

Trade Liberalization and Poverty Reduction in China and ASEAN*

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August 18, 2014

* Paper commissioned by the China International Center for Economic and Technical Exchanges for the 8th ASEAN-China Forum on Social Development and Poverty Reduction, August 7-8, 2014, Nay Pyi Taw, Myanmar.

Summary

China - ASEAN bilateral trade liberalization is further integrating the region along the line of global value chains. This gives high hope that the low income and poor in the region can be included into world trading system and be lifted out of poverty.

This paper first reviews China's experience in trade liberalization and poverty reduction. In agriculture, because the "grain self-sufficiency" policy and the stringent sanitary and phyto-sanitary (SPS) standards imposed by its main trading partners, China's agricultural trade liberalization has not lead to substantial labor intensive horticultural exports to high end market. Its impact on poverty reduction is limited. However, its innovative processing trade regime has generated millions of manufacturing jobs for unskilled migrant workers and is regarded as a success in poverty reduction.

ASEAN countries are not homogeneous. This paper examines the evolving trade patterns since 1997 between China and ASEAN countries in electronics and machinery, and the textile and clothing sectors, the two sectors that are most fragmented in production. It finds that high-income ASEAN countries are specializing towards R&D intensive parts production with China as an assembly center. At the same time, the low-income ASEAN countries are becoming the assembly center for China made parts. This suggests the opportunities of labor intensive assembly jobs in the two manufacturing sectors for the unskilled low income and poor labor in ASEAN.

The shift of Chinese labor intensive assembly operations towards the low-income ASEAN countries has implications for poverty reduction in the region. Given that the large scale processing trade is crucial for effective poverty alleviation, China's innovative processing trade customs arrangement shall be introduced to the new host countries. In this regard, there is much scope for China to beef up its aid for trade programs to help poverty reduction in the region.

I. Introduction

Ever since Deng Xiaoping's South Tour in early 1992, China has embarked on a road to open up its foreign trade and investment regime. Its foreign trade has been increasing with the inflow of export-oriented FDI. This development was accelerated after the Asian financial crisis in 1997 when FDI started to shy away from the crisis-stricken ASEAN and flocked to China. China's WTO accession in 2001 secured its access to the US market and the subsequent domestic reform to conform with the WTO rules helped improve the investment environment, leading to another wave of FDI-induced export surge. The slowdown of the US and EU economies as a result of the 2008 global financial crisis pushes the Southeast Asia to turn towards alternative export markets within the region in search for new growth engine.

The FDI movement in the region and the refocus on growth opportunities within the region has strengthened the production linkage and the increasingly finer production fragmentation has made it possible to better explore the comparative advantage within the diverse Southeast Asia.

The establishment of the China-ASEAN Free Trade Area (CAFTA) in 2002 is a landmark event in the integration of China and ASEAN economies. CAFTA reduces the tariffs, and for some least developed ASEAN countries, China has even offered duty free access to its market. This lowers the cost of cross border merchandise movement and represents further deepening of economic and social integration between China and ASEAN.

Trade liberalization generally improves the efficiency of the economy and hence the welfare of the country. At the same time, Southeast Asia is a key part of the global value chains. The increasing fragmentation of production process creates more opportunities for the unskilled poor who would otherwise have to master the whole production process. As such, trade deepening induced by lower tariffs and production fragmentation has the potential to help fight poverty. While China and ASEAN countries have made remarkable progress in reducing income and non-income poverty in recent years, trade liberalization has played different roles. The development of

China's processing trade regime has helped create labor intensive manufacturing jobs for unskilled migrant workers and lifted millions of rural poor out of poverty. ASEAN countries have relied more heavily on national anti-poverty programs, and the potentials of trade opportunities have not yet been fully exploited. One of the reasons is the export constraint on the part of ASEAN members, especially the least developed members, reflected in their weak trade policy governance capacity and poor infrastructure. As a result, the poor and low income people often benefit little from trade liberalization in the region.

To find a solution to this problem, we need to have a good understanding of the evolving trade patterns between China and ASEAN. ASEAN countries are not homogeneous. The patterns of their production linkage with China are evolving in different ways. While high income members (Singapore and Malaysia) are increasingly specializing in R&D intensive parts production for assembly in China, low income members (Vietnam, Cambodia, Laos and Myanmar) are becoming host of labor intensive assembly operations for China made parts. The patterns are consistent with the evolution of global value chains in line with the comparative advantage in the region. Their implications for poverty reduction in the region are clear, as the assembly operations create jobs for the unskilled labor who are mostly poor. China's successful experiences in managing trade liberalization to fight poverty and her emergence as a major donor qualify her as a key contributor to the aid for trade programs in ASEAN.

In section II, this paper will first review China's experience in managing trade liberalization in fighting poverty in both agriculture and manufacturing sectors. The dilemma between trade reform and poverty reduction in agriculture has largely been overcome by the innovative manufacturing trade promotion in the form of processing exports. Section III examines the distinctively different patterns of closer production linkages of high versus low income countries with China. In view of this, priority areas for foreign aid are identified. Finally in section IV, the paper evaluates China's foreign aid practice and argues for a proactive Chinese aid for trade program in ASEAN.

II. Trade liberalization and poverty reduction: China's experience

Most of China's poor live in the rural areas. Rural poverty alleviation in China has benefited from reform in agriculture and in other areas of the Chinese economy in the past thirty seven years. Agricultural reform has reduced distortions inherited from the era of central planning and early industrialization that discriminate against agriculture and farmers, and the livelihood of Chinese farmers have been improved. In the 1980s, the emergence of the township and village enterprises led to rural income improvement. In 1992 when Deng Xiaoping made his tour to the south to re-activate China's reform, foreign direct investment (FDI) in China started to gain its momentum. In the coastal cities, foreign funded enterprises have set up processing and assembly operations for exports and this has created job opportunities for millions of rural migrant workers. Thus, Chinese trade reform in manufacturing is believed to have been helpful with rural poverty alleviation.

In contrast, agricultural trade reform is generally perceived as being detrimental to rural development at least in the short run. Due to WTO and FTA negotiations and water shortage in China's grain belt (Murphy, 2004), market access for grain imports is expected to improve leading to agricultural production adjustment, but this will not happen in a significant way in the short run. Food security will continue to be a major concern and dominate agricultural trade policy debate in China. As a result, to fight poverty through labor intensive horticultural export is not a realistic option.

2.1 Agriculture trade liberalization and poverty reduction

Chinese agriculture trade reform¹

Before reform started in 1978, Chinese agricultural sector was depressed. Within agricultural sector, grain production was emphasized to ensure adequate food supply for the country. On the international trade front, the US-led UN embargo against the new communist regime in the 1950s and the policy-induced 1958-60 famine reinforced the conviction of the Chinese leadership that "grain self-sufficiency"

¹ For detailed discussion on Chinese agricultural trade reform, please see Yao (2007).

should become the principle of utmost importance in agricultural trade policy making. Implementation of China's WTO accession commitments has made China one of the most liberalized countries in agricultural trade. Grain TRQs are expanded, and both in-quota and out-quota rates are lowered. Cotton and soya imports have been opened up to meet the rising domestic demand.

Agricultural trade liberalization has unleashed the potentials of labour-intensive production in agriculture. Development of horticulture, poultry, dairy and animal husbandry sectors has helped increase farmers' income and thus contribute to poverty reduction. However, "grain self-sufficiency" is still the priority in agriculture. Agriculture trade liberalization only slightly relaxed it from 100% down to 95%.

For Chinese agriculture, domestic liberalization has left market as the sole regulator of grain production, and WTO accession commitments have opened the door (up to TRQ limits) for imports. However, the ongoing WTO and FTA negotiations, which have been stalled or slowed down, are unlikely to further liberalize agricultural trade. In the Doha WTO negotiations, the most contentious issue is agriculture market access, which China has been resisting any further concessions. China's FTA with ASEAN (CAFTA), and its ongoing negotiations with Australia, all have significant agricultural components. However, rice is excluded in CAFTA. In the prolonged ongoing China-Australia FTA talks, China is under pressure from Australia to open up its grain trade, but has been reluctant to do so.

All these developments would make it difficult to maintain sufficiently high domestic grain prices. To boost grain production through farm subsidies, though allowed under China's accession protocol, was not a financially viable option, given the sheer size of the grain sector, and become constrained today by the 8.5% cap for allowed domestic support. Therefore, farmers can hardly become rich through growing land-intensive grain.

China is abundant in farm labors but scarce in arable land. Under free trade, China would become a net importer of grain and other land intensive crops and net exporter of horticultural and other labor intensive agricultural products. But recent

developments (or lack of development) in WTO/FTA negotiations would not significantly further liberalize grain trade either. Without a dramatic transformation of Chinese agricultural trade, labor-intensive horticultural exports would not have a chance to grow. Meanwhile, agriculture market access reform in other countries will not help with China's horticultural exports very much, as tariffs for horticultural products have been low and the key hurdles for China's agricultural exports has been sanitary and phyto-sanitary (SPS) requirements, or disguised protectionism in the form of SPS. Since SPS is not on the WTO/FTA negotiation agenda, the prospects of Chinese agricultural exports are not promising, unless resources are unlocked from the grain sector and efforts are made to upgrade the quality of its products, much of which are grown with heavy use of pesticides and other farm chemicals.

Implication for Poverty Alleviation²

The expansion of horticultural exports would create more rural employment opportunities. The nature of being labor intensive does not mean that horticultural production and exports can be done with only labor input. Rather, capital input is critical to ensure the quality of the horticultural products to meet the SPS requirement, to maintain a well-functioned quality certification system and to provide efficient logistics to deliver the products to both domestic and overseas high-end markets. Clearly, capital injection into the horticultural sector would bring high income to the labors employed. Indeed, high quality Chinese horticulture has witnessed significant expansion to high-end overseas markets and domestic markets in metropolitan areas, thanks to Japanese and Korean investment in Shandong province and industrialization of the sector led by large domestic agric-business groups in the southern provinces. Horticultural growers generally earn more than they did in the traditional grain production. However, the horticultural sector has not fulfilled its potential in international trade and in poverty alleviation due to the following reasons:

(1). Lack of funding. Horticultural production is labor-intensive, but also requires access to land, quality seeds, market information and marketing channels. Except foreign investors and domestic large agri-business groups, ordinary farmers often are

² Case studies on horticultural production and poverty reduction in China can be found in Yao (2009).

constrained by lack of funds for initial investment, which usually takes years to show any return. The horticultural sector, dominated by smallholders and private businesses, does not have the political status as the grain sector. Therefore, the horticultural sector is not in a position to compete for funding with the grain sector. As a result, it is not a surprise to see poverty boxes in the grain belt in central China (French, 2008). This situation is very much like the small and medium-sized enterprises in China's export oriented labor intensive manufacturing sectors.

(2). Low quality. Unlike manufacturing exports, however, horticulture faces much tougher quality standards known as SPS in high-end overseas market. In cross country comparison, for per unit output, China uses more farm chemicals than EU and US. In China, the use of pesticides and other farm chemicals in horticulture is heavier than in grain production. This has not only contributed to rural environmental deterioration, but has also made it difficult for Chinese horticultural products to enter overseas market. To improve the quality of Chinese horticultural exports to meet the SPS standards in developed countries is very challenging given that the sector itself is under-funded.

(3). Lack of strict enforcement of quality certification system. China does have a strict testing and certification system in place for organic, green and non-hazard agricultural and food products. Due to lax enforcement, however, one can actually buy a certificate. That's one of the reasons domestic horticultural products can not sell for a good price in major Chinese cities, even though there are consumer groups who are willing to pay more for organic and green produce. Lack of strict enforcement not only raises the food safety concern, but also denies the genuinely good producers of

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