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Why China Wants to Join the WTO

After its agreement with the United States in November 1999, China's difficult negotiations with the European Union are now in the last stages of the long process towards its membership of the WTO. There are substantial issues at stake. Concessions negotiated bilaterally will be extended to all member countries, but each partner is striving to open up the Chinese market most in those areas in which it has a strong capacity to export and invest. For China, WTO membership will mark the end of the selective "open door" policy it has pursued for 20 years. The liberalisation will lead to an important reallocation of resources across sectors, which will entail high economic and social costs, but which China expects will benefit growth in the medium term. Indeed, WTO membership appears as a means of re-launching reforms that are necessary for the modernisation of the Chinese economy.

Selective Openness

Since 1979, China's "open door" strategy has been characterised by promoting exports while protecting its domestic market. Drawing on the model of Asia's Newly Industrialised Countries, China has maintained relatively high tariff and non-tariff barriers, while ensuring that such protectionism does not penalise its export industries through the use of special trade regimes[1].

On the one hand, this dualist trade policy has favoured the creation of extremely dynamic, outward-oriented industries, based on the transformation of imported goods. On the other hand, it has kept the import penetration level of the domestic market relatively low: imports for local companies and customers are subject to customs duties and have only risen modestly, accounting for less than half of all imports.

China's policy towards foreign investment has also been selective. Various measures, such as export quotas or the obligation to balance foreign currency accounts, have oriented such investment towards export industries. However, these constraints were reduced progressively during the 1990s, and foreign-equity companies today supply a larger share of the domestic market than do imports (see Table 1).

With a view to joining the WTO, China has progressively reduced its customs duties. In 1996, these fell from 35% to 23.4% (unweighted average), but non-tariff barriers were still estimated to be equivalent to a 9% tariff[2]. In 1997, China cut its customs duties to 17% on industrial products, and announced its intention of bringing them down to 10% in 2005.

The Sino-American agreement constitutes a major step towards WTO accession (see Box). For China, the agreement involves a reduction in customs duties by 2005, an extension of agricultural import quotas and the suppression of quantitative restrictions on industrial imports, as well as the opening up of services to foreign direct investment. China's accession to the WTO means that it becomes a partner for the United States with "normal trade relations", on a permanent basis, no longer subject to annual reviews. From this point of view, Chinese quotas on textile imports are to be abolished by 2005. As a member of the WTO, China will also have to respect the obligations set out in the agreement relating to intellectual property rights in trade (TRIPs), to the liberalisation of trade in services (GATS), and to policies concerning trade-related investment (TRIMs). This latter issue implies notably eliminating constraints on foreign

Table 1 - Openness of Chinese Industry in 1997, in %

Export rate (exports/production)	
All local companies	12,9
Chinese companies	8,6
Foreign-equity companies	39,7
Supply of domestic market*	100,0
Local production	94,4
Chinese companies	85,5
Foreign-equity companies	8,9
Imports**	5,6

* Apparent domestic demand: production-exports+imports destined for the local market.
** Excluding imports destined for re-export.
Source: F. Lemoine, "Foreign Direct Investment in China's Economy", *CEPII Working Paper*, to be published May 2000.

1. See *La Lettre du Cepii*, No 178, April 1999.
2. World Bank, *China Engaged*, 1997.

BOX - CHINA'S ENTRY INTO THE WTO

In 1986, China applied to be a member of the GATT as a contracting party. As of 1995, negotiations over its entry into the WTO got underway. The accession process has unfolded on the basis of a multilateral plan, within a the Working Party which examines the candidate country's trade regime, including factors affecting services, non-tariff barriers and intellectual property rights. At the same time, candidates negotiate their commitments and concessions on liberalisation, bilaterally with members that have requested to do so. On this basis, the Working Party prepares an accession protocol whose conditions must be accepted unanimously by the Party. China is pursuing its negotiations with the European Union, having already reached an agreement with 27 countries, including the United States. After accession, the negotiated conditions are applicable to all WTO members.

Commitments by China under the China-US agreement:

INDUSTRIAL PRODUCTS	AGRICULTURAL PRODUCTS
By 2005, customs duties are to be cut from 24.6% to 9.4% and quantitative restrictions are to be eliminated. Automobiles: customs duties are to be cut (presently running at 80 to 100%) to 25% in 2006 (10% on spare parts). Foreign companies will have the right to provide credit to customers. Telecommunications: customs duties to be eliminated in 2005.	Customs duties to be reduced from 22.1% to 17% by 2004. A tariff quota system is to be set up for most staple products (wheat, rice, corn and cotton), with import quotas (at low tariffs) rising through to 2005.

SERVICES

- Trade and distribution
  Import and distribution duties: foreign companies are to have the right to export, import and sell directly to the domestic market, and may run after-sales and repair services.
- Telecommunications
  China is to become a member of the Basic Agreement on telecommunications.
  Foreign investments are to be authorised, up to 49 or 50%, with a delay of 2 to 6 years depending on the activity in question.
- Banks
  Foreign banks are authorised to carry out operations with companies, in local currency (2 years after accession), and with individual clients (after 5 years).
- Insurance
  Restrictions on foreign companies' activities are to be lifted in 5 years.
  Licences will be accorded to foreign companies, based on prudential criteria.
  Foreign equity will be limited to 51% (49% for life insurance).
- Stock markets
  Foreign investments in investment funds are to be authorised.
  Foreign equity in stock-issuing companies is to be limited to 49%.

direct investment relating to export requirements, local content and technology transfers.

The Impact of Liberalisation

It is generally considered that the costs of trade liberalisation are greater for countries with clear sectoral specialisations than those involved more in intra-industry trade. Greater openness then implies a shift in resources across sectors, within the country, as production factors are transferred to industries that have a comparative advantage, and away from industries with a comparative disadvantage and which are subject to greater competition from imports. The expansion of China's foreign trade is based on its comparative advantage in labour-intensive industries. China retains a strong advantage in textiles and apparel (20% of exports in 1999). The country has also acquired an advantage in certain downstream activities of several new industries (electrical and electronic equipment account for 22% of exports), due to its participation in the international segmentation of productive processes.

The macroeconomic and sectoral impact of trade liberalisation has repeatedly been estimated using computable general equilibrium models[3]. The results differ according to the assumptions made about trade liberalisation, but they all show up a positive impact on growth stemming from the reallocation of resources into labour-intensive sectors, at the expense of natural resource- or capital-intensive sectors. The most recent study simulates trade liberalisation similar to the terms of the bilateral Sino-American agreement[4]. The results show that compared to non-accession, China's entry into the WTO will lead to an acceleration of GDP growth (a 1 percentage point rise up to 2005), and a rise in foreign trade (exports and imports being 25% higher in 2005).

Table 2 shows the sectoral dimension of this scenario. The big winner is the texitles-apparel sector. The suppression of quotas in 2005 will encourage exports, and the expansion of output in finished goods will pull intermediate goods with it. Food & agricultural industries will benefit too from the fall in the agricultural import costs. The losers will be the producers of cereals and other major crops, due to the strong expansion of imports, together with most mechanical industries. These sectors, which are relative intensive in capital and technology, will face head-on competition from imported products.

3. Y. Yang, "China's WTO Membership: What is at Stake", *The World Economy*, 11/96; C. Bach, W. Martin and J. Stevens, "China and the WTO: Tariff Offers, Exemptions and Welfare Implications", *Weltwirtschaftliches Archiv*, No 3/1996, World Bank, China 2000, 1997; Development Research Centre, *The Global and Domestic Impact of China Joining the World Trade Organisation*, December 1998.

4. Development Research Centre, *op cit*. For agricultural products, the assumptions made go beyond the commitments undertaken by China, as they assume that import quotas on agricultural products will be eliminated by 2005 and replaced by customs duties averaging 10%.

These results should be interpreted with caution. Thus, the expansion of trade between 1999-2005 is likely to be far faster in the accession scenario than with no accession (50% growth versus 25%). But it is nevertheless considerably slower than the increase recorded for 1993-1999 (80%). Furthermore, the results provide an image of the situation once adjustments have been made, which does not take into account economic or social costs. These will, however, be significant. Joblosses will have the short term consequences of raising unemployment, which is already a source of social tension. Transfer payments will be necessary to compensate or support the regions and social groups most affected. Lastly, the opening up of services to foreign investments over the five years following accession will expose sectors to competition that have been protected until now (retail/wholesale trade and distribution, telecommunications, banking and insurance). The obligation of respecting intellectual property rights could also put some sectors under pressure.

Table 2 – The Consequences of WTO Membership for China's Industries

	Variations in %*				Share of sectors**	
	Production	Employment	Imports	Exports	Production	Employment total
Winners						
Clothing	+74	+52	+124	+214	2,2	0,7
Textiles	+25	+24	+86	+64	4,7	1,7
Lather	+6	+8	+124	+7	1,4	0,4
Livestock	+6	+5	+77	+13	4,0	2,9
Foods products	+5	+6	+16	+32	4,3	0,8
Chemicals products	+4	+4	+27	+14	7,6	2,0
Losers						
Vehicles	-15	-15	+105	-8	1,7	0,5
Cotton	-13	-23	+426	+209	0,3	3,1
Wheat	-9	-14	+206	+73	0,6	5,3
Oils	-6	-8	+260	+127	1,1	0,2
Electronics	-5	-3	+5	-5	2,9	0,5
Refined petroleum	-4	-3	+35	-7	1,5	0,2
Elitrical machinery	-3	-2	+12	-5	2,8	0,8
Machines	-3	-2	+10	-4	5,1	1,9

* In % the level expected for 2005, in the case of non-membership.

** In 2005, in the case of non-membership (in %).

The sectors included here are those for which the relative gain (loss) in output is greater (less) than 3% and which account for more than 1% of total output or employment.

Source: Development Centre Research.

The Acceleration of Reform

The scale of these expected adjustments explains why China's membership of the WTO is far from achieving unanimous backing from political leaders, experts, and among Chinese public opinion[5]. For supporters of membership, entry into the WTO is seen as a means for accelerating restructuring and economic reform, and hence as a condition for the modernisation of the country and its long term growth.

In contrast to the shock therapy that provoked recession in Eastern Europe, trade liberalisation in China comes at the end of a twenty-year, gradual transition process. The competition which has developed in the domestic market since reforms were started has already eliminated obsolete capital stock. At the same time, the wave of investment in the 1990s has created excess industrial capacity which is squeezing out a certain number of producers. Entry into the WTO will merely reinforce this process.

Over the last twenty years, Chinese industry has been characterised by the rise of new companies, outside the State sector. Industrial production[6] is presently divided among State-owned enterprises (26% of output), collective enterprises (36%), sole-traders (16%), foreign-equity companies (14%), and other forms of ownership (7%). The effect of liberalisation on these various categories will depend on their sectoral specialisations, along with their ability to meet new competition.

Non-State enterprises have a strong position in the textile and food & agriculture industries, which should allow them to benefit from China's membership of the WTO. But they are also very much present in sectors exposed to international competition. This is the case of foreign-equity companies in the automobile sector, and collective enterprises in machinery. State-owned enterprises are generally sensitive to liberalisation in as far as they are concentrated in capital-intensive sectors. However, the capacity to resist competition does not necessarily match the various types of property ownership: both the State and non-State sectors are very heterogeneous.

The State sector covers both a large number of loss-making companies and a core of more successful enterprises which could be a motor for growth[7]. Greater economic openness is a way of accelerating the selection process and disciplining company behaviour. This, however, can only take place if companies are relieved of their social welfare commitments, and any resulting losses these may cause. They could then be subjected to a hard budget constraint, backed up by bankruptcy procedures. Part of the finance needed for such restructuring, and in particular the establishment of a social security system could be obtained from the sale of assets. This argues in favour of State-entreprise equity being opened up, which was indeed already put forward by the Communist Party Congress in the autumn of 1998. Trade liberalisation only has a marginal direct impact on the State budget[8], but could have important indirect consequences for public finances.

5. The Chinese Academy of Social Sciences, ***China After WTO Entry***, October 1999; "The Say No Club", ***Far Eastern Economic Review***, 13/01/2000.
6. Used here in its wider sense, including rural industries.
7. World Bank, China, ***Weathering the Storm and Learning the Lessons***, 1999.
8. Customs duties only represent 3% of all budget receipts, given tariff exemptions and illegal imports.

Private companies and foreign-equity firms are currently the most dynamic part of the economy. For the Chinese authorities, having a strong local private sector has become imperative to create jobs but also to ensure a presence in those competitive sectors being opened up to foreign companies. The private sector was recognised by the Constitution in 1999 and has been encouraged to extend its field of activity. The sector is now being called upon to expand, provided that it can obtain the necessary resources. Chinese banks lend to State enterprises which are implicitly guaranteed, and restrain their lending to the private sector as interest rates are insufficiently flexible (presently fixed at around 10%). Interest rate liberalisation has for long been considered as a condition vital for private and collectivised companies to acquire bank credit, and is now again on the agenda.

Trade liberalisation will thus only have positive effects if the whole Chinese economic system pursues reform thoroughly. Change in the banking sector, in particular, would appear to be crucial given that the sector is to be opened up to foreign investors five years after China joins the WTO, and given that the four State banks (which account for 80% of banking activity) are currently insolvent because of the scale of their non-performing loans. The latter are estimated to account for at least 25% of bank assets[9]. These banks were recapitalised in 1998 and at the end of 1999 a demarcation structure was set up for each bank allowing bad debt to be bought up which can then be traded against company equity. This process is only in its first stages and will take time: its impact on company management and the ending of non-performing loans is far from certain.

The acceleration of reforms and social stability will only be compatible within a context of sustained economic growth. The upturn in domestic demand, which began in January-February 2000, suggests that the Chinese economy is once again on the upswing, following a downturn in it business cycle in 1998-1999. A favourable external environment has helped exports to rise (+6% in 1999, as opposed to +0.5% in 1998), and this should continue. Lastly, the upturn in foreign investment (commitments were up by 12% in January-February 2000) may be attributed to expected membership of the WTO.

China's economic growth will thus determine the gains which the industrialised countries can expect from it opening up. An accentuation of China's trade specialisation will likely reinforce its economic and trading complementarity with the developed countries. Japan, China's first foreign supplier ($34 billion in 1999), followed by the European Union ($25.5 billion) and the United States ($19.5 billion) will be the main beneficiaries of the expansion of China's domestic demand for capital-intensive and technology-intensive industrial goods, as well as for agricultural products. But the opening of the market will also favour the rise of a major partner, Taiwan, whose share of Chinese imports equals that of the United States.

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9. BIS, "Strengthening the Banking System in China: Issues and Experiences", ***Policy Papers***, No 7, October 1997.

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