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PEOPLE'S REPUBLIC OF CHINA

(Position as of December 31, 1996)

Status Under IMF Articles of Agreement

Article VIII

Date of acceptance: December 1, 1996.

Exchange Arrangement

Currency

The currency of the People's Republic of China is the renminbi (RMB). The currency unit is the yuan (100 fen = Y1 and 10 fen = 1 jiao).

Exchange rate structure

Unitary.

Classification

Managed floating

The exchange rate of the renminbi is determined in the interbank foreign exchange market. The People's Bank of China (PBC) announces a reference rate for the renminbi against the U.S. dollar, the Hong Kong dollar, and the Japanese yen based on the weighted average price of foreign exchange transactions during the previous day's trading. Daily movement of the exchange rate of the renminbi against the U.S. dollar is limited to 0.3% on either side of the reference rate as announced by the PBC. The buying and selling rates of the renminbi against the Hong Kong dollar and the Japanese yen may not deviate more than 1% on either side of the reference rate; in the case of other currencies, the deviations should not exceed 0.5% on either side of their respective reference rates. The selling price for cash transactions is the same as the buying price for cash transactions for all quoted currencies. The buying price for cash should not exceed 2.5% of its spot rate.

The Shanghai-based China Foreign Exchange Trading System (CFETS) is a nationally integrated electronic system for interbank foreign exchange trading. At present, it is electronically linked with 25 foreign exchange trading centers located in major cities. All foreign exchange transactions are conducted through the system. Financial institutions involved in foreign exchange transactions must become members of the CFETS.

Exchange tax

No.

Exchange subsidy

No.

Forward exchange market

No.

Arrangements for Payments and Receipts

Prescription of currency requirements

The currencies used in transactions are determined by the respective contracts.

Payment arrangements

Bilateral arrangements

Inoperative

China has terminated arrangements with Cuba, the Democratic People's Republic of Korea, Mongolia, Russia, and Vietnam. Cash settlements with these countries have been adopted.

Administration of control

Exchange control authorities

The PBC has authority over control and the State Administration of Foreign Exchange (SAFE) is responsible for implementing regulations.

International security restrictions

No.

Payment arrears

No.

Controls on trade in gold (coins and/or bullion)

Controls on domestic ownership and or trade

Trading of gold and silver is restricted to pharmaceutical, industrial, and other approved users. Private persons may hold gold but not trade it. Nonresidents can buy gold, gold products, silver, and silver products but must present the invoice to export them.

Controls on external trade

Unlimited amounts may be imported but must be declared. Exportation requires permits.

Controls on exports and imports of banknotes**On exports***Domestic currency*

The exportation of domestic currency is limited to RMB 6,000.

Foreign currency

Travelers on official business can carry as much foreign currency as needed. Residents going abroad can carry foreign currency in cash up to the equivalent of \$1,000. For amounts exceeding \$1,000, approval of the SAFE is required. Banks will issue a "permit to carry foreign currency abroad" based on SAFE approval.

On imports*Domestic currency*

n.a.

Foreign currency

The import of foreign currency must be declared to customs.

Resident Accounts**Eligibility to hold accounts**

Juridical persons

Domestic establishments may maintain specified categories of foreign exchange accounts with permits issued by SAFE. Foreign-funded enterprises (FIEs) may open (1) foreign exchange settlement accounts for receipts and payments under the current account with a maximum amount stipulated by the SAFE for each enterprise; and (2) foreign exchange special accounts for receipts and payments under the capital account.

Natural persons

Foreign currency savings accounts may be opened with authorized banks.

Foreign exchange accounts permitted

Yes.

Held domestically

These accounts are permitted, but prior approval is required.

Held abroad

These accounts are permitted, but prior approval is required.

Accounts in domestic currency convertible into foreign currency

Domestic establishments in need of foreign exchange may convert domestic currency into foreign currency at authorized banks by presenting valid proof and commercial bills.

Nonresident Accounts**Eligibility to hold accounts**

Juridical persons

FIEs and joint ventures can maintain foreign exchange accounts and use them to make authorized payments abroad.

Natural persons

Persons staying in China for a short time may open foreign currency savings accounts.

Foreign exchange accounts permitted

These accounts are permitted, but prior approval is required.

Domestic currency accounts

Yes.

Convertible into foreign currency

These accounts are permitted, but prior approval is required.

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Blocked accounts

No.

Imports and Import Payments

Foreign exchange budget

No.

Financing requirements for imports

Advance payment requirements

Importers may make advance payment of loans not exceeding \$100,000 at the banks, by presenting valid proof and commercial bills. Prior SAFE approval is required for payment of loans exceeding 15% of the contract amount or the equivalent of \$100,000.

Documentation requirements for release of foreign exchange for imports

Importers must provide valid proof and commercial bills, mainly import permits, automatic registration permits, proof of import, customs declarations, verification forms for foreign exchange payments, import contracts, and the like to obtain foreign exchange or pay directly from their foreign exchange accounts.

Preshipment inspection

All imports require prior inspection to their release by customs at the port of entry.

Letters of credit

n.a.

Import licenses and other nontariff measures

Positive list

All enterprises other than registered foreign trade companies (FTCs) must obtain approval from local foreign trade bureau, in accordance with the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) authorization, as well as a license from the local bureau for industry and commerce, to engage in foreign trade.

Negative list

Imports of all secondhand garments, poisons, narcotic drugs, diseased animals, and plants are prohibited. In addition, the importation of weapons, ammunition and explosives, radio receivers and transmitters, manuscripts, printed and recorded materials, and films that are deemed to be detrimental to Chinese political, economic, cultural, and moral interests is prohibited.

Licenses with quotas

Yes.

Import taxes and/or tariffs

Import tariff rates fall into 2 categories: general and preferential. Preferential rates are granted to imports from countries with which China has a trade treaty or agreement. Other imports are subject to the general rate of duty. The average unweighted tariff rate is 35.7%. China has a number of special economic zones where imports of inputs and capital goods are exempt from tariffs.

Taxes collected through the exchange system

No.

State import monopoly

FTCs conduct trade in specified products, including wheat, chemical fertilizers, crude oil and oil products, rubber, steel, timber, plywood, polyester fibers, tobacco and its products, cotton, and wool.

Exports and Export Proceeds

Repatriation requirements

Yes.

Surrender requirements

Domestic establishments must sell their export earnings to designated banks; FFEs may retain their export earnings, provided those earnings do not exceed the maximum amount allowed for a foreign exchange surrender account as prescribed by the SAFE; otherwise the balance, if any, must be sold to authorized banks or sold through foreign exchange adjustment centers.

Financing requirements

No.

Documentation requirements

No.

Export licenses**Without quotas**

Exports of specific machine tools require a license from the SAFE for the Inspection of Import and Export Commodities for purposes of quality control. Controls in the form of registration for surveillance purposes are exercised on the importation of machinery and electric equipment in order to monitor the supply and demand situation.

With quotas

Quotas for 24 product items are allocated through a bidding system under which successful bidders are required to guarantee maximum export value by offering higher benchmark export prices.

Export taxes

Export duties are levied on 47 products.

Taxes collected through the exchange system

No.

Payments for Invisible Transactions and Current Transfers**Controls on these payments**

Nontrade payments by FFEs and public enterprises are subject to the same provisions. Resident individuals are subject to different regulations. Payments for freight and insurance, unloading and storage, administrative expenses, commissions, travel, medical treatment, study abroad, consulting and legal fees, as well as foreign workers' wages, gambling and prize earnings, family maintenance and alimony, and remittances of profits and dividends are subject to indicative limits and/or bona fide test.

Commissions*Quantitative limits*

SAFE approval is required for amounts exceeding the prescribed limits (i.e., as a percentage of f.o.b. pricing. In the case of a hidden commission, the rebate should not exceed 2% of total contract amount and, in the case of a stated commission, the rebate should not exceed 5%. If rebates exceed those percentages, they should be below \$10,000). Traders may pay directly at authorized banks by presenting valid proof and commercial bills.

Payments for travel

The foreign exchange requirements of companies within the budget are provided according to the prescribed limits. There are no restrictions on payments for travel of FFE staff.

"Interim Regulations on Nontrade and Nonbusiness Foreign Exchange Utilization," published by the Ministry of Finance, imposes a limit on the amount of foreign exchange utilized by persons traveling abroad on official business. Residents traveling to Hong Kong, China, and Macao for personal reasons may purchase up to \$500 worth of foreign currencies; individuals traveling to other countries or regions (including Taiwan Province of China) may purchase up to \$1,000 worth of foreign currencies.

Prior approval

Approval of the SAFE is required for amounts exceeding those limits.

Quantitative limits

Yes.

Medical costs*Quantitative limits*

Residents may purchase foreign exchange up to \$500 for payments of medicines and medical equipment abroad; for larger amounts, they must submit appropriate documentation for SAFE's verification.

Study abroad costs*Quantitative limits*

Persons paying for their own studies abroad may be allowed a onetime purchase of foreign exchange of up to \$1,000. Larger amounts require the approval of the SAFE.

Subscriptions and membership fees*Quantitative limits*

Yes.

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Consulting/legal fees

Quantitative limits Yes.

Pensions

Quantitative limits Pensions, including severance and separation payments, may be converted into foreign currency.

Family maintenance/alimony

Quantitative limits Yes.

Credit card use abroad n.a.

Proceeds from Invisible Transactions and Current Transfers

Repatriation requirements Yes.

Surrender requirements

Foreign grants and financial aid received by domestic establishments and foreign exchange earmarked for external payments as prescribed by aid contracts may be maintained with the approval of the SAFE; foreign embassies and consulates, representative offices of international organizations and affiliates of foreign juridical persons, resident persons and foreign expatriates may retain their foreign exchange; FFEs may retain foreign exchange earnings from current account transactions, provided the retained amount does not exceed the maximum limit allowed by the SAFE. Balances, if any, must be sold to authorized banks or through foreign exchange swap centers.

Capital Transactions

Controls on capital and money market instruments

On capital market securities

Purchase locally by nonresidents

Nonresidents may only purchase B shares. The face value of B shares is denominated in renminbi, which are listed on the Chinese Securities Exchange and can only be bought by foreign investors.

Sale or issue locally by nonresidents

These transactions are not permitted.

Purchase abroad by residents

Residents, except financial institutions permitted to engage in foreign borrowing, and authorized industrial and trade enterprises or groups are not permitted to purchase securities abroad. A qualifications review by the SAFE is required for financial institutions to purchase securities abroad.

Sale or issue abroad by residents

Prior approval by the PBC, the SAFE, or the Securities Supervisory Board is required. Issuing bonds abroad must be integrated within the state's plan for utilizing foreign capital. Bonds can only be issued by financial institutions approved by the PBC.

On money market instruments

Purchase locally by nonresidents

Nonresidents are not allowed to purchase money market instruments.

Sale or issue locally by nonresidents

Nonresidents are not allowed to sell or issue money market instruments.

Purchase abroad by residents

Residents, except financial institutions permitted to engage in foreign borrowing, and authorized industrial and trade enterprises or groups are not allowed to purchase money market instruments. Financial institutions must undergo a review of qualifications by the SAFE before purchasing foreign money market instruments.

Sale or issue abroad by residents

Sale or issue abroad of securities, other than stocks, requires PBC and SAFE approval.

On collective investment securities

Purchase locally by nonresidents

These transactions are not allowed.

Sale or issue locally by nonresidents

There are no regulations, and if these instruments are traded, they must be approved by the Securities Policy Commission.

Purchase abroad by residents

Same regulations as for purchase of money market instruments apply.

Sale or issue abroad by residents

Same regulations as for sale or issue of money market instruments apply.

Controls on derivatives and other instruments

Purchase locally by nonresidents

These transactions are not allowed.

Sale or issue locally by nonresidents

These transactions are not allowed.

Purchase abroad by residents

Operations in such instruments by financial institutions are subject to prior review of qualifications and to limits on open foreign exchange positions.

Sale or issue abroad by residents

Same regulations as for purchases apply.

Controls on credit operations**Commercial credits***By residents to nonresidents*

Industrial and commercial enterprises may not provide lending to nonresidents. Provision of loans to nonresidents by financial institutions is subject to review of qualifications by the SAFE and to a foreign exchange asset-liability ratio requirement.

To residents from nonresidents

Only financial institutions permitted by the SAFE to engage in external borrowing and authorized industrial and commercial enterprises or groups can engage in external borrowing of commercial credit. For credit over 1-year maturity, the loan must be part of the state plan for utilizing foreign capital and must be approved by the SAFE. Short-term commercial credit (with a maturity of 1 year or less) is subject to foreign exchange balance requirements. Financial institutions permitted to engage in foreign borrowing are free to conduct short-term foreign borrowing within the target balance without obtaining approval, but must register the borrowing with the SAFE.

Short-term foreign financing with maturity of 3 months or less provided to enterprises (excluding FFEs) is not subject to limitations, but short-term financing of longer than 3 months is subject to short-term foreign exchange balance requirements, and the borrowing must be registered with the SAFE.

FFE's may borrow from nonresidents without obtaining approval, but must report the borrowing to SAFE.

Financial credits

Same regulations as for commercial credits apply.

Guarantees, sureties, and financial backup facilities*By residents to nonresidents*

The regulation on External Guarantees Provided by Domestic Entities of September 1996 allows the provision of guarantees by authorized financial institutions and non-financial legal entities that have foreign exchange receipts. Government agencies or institutions cannot provide guarantees.

Controls on direct investment**Outward direct investment**

Foreign exchange is provided for the investment after a SAFE review of sources of foreign exchange assets and an assessment of the investment risk involved, approval by MOFTEC, and registration with the SAFE.

Inward direct investment

As long as nonresidents meet requirements under Sino-foreign joint-venture laws and other relevant regulations, and are approved by MOFTEC, nonresidents are free to invest in China. There is no restriction on the inward remittance of funds as far as exchange control is concerned. For environmental and security reasons, inward direct investment in some industries is prohibited.

Controls on liquidation of direct investment	No.
Controls on real estate transactions	
Purchase abroad by residents	Same regulations as for direct investment apply.
Purchase locally by nonresidents	Same regulations as for direct investment apply.
Sale locally by nonresidents	n.a.
Provisions specific to commercial banks and other credit institutions	
Borrowing abroad	Same regulations as for commercial credits apply.
Maintenance of accounts abroad	Prior approval by the SAFE is required for domestic entities opening foreign exchange accounts abroad.
Lending to nonresidents (financial or commercial credits)	Lending is allowed subject to review of qualifications by the SAFE and to asset-liability ratio requirements.
Lending locally in foreign exchange	Lending is mainly subject to qualifications review by the SAFE and to asset-liability ratio requirements.
Purchase of locally issued securities denominated in foreign exchange	China does not issue securities denominated in foreign currency.
Differential treatment of nonresident deposit accounts and/or deposit accounts in foreign exchange	
<i>Reserve requirements</i>	There are different reserve requirements for deposits in renminbi and in foreign currency, and also between the latter in domestic banks and in FFEs (i.e., 13% for deposits in renminbi, 5% for any foreign currency deposit in domestic banks, and 3% for deposits in foreign currency for over 3 months and 5% for less than 3 months, in FFEs).
<i>Liquid asset requirements</i>	Bank foreign exchange liquid assets (1 year or less) should not be less than 60% of liquid liabilities (1 year or less) and 30% of total foreign exchange assets. Total deposits with 3-month maturities, deposits in both domestic and foreign banks, funds used for purchasing transferable foreign-currency-denominated securities, deposits with the central bank, and cash holdings should not be less than 15% of total foreign exchange assets. Nonbank foreign exchange liquid assets (1 year or less) should not be less than 60% of liquid liabilities (1 year or less) and 25% of total assets. Total deposits with 3-month maturities, deposits in both domestic and foreign banks, funds used for purchasing transferable foreign-currency-denominated securities, deposits with the central bank, and cash holdings should not be less than 10% of total assets.
<i>Credit controls</i>	Total loans, investment guarantees (calculated as 50% of the balance guaranteed), and other foreign exchange credits provided to a legal entity by banks or nonbank financial institutions should not exceed 30% of the foreign exchange capital owned by the banks or nonbank financial institutions.
Investment regulations	Bank equity investment should not exceed the difference between bank capital and mandatory paid-in capital. Nonbank financial institutions' total equity investment (excluding trust account) should not exceed the difference between their capital and mandatory paid-in capital.
Open foreign exchange position limits	For financial institutions trading foreign exchange on their own behalf, the daily total amount traded (total open foreign exchange position) should not exceed 20% of the foreign exchange working capital. As authorized by the highest level of management, financial institutions trading foreign exchange on their own behalf may retain a small amount of overnight open position, but this should not exceed 1% of the foreign exchange working capital.
Provisions specific to institutional investors	No.

Changes During 1996

Status under IMF Articles of Agreement	<i>December 1.</i> China accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement.
Exchange arrangements	<i>July 1.</i> Foreign-funded banks were allowed to sell foreign exchange for bona fide transactions and become designated foreign exchange banks.
Resident accounts	<i>July 1.</i> FFEs foreign exchange accounts were distinguished into 2 types: the foreign exchange settlement account with a maximum amount stipulated by the SAFE for each enterprise for current account transactions; and the foreign exchange special account for receipts and payments for capital account transactions. <i>July 1.</i> FFEs were allowed to conduct their foreign exchange transactions either with banks or in the swap center.
Payments for invisible transactions and current transfers	<i>July 1.</i> Limits on invisible transactions and current transfers by resident individuals were increased. Bona fide requests of foreign exchange above these limits are authorized by the SAFE, and provided by banks.
Capital transactions	<i>September 25.</i> The regulation on External Guarantees Provided by Domestic Entities was passed, allowing for the provision of guarantees by authorized financial institutions and nonfinancial legal entities that have foreign exchange receipts.

CHINA: MARKET ACCESS AND INVESTMENT CLIMATE

The objective of the U.S.-China agreement on trade relations, signed in 1979, is to promote international trade based upon the principles of mutual benefit, equality and non-discriminatory treatment. Nearly 20 years after the United States normalized relations with China, we still do not have a reciprocal trade relationship. China enjoys the benefit of multinational principles of fair trade but its trade regime operates upon unfair merchantilist trade practices.

The JCCT meeting in Beijing will touch upon some of the market access and investment issues explained below, but will not address them all. As a result of economic liberalization and government restructuring, these issues are increasingly vexatious because the power of the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), the Commerce Department's interlocutor, has diminished over time. So while MOFTEC promotes foreign trade and investment on the right hand, other more powerful central government ministries and commissions implement protectionist industrial policies on the left. The right hand and the left hand are working against each other. U.S. investors, exporters, and service providers are caught in the middle of inter-ministerial rivalries which create a very unpredictable regulatory environment. This paper describes the major business climate issues.

China maintains non-tariff measures which restrict imports on more than three hundred tariff lines including licensing requirements; import quotas, restrictions and controls; tendering requirements; and safety certification requirements. China's restrictive system of trading rights severely limits domestic and foreign-invested enterprises' ability to directly import and export, distribute, and sell their products. Such excessive governmental intervention in the market undermines open and fair competition. Protection of intellectual property is also a market access issue, but it is not discussed here because it is addressed in another section of the briefing book.

Statistical Trends

Trade statistics show the effect of China's complex maze of tariff and non-tariff barriers to trade. U.S. merchandise exports to China in 1997 were \$12.8 billion, an increase of 6.9 percent from 1996. China is the United States' fourteenth largest export market, accounting for 1.86 percent of total U.S. trade in 1997. Following Hong Kong, the U.S. is China's second largest export market, accounting for 18 percent of its total exports. U.S. imports from China in 1997 were \$62.6 billion, an increase of \$11.1 billion (21.4 percent) from 1996. The U.S. merchandise trade deficit with China was \$49.7 billion, an increase of \$10.2 billion from 1996. The U.S. and Chinese governments do not agree upon the actual size of the trade deficit, but they do agree upon the trend. In 1997, Chinese exports to the U.S. increased three times more than U.S. exports to China.

Estimated U.S. direct investment in China fell in 1997 by all indicators: the number of contracts was down 22 percent to 1,070; contracted investment was at its lowest level in 5 years, down 42 percent to \$4 billion; and utilized investment decreased 12 percent to \$3 billion. The U.S. ranks second as an investor in China's market, after Hong Kong with 34 percent market share and investment value exceeding \$12 billion, followed by the U.S. with 9 percent, and Japan with 7 percent market share and investment value of approximately \$2.5 billion.

A. Import Policies

China has generally complied with the requirements of the 1992 Market Access Memorandum of Understanding (MOU) to reduce tariffs and remove certain non-tariff barriers such as quotas and licensing requirements, but still maintains numerous non-tariff administrative controls to implement its trade and industrial policies.

1. Tariffs and Taxes

In 1996, China lowered its average import tariff from 42.1 percent to 23 percent, and on October 1, 1997, further lowered the average import tariff to 17 percent. Many other tariff reductions are still under negotiation in the context of WTO accession discussions. U.S. industry continues to express concern that tariff rates for sectors in which China is seeking to build its international competitiveness remain extremely high, particularly on chemicals and motor vehicles. China's customs valuation practices also lack uniformity because local authorities at different ports of entry have authority to charge less than the official rate. Negotiation between the importer and the customs officials result in charging different duty rates for the same product. In addition to tariffs, imports are subject to a 13 or 17 percent value-added tax (VAT) and a consumption tax. U.S. exporters complain that imposition of the tariff, VAT, and consumption tax reduce consumer demand for their products, and the taxes are not consistently applied to all products.

2. Transparency and Rule of Law

China does not have a system of administrative law which requires public participation in rulemaking, consistent interpretation of the regulations, and administrative adjudication of claims raised by citizens adversely affected by the regulations. Because it is not possible to obtain a binding administrative opinion on any trade and investment regulation, U.S. companies operate in an opaque and unpredictable regulatory environment. The transparency of China's trade regime has improved as a result of implementing one of the 1992 Market Access MOU's requirements. MOFTEC now publishes all trade-related regulations issued by the central government in a gazette and any rules remaining unpublished are to have no legal effect. A barrier to information access still exists because U.S. companies must subscribe to the gazette to keep abreast of regulatory changes. The Market Access MOU requires China to establish an official central repository of all laws and regulations which govern international trade, but this obligation has not yet been met.

A great deal of work must be done in this area to improve the reliability of the regulatory system. U.S. companies suggest that China should establish a process which enables them to seek official, binding administrative interpretations of trade-related regulations so that they can make informed business decisions before undertaking commercial transactions.

3. Non-Tariff Measures

China's non-tariff measures (NTMs) are a complex maze of import licensing requirements, quotas, and other administrative controls. The NTMs enable China to manage its foreign exchange reserves, ensures imported products do not compete with similar domestic products, and prevents foreign companies from acquiring control over important industries.

Import Substitution Policies. In the 1992 Market Access MOU, China agreed to eliminate the use of import substitution policies and measures which bar market access because an equivalent product is produced in China. It also agreed to refrain from subjecting any foreign product to import substitution policies in the future. Despite this commitment, in 1994 China announced an automotive industrial policy that explicitly called for production of domestic autos and auto parts as substitutes for imports, and established local content requirements. In 1996, the State Council issued regulations that discriminate against imported pharmaceutical products and impose a certain pricing formula based on whether domestic substitutes exist. In 1997 the former Ministry of Post and Telecommunications issued a directive that prohibits importation of telecommunications equipment which can be produced by domestic enterprises at less cost and same quality.

Standards, Testing, and Import Certification With few exceptions, China does not accept U.S. certification of product quality or safety. China's Import and Export Commodity Inspection Law explicitly requires that certain imported products, which have met international standards, be inspected by Chinese authorities prior to use or sale in China. Safety and quality licensing requirements vary according to the product, and affect U.S. exports in the areas of chemical products, electronic products, medical devices, industrial machinery, automotive parts, and telecommunications.

According to affected U.S. companies, the licensing and inspection process is not transparent, predictable, or based upon the principle of national treatment. There is some evidence that the safety and inspection procedures applied to foreign suppliers are more rigorous than those applied to domestic producers. U.S. exporters claim that the licensing process is burdensome, due to inconsistent inspection procedures and the maze of registration requirements. U.S. manufacturers must pay substantial fees for testing product samples and onsite inspections at the U.S. production facility. Certain products are subject to more than one safety license requirement, including boiler and pressure vessel products, pharmaceuticals, medical devices and instruments. U.S. companies have suggested that Chinese authorities should publish standard fee schedules and justify the need for duplicative safety license inspections.

According to U.S. exporters and investors, new alternative import requirements may be undercutting market access gains pursuant to the 1992 Market Access MOU. The MOU required removal of controls, quotas, and licenses on 176 categories of goods in 1995, and removal of other import restrictions on 13 other categories in 1997. About 400 products covered by the MOU's annex are now subject to "automatic registration" requirements. The imposition of this requirement appears to be a new defacto licensing requirement. The Chinese government has also imposed new quality and safety licensing requirements on electronic and medical equipment which were previously controlled by quotas.

Since 1992, China has made some progress on agricultural sanitary and phytosanitary issues having signed bilateral protocols for several agricultural items. However, unscientific agricultural import standards are a barrier to export of products such as citrus, meat and Pacific Northwest wheat.

Trading Rights. Authority to engage in international commercial transactions is restricted to state-owned trading enterprises which are owned by the central, provincial or municipal government. Manufacturing enterprises, wholesale distributors, and retail enterprises in the state-owned or non-state sector cannot directly import products or commodities. They are required to engage the services of an authorized trading enterprise to act as an agent to procure foreign products and commodities. The trading enterprise negotiates the international purchase contract, arranges the method of payment, and takes title to the goods after clearing customs. Every international trade

transaction involves two contracts, one between the foreign supplier and the Chinese trader, and a second domestic purchase contract exists between the trading enterprise and the actual buyer.

The Chinese trading system creates numerous problems for U.S. companies. It is difficult to locate an appropriate sales agent or distributor, and it is impossible to set up a nationwide marketing and distribution system for a particular product. Commercial disputes arise in instances where the buyer is involved in breach of the domestic purchase contract which causes the trading enterprise to breach its obligations under the international sales contract.

A separate distribution system exists for goods produced by domestic manufacturers. Foreign involvement in retail distribution is severely restricted and involvement in wholesale distribution is prohibited. The discussion below concerning services thoroughly explains this issue. Even if market access improves as a result of reducing tariffs or removal of other non-tariff measures, the distribution restrictions imposed through business licenses remain a significant trade barrier.

In the context of China's WTO accession negotiations, China pledged to liberalize current restraints on the right to import, export, and distribute products. At the end of the three year transition period, all foreign and domestic enterprises will have trading rights.

B. Services Barriers

The U.S. has a positive services trade balance with China. The value of U.S. services exported to China reached \$3.1 billion 1996, while the value of U.S. service imports was \$2.0 billion. Despite this services trade surplus, China's restrictive laws limit U.S. service exports and investments in all service sectors. Since China's services sector is underdeveloped, and foreign participation is minimal, it is difficult to gauge how significantly market access barriers have limited U.S. export potential. Nevertheless, Chinese regulation of the services sector is clearly inconsistent with WTO principles of transparency and national treatment.

Chinese law governing the services sector is at the "experimental regulation" stage and imposes limits on the form of establishment, scope of activity, and geographic location through restrictive business licenses. In accounting, insurance, and inspection services, a foreign company cannot establish a wholly-foreign owned profit-making entity. Instead foreign firms are required to establish joint ventures, which ensures transfer of business skills and limits market penetration. In addition to the service sectors discussed below, law, accountancy, engineering and tourism are also subject to various restraints which protect domestic service providers.

In the banking sector, Shanghai is the center of regulatory experimentation. Foreign branch banks and banking joint ventures were first established there in the mid-1990s. To date, only nine foreign branch banks have obtained permission to conduct local currency transactions in Shanghai, including Citibank. All other banking entities are restricted to foreign currency transactions and primarily engage in foreign currency exchange, negotiation of letters of credit, and loans to foreign invested enterprises. By 1997, China approved 142 branch banks, seven joint venture banks, and five wholly-owned banking firms, located in nineteen different cities.

In the insurance sector, China severely restricts foreign activity by limiting the form of business establishment to representative office or joint venture. While China has approved 181 representative offices, it has granted only three business licenses to foreign insurance companies, including one U.S. firm, American International Group. Since a representative office is not technically allowed to earn a profit and is authorized to only engage in "liaison" activities, most insurance companies have

established a presence in China in anticipation of market liberalization. Firms which have secured licenses are subject to limitations on geographic scope of operation. They are allowed to only operate in the city where they are licensed to do business and cannot offer services nationwide. In addition, scope of activity is restricted because a foreign insurance firm is allowed to sell only one form of insurance. The insurance law requires them to select either property or personal life insurance.

In distribution services, U.S. companies are significantly restricted in their scope of activity to a singular aspect of distribution service. Foreign firms are not allowed to provide a full range of services including marketing, equipment maintenance and after-sale service, and customer support. Chinese regulations prohibit foreign companies from directly servicing equipment exported to China. To offer equipment maintenance service within China, the equipment manufacturer must establish a joint venture with a Chinese entity.

Retail and direct sale activity by foreign firms is restricted in geographic scope and nature of activity. A foreign firm cannot set up one office to engage in nationwide sales activity. Instead, a business license must be obtained in each city. A foreign firm is allowed to only sell the products of the parent company and cannot sell or distribute domestic products.

In telecommunications services, foreign firms are not allowed to operate telecommunications networks. Their activity is limited to indirect market participation by providing equipment and services to state-owned Chinese entities. This issue is discussed in detail in a separate briefing paper.

C. Investment Issues

China's investment policy and regulations contain many restrictions such as debt-equity ratios, foreign equity limitations, export requirements, foreign exchange balancing requirements and local content requirements. Other significant disincentives to investment include labor laws which require the employer to heavily subsidize employee housing and health care and limit termination of excessive employees; excessive government interference in FIE operations; inconsistent interpretation of the law; and complex contract approval procedures.

Since initiation of its open door policies in 1978, China has offered a variety of incentives to attract foreign investment. Recently the investment climate has become more restrictive in some respects because key investment incentives have been modified. On January 1, 1998, a new investment guidance policy became effective which continues the preexisting categories (encouraged, restricted, and prohibited) but shifts certain projects between the categories to a less preferential status. The new policy also added projects to the "encouraged" category which entail more sophisticated technology. China encourages projects which support economic development objectives such as environmental protection, disaster mitigation, utilize advanced technology, and upgrade the infrastructure. Projects in the restricted category reflect protection of infant industries and strategic basic industries.

Value Added Tax. The imposition of a value added tax on exports in 1996 reversed a longstanding investment incentive which encouraged foreign invested enterprises (FIEs) to use domestic parts and components in their products. High rates of localization were previously tied to relaxation of foreign exchange balancing requirements. In 1996, the VAT refund for use of domestically sourced parts and components was reduced from 17 percent to 9 percent. Parts and components imported for FIE production are exempt from the VAT. The policy change increases production cost and reduces price competitiveness on the international market. It also penalizes FIEs which comply with China's local sourcing and export requirements.

Annual Financial Inspection. Another onerous sign of increasing restriction of foreign investors is the imposition of annual financial inspections. The FIEs are now required to submit various financial statements which allow Chinese regulators to evaluate production volume, debt management, and adherence to contract terms. The inspection results in an "A" or "B" rating which will be used in the future to evaluate requests to expand operations or increase registered capital. American investors are concerned that the exercise is simply another way for the Chinese government to exact fees and subject them to arbitrary regulation.

Tariff Exemption on Capital Equipment. On the positive side, Chinese authorities reversed their plans to phase-out the tariff exemption on capital equipment imported by foreign investors. The exemption was reinstated because foreign investment dropped dramatically during the time it was being phased out in 1996 and 1997. Under the revised policy, certain foreign-invested enterprises may receive a duty and tax exemption on mechanical appliances, electronic equipment, and measuring devices. Investment projects which utilize advanced technology and contribute to particular economic development goals in agriculture, environmental protection, telecommunication, disaster mitigation, and public health qualify for the exemption as projects in the "encouraged" or "restricted" investment categories. U.S. investors have encountered difficulty in determining the applicability and conditions for the capital equipment exemption. The issue is important because it contributes to the instability of the investment climate and significantly increases operation costs of affected investment projects.

Domestic Chinese enterprises also enjoy a tariff exemption on certain kinds of capital equipment, however the list applies only to domestic enterprises. Whether this exemption will cause enterprises to import more foreign equipment is unclear. Other factors affecting equipment imports include availability of funds, the equipment's degree of technological sophistication, and whether the equipment is destined for an inland province.

D. . Government Procurement

The World Bank estimates that China will need to spend \$500 billion to upgrade its infrastructure during the 9th Five Year Plan (1996-2000). Tendering procedures for projects funded by international organizations such as the World Bank must comply with standards set by the donor organization, and the Chinese adhere to them. Many of these tender opportunities are available online through the internet.

Transparent and competitive procurement procedures for projects funded by the Chinese central government do not exist, although regulations purportedly exist on the provincial level. This is a significant issue because China's vast infrastructure needs present significant trade and investment opportunities. In 1997, Chinese officials revealed that the State Planning Commission has been working on a government procurement law and suggested the law would be promulgated during the National People's Congress (NPC) in 1998. Since the NPC's legislative agenda is not a public document, whether the procurement law is on this year's agenda is unknown. The NPC is scheduled to resume its work at the end of April.

U.S. companies have informed the Department that Chinese government procurement procedures are not transparent and that it rewards contracts based on the type of concessions it can obtain from foreign bidders. Chinese officials characterize this practice as "allowing foreign participation on the basis of mutual benefit." These concessions include soft loans, technology transfers, related investment contracts, and counter-trade. Foreign bidders are not accorded national treatment in that these concessions not required of domestic Chinese firms. Since China is not a signatory to the

WTO agreement on government procurement, it is currently under no obligation to allow foreign

THE CASE FOR CONDITIONAL FREE TRADE

THE REAL CHINA QUESTION

BY GREG MASTEL

Links between Chinese officials and U.S. political campaigns—coupled with renewed concern about human rights abuses by the Chinese government—have put China policy center stage. But while public officials and many commentators here have focused their attention mostly on the contentious issue of whether to renew China's most-favored-nation trading status, the more important question is whether China should be admitted into the World Trade Organization (WTO)—and whether formerly communist states such as Russia should be next.

Created in 1994 as a more potent successor to the General Agreement on Tariffs and Trade (GATT), the WTO is the Geneva-based organization that sets and enforces the rules for world trade among developed nations. By agreeing to abide by WTO rulings, countries forfeit some control of their trade policy to gain access to foreign markets.

Although controversial at its founding—in part because American critics alleged it would compromise U.S. sovereignty and environmental laws—so far the organization has performed respectably, if not admirably. The organization's settlements of disputes between members have been well received, and recently it concluded two new agreements on information technology and telecommunications services and equipment.

Yet with several formerly communist (and some still communist) nations applying for WTO membership, the organization is at a difficult crossroads. The growing economic power of these nations makes them difficult to ignore. But their repeated refusal to play by many WTO rules suggests that they would exploit the economic benefits of membership without abiding by the rules that are the very premise for the WTO's existence.

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China, which is pushing hard for WTO admission, is by far the most important and dangerous of these candidates. In the months to come, the WTO will make a decision on whether to admit China—based in large part on the disposition of the United States—and that decision will set the standard for future applications from nations like Russia and Vietnam. Some argue the United States should block Chinese membership altogether; others, including the Clinton administration, argue that such a move would be either futile or disastrous. China's disdain for civil liberties on the mainland, and perhaps now in Hong Kong, and the fact that conservative Republicans along with many liberal Democrats are skeptical, combine to widen the odds against China's WTO membership this year. However, supporters of China's accession to the WTO argue, with some logic, that the world community will have more leverage on China's domestic behavior with China in the WTO rather than out.

Both arguments have some merit. The best policy, as I will argue, may be a middle course: allowing the Chinese to join gradually. This could mean creating more than one tier of membership, and forcing them—as we did for other formerly communist nations entering GATT many years ago—to meet hard numerical targets for trade balances in order to gain admission.

It was perhaps inevitable that the status of communist and formerly communist nations would pose such a challenge for the global trading system. The WTO's predecessor, the General Agreement on Tariffs and Trade, was a postwar invention designed to unite free market nations and, in part, to thwart communism. Initially GATT included only the world's major trading powers, but it grew in the intervening years to its current membership of well more than 100. Nations with nonmarket economies were not a problem, because they were outside the GATT system.

Unfortunately, this also meant that GATT was ill-equipped to manage the post-Cold War world—an era in which foreign threats were often of an economic, not a military, nature, and in which potential adversaries included vibrant democracies as well as totalitarian states. Beginning in the 1970s,

Japan and several other GATT nations used their positions to create one-sided trade relationships with wealthy consumer nations such as the United States. Although these countries had market-based

economies, they built globally dominant industries by subsidizing these operations, selling their wares abroad, and then closing off their domestic markets to outsiders. GATT, burdened with an extraordinarily ineffective dispute settlement system and rules that were perennially one step behind the latest generation of trade barriers,

simply could not curb the mercantilist ambitions of Japan and like-minded emerging powers.

Conceived as a solution to this challenge, the WTO has a stronger dispute settlement system and better rules to enforce. It has taken additional steps to ensure that those countries that benefited from free trade also opened their markets. A key early test will be whether the WTO proves itself an effective policeman of Japanese protectionism in the current dispute over imported photographic film.

But it remains to be seen whether the WTO can deal with the next challenge: incorporating communist and formerly communist states into the global economy. About two dozen such countries, including China and Russia, want to join WTO, and the potential admission of these nonmarket economies into the ultimate market-oriented, rule-based organization, raises serious questions.

The unstated assumption in the West is that former communists have abandoned nonmarket economics, but the demise of communism as an economic philosophy has been exaggerated. China, in addition to maintaining highly protectionist policies, maintains numerous features of the communist system, such as government economic planning, government ownership of industries, and widespread subsidies. Russia seems to have come further in implementing political reforms, but a surprising amount of the communist economic machinery remains in place and the Russian government is still deeply involved in owning and managing the economy. Worse yet, Russia shows strong signs of becoming increasingly protectionist and suspicious of foreign companies.

Does China belong
in a trade organization
designed for market
economies?

The lack of a reliable rule of law in former non-market economies may pose an even more serious problem for the WTO. In Russia, corruption and crime seem the rule, not the exception [for more on the chaos in Russia, see Stephen Holmes, "What Russia Teaches Us Now," page 30]. Many Western businesses that have attempted to operate in Russia complain of contracts being ignored by the government, which is now renationalizing industry in concert with adoption of more protectionist policies.

China is no better. As the head of China's National People's Congress, Qiao Shi, has argued, China is a society ruled by strong men, not by laws. Laws and contracts can be swept aside if China's rulers wish to do so. China's lack of respect for rules is also a problem at the international level. In recent years, the United States has concluded a number of important trade agreements with China on such topics as protection of intellectual property and market access. Unfortunately, these agreements have had only a limited impact on China's behavior.

For four years the Chinese essentially ignored an intellectual property agreement designed to outlaw the widespread pirating of U.S.-produced software and entertainment, which was costing U.S.-based firms billions of dollars. Even when the United States threatened trade sanctions, China only grudgingly made an effort to enforce the agreement. The Clinton administration now believes that China is doing a better job enforcing the intellectual property agreement, but U.S. industries still complain of enormous enforcement lapses. There is also good reason to believe China has violated trade agreements with the United States on textile shipments, prison labor, and market access.

The case against admitting these nations into the WTO—beginning with China—might thus seem compelling. But thanks in part to heavy lobbying by both the Chinese government and multinational firms with interests there, China's bid has received an enthusiastic

response from the Clinton administration as well as from Japan and Europe.

In fairness, the issue is a complicated one. On the one hand, if China and Russia are on the outside, can the WTO truly be a *world* trade organization? Chinese officials are fond of arguing that they

may soon be able to write the world trading rules themselves. These statements are of course exaggerated, but in fact the reforming nonmarket world now has a \$5 trillion economy, larger than that of Japan. Especially as China moves toward becoming the world's largest economy and one of the most successful trading countries in the world, if the WTO does not cover China and other major former nonmarket economies, the WTO could lose credibility.

On the other hand, throwing the doors open to former nonmarket economies could also compromise the WTO's credibility. The WTO could, for instance, admit China, Russia, and other nonmarket economies by granting them broad waivers and long phase-ins to key provisions such as rules on subsidies, investment, and protection of intellectual property. Yet this would effectively make these countries free riders on the trading system; they would enjoy the full benefits of WTO membership without shouldering the responsibilities. No doubt other WTO members would ask for similar arrangements—why should China get special treatment?—and that could cripple the organization, or maybe bring it down altogether.

True, other WTO nations might sit still for special allowances if the time frame for compliance were short enough, but it's not clear that China and the other countries would even meet such requirements. Some WTO provisions, such as the restrictions on subsidies to state enterprises, would require a wholesale restructuring of the economies of China, Russia, and similar countries—changes these countries would be unlikely to make even if they agreed to them in principle. As the experience with the intellectual property agreement with China demonstrated, having an agreement on paper is no guarantee that Chinese behavior will change. The same can be said for other reforming nonmarket economies.

China, Russia, and other past nonmarket

Chinese officials may not abide by trade accords. Russian officials may be powerless to enforce them.

economies often do not govern through publicly available rules and regulations; informal actions by ministries to exclude foreign products and to make life difficult for foreign companies are more common. These informal actions leave no paper trail and may be next to impossible to prove before a WTO dispute settlement panel. This makes it unlikely that even a strong agreement could or would be vigorously enforced.

Meanwhile, by admitting nonmarket nations into the WTO, the U.S. and other member nations would greatly limit their ability to impose unilateral sanctions—the one method that has produced any results. So long as China is outside the WTO, the United States has some leverage; the modest progress that was made on intellectual property and market access was made only under the threat of U.S. trade sanctions. (These sanctions have proved ineffective in moving China to improve treatment of dissidents, but that is because the Chinese leadership fears that concessions on this issue would threaten their hold on power. That is not true, however, for sanction threats over trade matters.) Like most other countries, the Chinese leadership treats economic sanctions as bottom-line business negotiations; thus it has sought accommodation instead of conflict. As noted, the agreements reached have not been terribly effective, but that is at least partially the result of inconsistent U.S. attention to these issues.

If China were a WTO member, the U.S. could not make such threats—at least not in a timely way. As the United States found in the dispute with Japan over access to the Japanese auto market, trade sanctions against WTO members only work *after* a WTO dispute settlement panel has ruled in favor of the United States. If the United States were to impose trade sanctions without WTO approval, it would almost certainly face an adverse WTO ruling for raising new trade barriers and probable sanctions. Thus, there is a real cost in terms of lost negotiating leverage to letting China or other former nonmarket economies into the WTO.

Would sanctions against China work? But even

if the WTO supported the United States in disputes with China, there would still be serious enforcement problems. If a dispute settlement panel obligated China to fully implement the subsidy and investment provisions of the WTO, there are good reasons to think the current generation of leaders would not be willing to risk the potential political disruption of forcing state-owned enterprises to operate without subsidies because that would require enormous layoffs. The United States and like-minded countries could continue to threaten China with trade sanctions, but it is unclear that trade sanctions alone would be enough to move China on matters of great political gravity, particularly because, at least in serious disputes, China would likely respond with counter sanctions.

Since China has demonstrated little respect for the rule of law, this scenario is all too realistic. Further, it is entirely possible that if China lost a

series of disputes it would charge that the WTO was rigged against it and threaten to pull out. Given the strange logic of diplomacy, such a threat would surely give the U.S., the WTO, and others pause. In a strange turn of events, many would likely argue against forcing China to heed the WTO for fear that China would withdraw from the organization, creating tensions on

other fronts. Here again, the credibility of the WTO as a trade policeman and support for the system, at least in the United States, would decline, dealing a potentially serious blow to the world trading system.

The choice thus appears to be between risking the survival of the trading system by leaving these countries outside the system or risking the survival of the system by trying to bring them in. But perhaps there is a third way. It may be possible to bring nonmarket economies into the trading system without treating

The choice thus appears to be risking the survival of the trading system by leaving these countries outside the system or risking the survival of the system by trying to bring them in.

them just like market economies. In the late 1960s and 1970s, the United States spearheaded an effort to bring some nonmarket economies, notably Poland and Romania, into the GATT system. At the time, many countries objected, arguing—rightly—that former communist economies were not compatible with the market-based trading system.

The final compromise incorporated the formerly communist countries into the trading system by making unique entry requirements that included numerical targets for growth in imports from GATT members and special trade restrictions (such as quotas on specific commodities) that could be imposed if exports from these nonmarket countries undermined Western markets. Today's trade negotiators could essentially adopt the same strategy by admitting China and the other applicants with four special caveats:

- To ensure that other WTO members gained trade benefits and were not restricted by government planning or other distortions, former, non-market members would be required to increase imports from WTO members by a fixed percentage. Since state planning machinery continues to operate in most of these countries, such a task should be achievable.
- Given the widespread presence of subsidies and government-inspired predatory pricing, other WTO members should be able to restrict onetime nonmarket country exports if they undermined Western markets.
- To assist in enforcing the pact, current WTO members should be able to withdraw from the pact with reforming nonmarket economies if they felt nonmarket economies were not obeying its terms.
- If the former nonmarket economies could prove that they had become market economies and were obeying WTO rules, they should be graduated to normal WTO member status.

This approach would likely require hard negoti-

ation. And because it involves numerical targets for exports—that is, “managed trade”—it will offend many economists who believe tinkering with a free market is inherently counterproductive. Some nonmarket economies may also criticize the approach to making them second-class citizens in the world trading system.

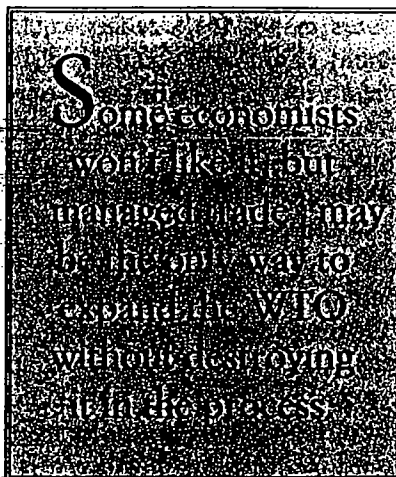
This approach, however, is already proved workable in connection with Poland and Romania; it has the unique advantage of turning the state planning machinery into a tool that opens markets and encourages trade liberalization. It also makes it politically possible to extend these mixed economies more time to manage the difficult economic transi-

tion to the free market by creating a balance between reduced responsibilities and reduced benefits. This balance could allow a longer transition without undermining the political consensus that holds the WTO together.

If American foreign policy has a consistent weakness, it is that America seems to view the world as a giant house of mirrors. Everywhere it looks, America sees reflections of itself. They may be a little taller or a little shorter, a little fatter or a little thinner, but fundamentally other countries are just like us. Just below the surface, every country is a budding Jeffersonian democracy with a free market economy.

Unfortunately, the world is not so simple. Owing to its distinctive history, culture, political structure, and economic institutions, America is largely unique. More shatteringly, most other countries do not desire to be reflections of the United States; they have their own political and economic philosophies and institutions.

The struggle to bring nonmarket economies into the WTO is but the latest example of this American failing. We are attempting to make the former communist world fit into the market trading system. Pounding hard enough to make them fit risks damaging both American interests and the WTO that the United States worked so long to create. □



foreign exchange balancing requirement for these enterprises were removed.³⁴ Limits on purchases of foreign exchange for current payments and transfers became indicative, with SAEC³⁵ indicating access for all bona fide current transactions.³⁶ Following these changes, China accepted the obligations of Article VIII effective December 1, 1996.

C. Reform of the Trade System

13. In the reform of China's trade system over the past two decades, the expansion of trading rights and gradual phasing out of mandatory planning have played a key role. However, as the system became more decentralized and the plan was scaled back, other instruments to regulate exports and imports, such as tariffs and licenses, gained importance. At the beginning of the 1990s, China's trade regime was characterized by a complex and rather intransparent system of high and widely differentiated tariffs as well as numerous, frequently overlapping, nontariff trade barriers (NTBs). Since then some progress has been made scaling back these measures, but a broad-based liberalization lies ahead.

14. The proliferation of FTCs has been instrumental in the decentralization of China's trade system. From a dozen of companies executing foreign trade in the late 1970s, the

³⁴On April 1, 1996, the restrictions arising from the SAEC's authority to freeze the foreign exchange accounts of FFEs and subsequently deny them access to the foreign exchange market were removed. Nonetheless, FFEs remained subject to an annual exchange control examination, which focused on the enterprises' compliance with their contractual obligations and China's exchange regulations. FFEs could be denied access to the foreign exchange market upon failure of the examination. The "Regulations on the Sale and Purchase of and Payment in Foreign Exchange" of July 1, 1996 eliminated the restrictions on FFEs' access to the foreign exchange market for current payments and transfers, as well as most remaining restrictions on current payments and transfers, such as the nontransferability of investment income by nonresident Chinese emigrants, and the non-transferability of proceeds from sales of personal items by nonresidents.

³⁵Shortly after acceptance of Article VIII, the name of SAEC was changed into State Administration of Foreign Exchange (SAFE).

³⁶The policy to approve all bona fide requests for foreign exchange for current payments and transfers was announced in an official statement on November 28, 1996 and subsequently incorporated in the "Foreign Exchange Administration Regulation of the People's Republic of China

number of state-owned FTCs rose to 1,200 in the mid 1980s and to more than 9,000 in 1994.³⁷

15. Although in the 1980s, FTCs still operated within the constraints of the existing planning system, their scope for trading on their own account increased as mandatory planning was scaled back. Moreover, the range of products in which individual FTCs were allowed to trade was expanded significantly over time.³⁸ Nevertheless, with part of their business still subject to plan targets and many domestic prices of imports still under control,³⁹ FTCs incurred substantial losses, which required budgetary subsidies averaging 2 percent of GDP per year in the second half of the 1980s.⁴⁰ These losses declined after 1991, following a series of adjustment in domestic prices for imports,⁴¹ the abolishment of the mandatory export plan, and the elimination of budgetary subsidies on exports.

16. While FTCs are allowed to trade in a wide range of products, producing enterprises have been granted trading rights only for their own products and their inputs. Whereas FFEs have tended to have access to such direct trading rights from the outset, for a long time only a small number of domestic enterprises enjoyed this right.⁴² In recent years, however, access to trading rights appears to have increased, with direct trade by domestic producing firms

³⁷World Bank (1994), pp. 24 and International Trade Centre (1995), p.22. The number of FTCs increased rapidly after 1984, when the provincial branches of national FTCs were allowed to become independent, and provinces were permitted to set up their own FTCs. By 1988, FTCs were estimated to number more than 5000, but in the subsequent consolidation phase, a series of FTCs were closed or merged.

³⁸In the late 1970s, each FTC specialized in a certain range of products. FTCs are allowed to trade in most product that are not subject to designated trading.

³⁹While domestic prices of products imported under the mandatory plan were generally insulated from foreign prices, other imports were priced on the basis of the agency system, i.e., importing FTCs charged their customers foreign prices (converted into national currency) plus tariffs, taxes, and handling fees.

⁴⁰One of the objectives of the foreign trade contract system established in 1988 was to control budgetary subsidies to FTCs. Under the system, national FTCs and provincial administrations signed contracts with the central government, which stipulated targets for foreign ex the CFETS quickly developed into a unified wholesale foreign exchange market. change earnings as well as limits for subsidies. See World Bank (1994), p.26.

⁴¹The domestic prices of a number of products imported under the mandatory plan were raised and linked to foreign prices in 1989-90, see World Bank (1994). According to Lardy (1995), by 1991, prices of some 90 percent of imported goods were based on world market prices.

⁴²In 1992, only 538 domestic enterprises had trading rights for their own products and inputs. See World Bank (1994), p.114.

accounting for 17 percent of exports and 8 percent of imports in 1994. Nevertheless, the share of producing enterprises with direct trading rights is still relatively modest.⁴³

17. Along with the decentralization of the foreign trade system during the 1980s, mandatory planning was gradually scaled back. The export plan was split into mandatory and guidance components, while on the import side, the mandatory plan was supplemented by a list of priority imports for key national projects. By 1986, mandatory planning had been reduced to 60 percent of exports and 40 percent of imports. Some 20 percent of exports were subject to guidance,⁴⁴ with the remainder handled as "above plan" exports. The import priority list covered 30 percent of imports, and the remaining 30 percent were controlled through licensing. Mandatory trade planning declined further in the late 1980 and was abolished in 1991 for exports and in 1994 for imports.

18. As decentralization progressed and the role of the mandatory trade plan declined, instruments such as licenses and tariffs, which had been of minor importance at the beginning of the reforms, became increasingly important in regulating exports and imports.⁴⁵ Many products that had been under the mandatory trade plan continued to be controlled through canalization, which limited exports and imports to a relatively small number of FTCs.⁴⁶ In 1992, after the abolition of the mandatory export plan, some 15 percent of exports were still subject to canalization. On the import side, canalization covered close to one third of total trade, although the scope of the mandatory import plan had been reduced to 18 percent of imports.⁴⁷

19. NTBs such as licenses and quotas expanded during the 1980s. A complex system of frequently overlapping measures evolved, which often also applied to products subject to canalization.⁴⁸ Import licensing was used to allocate quotas or influence imports in line with domestic or balance of payments objectives, while import controls were employed in certain

⁴³See International Trade Centre (1995), p. 22.

⁴⁴Export targets under the guidance plan were allocated to provincial governments, which were relatively free in determining how to achieve them.

⁴⁵See Wall, Jiang, and Yin (1996).

⁴⁶Products subject to canalization were grouped into two categories. Category I products could only be handled by a small number of designated FTCs, category II products could be traded by a somewhat larger, but still limited, number of FTCs. Products that were subject to mandatory trade planning were generally also canalized. However, the coverage of canalization did not decline in line with mandatory planning.

⁴⁷See World Bank (1994), p.28.

⁴⁸In 1992, more than half of the imports subject to licensing were also subject to canalization. See World Bank (1994), p.65.

sectors to protect domestic producers.⁴⁹ Export licenses and quotas helped to influence the domestic supply of exportables, implement agreements with trading partners, and regulate export volumes in markets where China had a substantial market share. The share of imports subject to licensing appears to have approached one half in 1989,⁵⁰ but declined subsequently to about one quarter in 1992. Half of the imports covered by licenses in 1992 were also subject to canalization. In addition, close to 8 percent of imports were affected by import controls (Table V.1). Export licensing was estimated to have affected close to two thirds of exports in 1987 but its scope declined significantly thereafter to about one half in 1989⁵¹ and 15 percent in 1992.⁵²

20. NTBs were complemented by an increasingly complex tariff system. Average import tariffs in China in the early 1990s were higher than in the mid-1980s⁵³ and generally well above those in many other Asian countries (Table V.2). Tariff rates were widely dispersed, with rates above 100 percent for certain "nonessential" consumer goods, such as beverages and tobacco, and rates in the 5-20 percent range for certain agricultural and industrial inputs, such as fertilizers and metals, as well as a number of capital goods.⁵⁴ The impact of high import duties was, however, partly offset by a relatively generous, albeit complex, system of duty exemptions, mainly for imports related to export production, FFE imports, and border trade. Tariffs were also imposed on a significant number of exports, which increased during the 1980s

21. The complex system of tariffs and NTBs that evolved during the 1980s called for a new round of trade reforms. China's application to resume its membership in the General

⁴⁹In 1992, import controls applied to a range of products in the machinery and electronics sector. Imports of such products required special approval by the State Council Machinery and Electronics Import Control Office.

⁵⁰See Lardy (1992), p.44.

⁵¹See Lardy (1992), p.44.

⁵²World Bank (1994), p.68.

⁵³The unweighted average import tariff in early 1992 (after a round of cuts at the beginning of the year but before further tariff reductions implemented later in the year) was 43 percent, some 5 percentage points higher than in 1986. See World Bank (1994), p.49.

⁵⁴See World Bank (1994), pp. 51-52.

Agreement on Tariffs and Trade (GATT), and bilateral negotiations with the United States⁵⁵ provided additional impetus. Against this background, import tariffs have been reduced on several occasions in the past five years, starting with two rounds of tariff cuts in January and December 1992.⁵⁶ The latest round of cuts was included in the April 1996 trade package, with reductions in tariffs covering almost two thirds of imports.⁵⁷ As a result, the unweighted average import tariff fell from close to 40 percent at end-1992 to 23 percent at end-1996, while the weighted average tariff declined from 31 percent to 20 percent (Table V.3).⁵⁸ The authorities envisage a further reduction in the unweighted average import tariff to around 15 percent, the developing country average, in the next few years.⁵⁹ The tariff cuts have resulted in a reduction in the dispersion of tariffs. Moreover, they have been accompanied by a scaling back of duty exemptions.⁶⁰ Nevertheless, tariff revenue in relation to imports has remained small, averaging less than 3 percent in the past 2 years.

22. Trade reform initiatives in recent years have also included steps to reduce NTBs. The lists of products subject to various types of nontariff measures have been shortened on several occasions. After the implementation of the changes included in the April 1996 trade package,⁶¹ the share of imports subject to nontariff restrictions was about one third, compared with more than one half in 1992. The share of imports subject to state or designated trading (canalization) declined from close to one-third in 1992 to 18 percent in 1996. Export licenses and tariffs have also been scaled back in recent years. Finally, in order to further expand trading rights, joint venture FTCs were, for the first time, allowed in 1996, albeit only on an experimental basis in Shanghai and a few other pilot cities.

⁵⁵Following lengthy negotiations, China and the United States signed a memorandum of understanding in October 1992, in which China agreed to remove by 1997 import quotas, controls and licensing requirements on a wide range of products. In addition, to enhance the transparency of the trade system, China promised to publish and make readily available all laws, regulations, and decrees governing external trade, and to clarify the responsibilities of different government departments and agencies involved in trade.

⁵⁶In January 1992 China also introduced a new tariff schedule based on the Harmonized System.

⁵⁷The April 1996 trade package also introduced a tariff quota system with low "in quota" tariffs for a number of agricultural products.

⁵⁸The weighted average tariff is estimated on the basis of 1992 import shares and "in quota" tariffs for products under tariff quotas.

⁵⁹This objective was announced at the November 1996 APEC meeting.

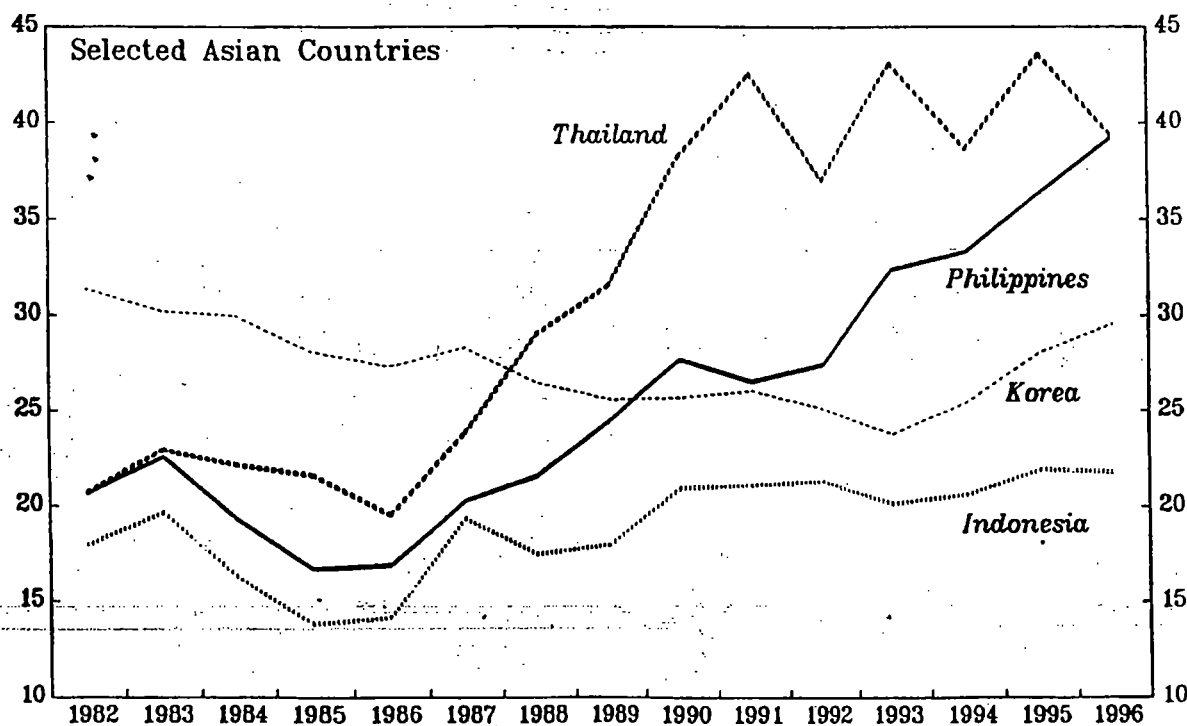
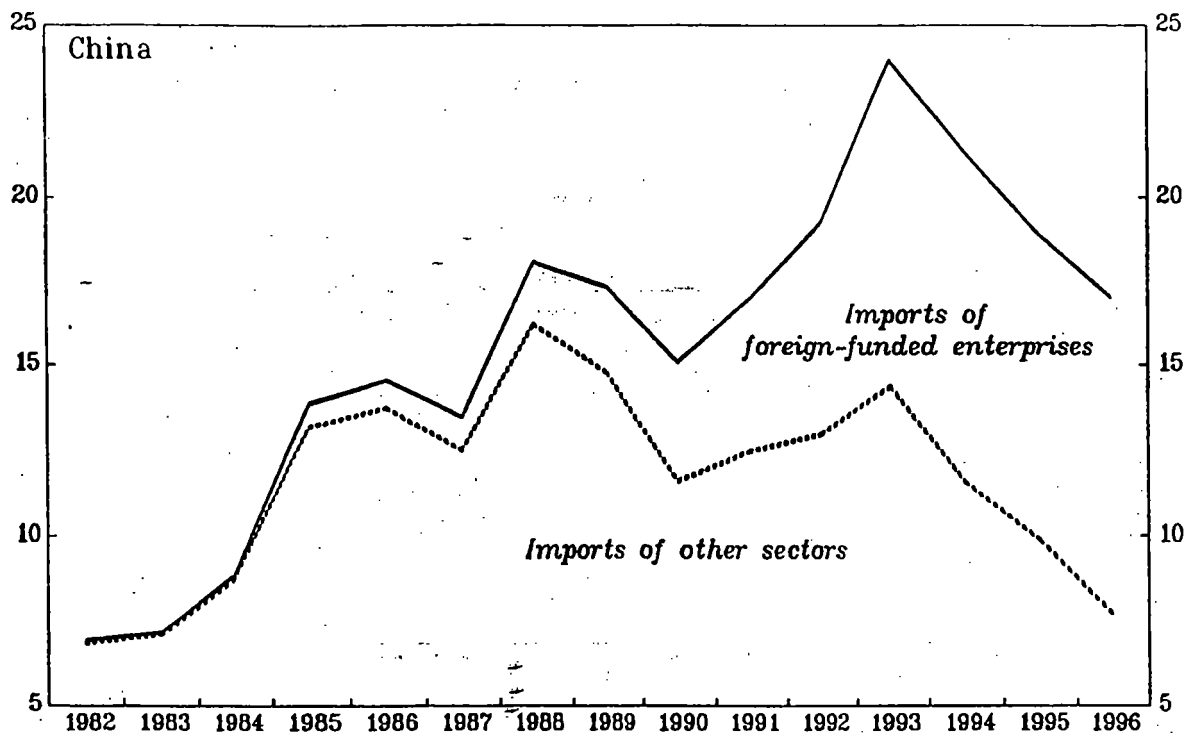
⁶⁰In 1996, duty exemptions on imports of capital goods were revoked, but existing exemptions were subsequently grandfathered until mid 1998.

⁶¹The trade package of April 1996 eliminated NTBs on 176 items.

CHART V.4

CHINA

IMPORT TO GDP RATIOS FOR CHINA AND
SELECTED ASIAN COUNTRIES, 1982-96 1/



Sources: Data provided by the Chinese authorities, IMF, World Economic Outlook; and Fund staff estimates.

1/ Merchandise imports (customs basis; in percent of GDP).

U.S. - CHINA TRADE DATA DISCREPANCY

SUMMARY

The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) of China continues to charge that U.S. trade statistics are in error. A June 1996 paper from Minister of Foreign Trade Wu Yi states "The US side insists that its trade statistics are compiled according to international guidelines, but its trade statistics have overtly overstated the amount of its trade deficit." This statement, repeated subsequently in other papers and press articles, is made despite studies that show that the trade data discrepancies are accounted for by the intermediary role that Hong Kong plays in China's trade.

At the October 1995 Joint Commission on Commerce and Trade (JCCT) meeting, MOFTEC proposed that it and the Census Bureau jointly study "country of origin issues" in more depth. China's specific proposals were detailed at the September 1996 JCCT meeting. Since they extend beyond the Census Bureau's area of responsibility, we sought departmental guidance on how to proceed. Subsequently, at the October 1997 meeting of the JCCT, the Department of Commerce declined to pursue this area of study and the JCCT instructed Census and MOFTEC to simply update the 1992-1993 comparison of U.S. and Chinese trade statistics through 1996.

Comparison of U.S. and Chinese Published Trade Statistics 1990 through November 1997 (In billions of U.S. dollars)

Year	Bound for U.S.		Bound for China		Trade Balance	
	China Exports	U.S. Imports	China Imports	U.S. Exports	China Viewpt	U.S. Viewpt
1990	5.18	15.22	6.59	4.81	-1.41	-10.41
1991	6.16	18.97	8.01	6.28	-1.85	-12.69
1992	8.59	25.73	8.90	7.42	-0.31	-18.31
1993	16.96	31.53	10.69	8.77	6.27	-22.76
1994	21.46	38.79	13.89	9.28	7.57	-29.51
1995	24.71	45.54	16.12	11.75	8.59	-33.79
1996	26.69	51.51	16.16	11.99	10.53	-39.52
1997	32.69	62.55	16.30	12.90	16.39	-49.75

BACKGROUND

The gap between U.S. and Chinese trade statistics continues to grow. For January through November 1997, the U.S. trade deficit with China is almost triple China's published trade surplus with the United States. In 1994, under the auspices of the JCCT, the Census Bureau and

MOFTEC studied the discrepancies in the 1992-1993 trade data. As expected, the study showed that most of the differences resulted from the role of Hong Kong in the Chinese economy.

Preliminary results from the 1994-1996 comparison study show similar results. Census is currently preparing comments on a draft report prepared by MOFTEC. In spite of instructions from the JCCT to simply update the 1992-93 study, MOFTEC conducted an evaluation of so-called "processing trade" and other country of origin issues that they included in their draft. Census has let them know that that part of the draft is not appropriate.

The 1994-1996 study, like the earlier 1992-1993 study, found that both sets of statistics were essentially correct. However, in public statements and articles in the press, MOFTEC continues to claim distortions in U.S. statistics.

MOFTEC has successfully convinced others that the U.S. trade deficit is overstated or at least misleading. In a seminar on "The Integration of China into the World Economy" at the Harvard Institute for International Development on January 17, 1998, a number of American and Chinese academicians and economists collaborated on papers focusing on the discrepancies in the trade statistics of the United States and China and suggested ways to correct or at least analyze the trade data imbalance. They stated that the imbalance in the trade statistics is preventing the normal development of bilateral trade between the two countries. Even a United Nations(UN) official called on the United States to revise its statistics, which he said overstated the trade deficit with China.

The U.S. statistics do not overstate the trade deficit, as it is defined under the UN guidelines for reporting international trade. However, the trade deficit is not easily interpreted under those guidelines, particularly where there is as much foreign involvement as there is in China's trade. In order to permit differential quotas and tariffs, the UN recommends that imports be attributed to the country of origin, and exports to the country of final destination as known at the time of export. Many of China's exports are sent to Hong Kong distributors who tack on a profit and reexport the goods to the United States. In this situation, China shows an export to Hong Kong while the United States shows an import from China at a higher value which reflects any markup added in Hong Kong. This situation, and the less significant markups made to U.S. goods exported to China via Hong Kong, creates most of the bilateral discrepancy.

The MOFTEC has raised two major concerns: the inclusion in U.S. import statistics of value added in Hong Kong and other intermediaries, and the high proportion of contract trade and other foreign involvement in China's exports. Since China does not receive the full cost of these goods, it considers attribution to China of the full value of these imports in U.S. statistics as a distortion. However, these same factors cause discrepancies between China's statistics and those of most of its trading partners. In a recent review of its guidelines for merchandise trade statistics, the UN considered the discrepancies resulting from the attribution of imports to the country of origin, but decided that it was the best approach despite these limitations.

U.S. TRADE WITH CHINA (US\$ Billions)

Totals	1994	1995	1996	1997	% Change
U.S. Exports to China	9.3	11.8	12.0	12.8	6.67%
U.S. Imports to China	38.8	45.6	51.5	62.5	21.36%
U.S. Trade Balance with China	-29.5	-33.8	-39.5	-49.7	25.82%
U.S. Total Trade with China	48.1	57.4	63.5	75.3	18.58%

Principal U.S. Exports to China

Boilers, Machinery, etc.	1.92	2.19	2.30	2.48	7.83%
Aircraft, Spacecraft	1.91	1.18	1.70	2.12	24.71%
Electric Machinery	0.92	1.27	1.43	1.52	6.29%
Fertilizers	0.94	1.20	0.89	1.05	17.98%
Optic, Photo, Med. or Surgical Instr.	0.39	0.45	0.49	0.63	28.57%
Cotton, incl. Yarn & Woven Fabric	0.65	0.83	0.73	0.58	-20.55%
Misc. Grain, Seed, Fruit	0.01	0.06	0.43	0.43	0.00%
Plastics and Plastic Articles	0.18	0.35	0.40	0.43	7.50%
Vehicles	0.32	0.17	0.16	0.35	118.75%
Paper and Paperboard	0.13	0.14	0.25	0.26	4.00%

Principal U.S. Imports from China

Basic Machinery	6.52	7.89	8.91	10.56	18.52%
Toys, Games & Sport Equipment	5.15	6.22	7.50	9.36	24.80%
Footwear	5.26	5.82	6.39	7.41	15.96%
Boilers, Machinery, etc.	2.37	3.62	4.48	5.99	33.71%
Apparel, Unknit	3.51	3.28	3.51	4.16	18.52%
Furniture, Bedding, etc.	1.59	1.98	2.39	3.02	26.36%
Leather, Saddlery, Handbags	2.49	2.54	2.63	2.96	12.55%
Plastics and Plastic Articles	1.34	1.62	1.74	1.98	13.79%
Optic, Photo, Med. or Surgical Instr.	0.73	1.27	1.54	1.98	28.57%
Apparel, Knit	1.57	1.38	1.51	1.84	21.85%

Source: U.S. Department of Commerce, Bureau of the Census

U.S. - CHINA TRADE IN PRIVATE SERVICES, 1992-1997 (\$US millions)

	1992	1993	1994	1995	1996	1997
Exports to China	1,587	1,971	2,183	2,543	n/a	n/a
Imports to China	1,106	1,378	1,480	1,606	n/a	n/a

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

CHINA'S TRADE WITH THE WORLD (\$US billions)

Totals	Year 1994	Year 1995	Year 1996	1996 Q I & II	1997 Q I & II	% Change Q I & II
Chinese Merchandise Exports	121.0	148.8	151.1	64.0	80.9	26.41%
Chinese Merchandise Imports	115.6	132.0	138.8	63.2	62.8	-0.63%
Balance	5.4	16.7	12.3	0.8	18.1	2162.50%

Foreign Supplier Share of Imports (%)

	Year 1994	Year 1995	Year 1996	1997 Q I & II
Japan	22.80%	22.00%	21.00%	17.66%
Taiwan	12.20%	11.20%	11.60%	n/a
United States	12.10%	12.20%	11.60%	17.44%
Korea			9.00%	5.12%
Hong Kong	8.20%	6.58%	5.60%	24.49%
Germany	6.20%	6.10%	5.30%	3.56%

Foreign Buyer Share of Exports (%)

	Year 1994	Year 1995	Year 1996	1997 Q I & II
Hong Kong	26.8%	24.2%	21.8%	5.08%
Japan	17.8%	19.1%	20.4%	20.21%
United States	17.7%	16.6%	17.7%	11.78%
Germany	3.9%	3.8%	3.9%	4.20%
Korea	3.6%	4.5%	5.0%	10.51%

Source: International Monetary Fund (IMF) December 1997 Direction of Trade Statistics Yearbook



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U.S. Official Says Trade Clouds Ties with China

BEIJING -- (Reuters) China's ballooning trade surplus with the United States is "unsustainable" and could cast a pall over a presidential summit planned for this year, a top U.S. trade official said on Tuesday. (Pictured, Chinese President Jiang Zemin hosts a joint press conference with his U.S. counterpart Bill Clinton during October's Sino-U.S. summit, the first meeting between heads of the two nations since the 1989 Tiananmen massacre.)



"U.S. commercial relations with China have often been one of the few rays of sunshine on a sometimes clouded horizon," Under Secretary of Commerce for International Trade David Aaron said.

"However, the increasing deficit -- since 1990 a more than a fivefold increase -- has cast a growing shadow on an otherwise bright future," Aaron told American businessmen after meeting Chinese trade officials.

Beijing's trade surplus with Washington hit \$50 billion last year, Aaron said.

Chinese exports to the United States had rocketed by an average of 25 percent a year since 1985, while U.S. imports had grown by just 10 percent a year, he said.

"The deficit cannot continue on its current path. It is unsustainable," Aaron said.

"If left unattended, the growing imbalance in our trade relationship could even have a somber impact on the summit," he said.



Sino-U.S. ties have improved dramatically in recent months and are expected to hit a new high with a visit to China by U.S.

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D. Opening to Foreign Direct Investment

23. The opening of the economy to FDI has been the third pillar of China's external sector reforms. Foreign investment was expected to introduce new technology, know-how, and capital, and help develop the export sector. In the process of opening the door to foreign investors, various types of open economic zones (OEZs) have played a key role. These zones have offered special tax incentives and a more advanced infrastructure than other regions. Their geographical locations, concentrated predominantly in the coastal regions, have facilitated outward oriented activities. Most importantly, the business environment in the zones has been more liberal than elsewhere, especially in the early stages of the reforms when central planning and price and investment controls still dominated the economic system. While OEZs were established to encourage both domestic and foreign investment, they have been particularly important in attracting foreign investors.

24. Following the enactment of the Foreign Investment Law in 1979, which defined the legal framework for foreign investment, four Special Economic Zones (SEZs) were set up in 1980, three in Guangdong Province and one in Fujian (Box V.1).⁶² These SEZs remained the only open economic zones until 1984. New types emerged in the mid-1980s in the form of open coastal cities, several of which combined to form larger open development areas. These cities and areas were authorized to establish Economic and Technology Development Zones (ETDZs), which in many respects provided conditions similar to those in SEZs. In the second half of the 1980s, steps to improve the environment for foreign investment, especially in advanced technologies,⁶³ were accompanied by a further expansion of open economic zones. Additional ETDZs were approved in open border cities and inland provincial capitals, and in 1988 Hainan became the fifth SEZ. The largest ETDZ, the Pudong New Area, opened in 1990. The first half of the 1990s saw a rapid proliferation of open economic zones, several of them without formal central government approval, in the context of a general broadening and deepening of economic reforms since 1992.

25. SEZs, and in varying degrees other types of open economic zones, have offered a less restrictive investment and trading environment than other parts of the country.⁶⁴ Both local governments and firms have enjoyed a significant degree of autonomy regarding investment

⁶²The development of the different types of open economic zones is described in Bell, Khor, and Kochhar (1993); "People's Republic of China—Background Paper," (SM/95/44, Supplement 1, 3/9/95); and Wall, Jiang, and Yin (1996).

⁶³In October 1986, "Provisions of the State Council of the People's Republic of China for the Encouragement of Foreign Investment" were issued. Special tax incentives for high-technology investment were introduced, wholly foreign owned firms were allowed outside SEZs, and FFEs were granted access, on a limited scale, to the domestic market.

⁶⁴A number of ETDZs, in particular the larger ones like Pudong, have offered conditions similar to those in the SEZs.

decisions.⁶⁵ Restrictions on domestic and external trade have been fewer and tariff and tax concessions more generous than elsewhere.⁶⁶ Firms in the zones have also benefited from more flexible labor relations⁶⁷ and more liberal land use rights.⁶⁸ On numerous occasions, open economic zones, in particular SEZs, have served as laboratories for experiments with new, market-oriented policies. Swap markets, stock trading, foreign banks, and joint-stock public enterprises were first introduced in SEZs.

26. In addition to a more open business environment, open economic zones have offered investors considerable tax concessions. Most types of zones have applied lower income tax rates, in general half the standard central government rate, to domestic as well as foreign investors. FFEs, however, have furthermore benefited from generous tax holidays, in particular for export-oriented activities, high-technology projects, and investment in infrastructure (Box V.2). These tax holidays generally also apply to foreign investors outside the zones, which are subject to the same standard income tax rate as domestic enterprises. SEZs and other types of open economic zones, notably ETDZs and HTDZs, have tended to offer more generous exemptions and reductions on tariffs and indirect taxes for imports, particularly for raw materials, intermediate and capital goods.⁶⁹ Some of these exemptions

⁶⁵SEZs, and subsequently also other open economic zones, have been granted autonomy, within certain limits, to approve investment projects and draw up their own infrastructure development plans, provided the latter can be financed from local sources.

⁶⁶SEZs have been treated as separate customs areas and have enjoyed significant privileges in the area of external trade, such as exemptions from licensing requirements, customs duties and internal indirect taxes for approved imports of raw materials, intermediate goods, and capital goods (exemptions for the latter were canceled in 1996).

⁶⁷Firms in open economic zones have greater scope than firms outside for dismissing employees and hiring workers on short-term contracts. In addition, more advanced government social security systems have helped enhance labor market flexibility. See Wall, Jiang, and Yin (1996).

⁶⁸Markets for land use rights developed first in the SEZs. In 1990, FFEs were allowed to purchase land use rights.

⁶⁹In SEZs, approved imports of raw materials, as well as intermediate and capital goods, have been exempt from tariffs and indirect taxes. Until 1995, sales of imported and locally produced goods inside the zone (with the exception of certain consumer durables) were subject to half the standard tariff and tax rates, with the full rates applying to sales to the domestic market outside the zone. Similar tariff concessions, except for those on sales within the zone, have been extended to ETDZs and HTDZs, but not to other parts of open coastal cities.

have, however, been scaled back in recent years in an effort to level the playing field between regions.⁷⁰

27. While the open economic zones have offered favorable business conditions to foreign as well as domestic investment, in a number of areas, such as direct and indirect taxation and management autonomy, foreign investors have been at an advantage. However, they have also faced special constraints. In particular, the foreign exchange balancing requirement, which in the past entailed restrictions on FFEs' access to the foreign exchange market,⁷¹ combined with constraints on access to the domestic market largely limited their business scope to export-oriented activities. Moreover, in the early phases of the reform process, foreign investment was mainly restricted to joint ventures. These constraints were eased in the second half of the 1980s. With the introduction of swap centers, trading of retained foreign exchange earnings became possible, FFEs were granted limited access to the domestic market, and wholly foreign owned enterprises were allowed outside SEZs. These policy changes, together with the expansion of open economic zones, laid the ground for the surge in FDI inflows since 1992.

28. The evolution of China's policies towards foreign investment is reflected in the structure of FDI inflows (Table V.4). In the early 1980s, more than half of total foreign investment went into joint ventures in natural resource exploration (development joint ventures). The importance of such projects dwindled quickly and since the mid 1980s their role has been negligible. At the same time, until the mid-1980s, policies towards wholly foreign owned enterprises remained reserved, with contractual and equity joint ventures in export processing and similar activities accounting for almost all FDI inflows. The structure of foreign investment changed significantly in the late 1980s after important reforms in the exchange system and the adoption of a more forthcoming approach toward wholly foreign owned enterprises. Since 1989, establishments of wholly foreign owned enterprises have on average accounted for nearly one third of FDI inflows into China.

29. The regional distribution of FDI inflows illustrates the dominant role played by the open economic zones in the process of opening to foreign investment. While in the initial phase a substantial share of FDI was under the control of central government departments, the importance of the central government declined rapidly in the late 1980s and has been negligible in recent years. Most of the remaining FDI inflows, between half and two thirds of total FDI, have been accounted for by a handful of coastal provinces in which the majority of the open economic zones are located. Guangdong, where three of the first four SEZs were

⁷⁰In 1995, the tax and tariff reductions on sales within SEZs were canceled, and in 1996 the tariff exemptions on imports of capital goods were revoked, with existing exemptions grandfathered until mid-1998.

⁷¹In 1996, FFEs were assured access to the foreign exchange market for current payments and transfers irrespective of their compliance or non-compliance with foreign exchange balancing requirements.

established, absorbed on average almost 40 percent of FDI during 1983-92. Its share has declined somewhat in recent years as other provinces with clusters of open economic zones have gained importance but it remains the largest recipient of FDI inflows into China.

E. Policies Toward Other Capital Flows

30. While China has pursued an "open door" policy toward foreign direct investment, other capital account transactions have remained subject to controls to limit the growth of external debt and avoid complications for domestic monetary policy. Liberalization of capital account transactions is a medium term objective, and the authorities have taken the view that the appropriate sequencing of reforms requires further progress in other areas, notably in the areas of financial sector and trade reform, before capital account opening can be addressed.

31. China maintains controls on most transactions involving capital or money market instruments (Table V.5). Equity purchases in China by nonresidents are limited to special shares, which are reserved for foreign investors ("B" shares). Nonresidents are not permitted to issue capital or money market securities in the domestic market, although sales of collective investment securities are possible, subject to approval. Purchases abroad of capital and money market instruments by Chinese nationals are restricted to special financial institutions that are permitted to borrow abroad, and to a few authorized industrial and trade enterprises. Stock and bond issues abroad are also limited to selected institutions and require prior approval.

32. The foreign borrowing plan, which is drawn up annually, has remained the framework for controlling foreign borrowing.⁷² The plan sets mandatory ceilings for all medium- and long-term borrowing⁷³ by central government departments, provincial governments, and enterprises (except FFEs). Only a few selected financial institutions are allowed to borrow directly in international capital markets through bond issues, while a somewhat larger, but still restricted, set of entities, including a few nonfinancial enterprises, are permitted to engage in commercial foreign borrowing. Most enterprises thus have only indirect access to foreign borrowing through domestic financial institutions. Short-term liabilities, such as interbank borrowing and trade credit, are generally controlled through ceilings.

33. As a result of these controls, capital flows, other than FDI, have been modest, averaging around one percent of GDP annually over the past 15 years. While external debt has risen steadily, it has remained moderate in relation to the size of the economy, peaking at 20 percent of GDP in 1993 and declining thereafter to 14 percent in 1996. Debt-service payments have amounted to just over 10 percent of exports of goods and nonfactor services in recent years, and the share of short-term debt in total debt, which was relatively high in the early 1980s, has fallen to 10 percent at the end of 1996.

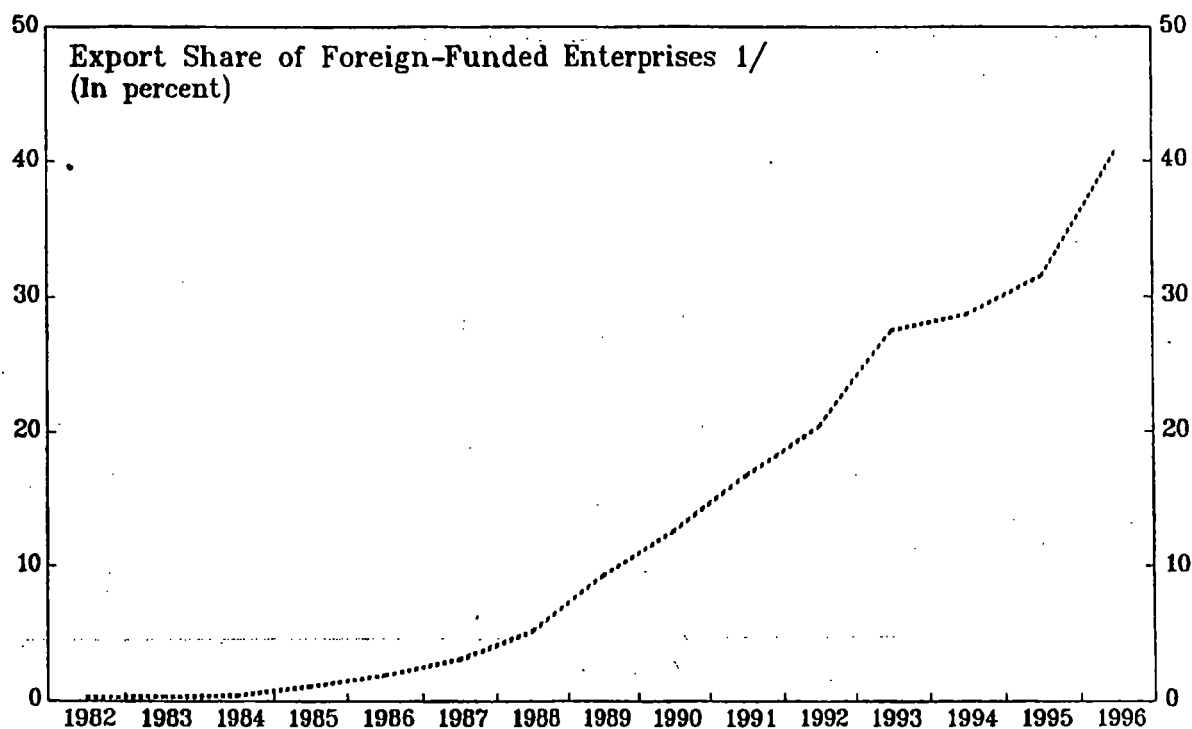
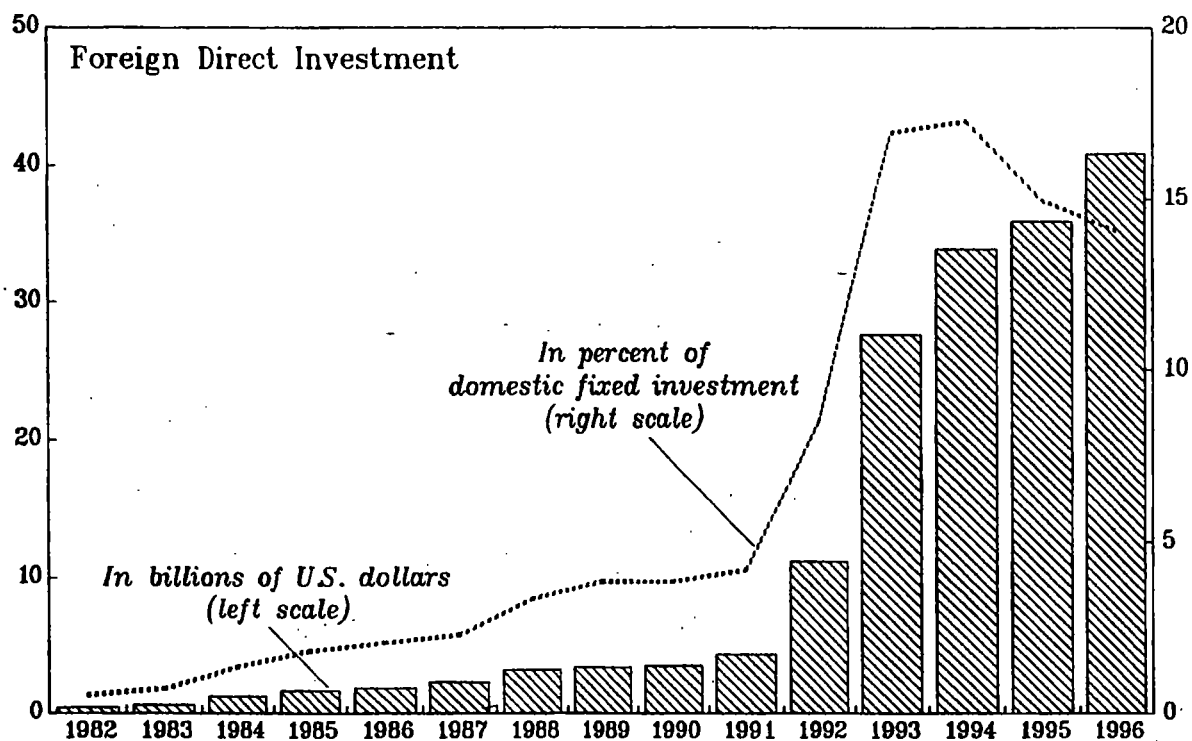
⁷²For a detailed description of the system of external debt management, see "People's Republic of China—Background Paper," (SM/95/44, Supplement 1, 3/9/95).

⁷³Loans with a maturity of one year or more.

CHART V.2

CHINA

THE ROLE OF FOREIGN DIRECT INVESTMENT, 1982-96

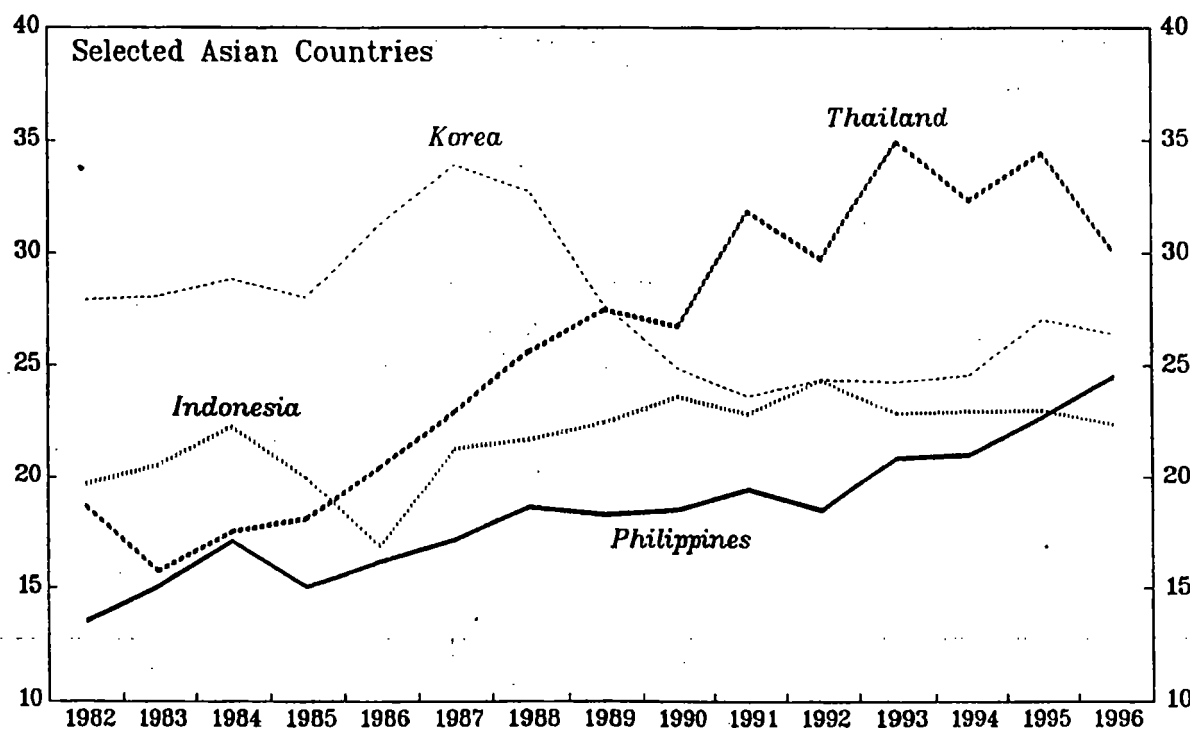
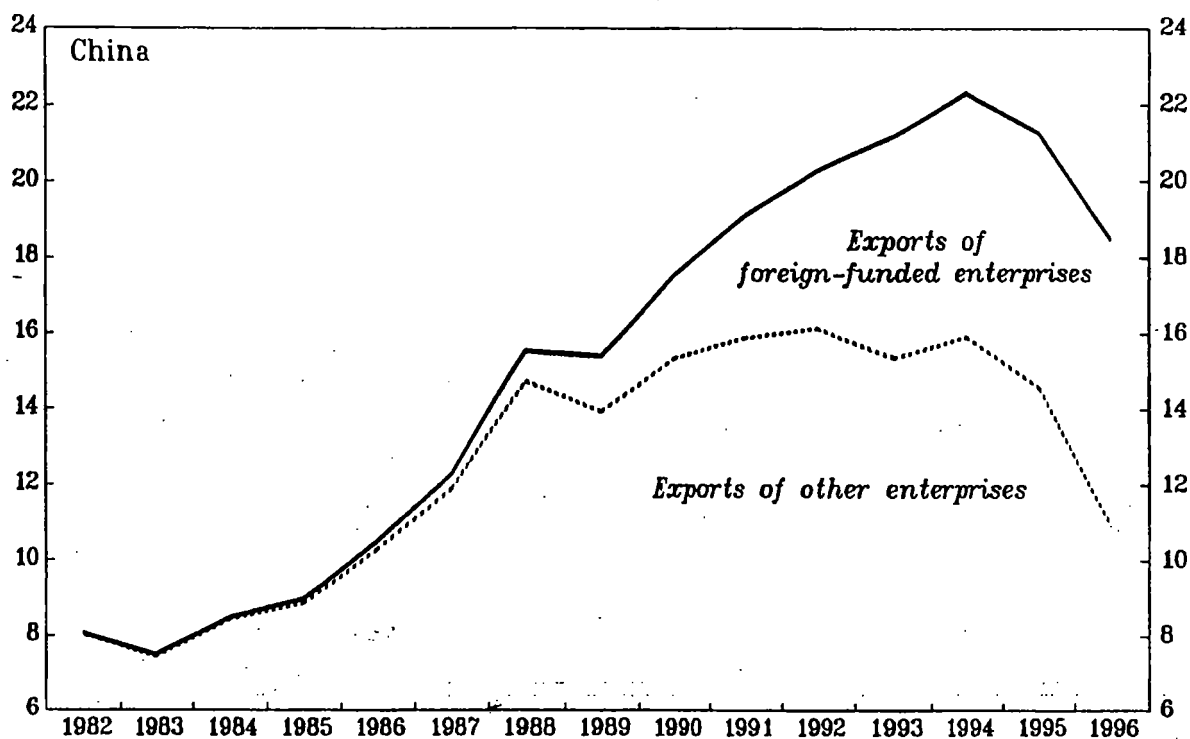


Sources: Data provided by the Chinese authorities; and Fund staff estimates.

1/ Exports of foreign-funded enterprises (foreign-owned enterprises and joint ventures) in percent of total exports (customs basis).

CHART V.3

CHINA
EXPORT TO GDP RATIOS FOR CHINA AND
SELECTED ASIAN COUNTRIES, 1982-96 1/



Sources: Data provided by the Chinese authorities, IMF, World Economic Outlook; and Fund staff estimates.

1/ Merchandise exports (customs basis; in percent of GDP).

Table V.4. China: Structure of Foreign Direct Investment

(In percent)

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
By type of enterprise 1/													
Wholly foreign-owned enterprises	2.3	3.8	0.8	0.7	12.7	9.0	29.5	37.0	30.6	27.0	27.3	26.5	36.8
Contractual and equity joint ventures	39.9	96.2	93.1	96.5	87.2	89.9	66.9	60.1	68.6	73.0	72.4	73.2	63.2
Development joint ventures	57.8	...	6.1	2.8	0.1	1.1	3.6	2.9	0.8	—	0.3	0.3	—
By region 2/													
Fujian	1.8	3.6	6.1	2.8	2.1	3.9	9.2	8.5	10.1	12.6	10.4	10.9	10.7
Guangdong	43.7	45.8	33.3	38.4	27.8	33.5	35.1	42.1	41.6	32.8	27.2	27.9	27.1
Jiangsu	1.0	1.4	1.7	1.5	3.3	3.4	3.4	3.6	4.7	13.0	10.2	11.1	13.7
Liaoning	0.8	0.5	1.3	2.1	3.4	3.5	3.4	6.9	7.8	4.6	4.6	4.2	3.8
Shandong	0.3	0.3	1.8	2.9	2.5	2.4	4.3	4.9	4.6	8.9	6.7	7.5	7.1
Shanghai	1.2	3.0	5.6	6.6	8.1	6.2	11.2	4.6	3.1	4.4	11.4	7.3	7.7
Other regions	14.1	7.8	17.6	23.3	20.2	31.3	24.5	20.9	22.9	21.2	30.0	29.1	28.3
Central government departments	37.1	37.6	32.6	22.4	32.6	15.8	8.9	8.5	5.2	2.5	1.5	2.0	1.6
Memorandum item													
Total FDI (In billions of US\$)	0.64	1.26	1.66	1.88	2.31	3.19	3.39	3.49	4.37	11.16	27.52	33.79	35.85

Sources: China Statistical Yearbook, various issues, and China Foreign Economic Statistics 1979-91.

1/ Shares in total contracted amounts.

2/ Shares in utilized amount.

Box V.1. Open Economic Zones in China

Since the beginning of economic reforms, a variety of open economic zones have emerged, which have offered a more liberal investment and trade regime than other areas, as well as special tax incentives. While open to both domestic and foreign investors, these zones have played an important role in attracting FDI, although most of the investment in the zones has come from domestic sources.

Special Economic Zones (SEZs)

SEZs were the first, and until 1984 only, open economic zones. Four SEZs were established in 1980, three (Shenzhen, Shantou, and Zhuhai) in Guangdong Province near Hong Kong, one (Xiamen) in Fujian Province, close to Taiwan Province of China. In 1988, Hainan Province became the fifth SEZ.

SEZs have enjoyed considerable autonomy in their investment policies regarding both infrastructure projects (provided they can be financed locally) and investment approvals (for projects up \$30 million). They have offered preferential income tax treatment, and exemptions from import licenses (for FFEs automatically, for domestic enterprises subject to approval) as well as tax and tariff concessions for raw materials, intermediate and capital-goods (concessions for the latter were rescinded in 1996). Within SEZs, sales of locally produced goods have been free from duties and taxes, and sales of imported goods have been subject to a reduced tariff, with full tariffs and duties applying to sales outside SEZs (except exports).

Open Coastal Cities (OCCs)

In 1984, 14 cities in the coastal regions with already established industrial bases and infrastructure became OCCs and were opened to foreign investment. Although not separate customs areas and less independent than SEZs, OCCs have enjoyed greater flexibility in investment and tax policies than other regions in China. Several OCCs and the surrounding counties have created larger "development areas," such as the Pearl River delta and the Yangtze delta (including Shanghai).

Economic and Technology Development Zones (ETDZs)

Within the 14 OCCs, special areas were set aside for ETDZs, offering tax incentives similar to those in SEZs. Further ETDZs in the Yangtze valley, as well as border and inland cities, were subsequently approved by the State Council. The largest ETDZ, the Pudong New Area, opened in 1990.

High Technology Development Zones (HTDZs)

HTDZs emerged in the early 1990s. In most features similar to ETDZs, HTDZs have placed particular emphasis on attracting investment in high technology industries by providing additional tax concessions.

Free Trade Areas (FTAs)

The first two FTAs were established in the early 1990s in Pudong and Shenzhen, and a number of others have been opened since then. Exports and imports can be traded freely within FTAs and enterprises are free to engage in bonded entrepot trade as well as export-oriented production.

For a detailed description of the different types of open economic zones in China, see Wall, Jiang, and Yin (1996).

Box V.2. Income Tax Treatment of Domestic and Foreign-Funded Enterprises

Standard Income Tax Rates

Domestic enterprises: 33 percent.

FFE: 33 percent, 1/ FFEs with contracts for operating periods of 10 years or more are exempt from income tax for 2 years after the first profit is realized, and eligible for a 50 percent reduction in their tax liability in the following 3 years. FFEs that export at least 70 percent of their annual output remain eligible for a 50 percent reduction after these 5 years. Advanced-technology FFEs receive a 50 percent reduction for 3 years after the initial 5 years.

Special Economic Zones

Domestic enterprises: 18 percent.

FFE: 18 percent, 1/ and the same 2-year exemption, 3-year reduction as under the standard rate. Export-oriented and advanced-technology FFEs pay 10 percent (instead of 15 percent) after the initial 5-year exemption and reduction period has expired. FFEs engaged in infrastructure projects in Hainan (airports, harbors, docks, railroads, highways, power plants, and water conservation) and with contracts for operating periods of 15 years or more are eligible for a 5-year exemption period followed by 5 years at a reduced rate (10 instead of 15 percent) after the first profitable year.

Open Coastal Cities and Areas, Open Border Cities, Inland Provincial Capitals, and Yangtze River Open Cities

Domestic enterprises: 33 percent.

FFE: 27 percent, 1/ and the same 2-year exemption, 3-year reduction as under the standard rate. For projects with foreign investment of \$30 million or more (registered capital) and a long recovery period, knowledge- or technology-intensive projects, and energy, transportation or harbor construction projects, the 24 percent component may be reduced to 15 percent.

Economic and Technology Development Zones

Domestic enterprises: 18 percent.

FFE: 18 percent 1/ for all production-related FFEs, with the same 2-year exemption, 3-year reduction as under the standard rate. For export-oriented and advanced-technology FFEs, the same extended reductions as in the SEZs apply.

High Technology Development Zones

Domestic enterprises: 18 percent.

FFE: 18 percent, 1/ and the same exemptions and reductions as under the standard rate for high- or new-technology enterprises.

1/ Includes a 3 percent local government component on which local governments may grant reductions.

Table V.5. China: Capital Account Regulations, End-1996 (concluded)

Assets	Liabilities
Lending abroad by residents:	Other Capital: Loans
	Borrowing abroad by residents:
	Only financial institutions permitted by SAFE, and authorized industrial and commercial enterprises are allowed to borrow from abroad.
	For loans with a maturity of one year or more, SAFE approval is required and the loan must be part of the state plan for utilizing foreign capital.
	Foreign borrowing with a maturity of less than one year by authorized domestic enterprises is subject to foreign exchange balancing requirements and must be registered with SAFE; foreign borrowing with a maturity of less than three months is exempted from these requirements.
	Short-term foreign borrowing by authorized financial institutions within the target balance is free from restrictions but must be registered with SAFE.
	FIEs may borrow from abroad without approval but must report the borrowing to SAFE.
Other Capital: Deposit Accounts	
Domestic Financial institutions may open foreign exchange accounts abroad subject to prior SAFE approval.	Nonresidents staying for a short time in China may open a foreign currency savings account in China.

- 1/ 1989 "Regulation on Outward Direct Investment" and 1990 "Implementation Procedures on Outward Direct Investment."
 2/ Interim "Regulations Guiding Foreign Investors" and "Directions for Foreign-Funded Enterprises" were issued by the State Planning Commission and other relevant agencies in 1995.
 3/ Including capital market securities, money market instruments, collective investment securities and financial certificates.

Table V.5. China: Capital Account Regulations, End-1996

Assets	Liabilities
Direct Investment	
Outward direct investment, including purchase of real estate, is subject to review by the State Administration for Foreign Exchange (SAFE) as regards foreign exchange resources and investment risk, and requires MOFTEC (Ministry of Foreign Trade and Economic Cooperation) approval. 1/	Inward direct investment, except purchases of real estate, is permitted without restrictions, provided foreign investors meet the requirements of Sino-foreign joint venture laws and other relevant regulations. Investment projects require MOFTEC approval. 2/ FDI is prohibited in some industries for environmental and security reasons.
Portfolio Investment 3/	
Purchases abroad of foreign instruments by Chinese residents:	Purchases of domestic instruments by nonresidents:
Only financial institutions permitted to engage in foreign borrowing, as well as authorized industrial and trade enterprises, are allowed to purchase foreign capital market, money market, and collective investment securities abroad. Financial institutions require prior review of qualifications by SAFE.	Nonresidents may purchase "B shares," i.e., shares denominated in renminbi and traded on the Chinese Securities Exchange but reserved exclusively for foreign investors.
Purchases abroad of derivatives by financial institutions require prior review of qualifications and are subject to limits on open foreign exchange position.	Nonresidents are not allowed to purchase other capital market instruments, collective investment securities, money market instruments, and derivatives in China.
Sale or issue in China by nonresidents:	Sale or issue abroad by Chinese residents:
Nonresidents are not allowed to sell or issue capital market securities, money market instruments and derivatives in China.	Sale or issue of stocks requires approval by the People's Bank of China (PBC), SAFE, or the Securities Supervisory Board; sale or issue of other financial instruments, except derivatives, requires PBC and SAFE approval. Bond issues abroad must be included in the state plan for utilizing foreign capital and can only be undertaken by financial institutions approved by the PBC.
There are no regulations regarding the issuance or sale of foreign collective investment securities in China but trading must be approved by the Securities Policy Commission.	Sale or issue abroad of derivatives by Chinese financial institutions is subject to prior review of qualifications and to limits on open foreign exchange positions.

26. ASIAN CRISIS

Regional Stability

~~CNF~~ "China: Struggling to Sustain Growth Amid the Asian Crisis," Working Paper, Office of Asian Pacific and Latin American Analysis, April 10, 1998.

"Can China Avoid the Asian Disease?," The International Economy, Greg Mastel, March-April 1998.

"Will China Devalue?," The International Economy, Greg Mastel, March-April 1998.

The Asian Crisis and China (Sec. III, Fernald, Edison and Loungani, IFDP #604)

~~CNF~~ China Faces Limited Immediate Fallout from Global Financial Turmoil

~~CNF~~ China Moves to Stabilize Hong Kong Market

~~CNF~~ Property Sector Declines Putting Pressure on Banks in Hong Kong

~~CNF~~ China Withstanding Devaluation Pressures

"Can China Avert Crisis?," Business Week, March 16, 1998.

Did China Cause the Asian Crisis?

- Hong Kong and the Asian Crisis

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OF CLASSIFIED ATTACHMENTS
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REGIONAL STABILITY

The Asian Financial Crisis: The financial crisis in Asia began in July, 1997. The turmoil started in Thailand and spread quickly to other countries in Asia and beyond. Financial panic caused severe capital outflows from several Asian countries, sending their currencies and stock prices into a free fall. In the most seriously affected countries--Indonesia, Korea, Thailand, Malaysia, and the Philippines, stock prices and exchange rates fell 40-50 percent in the following six months. In these and, to a lesser extent, other Asian countries, corporate bankruptcies and unemployment are rising. Indonesia, Korea, and Thailand requested and received international bailouts led by the International Monetary Fund (IMF) with emergency credit totaling more than \$110 billion. China has been immune to the financial contagion because of its closed financial sector.

The causes of the Asian financial crisis are complicated. However, the crux of the problems lies with the foreign capital supported over-investment in some Asian countries. The situation was made more precarious by the short maturity of much of the foreign inflows to these countries. Most economists agree that the depreciation of the Chinese currency in 1993-94 is not a major cause of the crisis.

Although China's competitiveness has been eroded by the recent devaluation of other East Asian currencies, top Chinese officials have pledged not to devalue the Chinese currency. Most analysts believe the Chinese government will keep its promise, at least for the near term. A Chinese devaluation under the current environment is unlikely to help China regain its competitiveness because it may lead to further devaluation by other East Asian countries. Politically, it may damage the friendly-yet-precarious relationship that China has with some East Asian countries. The non-convertibility of its currency and its large foreign exchange reserves should enable China to withstand any foreseeable pressure on its currency.

- Official reserves stood at \$144 billion at the end of January 1998.
- Estimated total external debt was \$161.8 billion at the end of 1997, out of which \$41.7 billion was short-term.
- Capital inflows to China have been dominated by long-term foreign direct investment.

Although economic growth in China remains relatively strong, its contribution to the recovery of the region is limited. China, in spite of its size, accounts for only about 5 percent of the total exports of the five most affected Asian countries.

The crisis seems to have the following policy implications on China:

- Postpone indefinitely the full convertibility of its currency and the liberalization of its capital markets.

- Strengthen the supervision and regulation of banks.
- Speed up the restructuring of the SOEs.
- Tighten the reporting requirements for overseas branches of Chinese banks, especially on short-term liabilities.

Can China Avoid the Asian Disease?

Not without facing its Achilles' heel: hundreds of thousands of bleeding state owned enterprises which threaten the banking system.

BY GREG MASTEL AND ANDREW SZAMOSSZEGI

As the Asian economic crisis has engulfed more and more countries, many observers have confidently predicted that China would avoid the economic crisis because China is different. In many respects, those observers are correct. Unlike Thailand, Korea, and Indonesia, China still tightly controls its foreign exchange, runs trade large surpluses, and maintains a huge level of foreign exchange reserves, which makes any catastrophic drop in the yuan unlikely. In addition, most foreign investments in China are in plants and equipment, and are unlikely to be swept up in the wave of speculation that hit other Asian markets. Beyond that, China draws economic strength from an enormous labor force and a growing industrial base.

China, however, has its own economic Achilles'

heel: the enormous, inefficient, and bankrupt State Owned Enterprise (SOE) sector. The World Bank and even Chinese officials themselves acknowledge that SOEs are an enormous burden on the Chinese economy, and much of the nation's domestic savings are absorbed propping up SOEs. Direct subsidies have been reduced, but China's banks have been directed to fill the void by making "loans" to SOEs. The total of unrecoverable loans has grown so large that it now endangers the solvency of the Chinese banking system.

Even after two decades of economic liberalization and reform, SOEs continue to play a major role in the Chinese economy. According to Chinese statistics, there are more than 300,000 SOEs, 40 percent of which are

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classified as "industrial." Despite their falling share of output, production by SOEs is rising, and they are still responsible for about one-third of China's industrial output.

These statistics somewhat understate the role of SOEs in the Chinese economy. In addition to those firms directly owned by the state, there are subsidiaries of SOEs, joint ventures between SOEs and township and village enterprises or private firms, and ostensibly private firms which have direct links to government ministries and government officials, such as those operated by officials of the People's Liberation Army (PLA). China's SOEs are major employers, with more than 100 million people on their payrolls. To put this in perspective, there are currently about 130 million people employed in the entire United States. In many of China's urban areas, SOEs employ the majority of the workforce. By some estimates, as many as one-third of these employees could be laid off with no loss in productivity.

SOEs are a diverse group of enterprises. They range from small local service-oriented enterprises that employ only a handful of employees to large heavy manufacturing companies that employ thousands producing steel, chemicals, or other products. Many have direct ties with the government ministries charged with regulating them. The Ministry of the Chemical Industry, for example, operates a number of chemical manufacturing companies. Although much of China's export boom is the result of its growing private and foreign-invested sectors, SOEs continue to play an important role in foreign trade. During the first ten months of 1997, SOEs, including foreign trade corporations, were responsible for 56 percent of China's exports and 43 percent of its imports (see Figure 1).

As the Chinese Communist Party acknowledged at its most recent Party Congress, reforming inefficient SOEs is perhaps China's most pressing economic task. China simply cannot afford to make enormous economic transfers to the state-owned sector forever. The Chi-

nese economy is already straining under the burden. Due to state-directed bank lending and loans among SOEs, hundreds of billions of dollars worth of unrecoverable loans hang over China's banking system like a sword of Damocles, threatening to push China into the economic abyss with Indonesia, Malaysia, and South Korea.

Ironically, the SOE threat to China's domestic economy is also a threat to its efforts to become fully integrated into the international economic system. SOE reform is one of the highest hurdles standing in the way of China's decade-long campaign to join the World Trade Organization (WTO). The WTO does not prohibit state ownership per se. In fact, a number of WTO members maintain SOEs. The WTO does, however, greatly restrict subsidies to SOEs and limit the trade actions of state trading enterprises. China's SOEs violate both of these WTO provisions.

Through the years, SOE shortfalls have been covered with direct and various indirect subsidies. Although direct subsidies are known, there is no reliable estimate which captures the total flow of funds from the government to SOEs. Indirect subsidies include bank loans that are never likely to be repaid, research and development subsidies, and preferential access to inputs such as energy. Cumulatively and perhaps individually, these subsidies are far in excess of the WTO's limits on subsidies. Moreover, the recent state discipline on direct subsidies (see Figure 2) has led to an increase in indirect subsidies and local government funding of SOEs.

The issue of compliance with state trading provisions is a bit more complex, mostly because the world trading system has made only limited progress in regulating state trading enterprises. Almost since the creation of the world trading system, there has been an appreciation that government trading monopolies could thwart tariff bindings and prohibitions on quantitative



At the recent Party Congress, President Jiang Zemin endorsed the concept of selling stock in and effectively privatizing many, but not all, of China's SOEs.

Even after two decades of economic liberalization and reform, SOEs continue to play a major role in the Chinese economy.

Making the SOEs WTO-Friendly

There are several ways to bring China's state-owned sector into WTO compliance while improving the nation's economy. The simplest of these is to phase down the level of subsidies paid to the SOEs, which would enable China to comply with the WTO and cure its domestic ills in one stroke. Exporting SOEs are a logical starting point for phasing out subsidies, although massive trade distortions, if these SOEs should have their subsidies reduced quickly and more rapidly than other firms. There is also logic to this formula because the GATT prohibited export subsidies long before it began limiting domestic ones. While Chinese subsidies remain in place, other WTO members should maintain special rights to restrict exports from China's SOEs to prevent undue market distortions. Subsidies to SOEs that produce goods that compete with imports and the control that many SOEs exert over imports pose significant market access barriers. If China's trading partners are ever to enjoy free, uncensored access to China's market under the WTO, these issues must be addressed.

A lasting solution requires the elimination of subsidies and state trading powers. In the interim, the agricultural provisions of the Uruguay Round suggest another possible avenue. The final agreement requires a minimum guaranteed access level for imports in several tightly protected agricultural sectors. Similarly, a minimum level of import access in sectors dominated by SOEs could improve access for China's trading partners, thus enabling market forces to take hold. Over time, new consumer demand and increased familiarity with imports should build internal pressure for continued trade liberalization.

Another portion of the Uruguay Round agriculture agreement provides a model for dealing with the employment implications of SOE reform. Under the Uruguay Round agreement, countries are allowed to replace prohibited agricultural production subsidies with direct payments tied to production. This allows governments to provide farmers with income support without distorting trade. The same approach could be used with China's SOEs. Instead of subsidizing SOEs to keep workers employed, Beijing could make payments directly to unemployed workers, perhaps linked to some adjustment period or a retraining program. The employment benefits would not distort world markets, and would still allow China to meet the social and political needs served by SOEs. China could continue the payments as long as it wished because, in effect, they would convert the international trade problems of SOEs entirely into a domestic budgetary problem.

restrictions by merely implementing unannounced de facto limits on import purchases. Article XVII of the GATT was drafted and expanded in the Uruguay Round to provide some discipline to state trading activities; these provisions have a limited track record, however. In China, many SOEs have both direct and indirect power to control imports, particularly imports that compete with them. Given the many linkages between SOEs and their parent ministries, this is a particularly difficult problem to police with regard to China, but if it is ignored, other countries will be effectively denied access to portions of China's market.

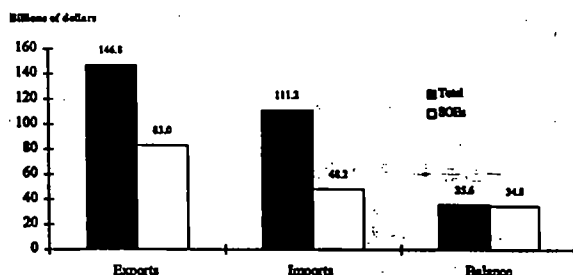
There are, however, several ways to bring China's state-owned sector into WTO compliance while improving the nation's economy. A number of ideas have been proposed to address trade reform and SOEs. The simplest of these is to phase down the level of subsidies paid to the SOEs, which would enable China to comply with the WTO and cure its domestic ills in one stroke. China has expressed interest in this approach, but it is by no means an easy solution because SOEs employ so many people. An army of forty million unemployed Chinese would pose enormous economic, social, and, ultimately, political challenges that China seems ill-prepared to address. Unless accompanied by a massive program to address the resulting unemployment, a phase-down would put the Chinese government in an untenable situation.

At the recent Party Congress, China's President Jiang Zemin endorsed the concept of selling stock in and effectively privatizing many, but not all, of China's SOEs. This proposal is difficult to evaluate because its details have yet to be fleshed out. Yet it is clear from other countries' experiences with privatizing SOEs that market actors typically wait until prices are deeply discounted before purchasing inefficient government enterprises. Such bargain hunting would still leave China's banks with mountains of bad debt. In China's case, it is difficult to imagine many of its flabby

*In many of China's urban areas, SOEs
employ the majority of the workforce.*

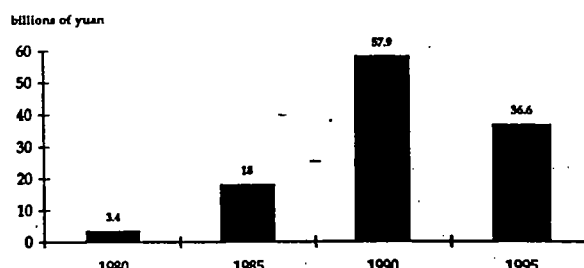
*By some estimates, as many as one-third
of these employees could be laid off
with no loss in productivity.*

Figure 1. Trade by China and Its State-Owned Enterprises
January-October 1997



Source: State Statistical Bureau

Figure 2. Direct Government Subsidies to
State-Owned Enterprises



Source: World Bank

SOEs attracting much private investor interest. This approach is therefore likely to succeed with only a few of the stronger SOEs, and loss-generating enterprises will probably remain wards of the state.

China's SOEs most directly involved in international trade pose serious compliance issues. Exporting SOEs are a logical starting point for phasing out subsidies. To avoid massive trade distortions, these SOEs should have their subsidies reduced quickly, and more rapidly than other firms. There is a logic to this formula because the GATT prohibited export subsidies long before it began limiting domestic ones. While Chinese subsidies remain in place, other WTO members should maintain special rights to restrict exports from China's SOEs to prevent undue market distortions. Exporting SOEs are only part of the problem, however. Subsidies to SOEs that produce goods that compete with imports and the control that many SOEs exert over imports pose significant market access barriers. If China's trading partners are ever to enjoy reciprocal access to China's market under the WTO, these issues must be addressed.

A lasting solution requires the elimination of subsidies and state trading powers. In the interim, however, the agricultural provisions of the Uruguay Round suggest another possible avenue. One of the Uruguay Round's primary objectives was the removal of trade distortions in agricultural markets. The final agreement requires a minimum guaranteed access level for imports in several tightly protected agricultural sectors. Similarly, a minimum level of import access in sectors dominated by SOEs could improve access for China's trading partners, thus enabling market forces to take hold. Over time, new consumer demand and increased familiarity with imports should build internal pressure for continued trade liberalization.

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Reforming inefficient SOEs is perhaps

China's most pressing economic task.

convert the international trade problems of SOEs entirely into a domestic budgetary problem.

In the end, each of these approaches to SOE reform seem likely have some role to play. Collectively, they can be combined to pave the way for China's entry into the WTO. The specific application of these proposals to particular sectors can best be worked out in the current WTO accession negotiations. But no matter which avenue China chooses to take, reforming its SOEs will require some sacrifice. China has benefited tremendously from the market reforms it has undertaken; most of the miraculous economic growth the country has enjoyed in the last two decades can be traced to them. By making a full commitment to market-based solutions and tackling SOE reform, China can provide its trading partners real access to its market, join the WTO, and become a full-fledged member of the world economy. While achieving this long-standing international economic goal, China can also tackle its most vexing domestic economic problem and put itself on a path toward continued economic growth. ♦

Will China Devalue?

BY DAVID MALPASS

The fate of Hong Kong — and perhaps the world economy — rests in the balance.

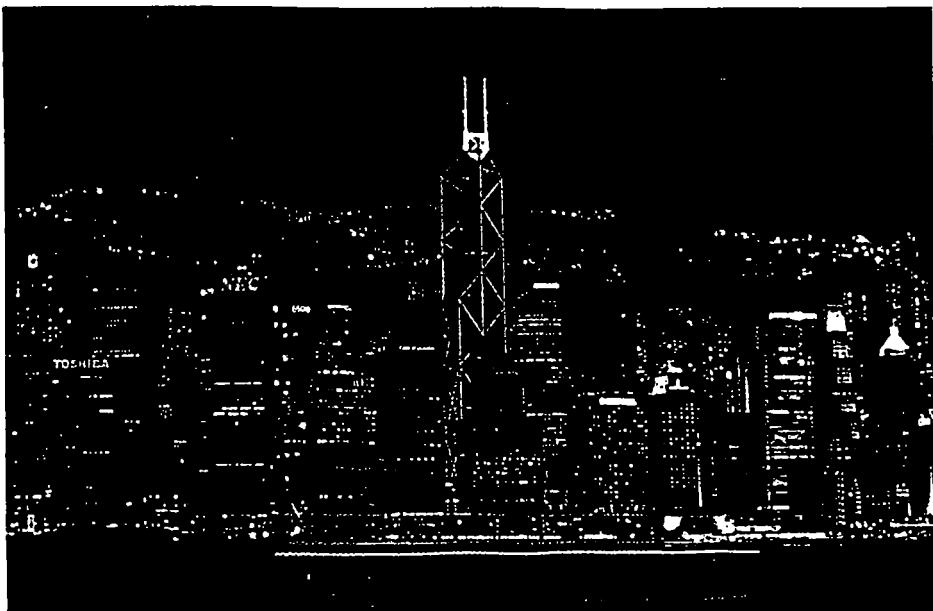
Hong Kong's dollar link will probably last for years. However, the commonly heard answer to the question of whether Hong Kong's currency will be repegged is "not now, but soon." It explains the stubbornly wide spread between interest rates on HK dollars and U.S. dollars.

The 1997 Hong Kong devaluation story was built on contagion from Southeast Asia and the supposed flaws in the currency board system. The perceived flaws included the "overvaluation" of the HK dollar after years of consumer price inflation above the U.S. level, the inability of a currency board to use monetary stimulus during an economic downturn, and the danger from high property prices. The HK dollar and banking system felt a sharp attack which peaked on October 28 and a milder attack in early January. The fixed exchange rate held relatively easily, helped by the automatic interest rate increases associated with currency boards and by a clear statement by China's central bank governor Dai that China supported the system.

The new Hong Kong devaluation story goes like this. China's export growth rate slows during 1998 in response to Southeast Asia's economic collapse and

the ongoing global slowdown. Political pressure mounts in China for a competitive devaluation. As the story goes, China would benefit from a devaluation rather than suffer the normal post-devaluation collapse, because China's dollar debt is not as large or short-term as Southeast Asia's and its currency is not as easily convertible. China undertakes a "controlled" devaluation more like Taiwan's than Southeast Asia's. At each step down this path, the Hong Kong economy comes under increasing pressure from high interest rates and slower growth in China. The ultimate result — a repegging of the HK dollar.

This new devaluation story is buttressed by the reappearance of a parallel market for U.S. dollars in China. It is fed by occasional statements from China and Hong Kong that "no devaluations are necessary because competitiveness exists at current exchange rates," an open invitation to devalue if export growth slows. The 1998 devaluation story is also getting help from a cadre of entrepreneurial English-speaking Chinese economists who have found that disaster stories sell better than happy endings. Schooled in mystical western devaluationism, they argue that controlled devaluations are both plausible and helpful. True, China is a key variable in the outlook for the HK dollar. If China devalued or expressed something less than ab-



Some analysts believe that China might undertake a "controlled" devaluation in response to slowing export growth in 1998, increasing pressure on the Hong Kong economy from high interest rates and slower growth in China and leading to a repegging of the HK dollar.

solite support for the HK dollar, the political and economic equation in Hong Kong could weaken enough to force a change in Hong Kong's currency system.

The best premise, however, is that China aggressively pursues its self interest. This leaves Hong Kong's currency fixed at 7.75 per U.S. dollar for years to come for the following reasons:

1. China is about as anti-devaluation as countries come. Part of the new devaluation story is that China has a history of competitive devaluations. This is a misreading of the January 1994 unification of China's official and parallel currency markets. In reality, China abhors devaluations because they cause massive social dislocation. In 1993 Zhu Rongji asserted his leadership by abruptly stopping the 1992-1993 devaluation and reestablishing coveted price stability. The 1994 currency unification was a major liberalizing achievement for China, ending the Leninist concept of currency isolation and, contrary to the anti-China game going on in the west, actually prolonging Southeast Asia's economic expansion. Looking back in China's recent history, Mao gained power in part to put a stop to currency chaos. And the Tiananmen Square crisis came after a period of currency weakness, inflation, and hoarding.

2. Unlike the many leadership gaffes in Southeast Asia and South Korea in 1997, China is in the process of promoting Zhu Rongji to Prime Minister, a clear endorsement for currency stability and low inflation. China has steadfastly maintained its independence from IMF and World Bank economic advice, another hopeful sign for the stability of the renminbi.

3. Taiwan remains at the forefront of China's policy decisions. No reasonable Beijing observer could argue that devaluation and economic collapse in Hong Kong would help China's endless efforts to bring Taiwan back into the family.

4. From a pure wealth standpoint, China will try hard not to reduce the proven value of Hong Kong's currency system. This showed up clearly in the smoothness of the 1997 handover, the prominence China has given to Hong Kong's role as a financial center, and

China's quick, clear support for the HK dollar in October.

5. While properly out for its own gain, China will also recognize that a competitive devaluation of the renminbi will harm its neighbors. This would have negative implications for China's relationship with Taiwan, with the important Chinese ethnic communities in Southeast Asia, and with China's hope to play a leadership role in the region. A devaluation would also set back China's aspirations to join the World Trade Organization.

Apart from a conscious political decision, the market is unlikely to have much effect on China's exchange rate. China holds \$140 billion in international reserves versus a manageable amount of short-term dollar debt. Its capital account is not fully convertible. While the state banking system is weak, the depositor base exhibits strong confidence in state-sponsored banks.

For Hong Kong, the stakes are high. There is no concept within the history or logic of currency boards which allows for a repegging of the currency. While China might allow a gradual weakening of the renminbi, a sudden devaluation of, say, 5 percent would put tremendous pressure on Hong Kong. On October 27, 1997, the U.S. stock market fell 554 points on fears of a Hong Kong devaluation, a proper reaction to what would be a cataclysmic mistake. If Hong Kong's 7.75 peg were abandoned, the island would lose almost all value to China, a tragedy both for Hong Kong and for China's net worth and its hopes of reunifying Taiwan. China's common sense and the sturdiness of Hong Kong's currency board are likely to prevail, leaving the HK dollar fixed to the U.S. dollar for years to come. ♦

importance to Korea and Singapore has diminished quite substantially over time.

III. The Asian Crisis and China

How is China likely to be affected by the 1997 Asian crisis? The first part of this section briefly reviews possible channels of contagion, through which negative shocks to one country can spread to other countries. We do not focus this review on China per se. However, we use this review in the second part of this section to discuss China's vulnerability to the Asian crisis. We highlight the role of reduced exports and capital inflows in slowing China's economy. We also argue that slowing capital inflows, as well as slowing growth generally, makes economic restructuring more difficult for China.

A. Contagion Considered

Even without any transmission of shocks across countries, multiple countries may be susceptible to a crisis if global shocks affect many countries at the same time. In Asia, three shocks seem particularly noteworthy: (1) moderating growth in industrial countries, (2) collapsing world prices for electronic goods in 1995, and (3) weakening of the yen relative to the dollar between mid-1995 and 1997 (a depreciation of about 50 percent over this time period). With their currencies pegged to the dollar, the movements in the yen led to a real appreciation of their currencies. Although these shocks did not, in and of themselves, appear to provoke widespread problems, they may have left many economies vulnerable, thereby making transmission of crisis easier.

But once an adverse shock hits one country, how might it be transmitted to other countries? Various (possibly interrelated) channels have been proposed, including:

- Trade linkages. There is both a price and an income effect. As a concrete example, consider events in Korea in late 1997, when the won depreciated sharply and growth slowed. The won's depreciation affected the current and prospective international competitiveness of other countries — China, for example, became less competitive relative to Korea. Second, lower income growth in Korea reduces growth in Korean demand for imports, including imports from China.

- Reassessment of Fundamentals. Investors may reinterpret or downgrade the information that they have at hand, even if no new information is available. Nervous foreign investors may focus particularly on economies with policies and conditions similar to those of "crisis" economies, even if they did not see those policies and conditions as major risk factors before. For example, events in Thailand and Indonesia in mid-1997 highlighted the dangers of financial sector weaknesses, so investors may have paid closer attention to other countries with weak financial sectors, such as Korea. (Of course, fundamentals *may* in fact change following the crisis. For example, the change in demand for a country's net exports intrinsically represents a change in fundamentals, which may therefore merit a reassessment.)

- Perceptions of risk. Following a negative shock to one market, investors may require a larger risk premium in other markets. This increased risk premium may reflect an increase in volatility in the region generally, which raises uncertainty. One reason uncertainty might rise is if investors fear that *other* investors will withdraw funds, and perhaps spark a currency crisis (as discussed in the next bullet point). Risk premia may also rise because of principal-agent incentives in the financial services industry¹⁷; for example, investors might expect diligent fund managers to reduce exposure to South Korea and other Asian economies after the crisis began.

- Speculators. Speculators can hasten the demise of a currency following changes in any of the factors above—relative prices, assessments of fundamentals, or perceptions of risk. To a large extent, this process simply accelerates adjustments that needs to be made in any case. But in addition, speculation may reflect a rational, self-fulfilling crisis of confidence, akin to a bank run. For example, a pegged rate may be sustainable if speculators do not attack; but once speculators attack the currency, policymakers abandon the peg rather than bear the cost of the high real interest rates necessary to sustain it. (A large literature explores when such self-fulfilling currency crises are possible; see, for example, Obstfeld (1996) and Krugman (1997).)

- Proxy hedging or proxy disinvestment. Many financial markets lack the depth to hedge risks appropriately. However, investors may be able to take a large hedging position using an asset (the "proxy") with which its movements are likely to be correlated. For example, investors might short the Hong Kong dollar as a way to hedge exposure to the Chinese renminbi. (In other words, you cannot easily speculate against the renminbi directly — but if you think that China's exchange rate regime is unsustainable, you may speculate against the Hong Kong dollar and Hong Kong dollar assets, even if you think the fundamentals in Hong Kong are otherwise relatively strong.)

B. Will China catch the Asian Flu?

Despite the existence of these numerous channels, China has not—as of March 1998—been greatly affected by the region's current financial crisis, with the currency remaining stable against the dollar and foreign-exchange reserves increasing. Output growth slowed in the second half of 1997 to only about 8

¹⁷ Dow and Gorton (1997) provide one such model.

percent year-over-year (compared with average annual growth of more than 11 percent between 1991 and 1996), but most observers attributed the slowdown to domestic rather than external economic developments. In part, the relative immunity reflects the lack of convertibility of China's currency, which makes a speculative attack difficult, eliminating one major channel of transmission discussed above.

Several other features of China's economy are also noteworthy: China has a large current account surplus, large foreign-exchange reserves, a relatively low ratio of debt-to-GDP, and relatively little portfolio investment. These features tend to weaken some of the channels of contagion described above. However, several channels do remain at work, including trade linkages, reassessments of fundamentals, and perceptions of risk. Hence, to the extent speculation simply accelerates adjustments to changes in fundamentals or perceptions, the lack of capital account convertibility suggest that China's adjustments will be slower but that China will feel the effects of the crisis.

The primary mechanisms for these channels to affect China is through reduced exports, and reduced capital inflows. Consider exports first. Between June 1997 and early February 1998, exchange rates for all major Asian currencies other than those of China and Hong Kong depreciated against the U.S. dollar, by moderate amounts (around 20 percent) in Taiwan and Singapore, and larger amounts (between 40 and 75 percent) elsewhere. Although inflation has edged up in all of these economies, it appears unlikely that the real depreciations will reverse in the near term (in part because there has been a substantial decline in the relative price of non-tradeables and tradeables, and this relative-price change is likely to remain). The real depreciations of Asian (especially ASEAN-4) currencies hurts China's export prospects by increasing the competitiveness of these economies exports. The effects through the income channel (working through the weakness of Asian economies, including Japan) have not been fully played out, but also work in the direction of weakening China's exports.

To the extent that China produces different goods than other Asian economies, it is less sensitive to the depreciations of other Asian economies. In addition, more than half of China's export volume (56

percent in 1996)¹⁸ involves processing trade, in which China imports partially assembled goods, and completes labor-intensive assembly. The relative appreciation of the renminbi reduces the renminbi-cost of these imported components, partially offsetting the competitive effects of the Asian crisis. However, the Asian depreciations reduce the incentives to locate labor-intensive assembly in China, so at the margin, export growth will slow. In addition, the changes in relative prices can also lead to a shift away from goods in which China has a comparative advantage, and goods where other Asian economies have a comparative advantage.

Now consider capital inflows. A likely reason for inflows to slow is that the Asian crisis has already caused investors to increase their China risk premium. The top panel of Figure 6 shows the widening of the yield spread between Chinese sovereign debt and U.S. Treasuries, using a dollar-denominated Chinese government bond due in February 2004. The yield spread, which averaged about 75 basis points until early September 1997, had risen to about 150 basis points by early January. (In late February, the spread narrowed slightly to about 130 basis points, and remained there into early March.)

Even more striking is the offshore renminbi forward exchange rate, shown in the bottom left panel. (There is no formal forward market for renminbi in China, but there is an offshore non-deliverable-forward market, where all contracting and delivery is done in foreign currency, but based on the value of the renminbi.) The bottom right panel translates these forward exchange rates into offshore interest differentials relative to U.S. dollar interest rates, using the covered-interest-parity condition. The forward rate remained relatively stable until late October; when the Hong Kong dollar came under speculative pressure on October 24, the renminbi forward rate also spiked upwards, and the interest-rate differential rose to more than 20 percent.

The forward rate primarily reflects exchange-rate risk, and incorporates both expectations about the expected future spot rate, and a currency risk premium. The risk premium is likely to be particularly important, since the main participants in the market are probably investors who have a large renminbi

¹⁸ From "Foreign Trade Approaches \$300 billion in 1996," *Zhonguo Xinwen She*, January 10, 1997, reported as FBIS-CHI-97-007.

exposure over the next year, and are willing to pay a sizeable premium to insure against the possibility of a large devaluation. Whether it reflects a change in exchange rate expectations or a change in the risk premium, the forward rate suggests a substantial shift in perceptions by financial market participants. (For comparison, as of early February 1998, Consensus Estimates (1998) forecast an expected renminbi depreciation of about 1 percent over the next year; if the forward rate were an unbiased estimate of the future spot rate, the forward rate of about 9 renminbi/dollar implies roughly a 10-percent depreciation over the next year.)

A higher risk premium is likely to show up in reduced capital inflows. Of course, more than 85 percent of China's capital inflows take the form of foreign direct investment (FDI)¹⁹—amounting to \$38 billion in 1995, \$42 billion in 1996, and \$45 billion in 1997—which is usually presumed to be less subject to reversal than other forms of capital inflows.²⁰ Nevertheless, even if FDI does not *reverse* (with investors dismantling a factory and shipping it to, say, Korea), the level of inflows can fall substantially. Indeed, the value of new contracts signed for FDI fell sharply in 1997 from 1996 (down 29 percent); although the relationship between China's contracted FDI and actual future inflows is not clear, the figures already suggest a likely slowdown. The slowdown in contracted FDI appeared in the first half of 1997, even before the Asian crisis. The crisis in the second half of 1997 only makes things worse.

Even apart from the evidence on contracted FDI, there are at least two reasons to expect the Asian crisis to contribute to a sharp decline in actual FDI. First, more than 80 percent of Chinese FDI comes from other Asian economies, and investors from many of these economies are in no position to continue rapid investment into China. For example, between 1992 and 1995, Hong Kong accounted for about 60 percent of FDI, Taiwan 10 percent, and Japan 7 percent. (The United States, by comparison, accounted for a little

¹⁹ Figures from "China: Joint-Stock System Development in Perspective," FBIS-CHI-98-022, January 22, 1998. See also *China Statistical Yearbook (1996)*, Table 16-15, p. 598.

²⁰ Anecdotal evidence suggests that some of China's FDI may be disguised lending. First, some FDI contracts specify fixed dividends that look a lot like interest payments. Second, Chinese firms sometimes circumvent the severe restrictions on foreign borrowing by establishing subsidiaries in Hong Kong, who borrow from international markets and then undertake FDI in China. Conceptually, both of these examples are closer to being debt than to being FDI.

over 7 percent). In recent years, investors from other Asian economies have also been investing increasing amounts in China: In 1995, for example, the ASEAN-4 economies, plus Korea, accounted for about \$2 billion in FDI (5 percent of the total), and Singapore accounted for an additional \$2 billion.^{21 22}

Second, even Western firms that undertake FDI in China may well reduce investments. If firms invest as an export platform, other Asian economies now appear more competitive. If firms invest in order to get access to China's domestic market, a possible slowdown in China makes that less enticing. Finally, firms may perceive Asia generally as a less desirable place to invest and produce, consistent with a higher regional risk premium.

Finally, one implication of a slowdown of capital inflows is that it makes enterprise restructuring more difficult. In 1997, China announced plans to restructure state-owned enterprises (SOEs) and reduce their role in the economy. This major shift requires a massive reallocation of labor and capital, which in turn requires substantial investments in new firms. But FDI is a major source of financing for the non-state sector, so any decline in FDI is likely to make this reallocation more difficult. In other words, downsizing SOEs requires destroying existing jobs and laying off workers, a politically difficult step. This downsizing is easier if new jobs are being created, and the pace of job creation is likely to slow because of reductions in the financing available to the non-state sector.

Unemployment is already a concern of Chinese policymakers, and press commentary already suggests concerns about social stability. The official urban unemployment rate was only 4 percent at the end of September 1997, but is misleadingly low for at least two reasons. First, it excludes workers who have

²¹ Data in this paragraph are from *China Statistical Yearbook*, various years.

²² The ultimate sources of financing for Hong Kong FDI into China remains unclear. One source is Chinese money, illegally diverted to Hong Kong and then repatriated in order to take advantage of foreign investment incentives. In addition, Chan and Chow (1997) report that in a sample of audited Chinese joint ventures, only about half of Hong-Kong-incorporated enterprises were owned primarily by Hong Kong residents: Many multinationals invest in China through Hong Kong subsidiaries, and smaller Western investors often form joint ventures with Hong Kong firms in order to benefit from their Chinese expertise; many Taiwan residents invest in China through Hong Kong for political reasons. In addition, much of the ultimate funding for FDI may take the form of borrowing (e.g., from Japanese banks) by Hong Kong firms, who then undertake FDI. If this bank lending dries up, as seems likely, Hong Kong investment will also decline.

been sent home on partial pay. Second, it includes only official urban residents (29 percent of the population); hence, it does not include the presumably substantial unemployment among the "floating population" of generally unskilled rural workers who have moved to the cities in search of jobs. At least 30 million surplus rural workers (estimates range as high as 110 million, or 9 percent of the population) have moved to urban areas but do not have official residency status.

The main argument for continued enterprise and banking reforms is that without them, growth will slow over time and perhaps stagnate. However, radical reforms are costly in the short run, and could easily generate a sharp contraction. Enterprise restructuring of the sort discussed following China's 15th Party Congress represent a substantial restructuring of the economy. Restructuring was enormously costly in terms of output in Eastern Europe and the former Soviet Union. One can argue about whether China is, or is not, similar to those countries. But even for industrial countries, there is a substantial body of macroeconomic literature that explores the importance of sectoral shifts, suggesting that reallocations are costly in the short-term. The controversy in this literature is not whether reallocations/restructuring are costly in principle, but whether they are important in practice (they might not turn out to be a significant source of shocks to the United States, say). So macroeconomic literature suggests that a contraction is likely in the short term, should China attempt radical restructuring.

A concern is that Chinese leaders may find the political risks of a short-term contraction greater than the risks from a long-term slowdown in growth. The Asian crisis may raise the short-term risks, because China already faces a possible slowdown in the next year or so.

How much of a short-term risk do China's financial market weaknesses pose to China? After Thailand's currency crisis erupted in mid-summer 1997, it became clear to many investors that they had underestimated the risks associated with weak financial systems, contributing to a reassessment of other Asian developing economies. Some commentators argue that China's financial system looks at least as bad, and perhaps far worse, than those of other regional economies.²³ Most notably, China's banking system has

²³ See, for example, Nicholas Cashmore, "Work in Progress," *Asiamoney* June 1997, p 51-55; and George Melloan, "The Stakes Are Rising on China's Banking Reforms," *Wall Street Journal* July 14, 1997, p. A15.

an enormous overhang of bad loans. In January 1998, for example, People's Bank of China Governor Dai stated that more than 20 percent of bank loans are nonperforming, although he argued that only 5 to 6 percent of loans are unrecoverable; but Western observers generally estimate that the proportion of non-performing and unrecoverable loans may be far higher.²⁴

In most Asian economies, policymakers' post-crisis concern with banking-sector health generally reflects both short- and long-term concerns. In the short-term, poor bank health can lead to a "credit crunch," as banks reduce lending even to viable non-financial firms, thus exacerbating the real effects of the crisis. For example, banks may lose the funding base (deposits) with which to make loans; and even if they have the funding, they may not have adequate capital to make loans.

This short-term concern is probably not relevant to China. In particular, if China's bank loans go bad, or are recognized as bad, they will not have the same impact on the lending behavior of the banks as would occur elsewhere. In particular, it is unlikely that in order to restore their "profitability," Chinese banks will be forced to cut back on other loans. First, it is fairly clear that the Chinese government continues to guarantee bank deposits—which are, after all, primarily held in state banks. Hence, depositors continue to have faith in the banking system. Second, if a severe credit crunch begins to impinge on the real economy, Chinese authorities can in essence order the banks to lend. In other words, despite substantial moves in recent years to make the banking system more competitive and commercially oriented, neither the Chinese authorities nor anyone else believes the banking system is fully commercially oriented, or operates independent of the government. The problems of China's banking system are primarily a fiscal issue, and as long as government guarantees are credible, the financial sector weaknesses are unlikely to lead to a short-term credit crunch.

Nevertheless, despite the fact that banking system weakness is unlikely to result in an immediate credit-crunch, one short-term risk is that a slowdown in output and increases in bankruptcies might cause some of banks to become illiquid, when interest income cannot cover normal deposit withdrawals. Alternatively, if depositors decide to increase their withdrawals—perhaps because they lose faith in the

²⁴ See, for example, Roell (1997).

banking system, or perhaps because they simply decide to reduce their (currently large) holdings of broad money—banks may find themselves illiquid. If the government is then forced to rescue the banks, the most accessible source of funding is the central bank. Then the government may face the undesirable choice of seeing an increase in inflation, or a substantial slowdown in growth.

In the long-term, China's financial market weaknesses raise severe concerns about whether resources are channeled to their most productive uses. Because of these long-term concerns, Chinese policymakers hope to continue progress on removing the need to make policy loans (through enterprise reform), in providing banks with experience and skill in assessing loans on commercial grounds, and in improving the transparency and accountability of banks. These are necessary steps before Chinese policymakers can successfully recapitalize the banks or otherwise try to solve the underlying problems of inherited bad loans of the banking system.

For example, even if China's banks were financially sound and healthy, recapitalization would not resolve the inherent incentive problems of the banks. The savings and loan problem in the United States highlighted the moral hazard problems facing financial institutions with low net worth, but access to deposit insurance. In the United States, there were clear incentives for the *owners* of these institutions to engage in risky behavior; if they were more solvent, the owners would not have faced these incentives. For Chinese banks, however, the issue is the incentives faced by bank *managers* (rather than owners). Managers may continue to have incentives to make loans to friends or powerful politicians, for example.

An important lesson of the Asian financial crisis is that weaknesses in financial markets, and moral-hazard incentives facing bankers, can have devastating effects on an economy. Chinese policymakers appear aware of these dangers. It is noteworthy, and favorable, that in early 1998, policymakers announced numerous plans to accelerate financial market reforms, explicitly citing a desire to try avoiding an Asian-style crisis. Policies included central bank reforms, in order to improve local supervision, and bank reforms that seek to improve the ability of banks to operate on commercial grounds, with greater independence from government-directed quotas.

IV. Conclusions

Motivated by the 1997 financial crisis in Asia, this paper explores the links between China and the rest of Asia. Surprisingly, we find no evidence that China's export growth had a negative effect on exports of other emerging Asian economies. To the extent there is evidence of export competition, it is the period from about 1989 to 1993: China's exchange rate depreciated sharply over this period, Chinese export growth exceeded export growth of other Asian economies, and the composition of Asian exports (measured by export shares of various goods to the United States and other industrial economies) changed substantially. Since 1993, by contrast, China's exchange rate has appreciated, China's export growth has been strikingly similar to that of other Asian economies, and the composition of exports has been relatively stable.

Thus, it does not appear that China's emergence as a trading nation had a significant adverse effect on the rest of Asia's export performance. In recent years, Asian trade performance appears to have been driven primarily by factors common to all Asian economies, including China. In 1997, however, China's trade performance has far exceeded that of other Asian economies.

Finally, we speculate on the effect of the Asian crisis on China. Because of the large real depreciations of many Asian currencies, China will face more trade competition, and will face reduced demand for its exports, reflecting the slowdown in Asia. China is also likely to face a slowdown in capital inflows, which will lead to reduced domestic investment. This reduction in inflows will make state-enterprise reform more difficult, by reducing growth and job-creation in the non-state sector. Thus, although China has remained insulated from the crisis so far, it appears susceptible in the future.

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Cover Story

AVERT CRISIS?



WOLF AT THE DOOR *Laid-off factory workers seek jobs in the northern Rust Belt*

The swank bars and restaurants of Shanghai are filled with nervous talk these days about how the bottom is falling out of the local real estate market. Shanghai's five-year construction binge soaked up \$18 billion and astounded the world with its audacity. But now the city touted as the financial capital of the world's next superpower is filled with half-empty office towers and the concrete shells of apartment buildings. It may be Asia's biggest property glut yet.

Hundreds of miles away, in an export zone of the Pearl River Delta, the general manager of an import-export firm in Guangdong is worried, too. His company has been a star exporter of shoes and textiles. But now his suppliers are laying off half their workers, unable to compete with rivals in Southeast Asia who lowered prices after their currencies tumbled. With earnings dropping, this manager thinks he may have to cut workers, too.

China's economy is starting to sputter as the big sources of its economic strength all show signs of fatigue. Foreign investment is slowing because cash-starved Asian companies can no longer afford to build in China. Exporters are seeing business shift to cheaper factories in Thailand and Malaysia. The real estate boom in the rich coastal provinces is turning into a bust. Unemployment is rising and bad loans keep piling up in the state-owned banks, threatening the health of the entire economy. True, China does not have the convertible currency and massive short-term foreign debt that trig-

gered the meltdowns across Asia. But there are enough similarities that the outside world is now asking if China can avert a crisis.

Acutely aware that the country must change course, Beijing's mandarins are scrambling for solutions. Thousands of delegates meet in Beijing for the National People's Congress, the Chinese are waiting eagerly for signs of decisive action from new Premier and economics czar Zhu Rongji. "We need a New Deal with Chinese characteristics," says Chinese Academy of Sciences researcher Hu Angang, recalling the



Austerity programs are on the way out. Envisioned is a massive public-works program

bold economic activism of the U.S. six decades ago.

The pieces of China's new deal are still taking shape as the country's best and brightest pen white papers by the score. Much hinges on the outcome of leadership changes and a ma-

major shakeup of government ministries now under consideration. But some key el-

Cover Story

ements are emerging: Instead of devaluing its currency to boost exports, the government will try a major policy shift. To stimulate domestic growth it will abandon its current austerity program and promote hundreds of billions of dollars in new investment over the several years, much of it in public works and housing. The government will likely raise most of these funds by significantly expanding its fledgling bond market and loosening up on credit. And Beijing will inject \$32 billion in fresh capital into the country's four top banks so they can start shedding bad loans.

TWIN OBSESSIONS. For Zhu Rongji, who is expected to take over as China's Premier at the Congress, the moves to prime the pump signal a big change in thinking. Through administrative fiat, Zhu—nicknamed *Lao Ban*, or The Boss—started to choke off credit in mid-1993 to squeeze out speculation in the property and stock markets. His other obsession has been stopping inflation, which has cooled from 22% in 1994 to under 1% now. Associates say Zhu ignored

CHINA: THE PROBLEMS

BANKS The government channeled 75% of bank credit into state enterprises. But this practice has produced at least \$240 billion in bad debt and created a bank insolvency crisis.

EXPORT SLOWDOWN Coastal provinces absorbed billions in foreign investment to build factories for overseas markets. But Asia, which accounts for half of exports, has collapsed, and foreign investment has slowed.

SPECULATION Billions have poured into office buildings and shopping malls in Beijing, Shanghai, and Guangzhou. Overcapacity and new debt problems for the banks are the result.

JOB As state-owned enterprises pile up losses, more are shutting factories, producing new jobless masses—maybe twice as high as the official statistics.

appeals to ease up on his fight against inflation until the Asian crisis was well under way and its implications for China were clear. But by December, he realized that China's own economy could stall disastrously if he didn't step on the gas, risking the ire of die-hard conservatives who oppose any increase of inflation and deficit spending. Perhaps in antici-



PHOTOGRAPH BY GAMMA-LIAISON

THREE GORGES DAM PROJECT To finance such megaprojects, the government will have to go deeply in

pation of his new role as Premier, Zhu has been having sympathetic meetings with unemployed workers.

Party members are steeling themselves for a more fundamental reform of China's state-run capitalism. The country needs a modern banking system, not the profligate method of state-directed credit it has now. The Chinese must treat foreign investors as genuine partners and not as gullible sources of cash and technology. And the government must realize that the easy days of export-led growth are ending and that the task of building a domestic economy lies ahead.

What's amazing is how swiftly the Asia crisis has undermined China's growth formula. Under Deng Xiaoping, Beijing let the coastal provinces invest willy-nilly in hundreds of thousands of real estate and manufacturing ventures. The boondoggles and corruption were astounding. Zhu finally started cutting off the flow of cheap bank loans to pet projects. The austerity drive left even many sound companies starved for funds and forced to lay off workers. But Zhu and other leaders figured that as long as export industries remained strong, the economy would keep growing briskly. Officials figured they would have years to fix the state sector and perfect their brand of red capitalism.

But export growth may slow to 5% this year, from 22% in 1997, and cities from Beijing to Shanghai are feeling the pinch. The coastal factories, many of them started by

the go-go party cadres, are having trouble finding buyers for all their low-grade air conditioners, vacuum cleaners, and consumer electronics.

Consumer demand is dropping fast, and many retailers are desperate for shoppers. At Beijing's new Cofco Plaza shopping center, for example, the top two floors are empty of shops. And the designer clothes and bedding sold in the largest third-floor shop come from boutiques elsewhere in the building in order to fill up otherwise unoccupied space.

Such signs are alarming. If growth slips below 7%, the economy will not generate nearly enough jobs to soak up the 6 million Chinese entering the workforce each year, as well as the 12 million laid off by restructured state enterprises. Unemployment is expected to jump by an additional 10 million through 2001. The steel industry will dismiss a half-million workers—38% of its workforce—by 2000. The country's textile machine will probably lose 600,000 jobs in the next few years. City officials are frantically trying to retrain these former factory hands, many of them over 40.

Chinese policymakers know that a significant slowdown could force them to devalue their currency. That would set a new jolt through the world economy. Devaluations, warns Zhu Min, an economic adviser to the Bank of China's president, would lead to "export wars in the second half of this year and a vicious cycle of depreciations." A slowdown could also trigger the kind of social unrest that horrifies China's leaders. And if China slides into stagnation, the world loses one more important source of growth.

FEUDING PLANNERS. That's why reigniting growth is a central part of the new plan. But don't expect to see a lucidly packaged, well-organized stimulus program emerge from the Congress. Instead, the cadres will unveil remedies piecemeal as disagreements rage over the details. Even the official *China Daily* newspaper is reporting the debate among technocrats over the wisdom of abandoning fiscal rigor and risking the creation of another bubble. Sinologists say current Premier Li Peng favors only a 10% increase in government spending, below Zhu's target. Yet, at the end of the day, analysts expect the government to boost its spending on public works and other projects as much as 20% a year.

Much of this is to come from vast personal savings—some \$560 billion piled up in state-run commercial banks throughout the country after a decade of economic growth. The goal is to ladle this money into everything from Beijing's fourth ring road to Shenzhen's subway to such megaprojects as the Three Gorges and the Yellow River's Xiaolangdi dams. The usual way to capture these savings would be to issue bonds. But ordinary Chinese investors have traditionally steered clear of long-term debt instruments, either because interest rates are low or because it is too difficult to sell them on a secondary market. Banks also are not eager to set up a major bond market, which could divert funds from their deposits and make it more difficult to carry their estimated \$240 billion in dud loans.

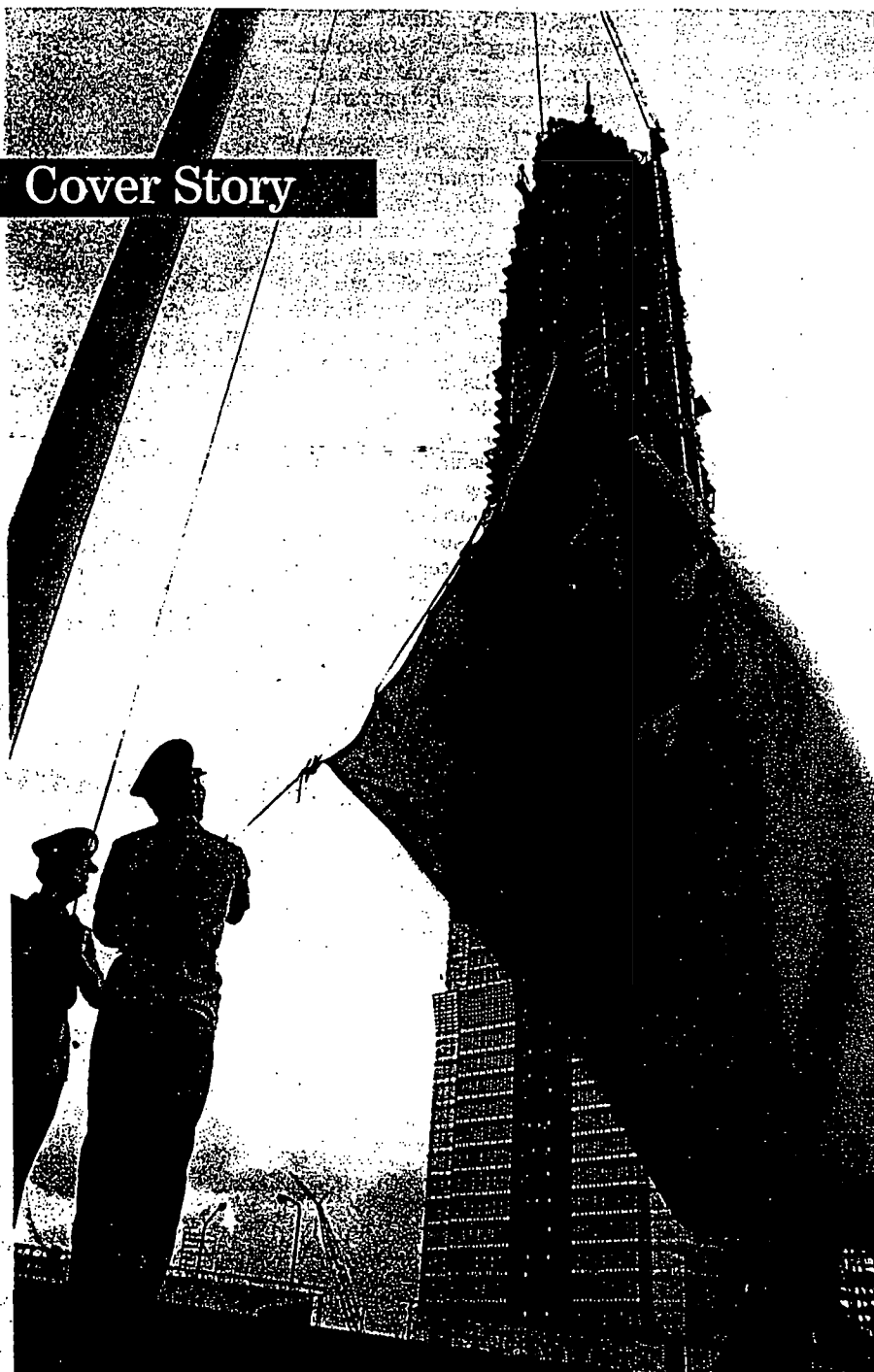
Yet policymakers are actively debating several bold



The risk is that China wastes its savings on projects that fail to develop a market economy



Spending may increase 20%



Cover Story

EDIFICE COMPLEX *Bank portfolios are stuffed to bursting with real estate loans*

ideas that could vastly expand China's debt markets. One would be a major expansion of corporate bonds, which authorities until now have kept at under \$2 billion a year. Liu He, an official at the State Information Center, recently proposed a big increase in the number of highway and railroad bonds. A more controversial idea is to let cities and provinces sell bonds both at home and abroad, a scheme Zhu opposes because local officials could go overboard again. The central bank is also considering an expansion of the money supply later this year through new loans to commercial banks. Plans are afoot to bankroll construction of \$350 billion in apartments over three years. The central bank also would earmark loans for infrastruc-

ture projects and small businesses.

The most urgent task Zhu faces, however, is to clean up the banking system. A key first step is Beijing's recent decision to pump \$32.5 billion in capital into its four main commercial banks by issuing new state treasury bonds. This will boost banks' capital levels to meet international standards, making it easier to carry nonperforming loans, lower lending rates, and increase profitability.

The government is also making attempts to curb the rampant growth in finance companies, which were notorious for providing loans to speculative investments. Computerization of bank data is making it easier for regulators to monitor loans. Zhu also wants to dramatically reduce the number of branches of the People's Bank of China to lessen the chances of local meddling. Top bank executives at the regional level now are appointed directly by Beijing and no longer report to provincial governments or party officials. Wang Qishan, former president of China Construction, has been named Vice-Governor of Guangdong Province, where he will try to ensure that local cadres don't dictate bank lending.

GREEN LIGHTS. Beijing will also sweeten terms for investors from the U.S. and Europe. "When the economy is bad, the authorities are polite to people like me," says William A. Hanbury Tenison, chief representative of Jardine Fleming Securities Ltd. in Shanghai. "At the moment, people are very polite."

They're about to get even nicer. Chinese authorities will soon sign off on major infrastructure projects involving Western multinationals that have been bogged down for years. In February, for example, Royal Dutch/Shell Group finally got the green light for a \$4.5 billion chemical complex, China's biggest foreign investment ever. Jack Perkowski, chairman of Asimco, a direct-investment fund with 17 joint ventures across China, is currently negotiating two more ventures, which are suddenly going more smoothly. "For everything in the contract, we're finding more flexibility now. We're seeing tangible signs," he says.

Reforms aimed at streamlining China's stifling bureaucracy would improve the investment climate immensely. Reducing the power of the Ministry of Post & Telecommunications, which both regulates and operates most of the telephone system, would help open China's phone market. Limiting the ministries' role in industry also could weaken China's ability to impose onerous rules on technology transfer and local content.

Beijing may even make it easier for foreigners to turn a profit, something it has not cared much about. Watch for new low-interest loans and reduced tax rates for particular infrastructure projects built by foreign joint ventures.

Ambitious stuff. But will it be enough? A good clue will be

in how China tackles its banking problem. Although Western analysts praise the \$32 billion capital injection as an important first step, "in terms of solving the problem, it's only a fraction of what they need to do," says Standard & Poor's China analyst Wayne Gee.

China's banks probably need a much more massive injection of new capital so that they can write off bad debts to state enterprises. Western economists also fear that China's short-term foreign debts—the Achilles' heel that brought down Thailand and South Korea—may be understated. Officially listed at \$15 billion, the real figure could be several times that if the offshore borrowings of Chinese corporate branches in Hong Kong and the U.S. are included. Beijing's \$140 billion in foreign reserves is still a comfortable cushion, but China may be more vulnerable to an external financial shock than it thinks.

KOREAN MODEL? Throwing money at the banks won't work unless they also start lending on the basis of credit analysis, rather than politics. Also lacking so far is a comprehensive plan for the banks to wipe bad debts off their books, which is necessary if they are to stand on their own as profit-making institutions. China does not have a legal framework for banks to seize corporate assets and sell them off to outside investors. And because there is no insurance program to protect depositors, shutting down bad banks is difficult. There isn't even a system to monitor the assets of state banks. All of these issues are now being debated actively in the Chinese press, but decisions aren't expected in the coming months.

The government also has not figured out what to do with the largest state-owned enterprises, the biggest money-losers in the system. Beijing has been urging strong state companies to buy up the weaker ones to create conglomerates modeled after South Korea's *chaebol*. The well-run Baoshan Iron & Steel Corp. in Shanghai, for example, is being strong-armed into buying a poorly run metallurgy company, while Beijing's Snow Lotus Cashmere Co., one of the profitable textile makers, may have to acquire other, money-losing cashmere producers. "We are being encouraged to take over a hurting enterprise, but I'm not sure that that is a sound strategy," says General Manager Li Yuanzheng.

The crisis of Korea's *chaebol* may well force Beijing to abandon this model and even to rethink the party's emphasis on large corporations. Now, policymakers are exploring special loan funds for smaller businesses, and they may make it easier for private enterprises to issue stocks and bonds. Ready cash raised in 1997 from Hong Kong's securities markets was supposed to ease the pain of restructuring state-owned behemoths. But that money is now dried up. So the government plans to approve \$3.7 billion worth of initial offerings in China's domestic markets this year, a sum that may grow. Trouble is, regulators fear that if failing companies manage to list, the already shaky credibility of China's bourses will be undermined further.

Opening up the interior of China to serious economic development could offset the slowdown in exports and boost demand for locally made goods. Beijing is hoping its ambitious public-works program will spread the wealth to such interior cities as Wuhan and Zhengzhou. They also want to help the three-quarters of China's population that lives in rural areas but who account for only 45% of retail sales. The average annual income of a Chinese farmer is a mere \$250, whereas city residents pull in about \$620. But this will take years: The roads and power generators must be built before industry moves en masse to the hinterland.

Give credit to Zhu Rongji and China's ablest bureaucrats for recognizing a developing crisis and mobilizing to solve it. Outsiders applaud his ambition. "Zhu is shooting for the moon, but even if he ends up only half way there, it will be a tremendous acceleration of what we have seen so far," says Nicholas R. Lardy of Washington's Brookings Institution.

Yet Zhu and his colleagues have only a few years to reignite China's economy with public works and public debt. If they succeed, China's economy will be vastly more market-oriented but with the party still at the helm. If they fail, China will have the same problems it has today, except it will have a lot more debt and far fewer options. Six months ago, the Chinese thought they could avoid the fallout of the crisis. Today, the crisis is already forcing major change in Asia's most dynamic economy.

By Joyce Barnathan and Dexter Roberts in Beijing, Mark L. Clifford in Shanghai, Bruce Einhorn in Guangzhou, and Pete Engardio in New York



Many of the banks have stopped lending, choking off credit to the worthy and reckless alike

China's Financial System

THE OLD WAY...

Beijing and local officials channel bank credits to state-owned businesses.



...AND HOW IT MAY CHANGE

Beijing uses bonds to tap \$560 billion in personal savings to back big public works, boost growth, and support strategic industries. Commercial banks are freed from political influence.



DATA: BUSINESS WEEK

DID CHINA CAUSE THE ASIAN CRISIS?

Some observers claim that Asian crisis has its origins in China's 1994 devaluation. In our view, this charge is ludicrous. Another possibility -- that Chinese export growth caused the crisis, either through competition with the affected countries' exports in third-country markets or through increases of imports into the crisis countries -- is also unsustainable by the data.

The 1994 Devaluation

Attributing the crisis to the 1994 devaluation makes little sense because the devaluation was really quite small. While the official exchange rate was devalued by 50% on January 1, 1994 -- the figure cited in most reports -- this figure is misleading. The 1994 action was actually a unification of different exchange rates, with the new value pegged at the then-existing swap rate. Since most transactions were already taking place at the swap rate, *the meaningful devaluation was less than 7%*. Furthermore, the real effective exchange rate (adjusted for inflation and China's trade mix) was devalued by less than 5% and recovered all of this by July 1994. It has since continued to rise, meaning that China's exchange rate has appreciated by more than 1/3 since the unification (figure 1).

Did China's Exports Crowd Out East Asia's?

China's exports have grown rapidly over the past decade -- an average of almost 25% p.a. from 1990-1996. It could be argued that this rapid growth came at the expense of other East Asian countries, and therefore was a proximate cause of the crisis -- devaluation aside. Certainly, Chinese exports must, in some cases, have crowded out exports from the crisis countries. These effects were not, however, sufficient to spark the crisis.

The greatest Chinese export growth has come in the U.S. market, whose imports from China more than tripled between 1990 and 1996, during which period China's market share rose from 3.1% to 6.5%. This growth did not come at the expense of the other East Asian developing nations, however: the market share of these seven (Korea, Thailand, Indonesia, the Philippines, Taiwan, Malaysia and Singapore) changed little over the period, falling from 5.46% to 5.31%.

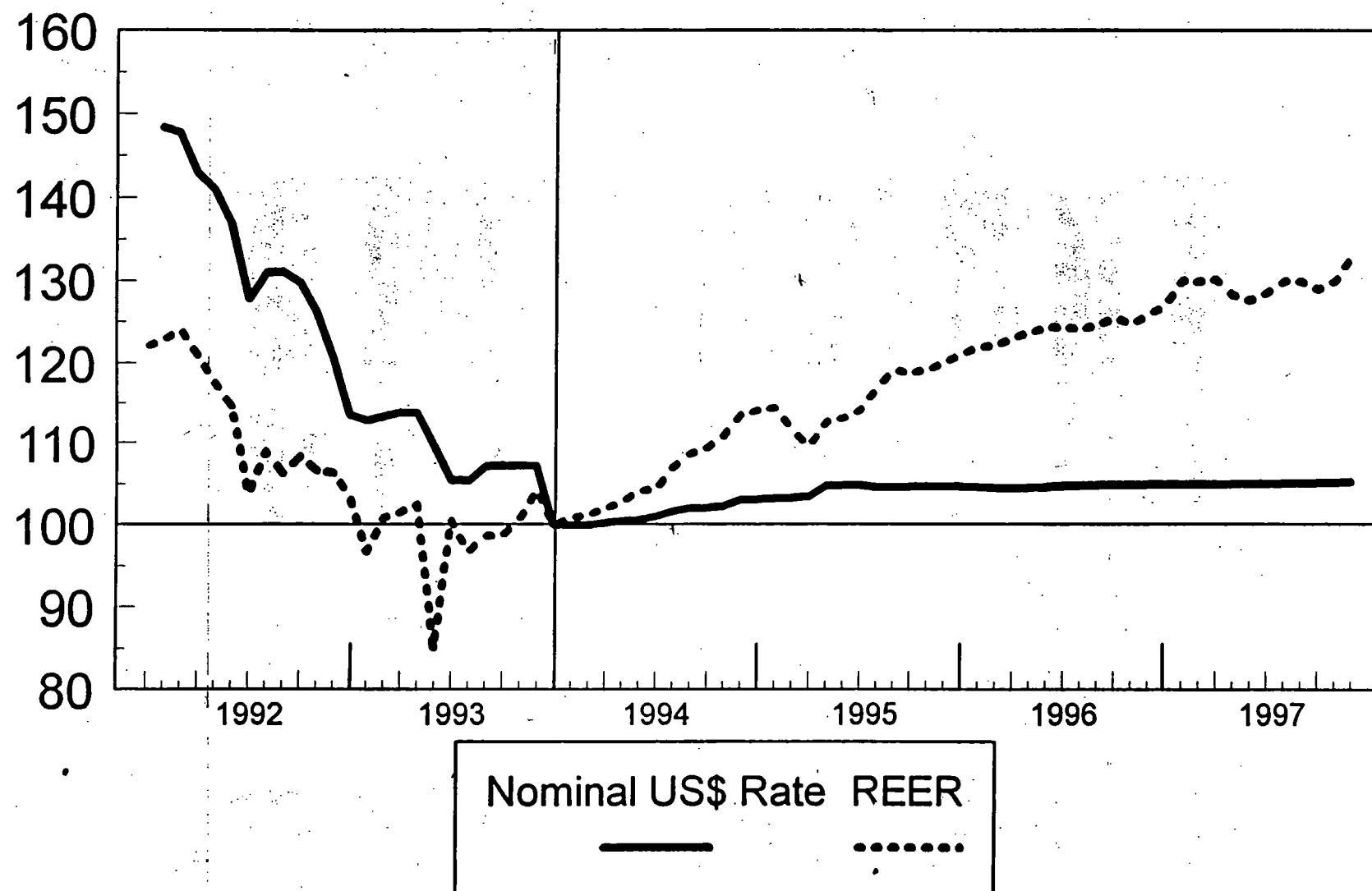
Attributing the crisis to competition from the Chinese export boom would require that Chinese exports to the world grew at the expense of those from the crisis countries. Figure 2 shows that this was not the case, however. Rather, growth rates of exports from China and from the seven East Asian countries tended to rise and fall together, suggesting that developments in the global economy were the primary determinants of export growth rates. Indeed, in 1996, the year before the crisis, Chinese exports grew *less* than those of its neighbors, other than Thailand. Chinese exports grew rapidly again in the first six months of 1997, immediately before the crisis struck, as did those of the Philippines and (less so) Indonesia. Export growth in the other five countries remained sluggish.

Did Imports from China Cause the Crisis?

Chinese exports could conceivably have caused the crisis not by competing with the affected countries' exports, but by providing a surge of imports which threw the balance of payments into catastrophic deficit. All of the crisis countries did, indeed, experience upsurges in their current account deficits in the years before the crisis. Again, however, it is difficult to attribute this to China. While imports grew significantly in all three countries over the 1991-6 period, China's market share remained modest, rising from 5.2% to 6.4% in Korea and from 4.1% to 6.2% in Indonesia, and falling from 5.1% to 3.8% in Thailand. Over this period, China accounted for only 7.4% of Korea's import growth, for 4.3% of Indonesia's and for only 2.3% of Thailand's. In the non-crisis countries (other than Taiwan, for which data are not available), the picture is similar: the Chinese market share grew slightly, but remained in the low single digits in all cases, while imports from China explained only a small portion (2.2-3.4%) of overall import growth.

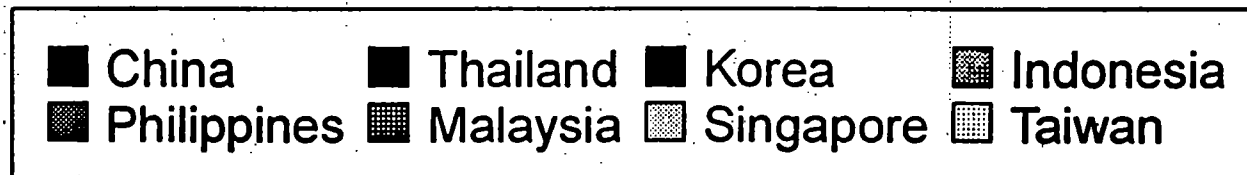
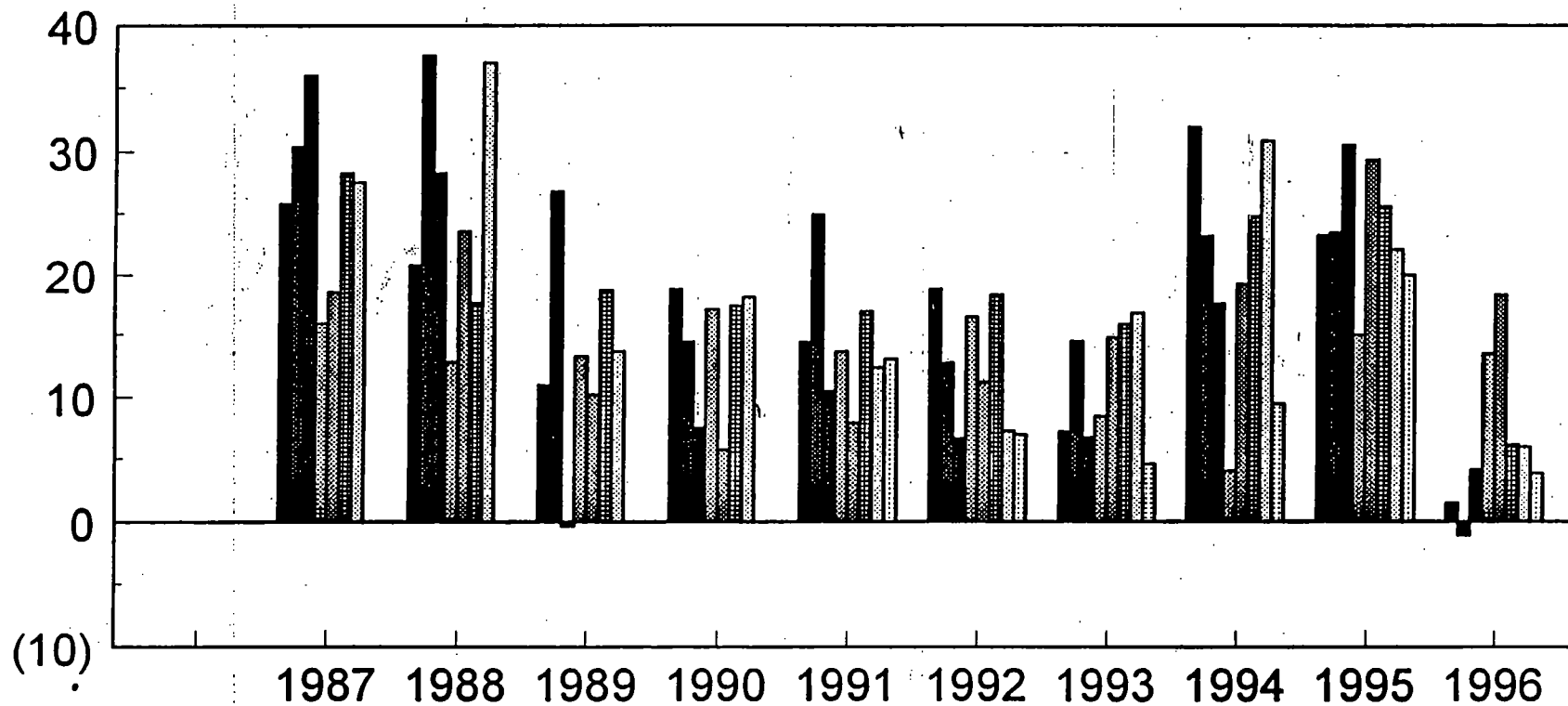
China: Exchange Rates

January 1992 - December 1997

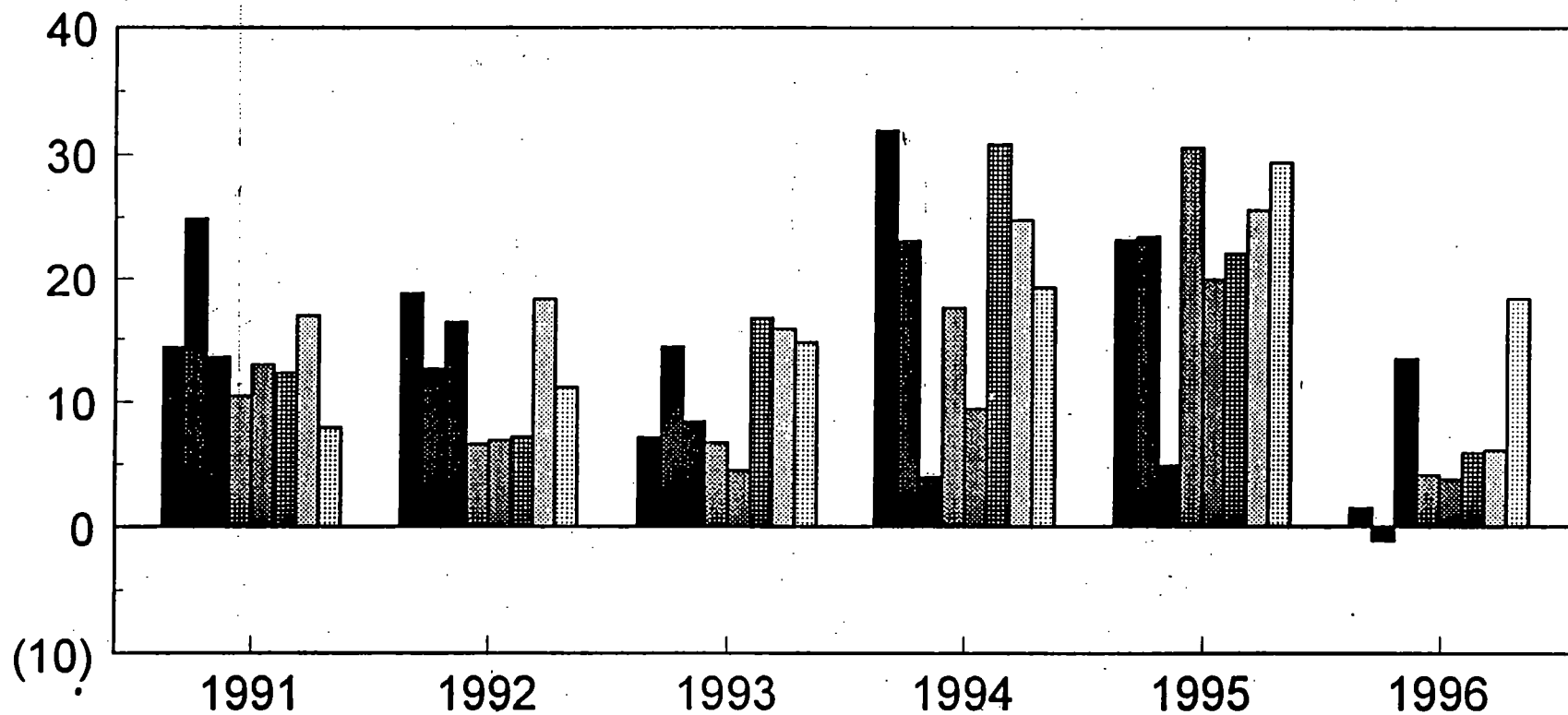


January 1994 = 100; increase indicates appreciation
Rates are weighted averages before 1994
Sources: IMF, Bloomberg

Export Growth, 1987-1996



Export Growth, 1991-1996



China	Thailand	Indonesia	Korea
Taiwan	Singapore	Malaysia	Philippines