Issues in China's Ascension to the WTO

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Abstract

Few events have unleashed so many passions and aroused so much hope or concern in the Chinese population as accession to the World Trade Organization (WTO). The stakes are considerable as the modifications of the foreign trade regime that China will have to put in place have potentially wide economic consequences. But it is also because accession to the WTO is seen as a new stage in internal economic reforms, in short as an instrument of domestic policy. The about WTO ascension are comparable to those that occurred in Spanish, Portuguese or Greek societies when they joined the European Community in the 1980s, or to those taking place today in the countries of Central and Eastern Europe which are negotiating their entry into the European Union. Many analyses have also compared accession China's to the WTO to the launch of the open door policy in December 1978, an economic policy decision that should upset the structures and modes of the economy. As in 1978, the leaders seem forced to reform and produce a strong economic growth from which they derive their legitimacy. In this context, it is not surprising to find a very broad spectrum of analysis on the economic consequences of China's accession to the WTO. Between the pessimists who insist on the incapacities of China to meet the challenges and the optimistic hopefuls who see in WTO ascension a rocket capable of placing in record time and without a hitch China in the orbit of the most economically developed countries, this paper proposes a more cautious and contrasted analysis. This analysis will focus in on particular factors that may limit the opening of the internal market, as well as on innumerable unknowns which have not been clarified by econometric models and which are likely to have many surprises for the economic development of the country.

Among the questions raised by a number of analyses of the risks incurred by China as a result of the change in its foreign trade regime, is the fear that excessive and rapid opening of the internal market does not permanently destabilise domestic producers. A closer look at the sales conditions of imported products, the long-term strategies chosen by foreign investors as well as the conditions of application of the WTO rules nevertheless makes it possible to temper this negative anticipation. Indeed, many damping factors’ should temper the shock of openness for domestic producers. Negotiated opening and ‘shock-absorbing’ effects: the example of Chinese domestic agricultural prices too far removed from world prices combined with the fall in tariffs provided for in the WTO agreement could, according to some analyses, trigger a shift in domestic demand to imported products and a drastic drop in the turnover of domestic producers, thus accelerating a massive rural exodus to coastal cities. This possibility has been widely discussed in relation to basic agricultural products, particularly wheat, soybean and rice. There are several factors to consider including China's accession agreements in which the WTO provides safeguards for the protection of its domestic agricultural market. Maximum agricultural imports have been negotiated on the basis of the general agreements provided for in the Uruguay Round for the liberalisation of agricultural products. Domestic market access quotas for imports are determined in relation to domestic consumption. These quotas will be gradually increased on an annual basis until 2004.Moreover, in case of excess quotas, China can impose tariffs able to effectively protect its domestic market although it has agreed to apply tariffs below those maintained by many other WTO members. These quotas should thus limit the effect on local producers. In addition, despite the variations observed between the different categories of agricultural products, world prices and Chinese prices have been converging more and more for several years thanks to the productivity gains achieved in Chinese agriculture. This trend is expected to improve the in the future competitiveness of Chinese products over imports. Finally, the Chinese domestic market is far from integrated. Transportation costs for agricultural products are, on average, five times higher than those recorded by producers in the United States. Inland selling in Local markets should therefore not be subject to instant competition. Indeed, the cost of transporting imported products to these markets increases significantly their price. This phenomenon should therefore, for a few years, allow farmers in the poorest remote areas to diversify their production or to try to increase their productivity.

The impact on the development of the domestic industry has been widely mentioned as one of the main negative elements of China's accession to the WTO. The econometric models, particularly those developed by Yang for the World Bank, and those of Li Shantong and Zhai Fai Development Center, of the State Council predict that certain industries such as automobiles and machine tools should suffer from China's accession to the WTO in terms of jobs and production. Will it really be like this? China's ability to develop Chinese manufacturers without foreign majority control is certainly gravely compromised today. But the consequences in terms of jobs and production are far from having been fully anticipated by the different econometric models.

First of all, with the increase in consumption expected from lower prices, even imagining that a large number of the cars purchased will be imported, service activities (distribution, repair, second-hand market) will rapidly develop, leading to increased employment in these sectors. In addition, important segments of the industry are controlled by Chinese firms (commercial vehicles, trucks, buses), and are highly competitive with foreign competition (the Dongfeng Group, or the No.1 Yiqi Automobile Group). .

Finally, an analysis of the situation of foreign car manufacturers, which at joint ventures currently dominate production in China, indicates that they are not going to withdraw from the Chinese market. These Sino-foreign companies previously protected by customs tariffs that allowed them to charge prices very far above world prices and not to be subjected to the technological race and to the annual introduction of new models. Since China's accession to the WTO, there is every indication that these companies will adapt their strategy rather than abandon their implementation. The exit costs for foreign car producers who would like to abandon China would be all the more considerable since they invested in oversized production (Citroën could manufacture 150,000 cars each year, whereas today sales are around 50 000 vehicles). Knowing that the Chinese market will gradually develop, these manufacturers will simply proceed as in other parts of the world open to international competition. This adaptation will involve lowering the price of their vehicles and the introduction of new models at a faster pace, which implies the relocation of part of the research and development activities. Finally, foreign manufacturers will seek to integrate the factories located in China in the Asian regional production network (perhaps even for some to make the Chinese factory one of the hubs of the Asian network). For all these reasons, even if the probability of seeing a Chinese producer survive entirely is low (as in England), in terms of jobs and production, the automobile industry as it exists today in China should not necessarily lose out to WTO accession.

The concessions granted by China are consistent with its former foreign trade regime and the benefits enjoyed by other developing country members of the WTO. Nevertheless, many exceptions to the general regime had been negotiated before China's accession to the WTO, by different members on several categories of products. The reduction in customs duties provided for in the Protocol of Accession will therefore have for many a relatively limited impact on industrial firms.

In addition, contraband or gray trade had in recent years become so important for Chinese enterprises as for foreign companies established in China, especially in coastal areas, that tariffs were ineffective for a significant part of imports, or even for certain consumer products. The countless scandals around smuggling that have erupted in recent years bear witness to this. The campaign against smuggling, in 1998, provided some figures revealing the extent of the phenomenon. China Customs has estimated that nearly 100 billion yuan of illegal imports, or 10% of total imports in 1997 had entered Chinese territory. For some products, such as integrated circuits, special steels, automobiles, cigarettes, photographic films, oil, the proportions are considerable. In the field of special steels, for example, illegal imports accounted for 200% of domestic production in 1997. In the automotive sector, a report by China's Automotive Institute Industry Development Research estimated that illegal imports accounted for nearly 17% of domestic demand.

Another widely discussed theme about the risks China faces in opening its domestic market is the strict application of WTO rules. Not only would China have negotiated more stringent rules than those normally applied to other WTO members, but it would have very little room for manoeuvre in their application. China's accession protocol to the WTO provides, it is true, oversight mechanisms to verify the application of the concessions that China has granted to its main partners trading. Nevertheless, several factors could allow it to apply these more flexibly rules and even provide loopholes.

The dispute settlement process of the Dispute Settlement Body (DSB) WTO is not only a matter of WTO law, but also depends on diplomatic negotiations between States. By imagining that a French company is a victim of non-application by China of a WTO rule accepted by this country, it must embark on a real obstacle course. It must initially make a filing to demonstrate the damage suffered, it gives it to the Chinese embassy in Paris which will transmit it to his supervisory authorities in France. Subsequently, they will forward the file to the European Commission in Brussels, which alone is entitled to initiate proceedings before the DSB. The parties then engage in a phase of bilateral consultations at this stage. If such consultations fail, then the DSB may establish a panel and initiate the quasi-judicial phase of the proceedings (with the possibility of an appeal for the defendant). In the event that these DSB's recommendations are not implemented by the party concerned, the implementation of compensations or suspensions of trade concessions is provided for in the WTO Agreement. Finally, if the party concerned refuses the proposed suspensions, we enter the final stage: that of arbitration. The procedure thus remains relatively lengthy and costly in terms of human and financial resources, but above all it is part of a political settlement between the states, which finally leaves some room for manoeuvre to the attacked countries. The trade disputes that have been dealt with by the DSB in recent years between the two major trading partners of the world, the United States and the European Union, particularly on the issue of bananas or on the protection of steel producers in the United States, show that conflicts very quickly assume a political character. Thus, WTO members are often tempted to patiently build files against their major trading partners that they put forward opportunely during the settlement of a dispute.

Unlike many developing countries, China has sufficient financial and human to enter this political game. The multiple violations of WTO rules by developed countries, particularly on agricultural subsidies or non-tariff barriers - which are a permanent object of conflict between industrialised and developing economies - will certainly be used by China in case of conflict over the application of WTO rules. Finally, China is likely to enjoy relative leniency on the part of major partners trading in the transformation of its legal system as they are aware of the immensity of the task at hand. Pascal Lamy, the EU Trade Commissioner, said that it would be better not to harass China during the first years of its accession to the WTO.

In any willingness to reform, the behavior of the different groups of actors affected by the reforms is of paramount importance in the success of the policy decided by the public authorities. The concessions granted by the Chinese government to open up its domestic market risks upsetting some of the rent-seeking actors at both national and provincial levels. It is precisely for this reason that the WTO is a privileged means for the central authorities to override certain advantages acquired or privileged situations that hindered the internal dynamics of the reforms. Beijing wants to advance some issues such as improving the governance of state enterprises, reform of the sector banking, regional protectionism that fragments the national market or the necessary exit of thousands of inefficient companies. The central government seems strong enough to impose painful reforms on restive groups within national ministries. However, its ability to control the provinces is much weaker: the complex relations between the centre and the provinces in terms of taxation, industrial policy, regulation of the financial system or harmonisation of distribution systems in the provinces testify to this. It is to be feared that, despite the remaining tax offsets and social protection, the provinces are likely to suffer from openness as they are still lagging behind and showing some inventiveness by introducing non-market tariff barriers.

Given the criticism that may come from abroad about the failure of the provincial governments to honour the concessions granted by China when it acceded to the WTO, it is reasonable to assume that the central authorities adopt a Janus-like attitude. On the one hand, there will be a strong speech to critical of provincial attitudes for foreign consumption; and on the other hand, there will be a more conciliatory attitude towards the provinces that suffer from openness, an attitude that will probably vary according to the local social consequences of openness. If clauses in the accession protocol are identified as responsible for too rapidly unraveling the local economic fabric that could lead to dangerous social and political consequences, it is reasonable to assume that the central government will close its eyes and tacitly tolerate (while criticising them in official discourse) the discriminatory practices put in place by provinces. On the other hand, if these social and political consequences are manageable, the central government will adopt a stronger attitude towards the provinces by arguing the need to implement the WTO agreements, which will allow it to break some local protectionism.

In general, WTO member countries have been overly imaginative in setting up non-tariff barriers or simply contravening the WTO rules they have negotiated. China will do the same if it considers its economic or political interests threatened. The agricultural field, for example, is certainly one where the industrialised member countries have the most difficulty in accepting the negotiated end of protectionism that has been the basis of the development of their national agriculture. Export subsidies, non-tariff barriers related to sanitary control or respect for the environment for European agriculture, particularly in France, are still widely used to restrict access of foreign agricultural products to the European market. Even the United States, whose administration is in favour of liberalising international trade and has fought against European practices, has just voted, one after the other, a law increasing the subsidies paid to agricultural producers and the raising of tariffs.

With regard to agricultural products, China has committed in its WTO accession protocol not to exceed the equivalent of 8.5% of total agricultural production for the whole of the world in its subsidies to producers. Despite the difficulties in calculating the totality of existing subsidies, estimated at around 2% of agricultural production, China has a margin of manoeuvre that it can use according to its needs. Apart from agricultural issues, China also has a multitude of options to narrow the scope of the concessions granted to open its domestic market. In the financial sector, it may limit the possibilities for foreign banks to refinance themselves on the Chinese interbank market, thereby increasing their costs *vis-à-vis* Chinese banks.

On the industrial front the maintenance of state control over certain distribution or import networks and other practices widely used by member countries the WTO allow it to amortise, if the need arises, the consequences of a provision in its protocol of accession. In general, China will be more inclined to use these practices if the industrialised countries do not set a good example as it turns out to be the case today. All in all, without underestimating the short- and medium-term consequences of China's accession to the WTO on China of the opening up of its internal market, the phenomena described above clearly show that it has several tools to cushion and control the shock associated with the opening. Nevertheless, in the same way that some analyses have exaggerated the potentially negative consequences of concessions granted by China to gain access to the WTO, some expected benefits have sometimes been overestimated, while others are still difficult to pinpoint as the variables that influence them are many.

According to the proponents of free trade, efficiency gains are possible not only in industry and agriculture but also in the services that have been the subject of negotiations since the Uruguay Round. The purpose of this paper is not to expose the limits of the theory of comparative advantage and liberalisation of trade regimes for developing countries under WTO law. However, in the case of China, these models ignore certain variables that reinforce the uncertainties as to the consequences of the liberalisation process. According to these models, the lifting of quotas on Chinese textiles proposed by the United States and Europe and foreseen in the WTO agreements, should ensure that the textile sector is to be the main winner in terms of production and employment. However, for several years now, Chinese manufacturers have been using indirect routes to circumvent quotas, selling in third markets, particularly in Southeast Asia, and then re-exporting to US and European markets. Gains in the textile industry may therefore be smaller than those anticipated by econometric models.

All the uncertainties surrounding the dynamism of international trade and the willingness of member countries to honour their decisions to open up their domestic market to Chinese products. Although international trade has grown steadily over the past forty years, slowdowns cannot be ruled out and would result in lost profits for Chinese exporters. At the same time, the industrialised countries have shown in the past their reluctance to open up their internal markets despite the commitments made under the WTO. At the Doha WTO meeting in November 2001, these barriers to entry provoked widespread criticism from developing countries and nearly blocked the negotiations on further trade liberalisation.

The US government's decision to protect its domestic steel producers by imposing tariffs in contravention of WTO rules is a good example of the trade-distortions that industrialised countries claim. This decision, as well as the one imposed by the European Union, which seeks in return to protect its own producers, is costly for Chinese steel producers, and China has formally requested the opening of negotiations to exempt them from new US tariffs. In the short term, labour transfers from the sectors losing out from opening up to the winning sectors will be difficult and costly. If related openness gains are concentrated in light industry, located mostly in the coastal provinces, agricultural and lagging industrial growth in inland provinces will accentuate population transfers to coastal cities. The population pressure in coastal areas will require the development of additional infrastructure (schools, housing, hospitals, roads). These may be financed by the tax revenues expected from the additional activities in these areas, but their implementation will often take a long time.

Moreover, mobility within the Chinese labour market is far from being total because of administrative barriers (residence permit or hukou, local financing of social protection), which implies that only a part of the population, often the youngest, will leave their home area to find a job. A part of the population affected by the opening up will therefore remain in interior provinces and will have to rely on minimum social cover that the authorities already have a hard time guaranteeing today. Only renewed economic dynamism of the losing regions could guarantee inexpensive and smooth adjustments. The experiences of liberalisation and openness in developed countries show that this is far from being the case. Restructuring is long and costly both socially and economically, let alone the political repercussions, which in the case of China, are an important element to consider. Moreover, the medium- and long-efficiency term gains expected from opening up are far from certain. In many cases, the ‘visible hand of the state’ must supplant the ‘invisible hand’ of the market so as to allow national economic actors to respond by increasing productivity or diversifying activities for which they have comparative advantage. In the case of agriculture, despite the many effects that may dampen the shock of openness, the most exposed farmers will however need additional funding.

What are the expected adjustments in the domestic banking sector that are supposed to be introduced in the opening of the Chinese market to foreign competition? Chinese banks will certainly benefit from a longer period than the transitional period faced with direct competition from foreign banks. They will also enjoy *de facto* advantages but before becoming serious competitors, they will have to set up extensive branch networks, hire and train personnel experienced in banking techniques. The adjustments facing the Chinese banking sector in order to rise to the level of foreign competition therefore requires a vast reform programme that has only just begun. And this effort is late compared to the one deployed since the 1997 Asian crisis by other countries in the region, such as South Korea, Thailand or Malaysia, which, *a fortiori*, did not suffer from any problems on a scale comparable to those facing the Chinese banking sector today. The four major state-owned commercial banks are going to have to be recapitalised for an amount that is more or less optimistically between 30% and 58% of GDP (between 327 billion and 632 billion US dollars). In order to avoid the accumulation of new non-performing loans, the Chinese government will have to tackle the liberalisation of interest rates, the development of the interbank market, the establishment of stronger prudential rules, the likely privatisation of much of the state-owned commercial banks and a considerable improvement in corporate governance. Knowing the current state of the Chinese banking sector and measure the work that has been done for the last ten years, there is doubt about the capacity of the Chinese state to carry out, in a such a short period - between 5 and 10 years - reforms of this magnitude.

The examples could be multiplied to show that, in many sectors, the adjustments resulting from the opening up will be long and costly. They will require significant financial and human resources from the state as well as an overhaul of the institutions that manage the economy, a whole set of measures that have not been taken into account in the econometric and economic models so it is very difficult today to predict the outcome.

Finally, it remains to be seen which type of economic system is heading China to with the opening up. According to the theory of comparative advantages, China should specialise mainly in intensive labour-sectors. But the legitimate ambitions of Chinese leaders go far beyond such specialisation. China aspires to climb the value-added chain and gradually emancipate itself from the subordinate position in which it is today in the pyramid of international subcontracting which represents nearly 55% of its foreign trade. China also aspires to develop world-class companies with strong technological capabilities. The question is whether such aspirations are compatible with a liberalised trade regime such as that accepted by China upon accession to the WTO. This question goes far beyond the case of China and concerns all developing countries and especially countries such as Russia, India or Brazil. An examination of the vast literature on the most successful catch-up strategies over the last 50 years shows that countries like Japan, South Korea or Taiwan are far from having recourse to liberalisation of their regimes at the stage of economic development equivalent to that of China at present. These countries have largely given priority to their domestic producers in their development strategy, controlling foreign direct investment, framing credit policy, protecting their domestic market, promoting the accumulation of technological capabilities in national firms or by prohibiting majority control of their capital by foreign firms.

By choosing the WTO map, Chinese leaders, on the other hand, give priority to consumers by giving them the choice between domestic products and foreign products (imports or products of foreign firms established in China). The extent choices of development strategy and catch up for developing countries, it is true, has been greatly reduced by the impact of the globalisation of production and finance as well as the multilateral trade liberalisation in the WTO framework. Developing countries can no longer easily practice protectionism for their development. However, in the light of the Asian experiences mentioned above, but also the experiences of developed countries, one is entitled to ask real questions about the emancipation capacity of technological developing countries, including China, and their legitimate desire to develop firms of a global size in the context of today's globalisation.

Economic nationalism, which is expressed by the technological power of large national firms, is far from having disappeared in China. Admittedly, the chaebol crisis in South Korea in 1997 and the economic stagnation of Japan since 1990 have considerably tarnished, for the Chinese leaders, the image of the models of development that these two countries conveyed. But has China forsaken the idea of bringing (unsuccessfully for now) several of its national firms to Fortune's list of the world's 500 largest companies? The policies for the creation of major Chinese groups and mergers in several industrial sectors, as well as measures to support research and development, indicate that this is not the case. Has China finally given up producing a Chinese car when the WTO seems to be moving it towards a situation close to that of Great Britain (an automobile industry without national producers)? The protections negotiated in the WTO framework on engine production - a sector in which foreign firms do not have the right to exercise majority control - or impossible for foreign firms to increase their capital participation to take majority control in automobile joint ventures, show that Chinese leaders have not abandoned this goal. One could multiply the examples in the aerospace, telecommunications, machine tools, integrated circuits (which despite increasing production remains largely dominated by the foreign firms sector).The aspirations of the Chinese leaders are not extraordinary since they are at the heart of the legitimacy of the economic policies of the developed countries which have the good luck to advocate liberalisation of international trade when they are in a position of overwhelming dominance over the world. What will be the consequences of the new strategy of openness adopted by China on all these wishes of greatness? How will these repercussions be managed politically? These are questions that are difficult to answer today and that econometric models are unable to anticipate.

In a recent interview, Sir Leon Brittan, former EU Trade Commissioner who participated in China's WTO accession negotiations, said that in the course of an interview with Prime Minister Zhu Rongji, Zhu told him that the concessions demanded of China were reforms that, in any case, would have been put in place even if China had not entered the WTO. This statement by one of the main policy makers of the post-Deng Xiaoping economic era was not only intended to obtain additional concessions from major China's trading partners, it also reflected the decision, independent of the outcome of the WTO negotiations, to use the opening and deregulation of the internal market as one of the main instruments of the vast reform work ahead. Since the mid-1990s, Chinese leaders have become very much aware that the problems facing the Chinese economy and, if left unchecked, risked creating a systemic crisis similar to those which Asian countries experienced in 1997.

Nothing better illustrates this interdependence of problems than the rapid development of non-performing loans in the banking sector. This phenomenon is indeed the expression of bad macroeconomic governance both at company and state level. The resolution of this problem is urgent because it is a question of the future fiscal health (the State must go into debt to recapitalise banks) and, more generally, of a more efficient use of national financial resources. To solve this problem, however, the state must intervene on all difficult fronts: that of corporate governance by improving issues ranging from the transparency of the activities of boards of directors to the possibility for minority shareholders to engage legal action against corporate malevolent leaders, and the ubiquitous role of the Communist Party in the decision-making process of state-owned enterprises. The state also needs to reform the banking system by improving prudential rules, depoliticising decision-making channels, and developing better risk management skills. In the same way, the reduction of non- performing loans involves restructuring that involves an urgent improvement of the social protection system.

In such a context, there is obviously the question of internal incentives for reform. It was necessary to find an instrument that would galvanise energies while creating irreversibility in terms of the timing and content of reforms. In addition, some reforms require sacrifices for certain stakeholder groups, provinces and departments. In order to break the established situation during the 1980s and the first half of the 1990s, it was necessary to find an instrument that avoids any hijacking or distortion by a coalition of interests hostile to reforms. In this context, one can better understand Zhu Rongji's remark and his decisive action in the conclusion of the negotiations on China's accession to the WTO (the trip to the United States in April 1999 and his interventions in the final phase). Openness and deregulation have not only been placed at the heart of reform process but have been negotiated as part of a multilateral international agreement, giving them all the attributes and qualities necessary to become a key catalyst for reform as China's accession to the WTO marks a definitive break with the economic legacy of Deng Xiaoping who, rightly or wrongly, favoured a partial and a gradual reform. China's accession to the WTO is first and foremost an internal instrument for pursuing reforms in a new way and at a new pace, which represents a new challenge for the Chinese government and whose outcome is difficult to predict.

In conclusion, China's accession to the WTO provides an impetus that has become increasingly difficult to generate domestically for painful and important reforms. Reforming by relying on external pressure while retaining the possibility of failure or difficulties is now a way for the modernisation of an economy. With the exhaustion of the internal political dynamics of the Deng Xiaoping era, the current Chinese leaders particularly needed this motive to override the benefits gained from the different categories affected by the forthcoming reforms.

If one adds the expected benefits of accession in terms of exports, foreign direct investment, liberalisation of the internal market and potential efficiency gains from liberalisation, one can be relatively optimistic about the economic gamble. In addition, the Chinese authorities benefit from multiple safeguards that protect them against a too violent shock related to opening up and which gives them some latitude in the rhythm and the extent of the adaptations to be implemented to manage in the best way the opening up of the internal market.

However, this optimism must be tempered because several important factors, which are difficult to quantify today, call for caution and humility in understanding the repercussions of China's accession to the WTO: the stability of a favourable international environment capable of absorbing Chinese exports;

the social cost of structural adjustments to employment in industry and especially in agriculture; the ability of Chinese firms to face foreign competition in their domestic market; and lastly, the difficulties of tackling large-reforms scale, such as those in the financial and the public sectors. All these factors are difficult to model. The theory of comparative advantage, which is the basis of most econometric models that have attempted to measure the economic consequences of China's accession to the WTO, is largely silent on these issues. In fact, the challenge is simply the successful passage of the last stage, perhaps the most dangerous and the most difficult, that of the transition to a market economy that China began almost a quarter of a century ago.

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