

Trade policy uncertainty and firm's decision to import

Published on October 10, 2019 – Updated on November 26, 2019

Dates

on the October 11, 2019

Focus on Research

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In this work, we empirically explore the adjustment of imports to reductions in trade policy uncertainty (TPU) in China, considering that firms may face large sunk costs when importing. Our main results suggest that a decline in TPU allows access to a larger number of foreign varieties that are also associated with higher quality. Moreover, tariff binding leads more producers and intermediaries to start importing, thus allowing more firms and consumers to obtain potential gains from trade. Finally, we find heterogeneous TPU effects across firms and products, highlighting interesting insights into the context of global value chains.

Since firms face large sunk costs to start trading, trade policy uncertainty (TPU) may postpone a firm's decision to enter international markets. The World Trade Organization (WTO) tends to pursue trade policy predictability by several instruments, such as tariff binding. Through tariff binding, WTO members commit not to increase applied tariffs above certain ceilings (bindings). Following the Uruguay Round in 1995, about 73% of product lines were associated with bound tariffs in developing countries, while almost all tariff rates were bound in developed countries (99%).

While previous studies have already stressed that TPU negatively affect firms' export behavior (Handley 2014), this work aims to explore how trade policy uncertainty may influence firms' import behavior, given that firms also incur large sunk costs to start importing. For instance, firms need to search for foreign input suppliers, verify whether foreign intermediates can be easily absorbed into the production process, learn customs procedures, eventually purchasing import licenses, etc.

The discussions on TPU and firms' export decisions are expected to be even more relevant for firms' import decisions since incorporating foreign intermediate inputs can imply irreversible changes in production technology. Indeed, importing may lead firms to increase their productivity and/or their investments in R&D (Zhang and Hongsong, 2017). Moreover, import decision may also be characterized by partial irreversibility due to the presence of some frictions, such as time delays in negotiations with new input suppliers, obstacles in matching with foreign suppliers, or harmonization with other input or investment decisions (Ramanarayanan 2017).

Using Chinese trade data during the period 2000-2006, we explore how tariff binding, arising from China's accession to the WTO in December 2001, affects imports at the product level. We first make a country-related analysis to verify whether Chinese TPU reductions positively affect the entry of new foreign varieties into China. In line with Handley (2014)'s findings, our results suggest that, due to tariff binding, the Chinese economy has been able to access a larger number of foreign varieties, especially from advanced economies, which are typically associated with high-quality. More specifically, while consumers seem to benefit from a wider range of all foreign final goods, firms enjoy access to both a greater variety and higher quality of intermediate goods. We also find that whereas the decisions made by worldwide firms to supply final and intermediate goods to China tend to be delayed by China's TPU, their decisions to supply capital goods are brought forward.

Next, we carry out a firm-related analysis to investigate whether a decline in Chinese TPU positively influences the entry of new Chinese firms into the import market. We document that tariff binding leads a greater number of producers and intermediaries to start importing a given product, which suggests that a larger number of Chinese manufacturing firms are able to import foreign intermediate inputs, directly or indirectly through wholesalers. Therefore, TPU tends to delay a firm's decision to import intermediate inputs. At the same time, we also find that TPU would hasten a firm's decision to purchase foreign capital goods. Finally, tariff binding appears to push more foreign-owned producers located in China to import intermediate inputs under the ordinary trade regime (rather than under the processing trade regime), and more foreign-owned intermediaries to be involved in importing final varieties. These results suggest that FDI in China is starting to become relatively more market-seeking than resource-seeking following Chinese TPU reduction: i.e. foreign multinationals tend to relocate the downstream stages of global value chains relatively more than the upstream stages in China.

This work is complimentary to two recent studies on trade policy uncertainty and export behavior in China, carried out respectively by Handley and Limão (2017) and Feng, et al. (2017). Using data on Chinese exports to the US, the first study argues that TPU reduction can lead more firms to start exporting, and a larger number of incumbent exporters to upgrade their technology, whereas the second work shows that TPU reduction implies the entry of new firms into the export market, and the exit of some incumbent exporters, as well as demonstrating that the former are associated with lower prices and higher quality compared to the latter. Unlike these two

evidences, we focus on Chinese firms' import reactions to domestic TPU declines in a context of multilateral trade, rather than concentrating on Chinese export adjustments to foreign TPU reductions in that of bilateral trade (US-China).

These new stylized facts may represent a call for further research in the future on trade policy uncertainty and firms' import behavior, to further understand potential welfare gains from reducing trade barriers.

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Imbruno, M. (2019). "[Importing under trade policy uncertainty: Evidence from China](https://doi.org/10.1016/j.jce.2019.06.004)", *Journal of Comparative Economics*, Volume 47, Issue 4, December 2019, 806-826.
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