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# WORKING PAPER

Emerging Economies

## China in the World Trading System

JOHN WHALLEY

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Working Paper No.2

October 2005

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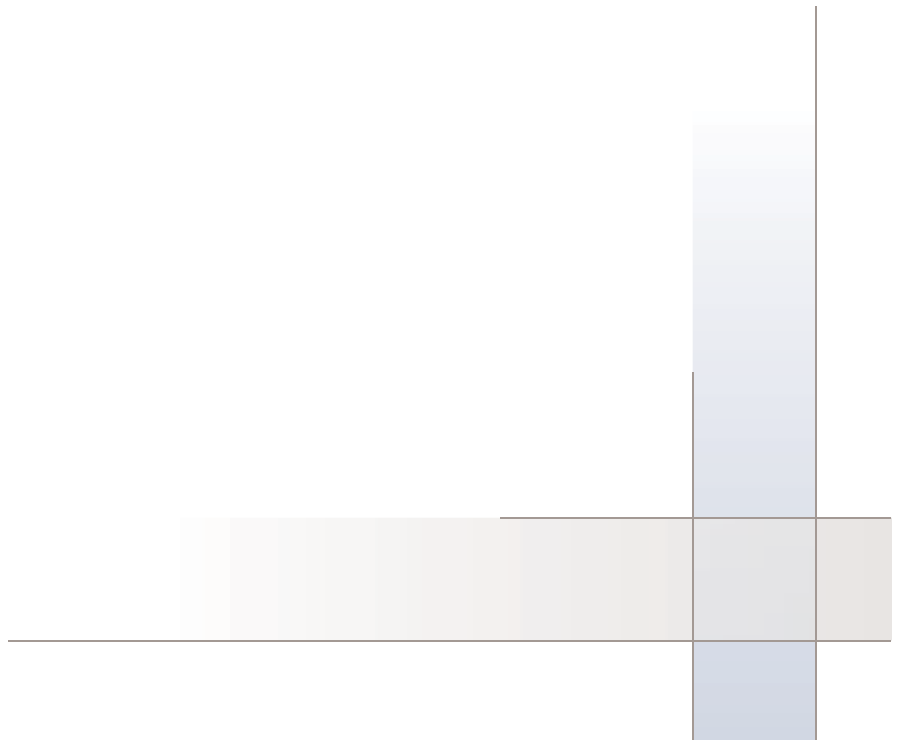
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## **Author Biographies**

John Whalley is one of Canada's most pre-eminent experts in the field of global economics. Currently, he holds a number of academic positions, including Professor of Economics and Director of the Centre for the Study of International Economic Relations at the University of Western Ontario, and Professor of International and Development Economics and Director of the Development and International Economics Research Centre at the University of Warwick. He is also the Co-Director of the ESRC Centre for the Study of Globalization and Regionalization (CSGR), a Research Associate at the National Bureau of Economic Research in Cambridge, Massachusetts, and a former Visiting Fellow at the Institute for International Economics in Washington, D.C.

Dr. Whalley has written and co-authored dozens of scholarly articles on a variety of subjects, including international trade and development, public finance, general equilibrium theory and computation, soviet and transition economies, environmental issues and the economy, and Canadian trade policy. He holds a B.A. in Economics from Essex University (1968), an M.A. from the University of Essex (1969), and an M.A. (1970), M.Phil. (1971), and a Ph.D. (1973) from Yale University.

## **Abstract**

This paper discusses China's trade policy stance following World Trade Organization (WTO) accession in 2002. Three broad issues are considered. The first is the extent to which WTO accession helps China in dealing with various key trade issues, including anti-dumping and the textiles and apparel trade. The second is China's participation in regional trade agreements post WTO accession. The third is the implementability of China's accession commitments in key service areas (banking, insurance, telecoms). The issues now for China are less the merits of WTO accession, and rather its trade policy decisions given WTO membership.

## 1. Introduction

It is widely agreed that China is undergoing a major transformation as growth in the 7-8 per cent range, which began in the late 1980s and continues into the mid-2000s. China's participation and involvement in both the global economy and, more broadly, the world trading system has brought about this transformation. China, a minor player in world trade in the early 1980s, has become the world's third largest trading country (after the United States (US) and Germany). China accounts for approximately 60 per cent of Foreign Direct Investment (FDI) flows from Organisation for Economic Co-operation and Development (OECD) countries to non-OECD countries, and runs large trade surpluses (its reserves currently stand close to US\$ 0.5 trillion).

China's involvement in the global economy, led by substantial and rapidly changing institutional arrangements also faces a series of issues as the country more clearly defines its position within the world trading system today. China acceded to the WTO in 2002, with implementation expected by 2007. The country faces a range of trade policy issues that WTO accession has done little to address, including the growing use of dumping actions against China and the design of a global textile and apparel regime following the end of the Multifibre Arrangement (MFA). China is also actively negotiating regional trade and broader economic co-operative agreements with a growing number of countries; these negotiations have occurred with surprising rapidity after WTO accession.

This discussion draws on three recent papers in this area (Whalley [2003a], Mallon and Whalley [2004], and Antkiewicz and Whalley [2004]) focusing upon several issues involving China's current and future participation in the global system. The first is China's stance on WTO and related global trade issues following accession, and how WTO accession assists in dealing with access issues in areas such as anti-dumping, textiles, and apparel. The second issue is China's emerging network of regional trade and economic co-operation agreements. The third is the implementability of China's WTO accession terms in key service areas (banking, insurance, telecoms).

This paper argues that the structure of the Chinese economy still differs sufficiently from those of OECD economies such that any simple application of

Western neoclassical economic analysis to policy issues in China can be misleading. In a recent speech to the World Economic Forum, Bill Gates suggested that China has created a “brand new form of capitalism,” which he then praised.<sup>1</sup> Instead, the Chinese economy embodies a brand new form of communism (or communalism). In this ideological approach, central direction through planning is removed. However, production units in the urban manufacturing sector remain largely communal in ownership and management structure, with many diverse forms including national, regional, and municipal governments and nongovernmental entities such as research institutes and units of the military.<sup>2</sup> Competition between communally owned units operates and can be aggressive, but many of these units accrue losses. Most units also involve management that seems to maximize size for personal network (guangxi) benefits rather than profits. Until recently, the banking system was primarily a mechanism for recapitalizing loss-making State-Owned Enterprises (SOEs); the banks have also carried large non-performing loans.<sup>3</sup> Finally, individual economic behaviour in China is much more heavily reflective of group (family, village, town, province, country) interest over individual interest than is true in OECD economies.

Taken together, these issues create difficulty in understanding the Chinese economy. It also influences any discussion of China’s participation in the world trading system. This paper argues that the changes in both economic structure and of social and cultural values are profound if the aim for China is to accommodate the world economy with more fully open trade and financial markets. Indeed, these considerations may well determine the extent to which the world and China will eventually integrate.

## **2. China’s Post Accession WTO Stance**

China’s lengthy WTO accession process concluded in 2002 with an agreement that involved tariff reductions and binding in manufactures trade, termination of subsidies to most state-owned enterprises, reduction/elimination of export and

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<sup>1</sup> See “China has a ‘new capitalism’,” at News 24.com. Online at: <[http://www.news24.com/News24/World/News/0,,2-101462\\_1654428,00.html](http://www.news24.com/News24/World/News/0,,2-101462_1654428,00.html)> accessed January 29, 2005.

<sup>2</sup> See H.E Broadman. “The Business(es) of the Chinese State.” *The World Economy*, 24, 7 (2001).

<sup>3</sup> See Bonin, J.P. and Y. Huang who suggest that perhaps 60 per cent of loans to the banking sector are nonperforming in “Foreign Entry into Chinese Banking: Does WTO Membership Threaten Domestic Banks?” *The World Economy*, vol. 25, 8 (2002).



production subsidies in agriculture, as well as far reaching market opening in banking, insurance, and telecoms.<sup>4</sup> These commitments are to be implemented between 2002 and 2007.

Recently, there has been much discussion regarding what brought China into the WTO (or, to Chinese observers, restored their General Agreement on Tariffs and Trade [GATT] membership, suspended in 1950). Arguments have ranged from the need to have the security of firm Most Favoured Nation (MFN) benefits in place of previous, insecure arrangements (subject to periodic review and renewal) to the domestic uses of WTO membership by modernizers who desire genuine, market-based policy reform that would speed growth and reform and curb the power of provinces.<sup>5</sup>

At the conclusion of negotiations, parallel speeches from Chinese negotiators spoke of a fair and balanced arrangement with restoration of normal trade relations, and from the European Union (EU) / US side, of a one-sided agreement in which China had made all the concessions with substantial commercial policy benefit to EU / US business interests.<sup>6</sup> The firmness of MFN benefits alone is insufficient to explain the drive to accession as de facto China had received MFN benefits already, despite periods of Congressional agonizing in the US over human rights and labour standards. Long Yongtu, identified the advantages to China as allowing the development of the service sector; generating international acceptance for China's economy as a market economy; allowing input in setting multilateral global trade rules; and providing greater access to dispute settlement.<sup>7</sup>

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<sup>4</sup> See Mallon and Whalley. "China's Post Accession WTO Stance," (2004) Cambridge, MA: NBER Working Paper No. 10649.

<sup>5</sup> Long Yongtu, the former chief negotiator for China on accession, argued, "We must let those [WTO] rules that stand at the core of the market economy, and which have to be obeyed, take firm roots in our society and country, so that our own market economy may become one that is truly orderly, efficient, honest and clean." See Long Yongtu, "On the Question of Our Joining the World Trade Organization." *The Chinese Economy* 33, 1 (2000).

<sup>6</sup> See the speech by Ambassador Charlene Barshefsky of the US Trade Representative to the Economic Club of Washington (March 16, 2000), describing what were portrayed as China's one-way concessions to US business interests. China's compliance with their WTO commitments discussed in T.P. Stewart, *China's Compliance with World Trade Organization Obligations: A Review of China's 1st Two Years of Membership*. A Report for the US-China Economic and Security Review Commission. (2004) Washington DC: USCC. <[http://www.uscc.gov/researchreports/2004/04annual\\_report.PDF](http://www.uscc.gov/researchreports/2004/04annual_report.PDF)> (accessed June 30, 2004).

<sup>7</sup> Yongtu, 2000.

Now in the WTO, China's interests lie both in using WTO disciplines and in writing new WTO trade rules in ways that most effectively guarantee access to large export markets in Europe and North America. This propitious access is also central to attracting inward FDI to produce for markets abroad. Thus, despite accession, China still faces a number of trade and WTO issues in the short to medium term, which affect both access to foreign markets and the access to domestic markets that China provides to foreigners. Some of these directly involve WTO disciplines; while others are broader reflecting the operation of the wider trading system.

### **Anti-dumping**

China's dynamic surge in exports has resulted in critical challenges in the area of anti-dumping—approximately 17 per cent of all anti-dumping actions occur against China.<sup>8</sup> In addition, under US statute China's classification as a non-market economy provokes a more stringent application of US dumping procedures.<sup>9</sup>

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<sup>8</sup> In the period from July 1, 2002 to June 30, 2003, China was subject to 42 initiations of anti-dumping investigations out of a world total of 238 or approximately 17.6 per cent. See *WTO Annual Report 2004, Table 11.5 Exporters Subject to Two or More Initiations of Anti-dumping Investigations 1 July 2002 – 30 June 2003* at 46 on the WTO website <<http://www.wto.org>>. In the preceding period, China was subject to 46 new initiations of a total 309. See *WTO Annual Report 2003, Table 11.6 Exporters Subject to Two or More Initiations of Anti-dumping Investigations 1 July 2001 – 30 June 2002*, at 83 on WTO website. From 1995-2001 China was subject to 14 per cent of total global anti-dumping actions. See *People's Daily Online*, "China, a Country Suffering Most From Anti-Dumping Cases," April 23, 2002 at <<http://english.people.com.cn>>. According to additional news reports, China has been subject to more than 200 anti-dumping cases since joining the WTO in 2001. See Oliver August, "Change of Beijing's Status May Cost US Billions," in *Times Online*, June 3, 2004 online at <<http://business.timesonline.co.uk/article/0,,131129-1132617,00.html>>.

<sup>9</sup> Article 15 of the protocol on China's accession to the WTO allows other WTO members to treat China as a non-market economy in dumping and subsidy cases for 15 years after its entry (*China Daily*, May 17, 2004). Under US anti-dumping laws, once a US trade authority deems a country a non-market economy it may disregard the prices of products exported from the country since they do not reflect supply and demand, and instead use costs in a third surrogate country to calculate dumping margins. At a hearing on June 3, 2004, the US Commerce Department said US deliberations over whether China is a market-based or state-controlled economy would take at least as long as deliberations on Russia (18 months). See Cheng Dawei, "China Deserves Market Economy Status," in *China Daily*, May 17, 2004 and Doug Palmer, "China Market Economy Bid Could Take Years," *US Reuters*, June 3, 2004.

China, in turn, has begun to intensify its own use of anti-dumping duties.<sup>10</sup>

WTO accession formally provides China with little additional defence against the use of anti-dumping measures by other countries. Article 6 of the GATT 1994 effectively legitimizes the use of anti-dumping measures, and only constrains their use procedurally by specifying how domestic administrative tribunals should determine their use. It is thus difficult to claim that WTO membership offers China any significant added benefits in dealing with this major access problem facing continued export growth. China may be able to push more aggressively for anti-dumping reform in the WTO, long seen as unacceptable by the US Congress even after China's WTO accession; however, for now this still appears non-negotiable.

China also faces the issue of whether to fight anti-dumping actions if the legal and informational costs are high. Press reports in the *People's Daily Online* claim that China had won over 37 per cent of anti-dumping cases in the 10 years prior to accession,<sup>11</sup> but at a high cost in legal fees and other charges. If dumping actions against China are focused on particular products, a simple strategy is to respond by producing and exporting other items. However, if dumping actions continue against China and grow in coverage, at some point the export product range will become sufficiently restricted such that export performance will suffer possibly in significant ways.<sup>12</sup>

## Trade Disputes

As China is now a WTO member, it faces a growing list of trade disputes, some of which have the potential to spawn a significant number of new WTO dispute panels. The list of potential disputes as reflected in the 2003 United States Trade

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<sup>10</sup> China initiated 17 anti-dumping actions from July 1, 2002 to June 30, 2003. See *WTO Annual Report 2003, Table 11.5: Summary of Anti-dumping Actions, 1 July 2002 to June 30, 2003*. The country initiated no actions in the previous year. China filed 24 anti-dumping cases in the period from 1997 to Sept 2003. See *People's Daily Online*, "China Files 24 Anti-dumping Cases since 1997: Official, September 14, 2003," <<http://english.peopledaily.com.cn>>.

<sup>11</sup> See *People's Daily Online*, "China Won 37.5% Anti-Dumping Cases in Past Ten Years". March 29, 2002. <[http://www.english.peopledaily.com.cn/200203/29/print\\_20020329\\_93087.html](http://www.english.peopledaily.com.cn/200203/29/print_20020329_93087.html)>.

<sup>12</sup> China has also begun to use domestic antidumping procedures. Investigative procedures for imports were implemented in March 2005, initially with two investigations, one regarding stainless steel imports from Japan and Korea, and the other on imports of Spandex from Singapore, Japan, Korea, and the US.

Representative (USTR) National Trade Estimate Report on Foreign Trade Barriers identifies a number of potential areas of US-China trade conflict, including import substitution policies in China in several product areas. These include fertilizer; automobile investment guidelines; tariffs on products that compete with sensitive domestic industries such as motorcycles and electronic equipment; tariff classification and customs valuation procedures; Chinese border policies that give preferential treatment to non-US imports (such as Russian timber);<sup>13</sup> non-tariff barriers in the form of regulations that set entry barriers to trade in services such as banking and insurance; unwarranted inspections of agriculture products; rules on biotechnology products; the use of sanitary and phytosanitary measures to control import volumes; and export subsidies on corn.<sup>14</sup>

WTO disciplines define clear rights for other WTO members when accessing China's markets for goods and services and allowing China use of intellectual property. Whether, by more clearly defining such rights, accession to the WTO has merely added to the list of disputes and hence the pressure for change in China, or whether the added clarity of rights for other WTO members works to accelerate trade and investment flows is unclear. China has thus to decide if WTO trade disputes, while superficially disruptive from a practical viewpoint, may speed modernization in China and confirm the arguments that led the country into the WTO in the first place. Alternatively, it must also decide if anticipated WTO disputes will add new pressures to implement policy changes that China does not yet wish to make.

On the offensive side of the trade dispute equation, China has thus far shown considerable reluctance to use the WTO membership to assert its rights. There have been no WTO trade panels initiated by China,<sup>15</sup> although it has been active in pressuring foreign governments on various trade matters such as the use of special

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<sup>13</sup> Russia is not a WTO member and so this practice by China is WTO-compatible.

<sup>14</sup> See United States Trade Representative, *2003 National Trade Estimate Report on Foreign Trade Barriers* (2004).

<sup>15</sup> Although China was the second of nine members to request a panel against the US on safeguards on imports of certain steel products. See *Request for a Panel against US Imports of Certain Steel Products*, April 2, 2002, on WTO website.

safeguards in textiles and apparel in the US, Japanese farm measures affecting Chinese exports,<sup>16</sup> and EU environmental barriers on Chinese appliance exports.<sup>17</sup>

The one dispute that has thus far resulted in a formal WTO panel against China involves the treatment of imported semiconductor memory chips into the Chinese market. Under the Chinese national value-added tax, imported chips are subject to a value-added tax of 17 per cent; however, domestically produced chips are eligible for special tax rebates that lower the effective tax rate to between three per cent and six per cent.<sup>18</sup> The US alleges that this practice is a violation of National Treatment (GATT 1994, Article 3). The EU and other suppliers, including Taiwan, have also notified an interest in the case to the WTO.<sup>19</sup> In July 2004, after negotiations with the US, China agreed to remove the differential tax treatment of domestic and imported memory chips after April 1, 2005.

Other emerging trade disputes involve financing packages offered by foreign automobile producers in the Chinese market were initially disallowed because China had yet to implement WTO commitments regarding financial services.<sup>20</sup> Another issue centres on the current Renminbi exchange rate and whether it is a factor in China's significant trade surplus position which supports a GATT 1994 Article 23 nullification and impairment action by exporters to China.

China has recently concluded a bilateral agreement on imports of coking coal from the EU, reflective of an approach that uses bilateral accommodation to defuse trade conflicts.<sup>21</sup> China's import quota in this area will sharply increase, although not remove, as WTO disciplines would seem to imply. The case will likely lead to

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<sup>16</sup> See Meng Yan, "Unfair Measures Condemned," in the *China Daily* (North American Edition), June 3, 2003. These complaints relate to a Japanese announcement to block imports of Chinese fowl and eggs in May 2003 after a flu virus was detected in exports originating in Guangdong.

<sup>17</sup> See *People's Daily Online*, "EU Environmental Barriers to Chinese Appliances," February 17, 2004 <<http://english.peopledaily.com.cn>>. This matter relates to a new EU directive on waste from electronic equipment that will impose a fee of one to 20 Euros on any colour TV or mobile phone exported to the EU.

<sup>18</sup> See *The Economist*, "Business: Broken China; The Chip Industry", January 10, 2004. 370, 8357: 57.

<sup>19</sup> See *China – value-added tax on integrated circuits – Request to Join Consultations, Communication from the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu*, April 5, 2004 on WTO website, and *China – value-added tax on integrated circuits – Request to Join Consultations, Communication from the European Communities*, March 30, 2004 on WTO website.

<sup>20</sup> See Xiao Zhang, *China Daily*, November 14, 2003.

<sup>21</sup> See Dai Yan, *China Daily*, May 31, 2004.

similar arrangements with other exporters of coking coal to the Chinese market, and possibly in other product areas.

## **Textiles and Apparel**

Key access-related issues for China also arise in the textiles and apparel trades. China is now the dominant exporter of apparel items from outside the OECD countries, in value terms accounting for approximately 45 per cent of non-OECD exports in 2002. Currently, China and India jointly account for most apparel exports from non-OECD to OECD countries<sup>22</sup> with a number of smaller suppliers in Asia, Eastern Europe, Central America, and Latin America garnering small shares of the global trade that nonetheless represents a large fraction of their countries' exports.

Several issues arise with the termination of the MFA at the end of 2004, as agreed in the Uruguay Round. This affects all MFA exporters, but the situation is especially critical for China. One issue is whether free trade will really replace the MFA in the medium to longer term. Scenarios for a post-MFA elimination regime abound, from a growing wave of new anti-dumping petitions from domestic producers in OECD countries forcing a new market-sharing regime (as exemplified by steel in the mid-1900s) to the use of broader safeguard measures<sup>23</sup> by OECD countries on textile and apparel products.

The concerns in the US and in the EU over labour adjustment from affected industry groups are clear and strongly stated.<sup>24</sup> A 2003 article from the Asian Labour News documented pressures in the US for use of new selective MFA transitional safeguards against apparel imports from non-OECD countries.<sup>25</sup>

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<sup>22</sup> See *Leading exporters and importers of clothing, 2002, Table IV.69*, WTO web site. This is in sharp contrast to the 1980s, when Hong Kong, Taiwan and Korea accounted for 60 per cent of such exports.

<sup>23</sup> GATT 1994, Article 19.

<sup>24</sup> See *The Standard*, "US Fears Massive Job Losses as Controls Lifted," August 2, 2003 <[http://www.thestandard.com.hk/news\\_detail\\_frame.cfm?articleid=40801&intcatid=1](http://www.thestandard.com.hk/news_detail_frame.cfm?articleid=40801&intcatid=1)>.

<sup>25</sup> See *Asian Labour News*, "China: US Invokes 'Safeguard' on Textile Imports," November 19, 2003. <<http://www.asianlabour.org/archives/000022.html>>.

Presently, MFA importers seem content to allow the continuation of special selective safeguards to define the regime as formulated in the Uruguay Round under the Agreement on Textiles and Apparel that terminated the MFA. However, as of March 1, 2005, China also implemented unilateral export taxes on a number of export items; in part due to pressure from other low wage exporters fearing MFA elimination will erode their export market share. China has also instituted a monitoring and approval procedure for textile and apparel exports. In addition, refunds of value-added tax on inputs for exported apparel items have been terminated. China is therefore following a policy of export restraint following MFA termination.

China's interest clearly lies in obtaining unhindered export access for this key area of Chinese trade through full access to OECD export markets for textile and apparel exports. The belief is both that exports to OECD countries will grow even more rapidly under free access, and that higher cost production, which has relocated to smaller countries in the region because of quotas on Chinese exports, will relocate in China. The question is whether China has an advantage now that it is inside the WTO, which it can use to ensure continued termination of restraints on these exports. It begs the question as to whether China could use WTO membership to link its position on textiles and apparel to other issues, including the remaining implementation of Chinese accession terms.

### **The Domestic Regulatory Regime**

Challenges with China's WTO accession also arise through efforts to refocus the domestic regulatory regime implied in the medium term. Standards issues involving China's trade figure prominently in the USTR foreign trade barrier reports regarding a lack of transparency in the certification process, lack of co-ordination among standards bodies and other agencies, burdensome requirements, and long processing times for licenses.<sup>26</sup> US and EU companies frequently claim that achieving certification under China's Compulsory Certification system is time-consuming, difficult, and costly, and that they are subject to redundant testing for cosmetics, pharmaceuticals, and several consumer

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<sup>26</sup> See United States Trade Representative, *2003 National Trade Estimate Report on Foreign Trade Barriers* (2004) at 67-71.



electronic products, inconsistent application of sanitary and phytosanitary measures, and excessive or inappropriate food labelling requirements. An illustration of such problems is China's Wireless LAN encryption standards, which differ from internationally recognized standards and force international companies to work through the few Chinese manufacturers who possess the necessary algorithm to meet these standards.

According to Li Zhonghai, director of China's standardization watchdog, China now has 20,900 compulsory national standards covering safety, hygiene, and environmental protection with more than 2,300 new national standards under creation. He states that only 44 per cent of China's standards reflect agreed international standards; the challenge is to modify remaining standards, and to rewrite domestic regulatory standards relating to health, safety, electrical, product liability, and other matters. While few studies exist, standards are widely agreed to impact domestic policy regimes on trade.

### **3. China's New Regional Trade Agreements**

Another key area of China's trade policy post WTO accession involves regional trade agreements (RTAs) aggressively pursued since 2002.<sup>27</sup> RTAs or initial frameworks of agreements, are now in place for China with Hong Kong, Macao, ASEAN, Australia, and New Zealand. Discussions on possible further Free Trade Agreements (FTAs) with India, Chile, Singapore, South Africa, and the Gulf Cooperation Council (GCC) are underway. Possible direct or indirect arrangements involving Korea and Japan are also the subject of speculation.

China, like other major trading powers (the US and the EU), has clear incentives to commit to multilateral disciplines in the WTO as a way of gaining non-discriminatory access to large markets and as a means of heading off discrimination in both these and smaller third-country markets. China has equally clear incentives to negotiate supplemental regional arrangements that deal with interests in local markets in ways that go beyond WTO disciplines. The US, with the North American Free Trade Agreement (NAFTA), and the EU, with accession and other agreements, have encountered similar incentives with equal results.

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<sup>27</sup> This section draws on Antkiewicz and Whalley. "China's New Regional Trade Agreements." (2004) Cambridge, MA: NBER Working Paper No. 10992.



There are several striking features of China's emerging network of agreements that differentiate it from both the one time negotiation of NAFTA by the US in 1991, and the process of ever-deeper EU integration initiated by the 1957 Treaty of Rome. The first feature of these agreements is their diversity, both in form and coverage. For example, the agreement with Hong Kong is concrete and focuses on both goods trade and cross-border investment and financial activities, while the agreements with Australia and New Zealand largely provide general statements of intent in a much wider number of areas. This diversity of approach affects the prospects for an eventual emergence of a trade bloc centred on these agreements.

A further feature is their seeming brevity, and hence the inevitable vagueness of the texts involved; the Hong Kong and Macao Closer Economic Partnership Arrangements (CEPA) have only 13 pages of main text with additional annexes. The negotiation of regional trade agreements for China seemingly represents as much a process of ongoing trade management, as agreement on a single legal text that defines rights and obligations. Much remains for subsequent joint agreement and mutual management of the trade relationship. Finally, also noteworthy are the extensive lists of specific bilateral commitments in services (especially in the case of CEPA), which go beyond the form and type of commitments undertaken by most WTO members in the General Agreement on Trade in Services (GATS). There is also substantial attention devoted to arrangements for both joint ventures and the operation of financial institutions in a joint regulatory environment in the Hong Kong Arrangement.

### **The Closer Economic Partnership Arrangements with Hong Kong and Macao**

The China with Hong Kong CEPA signed on June 29, 2003, with the aim of promoting joint economic development and further developing links between China, Hong Kong, and other countries or regions. The Macao CEPA which followed, is almost identical to the Hong Kong document. Minor differences include somewhat different names of agencies and regulations in Hong Kong and Macao, and the lists of goods in the Tables in Annexes 1 and 2 differ in some areas.

The Hong Kong CEPA contains 13 pages of text and six annexes. Its main content lies in progressive bilateral reduction or elimination of tariff and non-tariff

barriers applying to goods trade, reducing bilateral restrictions on service trade, and various steps to further promote bilateral trade and investment. The Hong Kong CEPA was notified to the WTO on January 12, 2004.<sup>28</sup>

China has agreed to introduce zero tariffs for a list of goods specified in Annex 1 as of January 1, 2004<sup>29</sup> and full elimination of bilateral tariffs to occur no later than January 1, 2006. All goods have to meet CEPA Rules of Origin, as set out in Annex 2. To acquire Hong Kong origin, a product must have 30 per cent value added in Hong Kong (this includes the value of raw materials, labour costs, component parts, and product development costs). Foreign companies in Hong Kong can export goods to China under CEPA if the products meet the value-added requirement.

The agreement also specifies that neither party is to introduce new quotas or other barriers towards bilateral imports, and neither party will use any-dumping actions against the other. CEPA allows for safeguards actions in goods trade after written notice, but these safeguards measures remain unspecified.

Bilateral liberalization of trade in services is specified in Annex 4 of both CEPAs. Eighteen services sectors are listed with specific bilateral commitments in each. The list includes, among others, management consulting, advertising, accounting, real estate and construction, logistics, freight forwarding, telecommunications, and legal services.

The agreement applies to a range of financial activities, banking, insurance, and securities, and opens financial markets in mainland China to entities from Hong Kong. CEPA, for example, lowers the required minimum assets for Hong Kong banks that establish branches in China from US\$20 billion to US\$6 billion. A significant innovation in these agreements is the definition of a new services entity, “a Hong Kong service supplier” (Annex 5), which opens doors to Chinese markets for international companies who can utilize this entity.<sup>30</sup> Benefits from the bilateral

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<sup>28</sup> See Notification From Parties, WTO WT/REG162/N/1, Jan. 12, 2004, and Minutes of Meeting of the Council for Trade in Goods, WTO G/C/M/72, January 26, 2004. To date, a working party has not been established and factual examination by the WTO Committee on Regional Trade Agreements has not begun.

<sup>29</sup> See Table 1 of Annex 1, 273 goods covering medicines and toys, among others.

<sup>30</sup> The Macao CEPA has a similar Macao service supplier company construct.

scheduled commitments in services only apply to this entity. To qualify, such a company must be established in Hong Kong for more than three years (five years for construction, banking, insurance, and related services), pay applicable profit taxes, have business premises (owned or rented) reflecting business activities in Hong Kong, and employ at least 50 per cent of the staff from amongst permanent residents. The intended business in China must be the same as the company's substantive business in Hong Kong, and documentation is required to establish this.

For the purposes of the agreement, CEPA also recognizes service companies acquired by an overseas company as a Hong Kong service company one year after the merger or acquisition takes place. Any qualifying Hong Kong company operating in China must have a Hong Kong Service Supplier Certificate issued in Hong Kong. Annex 5 excludes any overseas company registered in Hong Kong that is “specifically established for providing certain services to its parent company,” for example, representative offices and “mailbox companies.”

Both CEPAs also provide for co-operation in tourism and mutual recognition of professional qualifications, and both contain trade and investment facilitation provisions under which China and Hong Kong (Macao) agree in seven areas of co-operation. The overall co-ordination and implementation of each CEPA is through a Joint Steering Committee, established to resolve disputes and interpret provisions (Article 19).

In August 2004, further details beyond those in the original CEPA were established taking the form of a Record of Consultation on Further Liberalization under the Mainland and Hong Kong CEPA. In goods trade, China agrees to apply zero tariffs to the next stage of goods imported from Hong Kong at the beginning of 2005. This includes 713 goods (and applies to both existing and planned production) covering food, chemical, mechanical, and electronic products. Rules of Origin for these goods (which can differ from those in the original CEPA) concluded in October 2004. In services trade, China will further relax access conditions for Hong Kong service suppliers (no details provided). This includes 11 sectors specified in the original CEPA, and eight new sectors including among others airport, information technology, job intermediaries, and marketing services. These new commitments were established in January 2005 and are ongoing.

## **The ASEAN – China Agreement**

A China and Association of South East Asian Nations (ASEAN) Framework Agreement on Comprehensive Economic Cooperation concluded in November 2002, but is less concrete than the CEPAs. It sets out a broad framework in 21 pages of text and four annexes to accommodate more detailed agreements to follow.

The parties agree to work towards the establishment of a FTA between China and ASEAN within 10 years, however, what this will comprise and what its institutional underpinnings will be are unclear. What will be sought are elimination of tariffs and non-tariff barriers in goods trade, liberalization of services trade, promotion of bilateral investment, simplification of customs procedures and the establishment of mutual recognition arrangements. A China and ASEAN FTA with the original ASEAN six (Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand) is to be established by 2010, and by 2015 with the newer ASEAN members (Vietnam, Lao PDR, Myanmar, and Cambodia). Bilateral tariffs will lower to 0-5 per cent on most goods and non-tariff barriers will be eliminated.

Goods subject to reduction/elimination, along with tariff rates, schedules, and Rules of Origin are to be negotiated by the parties and spelled out in subsequent detailed agreements. The 2002 ASEAN-China agreement Early Harvest Programme which began in 2004 (Annex 1) cuts tariffs ahead of the planned establishment of the FTA in 2010. Any bilaterally agreed safeguard arrangements and disciplines on subsidies and anti-dumping measures based on existing GATT disciplines will be elaborated.

In trade in services, the parties plan to negotiate progressive elimination of all discrimination in new and existing service restrictions (unless permitted under GATS). In the investment area, the parties are to liberalize their investment regimes, strengthen co-operation, and improve transparency of rules and regulations.

The agreement also covers other possible areas of co-operation beyond trade in goods and services in unspecified ways in agriculture, information and communications technology, human resources development, investment, Mekong River basin development, banking, finance, transport, energy development, and

tourism. Co-operation will also cover promotion and facilitation of trade and investment through agreed standards (and conformity assessment); agreement on technical barriers to trade and non-tariff measures; customs co-operation; increasing the competitiveness of small - and medium-sized enterprises by promoting electronic commerce, capacity building, and technology transfer.<sup>31</sup>

Trade between China and ASEAN continues to grow, but still represents only three per cent of exports and five per cent of imports for the ASEAN 6. China will gain from more open markets for Chinese manufacturers and a more stable supply of raw materials (ASEAN is China's fourth largest supplier).<sup>32</sup> The FTA may also bring faster liberalization within the ASEAN itself as non-tariff barriers affecting goods and services trade toward China are removed.

### **Chinese Regional Agreements with Australia and New Zealand**

Besides the CEPA and ASEAN agreements, China has also signed two broad framework agreements with Australia and New Zealand, which may indicate how China plans to proceed in regional agreements with other OECD countries.

A Trade and Economic Framework between Australia and China, signed in October 2003, sets out areas of future co-operation that aim to “achieve balanced and comprehensive trade and investment facilitation and liberalization.”<sup>33</sup> The text is brief, containing three pages and two annexes (Annex 2 is six pages long). Paragraph 2 and Annex 1 indicate the specific areas where the parties will promote strategic co-operation and create favourable conditions for trade and investment in energy and mining, as an example. China and Australia state their wish to improve their joint regulatory and policy climate, co-operate in training, research, and development, and promote business linkages and exchanges. Additional arrangements will be concluded on a Natural Gas Technology Partnership Fund to enhance mutual understanding in the field of clean energy. In textiles, clothing, and footwear, China and Australia commit to hold regular trade fairs and exhibitions, encourage the development of business links and contacts, and support joint

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<sup>31</sup> See Article 7, Paragraph 3.

<sup>32</sup> See M. Vatikiotis, “China’s Tight Embrace,” in the *Far Eastern Economic Review*, July 1, 2003.

<sup>33</sup> See Paragraph 1.

ventures and joint development of brands. In agriculture and quarantine inspection, China and Australia will co-operate further under existing agreements<sup>34</sup> and conclude other Memorandums of Understanding (MoUs) and Protocols.<sup>35</sup> The two countries will also strengthen communication and consultation mechanisms regarding quarantine procedures. The text in these is not detailed, but mentions a dialogue on quarantine management regulations, registration policies and other practices, and consultation on food safety inspection and certification issues.

In the services area, the parties plan to co-operate on education and training through mutual recognition of professional qualifications, joint labour services, and facilitation of travel for Chinese personnel to Australia. The parties also plan to work together on engineering, resources, and mining development projects. There are few details, but the possibility of Chinese firms investing under contract in Australian projects in these fields has been raised. Investment between the two countries is to be enhanced through information exchanges, improved transparency and predictability of measures, and protection of investors and investments. The parties also commit to build institutional linkages between government agencies to promote co-operation and consultation.

In the area of technical barriers to trade, the countries will seek to improve trade facilitation by concluding a bilateral understanding that supplements multilateral commitments for quality supervision, inspection, and quarantine, and strengthening communication and consultation mechanisms. They will also strengthen co-operation in standards, certification, and accreditation including exchanges between officials and experts, and conclude a mutual recognition agreement covering mechanical and electronic products. In information and communications technology and e-commerce, the two countries plan to intensify their co-operation under an existing 1999 MoU. The countries will also explore improving facilitation of visa procedures for both work and business visas and support industry and business groups to strengthen bilateral trade. In anti-dumping, the countries plan to set up bilateral mechanisms for notification so that conflicts can be resolved through dialogue and consultation.

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<sup>34</sup> The 1984 Agreement on Agricultural Cooperation and the 1984 Protocol on a Program of Cooperation in Agricultural Research for Development.

<sup>35</sup> A Plant Quarantine Protocol on Australian Wheat and Barley Imports into China, a MoU on Cooperative Activities in Water Resources, and an MoU on Cooperation on Sanitary and Phytosanitary Matters.

Australia and China have also completed a Joint Feasibility Study in which the parties agree to negotiate a formal FTA. The Study provides an overview of trends in bilateral trade and wider economic interaction and assesses recent international trade policy developments and possible implications for trade and investment. The Study aimed to identify and describe existing barriers to trade and investment flows (in goods, services, and investment), possible co-operation to promote trade and investment liberalization, to assess the impact of the removal and/or reductions of barriers in trade of goods and services and investment, and to make recommendations for future action. Before FTA negotiations start, Australia will consider recognizing China as a market economy, which is important to China in its dealings with anti-dumping measures in countries (such as the US) who use different procedures for exporters designated as being from non-market economies.

China and New Zealand also signed a Trade and Economic Cooperation Framework Agreement in May 2004, similar to China's agreement with Australia. Through this the parties state their interest in seeking "comprehensive trade and investment facilitation and liberalization through all-round economic and trade co-operation" and agree on areas of further negotiation.

Specifically listed are areas of "significant mutual economic potential" where the countries will promote strategic co-operation. In agriculture, animal husbandry, forestry, biosecurity, and food safety, the parties will strengthen co-operation and further development of Joint Commissions established in 2001. Wool trade will be promoted using each countries respective trade organizations. New Zealand also offers to help China through training and technological co-operation in these areas. In science and technology, the parties will further develop the Agreement on Cooperation in Science and Technology signed in 2003. They will also seek to enhance co-operation between the two countries research and innovation communities.

In the area of technical barriers to trade, the parties plan to use WTO/Technical Barriers to Trade mechanisms. The issue is how to strengthen communication and consultation on technical and inspection regulations and standards so that reductions in costs to business are achieved. The aim is to conclude a co-operative framework program for quality supervision, inspection, and standards and



conformity assessment and also to enhance arrangements for consultation between certification agencies to support recognition of each other's testing and certification requirements.<sup>36</sup>

By developing a MoU concerning information and communication technology and e-commerce, the two countries will expand trade in services and explore possibilities for co-operation in education, tourism, air services, labour, and professional services. The parties aim to increase investment by exchanging information, enhancing transparency and predictability, protecting investments and investors, and building institutional linkages to promote investment visits, business to business initiatives (or B2B), conferences, and other innovations.

As with the Australian Framework Agreement, stress is on the importance of regular bilateral meetings between leaders and ministers. The countries have established a Joint Ministerial Commission as a forum for a dialogue on joint trade and economic issues. China and New Zealand will strengthen the role of their Joint Trade and Economic Commission and other sectoral Joint Commissions.

Unlike Australia, New Zealand has immediately recognized China as a market economy<sup>37</sup> and has agreed not to implement any anti-dumping measures against China under sections 15 and 16 of the WTO accession protocol, and paragraph 242 of the Report of the Working Party on China's accession to the WTO. The parties commit to undertake a Joint Feasibility Study<sup>38</sup> on a bilateral Free Trade Agreement and commence negotiations on establishing a FTA as soon as possible. China–New Zealand FTA negotiations will be the first China has had with a developed country, and there are good reasons for the country to choose New Zealand in this way: New Zealand has a one-China policy; it recognized China early in the 1970s; and reached early agreement on China's accession to the WTO.<sup>39</sup>

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<sup>36</sup> The aim is also to enhance cooperation in WTO-related training for Chinese personnel. The plan is to utilize the China-Australia-New Zealand Standard Wool Contract, establish liaison channels, enhance contacts and linkages, and adopt administrative measures to deal with outstanding issues.

<sup>37</sup> New Zealand is the first developed country to recognize China as market economy.

<sup>38</sup> See Annex 2.

<sup>39</sup> See Colin James. "Deal With It," in the *Far Eastern Review*, Apr. 22, 2004: 20.



## Other Potential Chinese Regional Agreements

While formal agreements involving China are limited, an agreement with India has been proposed. While there is no official text for any pre-FTA agreement between India and China thus far, both countries appear to be moving towards FTA negotiations. In the past, there have been border disputes between the countries; however, it seems that they now share common interests in trade and WTO matters.

A joint declaration signed after the Indian prime minister's visit to China in June 2003 indicated plans to use measures consistent with national laws and international obligations to remove impediments to bilateral trade and investment.<sup>40</sup> China and India have discussed possible bilateral trade arrangement on preferential tariffs (more preferential than the MFN tariffs) on a range of products, including paper, steel, chemicals, and food. The list includes 217 Indian exports and 188 Chinese exports, which would face lower than average tariffs in each other's market.<sup>41</sup> In June 2003, the two countries agreed to form a Joint Study Group to explore the potential for expanded bilateral trade and co-operation.<sup>42</sup> The resulting India-China Group met in March 2004 with the aim of preparing a five-year blueprint for bilateral trade and co-operation.<sup>43</sup>

Chile is now involved in trade negotiations with China. The two countries announced a feasibility study in April 2004 to consider strengthening trade and co-operation, and creating a FTA. The study evaluated a Chile-China FTA in different sectors and overall economic relations covering goods, services, and investments. Negotiations between China and Chile are expected to start later this year, and at this time, Chile may well announce recognition of China's market economy status.<sup>44</sup>

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<sup>40</sup> See *The India and China Declaration on Principals for Relations and Comprehensive Cooperation*. June 23, 2003 accessed through <<http://sify.com/news/pm-inchina/fullstory.php?id=13180463&vsv=574>>.

<sup>41</sup> See the *Decan Herald*, "India-China Preferential Trade Agreement Implementation Soon," July 26, 2003.

<sup>42</sup> See S. Sethuraman, "India & China: On a Path of Cooperation," in the *The Kashmir Telegraph*, August 2003 vol. 2, no. 4, online <<http://www.kashmirtelegraph.com/0803/eight.htm>>.

<sup>43</sup> See *Outlook India*, "India-China Joint Study Group Holds First Meeting," March 22, 2004.

<sup>44</sup> See China and Chile Joint Communique, June 29, 2004.

South Africa has also become an area of bilateral activity for China. In June 2004, China and South Africa issued a joint communiqué in which South Africa granted China market economy status. In the communiqué, China and South Africa also announced their plan to launch FTA negotiations. In the declaration, the two countries stated that they would work on encouraging bilateral trade and investment and expanding co-operation in “areas of mutual economic interest.”

There are also bilateral activities with the Middle East. In July 2004, China and the GCC (UAE, Bahrain, Kuwait, Oman, Qatar, and Saudi Arabia) signed a Framework Agreement on Economic, Trade, Investment, and Technological Cooperation. Under this agreement, the two countries encourage co-operation and technological exchange, expand trade, and promote mutual investment. They will also establish a Joint Committee on co-operation to implement the agreement and create a consultation mechanism.

China and the GCC have also agreed to launch negotiations on a FTA (the dates have not yet been set).<sup>45</sup> If established, a China-GCC FTA would be the second Chinese agreement with a regional group, the ASEAN agreement being the other. China’s aim would be to benefit from secure oil imports from the Gulf countries and to expand exports of garments, fabrics, and electronics to the region. China also seeks increased GCC investment in water and electricity supply, the energy and mineral industries, transportation, and communication, and closer co-operation in scientific and technological research.<sup>46</sup>

Singapore and China started consultations on a possible FTA after China concluded the ASEAN Agreement. Talks scheduled for November 2004 were delayed following the Singapore deputy prime minister's visit to Taiwan in September 2004.<sup>47</sup>

China has therefore intensified regional negotiations, proceeding pragmatically in different ways with various potential partners. These negotiations seemingly represent progressive engagement and the development of inter-country relationships as much as precise text with clearly defined and precisely articulated

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<sup>45</sup> See China and GCC Joint Communiqué, July 7, 2004.

<sup>46</sup> See Bo Xilai, Ministry of Commerce release, July 9, 2004.

<sup>47</sup> See Agence France Presse, August 3, 2004 and July 25, 2004.

commitments. Agreements go well beyond trade and services, and cover many areas of co-operation not touched on in WTO agreements.

#### **4. China's WTO Commitments and Key Service Sectors**

This section discusses the policy changes that WTO accession implies in key service categories in China (banking, insurance, and telecoms).<sup>48</sup> The commitments in these areas are deep and wide-ranging. Between 2002 to 2007, China has committed to opening all of its service markets to full international competition from foreign service providers in a series of key areas: distribution, telecommunications, financial services, professional business and computer services, motion pictures, environmental services, accounting, law, architecture, construction, and travel and tourism. Barriers to entry in the form of discriminatory licenses to operate are to be removed as well as conduct barriers in the form of differential regulation for domestic and foreign entries. China has also agreed to undergo a special Trade Policy Review Mechanism (TRM) exercise in the WTO, under which the WTO's 16 subsidiary bodies and committees will review the country's ongoing progress on implementation over the course of the next eight years. If fully implemented, these commitments amount to significant new market openings in China in terms of access to core intermediation services for foreign suppliers.

However, the starting point for implementing these policy changes also seems so highly restricted that doubts are raised over the feasibility of implementing such changes, even when faced with the threat of eventual retaliation from WTO partners. WTO members are monitoring the ability of China to implement WTO commitments, and following dispute settlement could retaliate if agreed changes are not implemented.

##### **Banking**

China has committed to grant full market access to foreign banks within five years.<sup>49</sup> The current regime is restrictive of foreign banks, which are not allowed to

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<sup>48</sup> This section draws on Whalley "China's WTO Commitments in Key Service Sectors: Some Scenarios and Issues of Measurement." (2003b) Draft Paper.

<sup>49</sup> See also the detailed discussion of China's banking sector and the implications of WTO accession in Bhattasali, "Accelerating Financial Market Restructuring in China." (2002) Washington, DC: The World Bank, mimeo.

conduct local currency (Renminbi) business with foreign businesses or individuals. Geographical restrictions also apply to the establishment of foreign banks. These restrictions will cease, and China will allow internal branching and provide national treatment for all new foreign entities. Local currency business will be allowed with Chinese enterprises two years after WTO accession and with Chinese individuals five years after.

Foreign financial institutions were permitted to provide foreign currency services in China immediately following Chinese accession to the WTO and without any restrictions as to clients or location. However, the Renminbi (or foreign exchange certificate and local currency) remains inconvertible. Local currency business is to progressively open up over the next five years until 2007. China will also open foreign banking business in local currency in 20 cities in five groups within four years of accession. Foreign financial institutions will be allowed to provide retail banking services everywhere in local currency and to all Chinese clients. Foreign institutions will also be allowed to provide intermediary and advisor services freely, including deposit services, financial lending services, merger and acquisition advice, and securities investment advice.

A number of foreign or joint venture banks have already received licences as part of the implementation of China's WTO commitments. These include the Bank of East Asia, Citibank, Hang Seng, the Hongkong and Shanghai Banking Corporation, and Standard Chartered. Rights to offer Renminbi lending to foreign companies and individuals have also been extended beyond regional pilot programs, and upon full implementation of China's WTO commitments, the aim is to open the entire Chinese banking sector to foreign competition. However, the initial starting point for these reforms is remote in part because the role of the Chinese banking sector in the past differs sharply from that of an OECD economy, such that doubts have inevitably been expressed as to China's ability to fully implement the commitments.

Prior to the economic reforms of the 1990s, China had a planned economy with development of heavy industry as the priority for its economic development.<sup>50</sup> Financial markets did not exist and the People's Bank of China (PBOC) was the

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<sup>50</sup> See Lin, Cai, and Li. *The China Miracle: Development Strategy and Economic Reform*. (1996) Hong Kong: Chinese University Press for a discussion of this evolution.

lone financial institution. It acted both as a central bank and as a provider of banking services via deposits and loans, but loans were made almost exclusively to state-owned enterprises. While the Chinese banking system today has a wider range of financial institutions with the PBOC now acting solely as a central bank, the function of the banking system continues to reflect the earlier structure.

At the top tier of the Chinese banking system (the largest of the system) are four large state banks: China Industry and Commerce Bank, China Agriculture Bank, Bank of China, and China Construction Bank. They are under no explicit mandate to lend heavily to state entities, but do so on the grounds that such loans are safe (for example, they are state-to-state loans), even though recipient enterprises lose money and cannot directly service their debt. The expectation is that the state (via the banking system) will bail out loss-making enterprises and the loans will eventually be repaid.

A second tier involves locally owned banks, such as the Shanghai Bank, and the Shenzhen Development Bank. These operate in similar ways to the state-owned banks, but are under different political control (typically provincial or citywide). A third tier consists of three major policy-based regional shareholder commercial banks, the Construction Agricultural Development Bank, the Import / Export Bank, and the Bank of China (foreign currency bank). A fourth tier involves mixed individual enterprise-owned banks. Ownership here includes state-owned enterprises, local enterprises, and local governments. Few of these banks issue securities that are traded on stock markets. Currently, there are four banks where trading takes place, and these banks deal solely in class A shares, which are only permitted to be held by Chinese residents.

State-owned enterprises remain the largest borrower from the banking system,<sup>51</sup> and four large state-owned banks conduct most of this business. Relatively few individuals have bank accounts. Personal assets (houses, automobiles) when acquired are usually paid for in full. Financing of these usually reflects informal credit (loans from family or friends). State-owned enterprises also typically lose money, and state-owned banks have major difficulties with non-performing loans. Official estimates put these as high as 25 per cent of loans outstanding, but

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<sup>51</sup> See the description in Broadman (2001).

unofficial estimates are as high as 50-60 per cent of loans outstanding<sup>52</sup> The Central Bank thus recapitalizes the state banks who in turn lend money to loss making state-owned enterprises.

Participation by foreign financial institutions in this banking system is limited and is developing. According to Lin (2001), by early 2000, foreign banks and financial institutions had already established 191 representative offices and subsidiaries in 23 city locations in China, with total assets of \$US36 billion.<sup>53</sup> Foreign banks have also recently been allowed to upgrade their representative offices to branches and to conduct local currency business in certain areas. More recently, foreign financial institutions have acquired minority share ownership in smaller mixed-ownership banks. For instance, Newbridge Financial has acquired a 15 per cent interest in Shenzhen Development Bank, and Citicorp has taken a five per cent interest in the Pudong Development Bank.

To complete the implementation of China's WTO accession commitments by 2007, additional changes still need to occur, and if enacted would also likely alter the structure of the Chinese economy substantially.<sup>54</sup> Foreign entry into banking services could provide strong competition for local banks not only believed to be inefficient, but also saddled with large non-performing loans. Some believe that the local banking industry could be greatly impacted by such changes; however, this may not be easily accommodated. Others argue that an incentive will remain for China to keep the Renminbi inconvertible so that foreign banks will have limited initial access to Renminbi deposits and hence will be unable to make local currency loans. Others argue that only the local Chinese banks fully understand how business is conducted in China, and hence local banks will keep most of their market share, especially in more remote rural areas.

Subsidies to state-owned entities are to be terminated as part of the WTO accession process, and loan activities based on the expectation that they will

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<sup>52</sup> See Jie Zhang "Non performing Loans of State Owned Banks in Transition Economy," *Journal of Financial Research*, May 1999; Gangming Yuan "An Empirical Analysis of Non-performing Loans in China's SUEs," *Economic Research Journal (Tan Ji Yan Jiu)* (2000) and Bonin and Huang (2001).

<sup>53</sup> Bhattasali (2002) reports the same data.

<sup>54</sup> See J.Y Lin "What is the Director of China's Financial Reform?" in Went Cai and Feng Lu (eds.) *China Economic Transition and Economic Policy*. (2000) Beijing, China: Peking University Press.

continue to be paid must also change. China's WTO commitments thus need to be viewed in their totality as they affect banking services, relating directly to both the banking sector and the real side of the economy. Given the scope of China's WTO commitments, the banking system must evolve from a structure that de facto recapitalizes loss-making, state-owned enterprises toward a more conventional OECD-style commercial banking system largely offering intermediation. For this to occur, the real side of the economy, it appears, must also undergo substantial change along with the banking sector.

## **Insurance**

In insurance, few foreign insurers operate in the Chinese market, and prior to WTO accession China reserved the right to limit operations by city and to terminate any rights granted to foreign entities. Most insurance activity in China is business related. There is relatively little personal life or house insurance, although the car insurance market is growing rapidly with the growth of the automobile sector. Under its WTO commitments, China has agreed to limit licences only on prudential grounds, with no limits on the number of licenses issued. China will progressively eliminate geographical restrictions on licenses within three years, and will also allow internal brokerage. The situation in insurance differs considerably from that in banking, and implementation of WTO commitments in this area will likely be easier to achieve.

The tiering of insurance companies differs from that in the banking sector since there is no insurance analogue to the central bank. The first level is wholly state-owned insurance companies, which are non-profit and account for about 70 per cent of the Chinese insurance business, the largest being Peoples Insurance and Life. Next, there are joint share insurance companies owned by state-owned enterprises, of which the largest is Pacific. The third level comprises joint venture insurance companies of various forms, followed by wholly foreign-owned companies directly offering insurance services, largely to Chinese companies. The latter are typically branches of foreign insurance companies.

Unlike in banking, foreign entry to China's insurance market is currently permitted through licencing, and an entry point has already been established for foreign insurance providers. In insurance, the main barriers to foreign activity seem



not to be policy related but rather market driven.<sup>55</sup> Licences for life insurance operations have been granted on a city basis to American International and Sun Life.

However, foreigners see the Chinese market as complicated because of unusual organizational structures, legal, and other arrangements, differing business customs, and the need for Chinese language skills to conduct business. Since foreign insurance companies seem to have difficulty conducting business in China, their entry into the market has been slow and often foreigners do not accept licences to operate, even when obtained. In insurance, however, unlike banking, foreign entry to the Chinese market is permissible, despite the reluctance of foreign investors. As a result, the terms of WTO accession in insurance appear to pose fewer problems for China than in banking since the market is formally open to foreigners, even if it appears de facto closed. As a result, WTO accession in insurance presents fewer adjustment pressures for China than in banking.

## **Telecoms**

In telecoms, as part of China's WTO commitments, China's Ministry of Information Industry (MII) has agreed to new rules for basic and value-added services in telecoms that allows for increased foreign ownership and reduced geographical restriction of licences.<sup>56</sup> This will limit the ability of dominant local carriers to keep rates high and depress demand for telecommunications services and electronic commerce.

Seven operators are currently licenced in China, reflecting a regulatory structure inherited from reforms in 1999. The most significant entity in the sector is China Telecom (CT), originally part of the Ministry of Posts and Telecommunications and established as a separate entity in 2000. CT controls 99 per cent of China's main fixed-line phone capacity. Next is China Unicom, the major mobile phone operator, established in 1994. A series of enterprises with regulatory approval to operate in various telecom markets follow. These include a

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<sup>55</sup> This may be more the perception on the Chinese side than that of OECD trade negotiators, but was communicated to me on a recent visit to China.

<sup>56</sup> Also see the discussion of the telecoms situation in Pangestu and Mrongowius "Telecommunications in China: Facing the Challenges of WTO Accession." (2002) Washington, DC: The World Bank, mimeo.



satellite operator, ChinaSat, a broadband IP network developer, China Netcom, as well as China Telecommunications Broadcast Satellite Corporation, Jitong, and China Railways Communications.

As part of WTO accession, China has also signed the WTO Telecommunications Agreement, which requires free entry to the Chinese market by 2007 for foreign service providers. This would place China on par with the larger OECD economies where, in recent years, foreign providers frequently and freely access foreign markets creating large rate reductions.

The current situation is that de facto two large state-owned providers (China Unicom, and Telecom China) dominate the market and there is both rate and entry regulation. This structure applies both for basic (hardwire and mobile) telecom services and for peripheral add-on services. Rates are set above international levels and profits from these utilities are a significant revenue source for both national and provincial governments.

The main commitments stemming from China's WTO accession in this area involve market access (via rights to establish) and national treatment. Foreign investment will be allowed in the sector, but with geographical restrictions and limits initially placed on ownership levels. Geographical restrictions are to be removed and the foreign ownership limit is to be raised to 49 per cent for most services, in two years for value-added services, five years for mobile telephones, and six years for international services.

Different issues arise in telecoms as compared with banking and insurance. One issue is the revenue implication of foreign telecom entry for national and provincial governments as both benefit by participating in regulated utilities either directly or indirectly under their management. An additional issue is the costs to consumers in switching when new entry occurs.

### **Implementability of WTO Commitments**

China's commitments in these service areas (banking in particular) are so extensive that they have inevitably led to questions concerning the feasibility and likelihood of full implementation. Once established, WTO commitments become

subject to dispute settlement and enforcement through retaliation. Whether China can retain sufficient autonomy to retain the unique economic structure it presently has and whether political opposition will in some way limit full implementation is an issue.

Concern also exists over the possible disappearance of domestic industry in these service categories under WTO implementation.<sup>57</sup> Another consideration rests with the potential unacceptability of this situation, were it to occur (and the political impact of the resulting labour market dislocation), as well as the perceived strategic need for domestic service industries (as argued by Brazil for its own banking sector in the WTO). Believers in such liberalization stress the benefits to China from the gains of free trade, but such benefits, if achieved, will likely not remove opposition to change. A conjecture that has been advanced is that Chinese negotiators either were not fully aware of what they were committing to or if aware, believed there was some form of escape available through other unconstrained regulation (perhaps new licences of some form). Those that argue this suggest that these pressures will likely force an eventual renegotiation of accession terms or a slowing of implementation. This is despite other WTO members who would likely argue that renegotiation is not permissible as the commitments involved are set out in firm contractual form.

There are those that contend that services liberalization in China be implemented as part of WTO commitments as it fits into the wider developmental strategy of State-Owned Enterprise (SOE) containment and achieving of efficiency gains and resource allocation improvements. The claim is that domestic service industries can compete in an internationally freer environment. One possible supporting mechanism sometime suggested involves other policy elements in the equation, which will shield Chinese industry from adjustment (such as an inconvertible Renminbi in the case of banking). Since implicit threats to pursue WTO dispute settlement and retaliation (if necessary) characterize the position of the US and other OECD country WTO negotiations (in public at least), the argument is that China will have no choice but to implement their commitments in these key service areas. Questions remain over China's objectives in negotiating WTO services liberalization and the ability to implement this and the resolve of foreigners to push it through.

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<sup>57</sup> The likelihood of this in the banking sector is discussed by Bhattasali (2002).

## 5. Concluding Remarks

This paper discusses three varying dimensions of China's current stance towards the global trading system: 1) how WTO accession affects China's market access situation; 2) how China's regional negotiations are evolving; and 3) China's commitments under WTO accession in key service areas.

In contrast to other global economic powers, China appears to be building its latest developmental strategy around accession to the WTO and implementation of accession terms. Outside China, the WTO does not enter domestic policy discussion in this central way, and there is uncertainty as to the WTO's prospects. Regarding access, it appears that the WTO yields China less than the accession rhetoric suggested at the time. There is also an emerging network of RTAs that China is presently negotiating, following accession to the WTO in 2002 and the issue remains as to whether Chinese national interest will be served by these agreements. The asymmetries in size and power in the trading system could inevitably produce a two-tier system of large power, non-discriminatory arrangements reflected in common multilateral disciplines, and regional agreements negotiated with smaller countries where the major power has the dominant interest.

China's trade is a central part of the equation; how it chooses to respond to the challenges it faces both within the WTO and externally will affect future global performance and could greatly impact the world economy.

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