Chapter 1

Introduction

This chapter gives an overview of the thesis. We first provide the motivation for this thesis, and then briefly introduce the research questions, as well as an integrative framework. Finally, we introduce the remaining six chapters in this thesis.

1.1 Motivation

The study of international trade is among the oldest specialities in economics. Changing environmental conditions and all kinds of economic or political events continuously introduce triggers that may give rise to new trade patterns. Such dynamics stimulate the theoretical and empirical study of international trade. As a result, the study of international trade still is a very active field in economics. The industrial revolution, collapse of the colonial system, regional integration, economic transition and globalization – these and other driving forces behind the development of trade have inspired this sub-discipline of economics to develop new theories and perform additional empirical studies. In the contemporary world of the late 20th and early 21st centuries, globalization has become what is probably the most talked-about theme, due to its forceful impact on the world economy and the heated debate between advocates and opponents. No country can escape its influence, and not many countries intend to exclude themselves from the process of globalization altogether. On the contrary, many countries that adopted inward-oriented strategies for many decades, are now making an effort to connect their economy into the world network of business and trade.

China is an extraordinary example. In 1978, China ended a long period of isolation by adopting an open-door policy. Since then, China has gradually increased its
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involvement in the international production network by launching successive steps in the context of an overall policy of liberalization. Owing to its huge market potential, high growth, deepening economic reform, and outward-oriented strategy, China is not only influenced by the trends of globalization, but is also among the most forceful countries that boost the current globalization process. China is particularly influential as a result of the high growth of its international trade and foreign direct investment. No wonder, then, that China receives so much attention, both in academic and policy circles. Furthermore, given its unique context as a distinctive cultural, economic, political and social system, China seems to offer an excellent setting for testing and adapting the theories that were developed with reference to the empirical evidence as to developed market economies in the West. Therefore, this thesis tries to enrich the literature by examining China’s foreign trade relations through a series of five empirical studies.

The reform process that started at the end of the 1970s, has gradually brought China in line with the economic rhythms of the world system. During this transitional process, China’s foreign economic relations witnessed an unprecedented history of changes, both in number and nature. In particular, after 1978, China became a prime example of a developing country that integrated into the world economy, particularly in the areas of international trade and foreign direct investment (FDI). The growth of China’s trade volume since 1978 has been four and a half times that of world trade, which changed China from a closed economy into one of the largest trading nations in the world. China’s share of world trade septupled from 0.67 per cent on the eve of reform in 1977 to 4.89 percent in 2002.\(^1\) In the post-war period, no other country has increased its share in international trade so rapidly. At the same time, China has become more open to FDI than most of the other developing countries, which increased China’s inward FDI from nearly zero in 1978 to a level that makes it

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\(^1\) Source: IMF’s DOTS databank.
the largest FDI recipient in the developing world in the early 21st century. As we will explore below, the large FDI stock is playing an unusually influential role in the development of China’s international trade structure.

The starting point of this thesis is the ‘old’ observation that the development of international trade is influenced by institutional and political dynamics, next to economic drivers. China’s institutional setting has experienced tremendous changes in the last five decades, first changing from a semi-feudal and semi-colonial economy after the Opium War into a centralized socialist economy in the 1950s, and subsequently shifting gradually from a highly centralized socialist system to a decentralized market-oriented economy in the last two decades. China’s contemporary history offers a natural experiment for a study into the impact of institutional and political changes on the evolution of trade relations. As a benchmark hypothesis, we expect that, during this accelerated evolutionary process, “traditional” economic factors (cf. the gravity model, Linder’s effect and new trade theories) especially started to exercise their role in driving the pattern of trade flows in the recent two decades of liberalization. Furthermore, after China opened its market to multinational companies, we hypothesize that foreign direct investment is likely to be an important determinant of China’s bilateral trade pattern.

In terms of economic growth, China has been the world’s number-one country over the past two decades. Not very surprisingly, this attracted a substantial amount of attention from economists. The literature is unanimous that expanding international trade is an important engine for high growth, also in the case of China. This thesis aims to contribute to the extant literature by figuring out empirically which factors indeed fuel this engine. In so doing, we broadly take into account the impact of a wide range of cultural, economic and political factors on the development of China’s foreign trade relations ever since the 1950s, with an emphasis on the late 20th and early 21st centuries. Another objective of this thesis is to test whether – in if so: to
what extent – established trade theories that were developed with reference to the
evidence as to developed market economies in the West work for China, an
emerging transition economy, as well. In order to achieve this pair of aims, we will
explore a rich panel data set by applying advanced econometric techniques.

Of course, in this thesis, we stand on the shoulders of giants. Much work has already
been done, both empirically and theoretically, also for the case of China. In the
following chapters, we offer reviews of the relevant literatures. From such overviews,
we learn that, although previous studies have revealed quite a few of the important
features of China’s international trade evolution, a number of issues still remain to be
explored. For example, very little effort has been devoted to the estimation of the
impact of changes in the institutional and political context on Chinese bilateral trade
patterns with panel data that cover a long time window, the number of studies that
address China’s bilateral structure and its determinants is quite limited, and the
detailed investigation of how FDI and trade (reciprocally) interact is just starting to
emerge. This thesis tries to fill these gaps by presenting a series of five empirical
studies.

1.2 Research Questions and Integrative Framework
This thesis focuses on empirical studies into China’s bilateral trade relations,
examining how and to what extent the bilateral trade relationships were and are
influenced by cultural, economic, geographical and political factors. To fulfill this
aim, the thesis deals with such questions as “How have China’s trade relations
developed over time?”, “How can bilateral trade relations be measured?”, “How and
to what extent do politicians influence bilateral trade relations?”, “Do the economic
invisible hands and the political visible ones both play a role in China’s bilateral trade
relations, and what is their relative importance?”, “What factors affect the structure
of bilateral trade?”, “Does Linder’s effect determine China’s trade pattern, at least in
part?” “Does FDI influence trade?” and “Is there a two-way causal relation between trade and FDI?” By answering these and other questions, we hope to contribute to the development of a better understanding of the drivers behind the changes in China’s bilateral trade relations during the last half century. Based on the extant literature, we can refer to the integrative research framework in Figure 1.1 to position our series of five empirical studies. The framework includes all the potential dependent and independent variables that we will examine in this thesis.

Figure 1.1 Integrative framework
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In the next section, we will briefly explain how our five studies relate to Figure 1.1.’s integrative framework. In advance, we like to emphasize that we purposefully decided not to eliminate all the overlap among our five studies (and, thus, our five empirical chapters). As a consequence of this strategy of reporting, that is, each of the five empirical studies can, in principle, be read without consulting any of the other four chapters. However, as we will explain in the next section and in Chapter 7, the five empirical studies produce different pieces of the overall puzzle of the development of China’s international trade in the post-war period.

1.3 Chapters

Chapter 2 reviews the historical changes of China’s foreign economic relations and related policies in the post WWII period. Here, the objective is to provide background information that sets the scene for the four empirical tests in subsequent chapters. China’s foreign economic relationships experienced tremendous changes during the last 50 years. These changes reflect important shifts in the larger world’s environment, such as the rise and fall of the Cold War from the 1950s to the 1980s, and intensifying processes of globalization in the late 20th century. However, shifts in China’s internal regimes and policies might take more responsibility for these trade relation changes. The review indicates that, in China’s pre-reform era, politicians were decisive in preventing or assisting trade with the rest of the world, whilst in the reform era open-door policies enabled – and still do so – economic factors to come to the fore. Subsequently, the purpose of the following four empirical studies is to rigorously test which determinants of bilateral trade were important when and how, taking this general observation into account.

Chapter 3 aims to find an answer to the following question: does trade follow the flag? To answer this question, we investigate the significance of the impact on bilateral trade relations of political factors by using data as to 78 of China’s trade
partners over the 1950-2002 period. We use the so-called trade intensity index to measure bilateral trade relations, which explicitly reveals the relative importance of trade between two countries. We test the impact of five political factors on this trade intensity index: (1) diplomatic relationship, (2) cooperation and conflicts, (3) high-level visit, (4) political system similarity, and (5) military alliances. To estimate the relative importance of these political factors vis-à-vis economic determinants, we explicitly take the latter on board as well. In the empirical model, we try to deal with issues of data censoring, temporal dynamics and heterogeneity. This study provides strong empirical evidence for the hypotheses that the establishment of diplomatic relations, cooperation, visits of heads of states and similarity of political systems are associated with higher intensities of trade linkages.

Chapters 4 and 5 focus on another question: does trade follow the market? For one, in Chapter 4, we try to reveal the impact of the Chinese trade liberalization program in the 1990s on changes in bilateral trade intensities. The objective here is to investigate whether or not trade liberalization measures have made the economic explanations more significant. We estimate six models for the 1993-1999 period, as well as for the 1993 and 1999 milestone years separately, explaining the shifts in the export and import intensities of trade with different trade partners in the 1993-1999 period. The differences across our estimation results for the six models indicate, indeed, that factors influencing bilateral trade intensities have been changing significantly during the transition process. Particularly, the political determinants of trade intensities that were still very important in 1993, have been moved to the background by economic explanations in 1999.

Next, in Chapter 5, we turn to the examination of China’s bilateral trade structure and its determinants. Here, we shift our focus from inter-industry trade, as explored in Chapters 3 and 4, to intra-industry trade (IIT). Growing importance of IIT is one of the major new developments in patterns of international trade in the last half
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century. A high level of IIT can be expected only when a country’s economic development reaches a certain stage, implying that this country integrates well into the world economy. Given its character, IIT is likely to be more beneficial than inter-industry trade, because it stimulates innovation and exploits economies of scale. During the last two decades, China’s intra-industry trade index has increased substantially, which implies that China upgraded its trade structure. The main objective of this chapter is to explore the determinants of bilateral IIT by using panel data. We estimate three models for total intra-industry trade, vertical intra-industry trade (VIIT) and horizontal intra-industry trade (HIIT). Using factor analysis, we are able to extend the extant literature by including more potential determinants into the models. On the one hand, VIIT appears to be positively related to differences in consumer patterns. On the other hand, HIIT is negatively related to these differences. In addition, we find that FDI has played an important role in determining IIT, especially VIIT. Other significant intra-industry trade drivers are geographical distance, economic size, trade openness and trade composition.

Subsequently, Chapter 6 deals with the FDI-trade causality issue. That is, we investigate long-run relationships and the causality structure between FDI, export and import by using cointegration and Granger-causality approaches. In Chapters 4 and 5, FDI is set, among many other potential trade determinants, as a very important explanatory variable of bilateral trade intensities (Chapter 4) and bilateral IIT (Chapter 5). Chapter 6 goes one step further to investigate the two-way causality relationship between FDI and trade by estimating a Vector Error Correction Model (VECM). In so doing, we unravel the causality and direction of FDI – trade linkages for the Chinese economy in the 1980 – 2003 period. The key findings indicate a virtuous process of the development of China’s outward-oriented economy: more imports lead to more FDI, more FDI leads to more exports, and more exports lead to more FDI.
Finally, Chapter 7 summarizes the main findings of the five empirical studies that form the core of this thesis. There, we point to a number of limitations of this thesis, suggesting a few issues that deserve attention in future work.