased rapidly. The share of manufactures rose from 49 percent in 1985 to 71 percent in 1989. As the prices of crude materials are very volatile, the growth rate of the exports of manufactures is a better indicator of export performance than the growth rate of exports as a whole. Table 5 shows the value of growth rate of China's exports of manufactures. 1978 to 1981 were years of high growth with an average annual rate of 35.0 percent. 1981 to 1985 were years of slow growth, with an average annual rate of 3.5 percent. 1985 to 1989 were again years of high growth, with an average annual rate of 28.9 percent. After 1985, the rate of growth of total exports has understated China's superb performance in export of manufactures, mostly labour-intensive manufactures such as textiles, clothing, and toys. The share of textiles and clothing (SITC categories 26, 65 and 84) in China's exports was close to one-third from 1986 to 1989. Though exports of textiles and clothing are restricted by the Multi-Fibre Arrangement (MFA), China is in a good position to obtain favourable agreements as it has considerable bargaining power in world trade. Even with a fixed quota, possibilities of quality upgrading should not be ignored. Moreover, exports of electrical machinery (mostly electronic products) have grown dramatically between 1986-1989. China had some success in diversifying its exports, and the share of textiles and

clothing declined from a high of 33.5 percent in 1987 to 32.1 percent in 1989. The potential for China to further expand its exports of labor-intensive manufactures should not be underestimated.

Table 5. China's Export of Manufactures (SITC 5 to 9)

	US\$m.	Growth Rate (%)
1977	3628	—
1978	4775	31.6
1979	6815	42.7
1980	9019	32.3
1981	11752	30.3
1982	12277	4.5
1983	11869	-3.3
1984	14193	19.6
1985	13484	-5.0
1986	19679	45.9
1987	26107	32.7
1988	33110	26.8
1989	37265	12.5

Source: 1977-80 data came from USCIA, National Foreign Assessment Centre, *China: International Trade*, various issues.
Data since 1981 are obtained from *China Customs Statistics*.

Table 6 shows the market composition of China's exports. As a substantial portion of China exports were re-exported via Hong Kong, it is important to distribute these re-exports to their final destination. Hong Kong was the largest final market (i.e. excluding Chinese exports via Hong Kong) for Chinese exports in the late 1960s and early 1970s, but the Hong Kong market was overtaken by the Japanese market and the US market in 1973 and 1987 respectively. However, the Hong Kong market still accounted for 9 percent of China's exports in 1989. China continues to regard Hong Kong as its largest market, as Chinese trade statistics disregard the substantial re-exports of Chinese products via Hong Kong.

Table 6. Market Composition of Chinese Exports (%)

	Hong Kong	Japan	USA	Singapore	West Germany	Top 3 Markets
1970	20.8 (16.6)	9.9 (10.6)	0.0 (0.0)	4.5 (5.2)	3.1 (3.1)	35.2 (32.4)
1975	19.0 (14.9)	19.3 (19.6)	1.8 (2.2)	3.3 (3.9)	3.0 (3.1)	41.6 (38.4)
1979	22.2 (15.2)	20.2 (21.1)	4.5 (5.4)	2.3 (2.9)	3.4 (3.6)	46.7 (41.7)
1981	24.0 (15.1)	22.3 (23.0)	7.4 (9.3)	3.2 (3.7)	3.9 (4.1)	53.7 (47.4)
1983	26.5 (16.1)	20.4 (21.0)	7.8 (10.7)	2.7 (3.3)	3.9 (4.1)	54.7 (47.8)
1984	27.5 (15.7)	20.4 (21.3)	9.2 (12.8)	5.0 (5.5)	3.1 (3.4)	57.1 (49.8)
1985	27.7 (13.8)	22.2 (23.4)	8.6 (13.0)	7.6 (8.1)	2.8 (3.2)	58.5 (50.2)
1986	33.8 (15.6)	15.3 (16.4)	8.5 (15.0)	4.0 (4.6)	3.4 (4.1)	57.6 (47.0)
1987	37.4 (14.2)	16.2 (17.8)	7.7 (15.4)	3.5 (4.0)	3.3 (4.5)	61.3 (47.4)
1988	40.8 (10.7)	16.7 (19.7)	7.1 (18.8)	3.1 (3.7)	3.1 (5.1)	64.6 (49.2)
1989	48.0 (9.0)	15.9 (19.0)	8.4 (22.1)	3.2 (3.9)	3.1 (5.5)	72.3 (50.1)

Bracketed figures indicate market shares when Hong Kong re-exports of Chinese products are distributed to their final destinations.

Source: Chinese exports — *Almanac of China's Foreign Economic Relations and Trade* (data for 1970-79); *Chinese Customs Statistics* (data since 1981).
Hong Kong re-exports of Chinese products — *Hong Kong Review of Overseas Trade*, various issues.

From official statistics, it appears that China's exports were over-concentrated: Hong Kong accounted for 48 percent of China's exports in 1989, and the share of the top three markets (Hong Kong, Japan, USA) rose from 47 percent in 1979 to 72 percent in 1989. However if we distribute Hong Kong re-exports of Chinese goods to their final destinations, we see that both the shares of the Hong Kong and Japanese markets

declined while the USA surpassed Japan to become China's number one market in 1989. The share of the top three markets had stabilized at around 50 percent since 1984.

China's success in the US market was related to its superb performance in labor-intensive manufactures. Since 1985, China also made significant inroads in the West German market. Besides commodity diversification, China also had some success in market diversification.

4. Estimation of Effective Exchange Rate

China's exports (imports) are heavily subsidized (taxed), and the official exchange rate is grossly overvalued. In the analysis of China's trade, the relevant variable is not the official or nominal exchange rate but the effective exchange rate (EER), which is defined as the amount of local currency actually received (paid) by the exporter (importer) per unit of foreign currency of goods exported (imported). The 'cost of earning foreign exchange' (COEFE), or the *Huanhui Chengben* (the cost in *Renminbi* of earning one unit of foreign exchange) is a convenient proxy for the export EER. The COEFE is confidential, but data on the average national COEFE from 1980-84 have been published. The author obtained the 1980-86 COEFE of Guangdong province from interviews with Guangdong trade officials, and the 1987-89 COEFE of Guangdong were available from scattered sources (Table 7). The 1985-89 national COEFE was estimated on the assumption that the rate of growth of the COEFE nationwide were the same as that in Guangdong. The results so obtained were quite close to the figures on the national COEFE obtained in interviews with Chinese academics.

Though the official exchange rate was grossly overvalued, the effective exchange rate as given by the COEFE appeared to be much more realistic.

In early 1988, China began to reform its foreign trade sector in a major way and came close to setting a realistic exchange rate. In the new system, the power to trade and financial responsibility were decentralized from Beijing to provincial governments and foreign trade corporations which were required to be financially independent. To enable provincial governments and foreign trade corporations to cover the

Table 7. China's Effective Exchange Rate for Exports (Yuan/US\$)

	Official Exchange Rate	Cost of Earning Foreign Exchange	
		National	Guangdong
1980	1.50	2.31	—
1981	2.80	2.48	2.84
1982	2.80	2.67	3.18
1983	2.80	3.07	3.44
1984	2.80	2.80	3.15
1985	2.94	3.24	3.65
1986	3.46	4.25	4.78
1987	3.70	4.77	5.37
1988	3.70	4.60	5.17
1989	3.70	5.15	5.79
Dec. 1989	4.70		
Nov. 1990	5.19		

The internal settlement rate is used for the official exchange rate in 1981-84.

Source: For Guangdong, the 1981-86 and 88-89 data were obtained through interview, the 1987 data came from Vogel, E. F., *One Step Ahead in China*, Harvard University Press, 1989, p.378. For the nation, the 1980-84 data came from Wang Shenzhong, "Changes in the Exchange Rate and Economic Development in the External Sector," *Jingji Yanjiu* (Economic Research), April 1984, pp. 44-51 (in Chinese); data since 1985 are estimated by assuming that the growth of the COEFE nationwide was the same as that in Guangdong.

losses from exports, they were allowed to retain 80 percent of their foreign exchange earnings that exceeded planned targets. This was in addition to the customary 25 percent retention of within-target foreign exchange earnings which had been allowed since 1979. Three industries, namely light industrial goods, textiles and arts and crafts, were selected for experimentation with the new system, and they could retain 70 percent of their within-target foreign exchange earnings. At the same time, China relaxed the restrictions on the sale of foreign exchange retentions. Domestic enterprises can trade their foreign exchange retentions in the foreign exchange adjustment centres at roughly free market rates. China planned to establish foreign exchange adjustment centres in

all the 30 provinces, autonomous regions, and municipalities throughout China, giving rise to a national market in foreign exchange (*Ta Kung Pao*, May 12, 1988). Restrictions were imposed on the source and use of foreign exchange. The seller was required to specify that the foreign exchange was obtained from a legal source, and the buyer had to specify a legitimate use of foreign exchange. Trading for speculation was strictly prohibited.

If China allows exporters to retain 100 percent of their foreign exchange earnings and freely transfer such earnings to importers for imports, it would be equivalent to a system of floating exchange rate for commodity trade with controls on the capital account. As it is, the retention ratio is slightly below 100 percent and there are still controls on imports, but China is not too far from a system of floating exchange rates for commodity trade with controls on the capital account.

In May 1988 at the Beijing foreign exchange adjustment centre, the average price of US currency was 6.1 *Yuan* per dollar (*Wen Hui Po*, September 13, 1988). The price of US currency at the centre was only a few percents lower than the black market rate, showing that the restrictions on the trading of foreign exchange at the centres were not very severe. In 1987, a total of 4.2 billion US dollars were legally swapped in China, and the share accounted for by foreign investment ventures were 0.33 billion US dollars (*Ta Kung Pao*, May 12, 1988).

Though the failure of price reforms in 1988 and the *Tiananmen* incident led to the retrenchment of the reform program on many fronts, reform of the external sector continued. In December 1989, the *Renminbi* was devalued by 21 percent against the US dollar to a level of 4.7 *Yuan* per US dollar, and on November 16, 1990, the *Renminbi* was further devalued by 9.6 percent against the US dollar to the level of 5.187 *Yuan* per US dollar. At the end of 1990, the official rate was quite close to the market rate in both the grey and the black markets and also quite close to the COEFE. The official exchange rate was thus no longer grossly overvalued.

In December 1990, it was reported that China would further liberalize its external sector in 1991 (*Hong Kong Economic Times*, December 4, 1990). Provincial governments and export enterprises would be allowed to retain 80 percent of their foreign exchange earnings, and subsi-

dies on exports would be abolished. The number of commodities that could only be exported with licenses will decrease from 185 categories in 1990 to roughly 90 categories. It appears that market forces have compelled Chinese planners to accept the verdict that a realistic exchange rate is necessary for successful economic reforms and trade liberalization.

5. The Middleman Role of Hong Kong

Capitalist and free-wheeling Hong Kong has significantly enhanced the flexibility of the socialist and rigidly regimented Chinese economy. Hong Kong contributes to China's export drive in many ways: Hong Kong is a significant consumer of Chinese goods, and Hong Kong re-exports and transships increasing amounts of Chinese exports. Hong Kong traders also act as brokers in China's direct exports to other countries, and facilitate China's exports in many indirect ways.

As mentioned before, 9 percent of China's exports were consumed in Hong Kong in 1989. Since 1978, the amount of China's exports re-exported and transshipped via Hong Kong grew much faster than the volume of China's exports consumed in Hong Kong. The distinction between transshipment and re-exports is important. Transshipment means that goods are consigned directly from the exporting country to a buyer in the importing country, though the goods are transported via an entrepôt. Transshipped goods may change their mode of transportation at the entrepôt: Chinese goods, for example, are carried by train or coastal vessels to Hong Kong where they are consolidated into containers. Transshipped goods are not usually regarded as part of the trade of the entrepôt, and they do not clear customs because they only represent goods in transit.

Unlike transshipment, imports for re-exports are consigned to a buyer in the entrepôt, and the buyer takes legal possession of the goods after clearing customs. These imports may then be processed before being re-exported: processing may include packaging, sorting, grading, bottling, drying, assembling, decorating, diluting, or even minor manufacturing processes such as the pre-shrinking of grey cloth. According to the official definition of Hong Kong, any manufacturing process that

permanently changes the shape, nature, form, or utility of the basic materials used in manufacture would turn the product into a domestic export, that is an export manufactured in Hong Kong, qualifying the good to be classified as of Hong Kong origin.

The value of transshipped goods is not available as they do not go through customs, but their weight is known. From 1983-89, transshipment of goods from China via Hong Kong have increased 2.7 times. In 1989, transshipment of goods from China weighed as much as 21 percent of China's exports to Hong Kong. If we assume that the value of transshipment per ton is the same as China's exports to Hong Kong, transshipment of goods from China via Hong Kong would amount to 10 percent of China's exports by value in 1989.

Since the inauguration of the open door policy, China has established numerous direct links with the rest of the world, including diplomatic, commercial, and transportation links. Paradoxically, the middleman role of Hong Kong is becoming more prominent, and an increasing share of China's commodity trade is handled through Hong Kong. To explain this paradox, it is worthwhile to construct a theory of intermediation.

The usual explanation of entrepôt trade in terms of transportation cost is faulty because it ignores the importance of transaction costs. It is useful to classify re-exports into processed re-exports and pure re-exports. Processed re-exports refer to re-exports that have been physically treated (packaged, sorted and so on), whereas pure re-exports have not been changed in any physical way.

Pure re-exports are difficult to account for theoretically because re-exports involve higher costs than transshipment (other things being equal) owing to two factors: one, re-exports have to clear the customs of an entrepôt twice, whereas transshipped goods do not have to clear the customs of the entrepôt at all, so fewer delays and lower storage costs for transshipment are involved; and two, transshipped goods are insured and financed just once, whereas re-exports have to be insured and financed twice — first when they are imported into the entrepôt, and second when they are re-exported. While transportation costs determines transshipment, pure re-exports are determined by both transportation costs and transaction costs, and processed re-exports involve processing costs as

well.

Since China's adoption of an 'open-door' policy in 1979, it is easier to trade directly with China. The fixed transaction cost of establishing a direct trade link has gone down, and this should lead to a rise in direct trade relative to indirect trade. However, China started to decentralize its foreign trade system in 1979, replacing vertical channels of command by horizontal links. The supervision and coordination costs of command are decreased, but transaction cost increases, creating a huge demand for intermediation. Before 1979, establishing trade links with ten Trading Corporations would have ensured a complete coverage of China's trade. The number of trading corporations increased to over one thousand by 1984, and it is prohibitively costly for an individual firm to establish trade links with all Chinese trading corporations. Intermediation emerged to economize on the fixed cost of establishing trade links, and this demand for intermediation was channeled to Hong Kong due to its comparative advantage in trading. China's foreign trade decentralization came in three waves: 1979, 1984 and 1988. The share of China's exports re-exported through Hong Kong jumped up after each wave of decentralization. The share was 6.5 percent in 1978, 7.6 percent in 1980, 14 percent in 1985, and 39 percent in 1989. Since China plans to further decentralize its exports in 1991, the prospect of Hong Kong as an entrepôt is very bright. There are significant economies of scale and economies of agglomeration in trading activity, and it is very difficult for other cities such as Singapore or Shanghai to compete with Hong Kong because Hong Kong is the established centre for China's trade (Sung, 1990:260-5).

Hong Kong trading firms also perform an important brokerage role for China's direct trade, amounting to US\$15 billion or 7 percent of China's total trade in 1988 (Hong Kong Trade Development Council, 1988). The shares of China's exports consumed, re-exported, transshipped, and intermediated by Hong Kong were 9%, 39%, 10%, and 7% respectively in 1988/89. The total of the four categories was 65 percent. Though there is likely to be some overlap in the last two categories, we can safely conclude that Hong Kong plays an important role in close to two-thirds of China's exports.

Besides consuming, re-exporting, transshipping and acting as a bro-

ker for China's exports, Hong Kong facilitates China's export drive in many intangible ways. Hong Kong serves as a contact point, being the foremost base for China's trade and investment for both foreign companies and Chinese companies. Hong Kong is an important conduit of market information and technology transfer. Hong Kong also provides a market and production training ground for China: some skills can only be learned through practice in a free-market environment, and Hong Kong provides a dynamic and convenient training ground. To utilize Hong Kong as a market and production training ground, China had invested close to US\$ 6 billion in Hong Kong by 1985 (*The Economist*, May 11, 1985), exceeding the amount of Hong Kong's direct investment in China.

The contribution of Hong Kong intermediaries to China's export drive cannot be over-emphasized. While China has vast amounts of cheap labour for processing and assembling labour-intensive manufactures, it is highly deficient in marketing, financing, sourcing, quality control, product design and production management. Hong Kong has the expertise that China needs for success in exports, and the expertise is provided to China by Hong Kong investors as well as Hong Kong traders acting as intermediaries for China's exports. The role of Hong Kong investors will be examined in detail in section seven, and we will concentrate on the role of Hong Kong traders here.

The role of foreign buyers have been well documented in the export drives of East Asian NIC's. In a World Bank Survey of exporting enterprises in South Korea, it was found that contacts with the foreign buyer were important for product design, improved techniques of production and quality control and improved cost accounting and control (World Bank, 1988:36). As China has a command economy, its external sector is more rigid than those of the NIC's at the initial stage of their export drives, and China's skills in marketing, financing, sourcing, quality control, product design and production management were also comparatively more deficient. This implies that the role of Hong Kong traders is all the more significant.

6. Circumventing Cumbersome Controls

There are two principal types of controls on the external sector: foreign exchange controls and monopolization of trade through official foreign trade corporations.

Foreign exchange controls can be circumvented by access to the black market, and monopolization of trade can be broken by covert links with the outside world, mainly through companies established in Hong Kong.

Hong Kong plays a catalytic role in the reform of China's external sector. As mentioned before, Hong Kong lowers the transaction cost of China's trade and facilitates China's interaction with the external world. However, the catalytic role of Hong Kong also goes beyond that of a middleman and a facilitator. Hong Kong activates market forces in China and adds to the pressures that push China down the path of liberalization and decentralization. Hong Kong expands the intended scope of China's trade decentralization because Chinese enterprises and local authorities can easily establish trading corporations in Hong Kong without approval. Beijing has been forced to accept the competition from these unofficial corporations and even recognised some of them as official. Hong Kong also acts as the offshore base for China's thriving black market in foreign exchange, and Beijing has relaxed its foreign exchange controls and established a grey market through the Bank of China and foreign exchange adjustment centres to compete with the black market.

From 1979-81, the number of Chinese Trading Corporations officially approved to operate in Hong Kong totalled fifty-one (*The Nineties*, February 1982:32). However, the number of unofficial traders was estimated to be around three hundred (*Hong Kong Economic Times*, October 4, 1988). A popular form of unofficial representation is a joint-venture with Hong Kong traders. Since the trading firm is nominally operated by a Hong Kong trader, approval from Beijing is not necessary. Local authorities in China have been encouraging people who have relatives in Hong Kong to emigrate and to promote trade and investment, and some of them operate as one-person operations after their arrival in Hong Kong. One Hong Kong trader had come across seven 'one-person operators' claiming to represent various local authorities in China (Sung,

1985:53). By 1988, the number of Chinese corporations in Hong Kong was estimated to total 3,200, and most of them are unofficial (*Hong Kong Economic Times*, October 4, 1988).

In the 1988 retrenchment and crackdown on irregular economic practices, it was reported that Deng Xiaoping was of the opinion that one-third to two-thirds of the Chinese corporations in Hong Kong should be closed (*Hong Kong Economic Times*, October 11, 1988), and it was rumoured that Guangdong would close around one hundred 'underground' enterprises in Hong Kong (*Hong Kong Economic Times*, October 24, 1988). However, there was no significant shake-up of Chinese corporations in Hong Kong as China cannot close enterprises registered in Hong Kong. Moreover, many managers of these enterprises originally entered Hong Kong on the grounds that they had relatives in Hong Kong. They have thus acquired residency rights in Hong Kong, and Beijing cannot recall them. Instead of closing such enterprises, the Guangdong provincial government proceeded to check the financial conditions of such enterprises and allowed them to register with the provincial government as official overseas enterprises (*Hong Kong Economic Times*, November 4, 1988).

Hong Kong abets the thriving foreign exchange black market and illicit exports of China in many ways. Hong Kong tourists supply foreign currency on the black market, and they carry native products, such as herbal medicine, to Hong Kong. Hong Kong firms in China producing for the Chinese market receive Chinese currency which they cannot remit. They sell Chinese currency on the black market or buy Chinese products for export, legally or illegally. Joint-venture companies in China have the right to export their products, but this right may be abused. For example, Hong Kong farmers investing in vegetable farms in Shenzhen have bought vegetables from local vegetable farmers for export. Hong Kong provides a contact point and off-shore operation base for the black market. For example, a Hong Kong resident sending remittance to his relatives in China can sell Hong Kong dollars to a Hong Kong enterprise that has unconvertible *yuan* in China. He pays Hong Kong dollars to the Hong Kong enterprise in Hong Kong. The enterprise pays his relatives in *yuan* in China, and there is no need to smuggle currency across the border. The black market is so rampant that people in

Hong Kong now remit money to their relatives in China mostly through the black market. Remittances through official channels have dwindled to negligible amounts.

In late 1984, the black market rate for the yuan had dropped to around one-half of the official rate. As mentioned before, China began to establish foreign exchange adjustment centres in late 1985 and a nationwide grey market for foreign exchange was established in 1988. Once again, Hong Kong has activated market forces that press China towards liberalization.

7. The Role of Foreign Investors

Despite the many problems of the Chinese investment environment, the inflow of direct foreign investment to China exceeded that of all other developing countries by 1985-86 (Lardy, 1987:4). However most investors are attracted to China by its vast market, and the greater portion of direct foreign investment is geared towards import-substitution. Exports from enterprises with direct foreign investment ('foreign-invested enterprises' or '三資企業') in 1990 totalled US\$7.8 billion or 12.6 percent of China's exports. It should be noted that Hong Kong accounts for close to 60 percent of China's direct foreign investment.

Foreign funds in 'processing/assembling' and 'compensation trade' are more important in China's export drive as these operations are geared largely towards exports, especially the exports of labor-intensive manufactures. Strictly speaking, funds involved in 'processing/assembling' and 'compensation trade' should be classified under commercial credit rather than foreign direct investment. However, the Chinese definition of foreign investment is broader than the conventional one; 'processing/assembling' and 'compensation trade' are regarded as foreign investment because foreign funds are involved. In this paper, *direct* foreign investment refers to foreign investment in 'foreign-invested enterprises' and 'foreign investment' includes both direct foreign investment and investment in 'processing/assembling,' 'compensation trade' and leasing. The last three categories are known as 'other foreign investment' in Chinese statistics. 'Other foreign investment' was 16 percent of total utilized foreign investment from 1979 to 1989.

Trade involving processing/assembling operations grew at the average annual rate of 32.2 per cent from 1987-1990, and exports from such operations reached US\$25.4 billion or 40.9 per cent of China's exports in 1990 (*Sing Pao*, 11 February, 1991:8). Comprehensive statistics on trade involving processing/assembling operations have only been released since 1991. Though China's customs statistics have a special category for 'products exported after inward processing or assembling,' the category only covers part of the exports from such operations because products under 'reciprocal contracts' are excluded. A substantial portion of the output of 'processing/assembling' operations are exported under 'reciprocal contracts' because they can thereby qualify for export subsidy. Together with exports from 'foreign-invested enterprises,' exports from operations with foreign investment would account for 53.5 per cent of China's exports in 1990. It should be noted however, that the value-added in assembling/processing operations was only around 20 percent, and their share in total exports overstated their share in value added through exporting.

8. Explaining China's Export Success

Table 8 brings together the many factors considered in the above section. Rather than repeating the figures given above, it is instructive to look at the increase in exports from 1978 to 1989 and the share of the various factors in accounting for the increase in exports.

From 1978 to 1989, China exports increased by US\$42.7 billion. The US market accounted for 26 percent of the increase. This is due to the rapid rapprochement between China and the USA, and China enjoyed the Most-Favored Nation status in the US market.

Manufactures accounted for 76 percent of the increase. The most important commodity was clothing and textiles, accounting for 33 percent of the increase. Exports of clothing and textiles to the US market accounted for 8.5 percent of the increase. China's reliance on textiles and clothing was heavy but less than some East Asian NIC's. For example, exports of textiles and clothing accounted for over 50 percent of Hong Kong's exports in 1973 to 1976. China was less dependent on the US market than most East Asian NIC's. As mentioned before, China had

some success in commodity and market diversification.

Exports from 'foreign-invested' enterprises accounted for 11.5 percent of the increase and exports from processing/assembling operations accounted for 45 percent of the increase. Taken together, foreign investment accounted for 56.2 percent of the increase. The four Special Economic Zones accounted for 7.5 percent of the increase, and this overlaps with the share of foreign investment due to the predominance of foreign investment in these Zones. Exports from operations with foreign investment are increasingly important, and foreign investment accounted for 63.5 per cent of the increase in exports from 1978 to 1990.

The Hong Kong connection is also of overwhelming importance. Hong Kong's consumption, re-exports, transshipment, and intermediation accounted for respectively 7%, 46%, 11%, and 9% of the increase, and the total was 73%. As Hong Kong accounted for 62 percent of China's total contracted investment from 1979 to 1989, there was considerable overlap between the share of foreign investment and the share of the 'Hong Kong connection.'

Though China's external sector is heavily regulated, there are significant elements of flexibility. Hong Kong has enabled China to capitalize on these elements of flexibility, and they have played a crucial role in China's export drive. China has vast amounts of cheap labour, but the utilization of cheap labour to produce labour-intensive manufactures for the world market is a tricky task. Foreign investors, especially Hong Kong investors, have provided the know-how and the capital. In addition to Hong Kong investors, Hong Kong traders have provided skills in marketing, sourcing, product design, quality control, technical assistance, and also production management. China itself has contributed with economic reforms. The major reforms that impinge on the external sector include setting a realistic exchange rate, encouraging foreign investment in open areas, especially the Special Economic Zones, and the breaking of the foreign trade monopoly. Reforms of the domestic sector are also important because they increase the flexibility of domestic enterprises and enable them to respond to the world market. The decollectivization of agriculture, encouragement of rural enterprises, and partial marketization of the state industrial sector all contribute towards China's export drive.

Table 8. Explaining China's Export Drive

	1989 Exports		1978 Exports		Increase of Exports from 1978-1989	
	US\$m	Share of total (%)	US\$m	Share of total (%)	US\$m	Share of total (%)
1. Total Exports ^a	52486	(100.0)	9745	(100.0)	42741	(100.0)
2. US Market ^b	11583	(22.1)	350	(3.6)	11233	(26.3)
3. Manufactures ^c	37265	(71.0)	4775	(49.0)	32490	(76.0)
4. Clothing & textiles	16848	(32.1)	2713	(27.8)	14135	(33.1)
Clothing & textiles to US market ^d	3769	(7.2)	134	(1.4)	3635	(8.5)
5. Exports of foreign ventures						
Foreign-invested enterprises ^e	4920	(9.4)	0	0	4920	(11.5)
Processing / Assembling operations ^f	19100	(36.4)	0	0	19100	(45.0)
Subtotal	24020	(45.8)	0	0	24020	(56.2)
6. Exports from 4 Special Economic Zones ^g	3200	(6.1)	0	0	3200	(7.5)
7. Hong Kong Connection						
HK market ^h	4698	(9.0)	1598	(16.4)	3100	(7.3)
Re-exports via HK ⁱ	20517	(39.1)	664	(6.8)	19853	(46.4)
Transshipment via HK ^j	5249	(10.0)	502	(2.2)	4747	(11.1)
HK as broker ^k	3674	(7.0)	0	0	3674	(8.6)
Subtotal	34138	(65.0)	2764	(28.4)	31374	(73.4)

Source:

a, b, c: From Tables 1, 6, and 4 respectively.

d: From US import statistics (China export statistics are not used because of re-exports of Chinese textiles from Hong Kong are very substantial).

e: *Economic Daily*, August 4, 1990.

f: Estimated from the exports of processing/assembling operations in 1990 on the assumption that the rate of growth of such exports from 1987-90 was constant.

g: Mao Zongcheng (1990:9).

h, i: *Hong Kong Review of Overseas Trade*.

j: The weight of transshipment in 1989 is available from *Hong Kong Shipping Statistics*.

The weight of transshipment in 1978 is extrapolated from the growth of transshipment from 1983-89. It is further assumed that the value of transshipment per ton is the same as Hong Kong's imports from China.

k: Hong Kong Trade Development Council (1988).

On the demand side, rapprochement with the USA and the granting of Most-Favored Nation status to China have evidently helped China's export drive.

To summarize, China's economic reforms, especially reforms of the external sector, have permitted the synergy of foreign know-how with China's cheap labor into a potent force to penetrate the world market. The role of Hong Kong is particularly important, not only as financier, investor, consumer, supplier, middleman, and technical consultant, but also as a catalyst in China's economic reforms and trade liberalization.

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解釋中國出口的成就： 指令經濟中的唯一成功案例

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(中文摘要)

由於中國在外貿方面的管制甚為繁複，不少中國問題專家，包括世界銀行的專家，都認為中國近年在出口方面的成就不能持續下去。可是中國在1978—1990年經改時期中的出口卻不斷有出人意外的表現。雖然中國對外經濟部門受沉重的管制，可是其中也有不少靈活的因素，包括經濟特區、開放區、自由運作的鄉鎮企業、擁有較大自由的外資企業，及龐大的外匯灰色市場。業者更可通過活躍的外匯黑市及香港的地下公司或隱蔽的香港聯繫來逃避管制。本研究量度上述各種因素對中國出口的貢獻，發現中國通過其香港聯繫，得以充份利用上述種種靈活因素，使外國的技術和中國的廉價勞工結合起來，成為進軍世界市場的有效力量。