

# Is Processing Good?: Theory and Evidence from China \*

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## ABSTRACT:

Policies encouraging processing trade are common in developing countries and are thought to encourage integration into global markets. Agents engaged in processing production import duty free but are not allowed to sell the resulting output on the domestic market. For ordinary production, the reverse holds: imports are subject to tariffs but domestic sales are allowed. This paper studies the welfare effects of these policies using Chinese data for 109 industries for 2000-2007. Counterfactual policy experiments imply large welfare losses ( $\approx 10\%$  to  $14\%$ ) for Chinese agents from not being allowed to buy processing output. There are smaller welfare gains ( $< 1\%$ ) from the duty free status of processing imports. We also develop a new method to estimate correlation parameters for multivariate Fréchet distributions with trade models that deliver multiplicative gravity equations.

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