The Impact of Chinese Accession to the World Trade Organization (WTO) on the Chinese Economy

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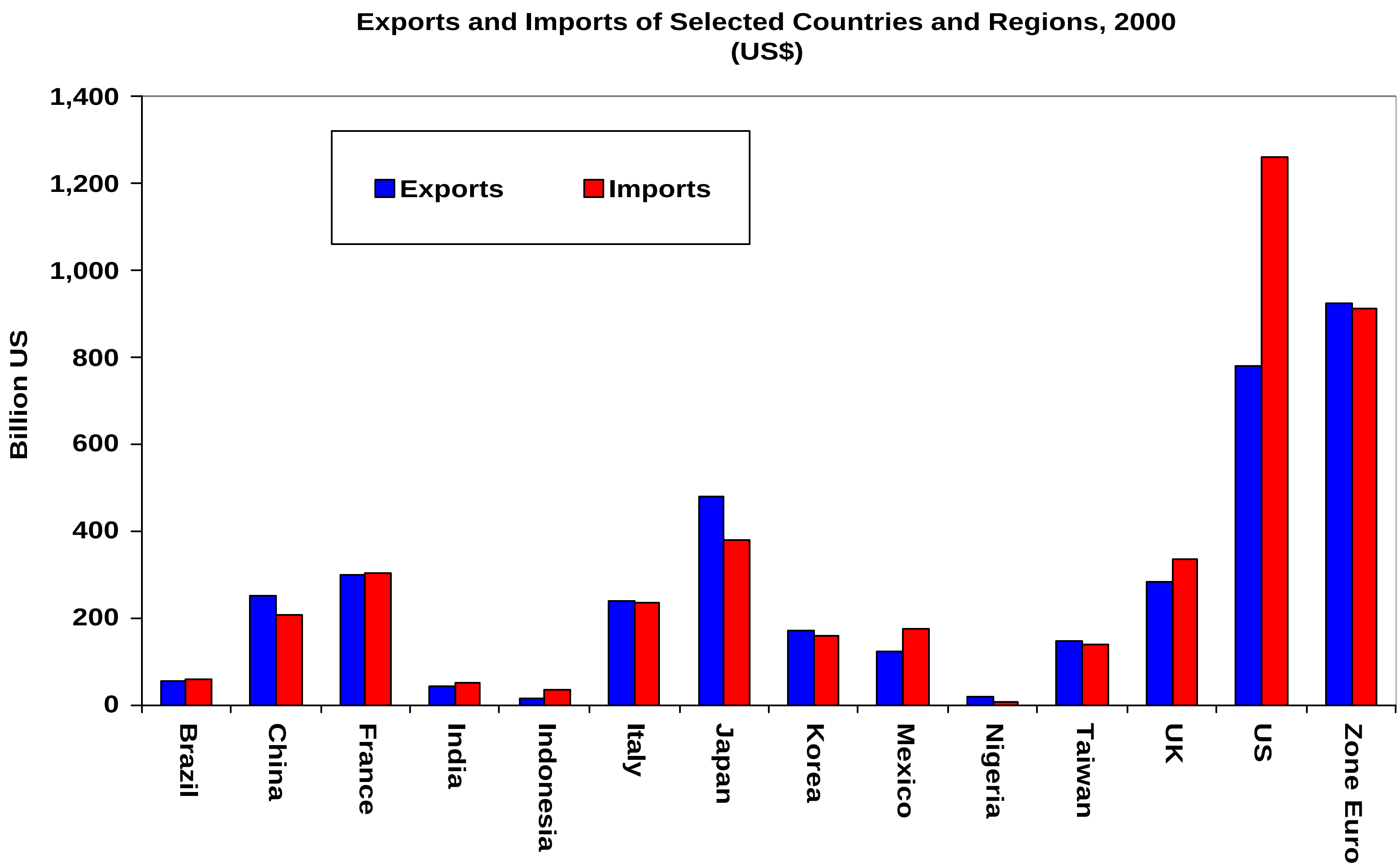
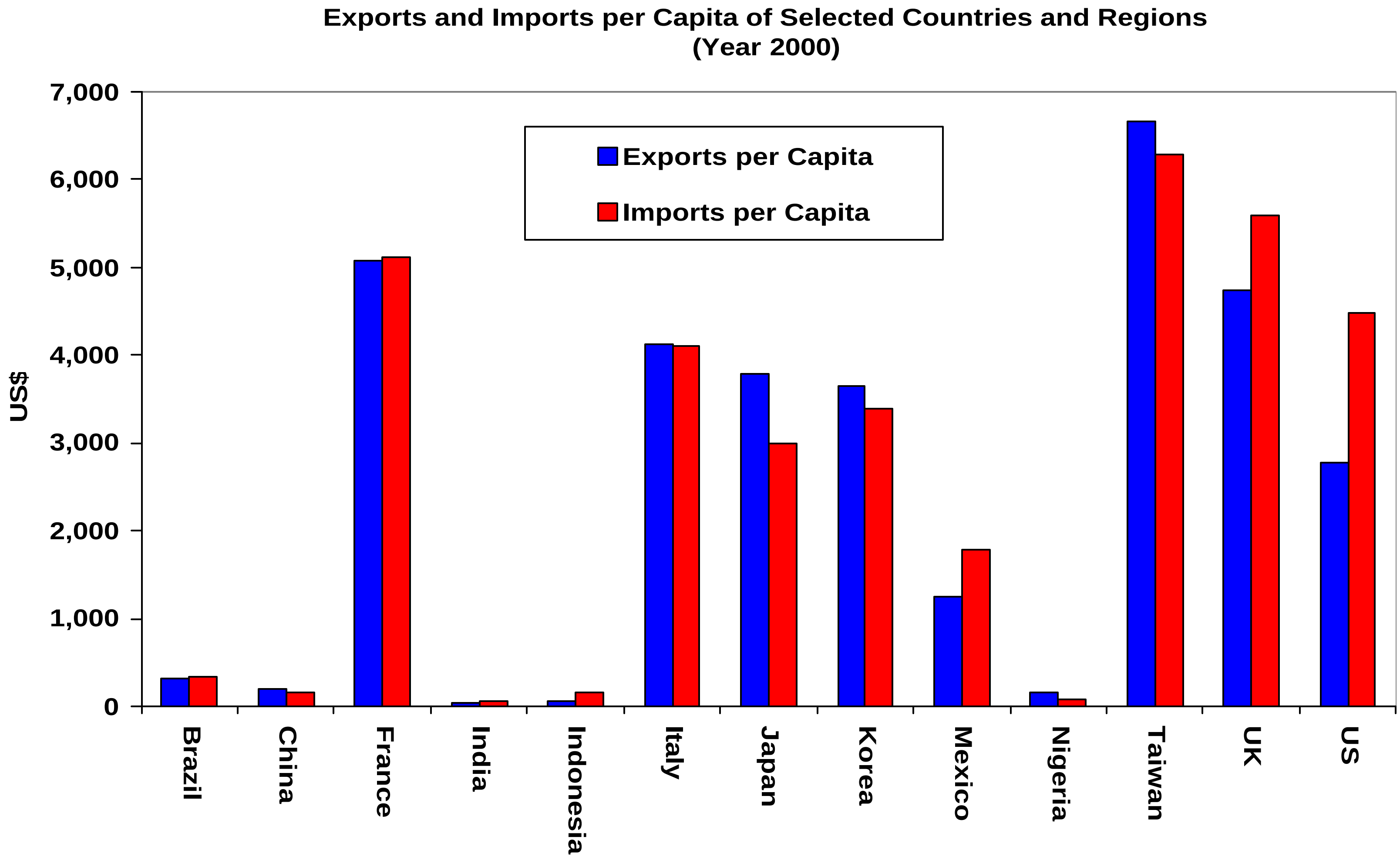
Preview

- The Importance of China in World Trade
- The Importance of International Trade and Foreign Direct Investment to China
- Chinese Commitments and Benefits under the WTO
- Economic Impacts of WTO Accession to China
- Long-Term Implications
- Challenges and Opportunities

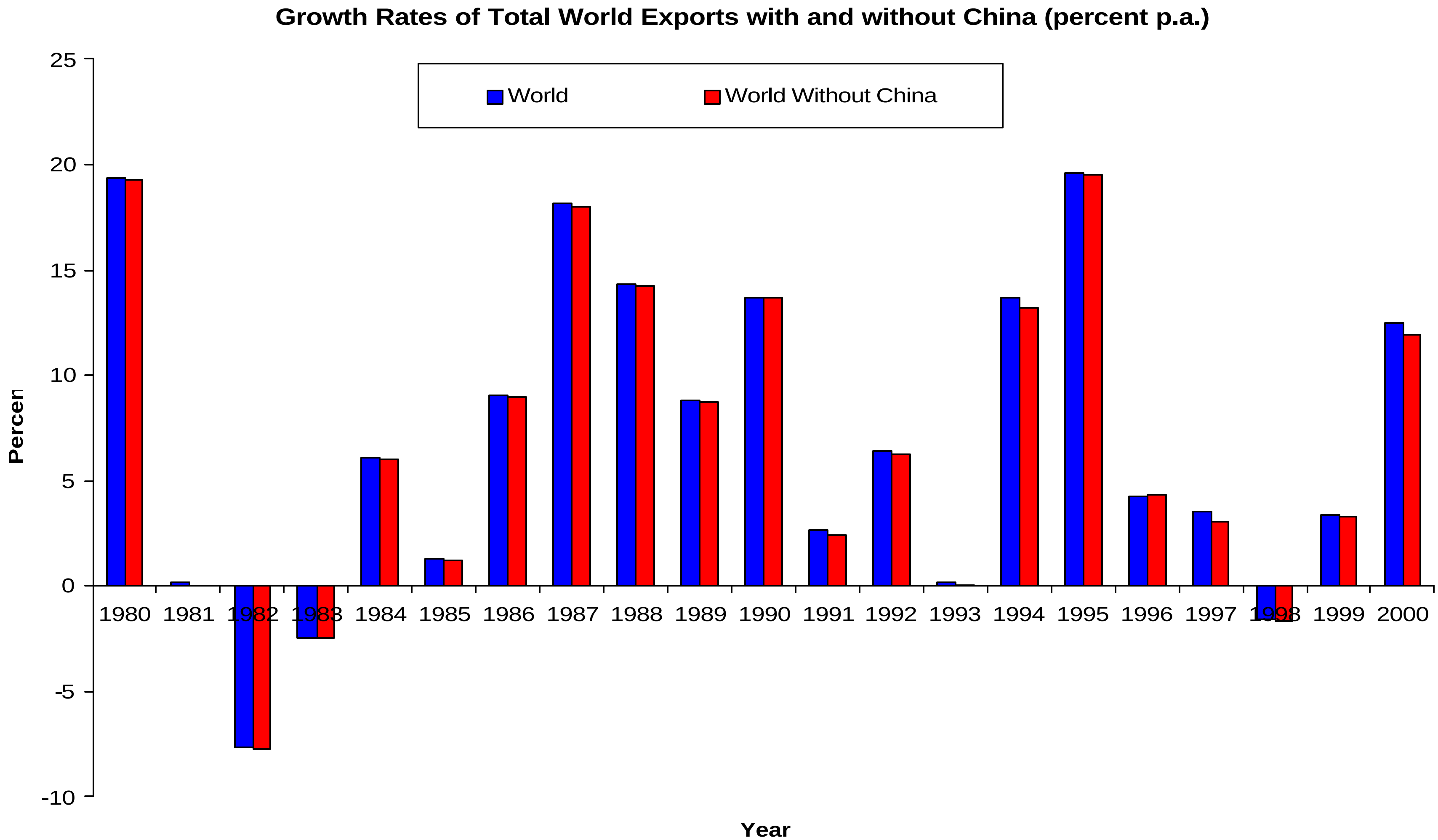
Exports and Imports (US$): Selected Countries and Regions, 2000



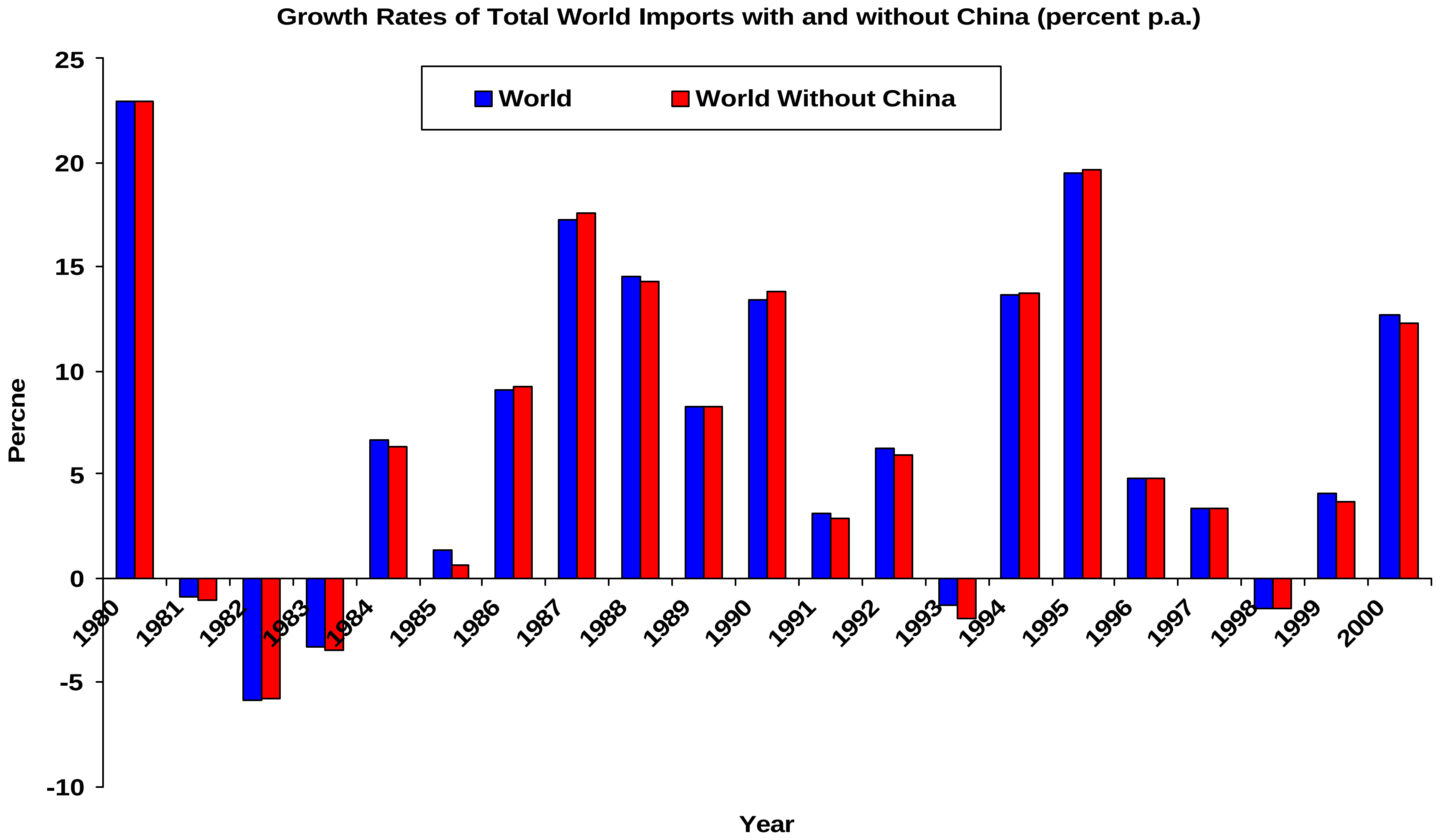
Exports and Imports per Capita (US$): Selected Countries and Regions, 2000



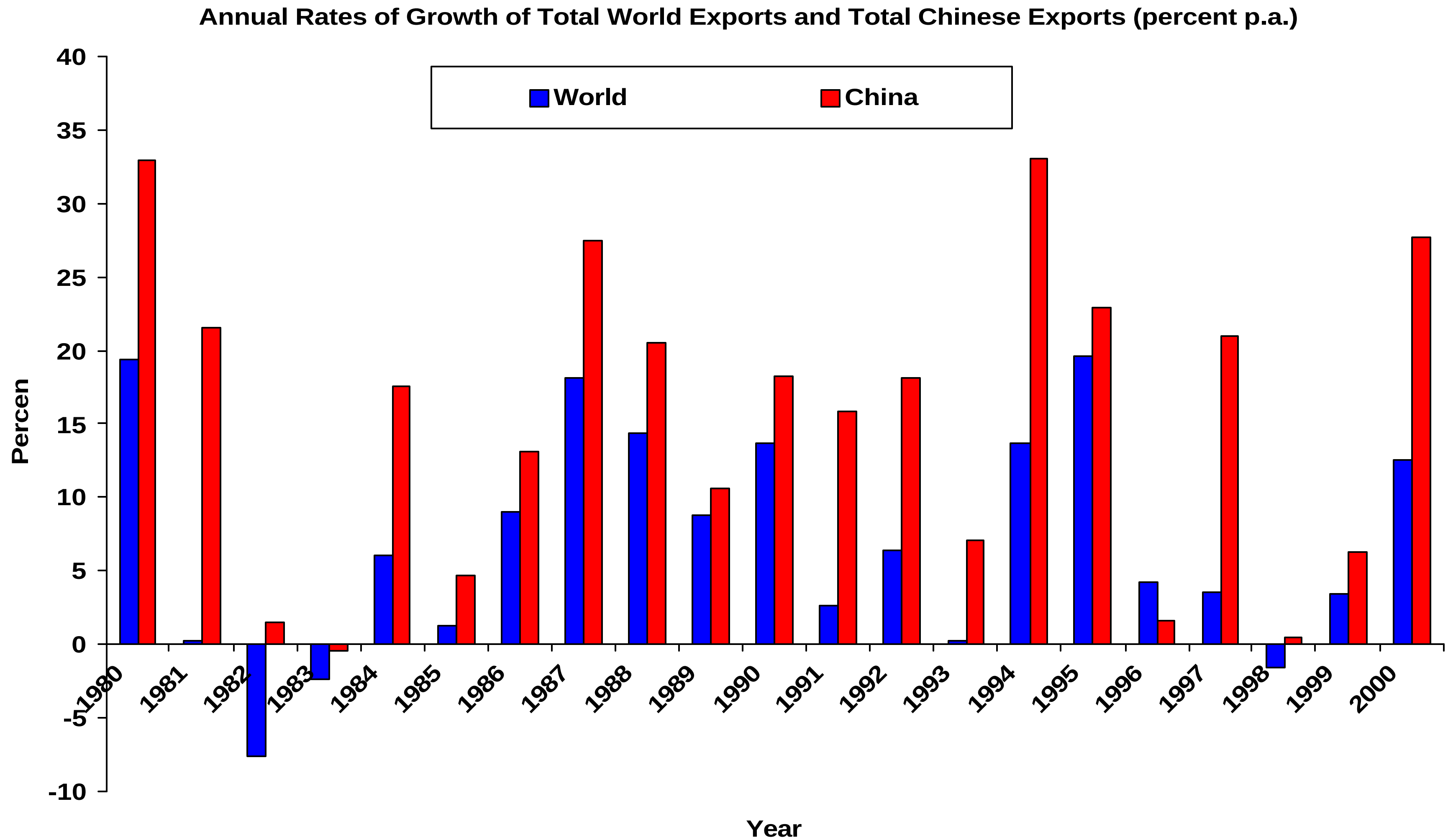
Rates of Growth of Total World Exports (US$) with and without China



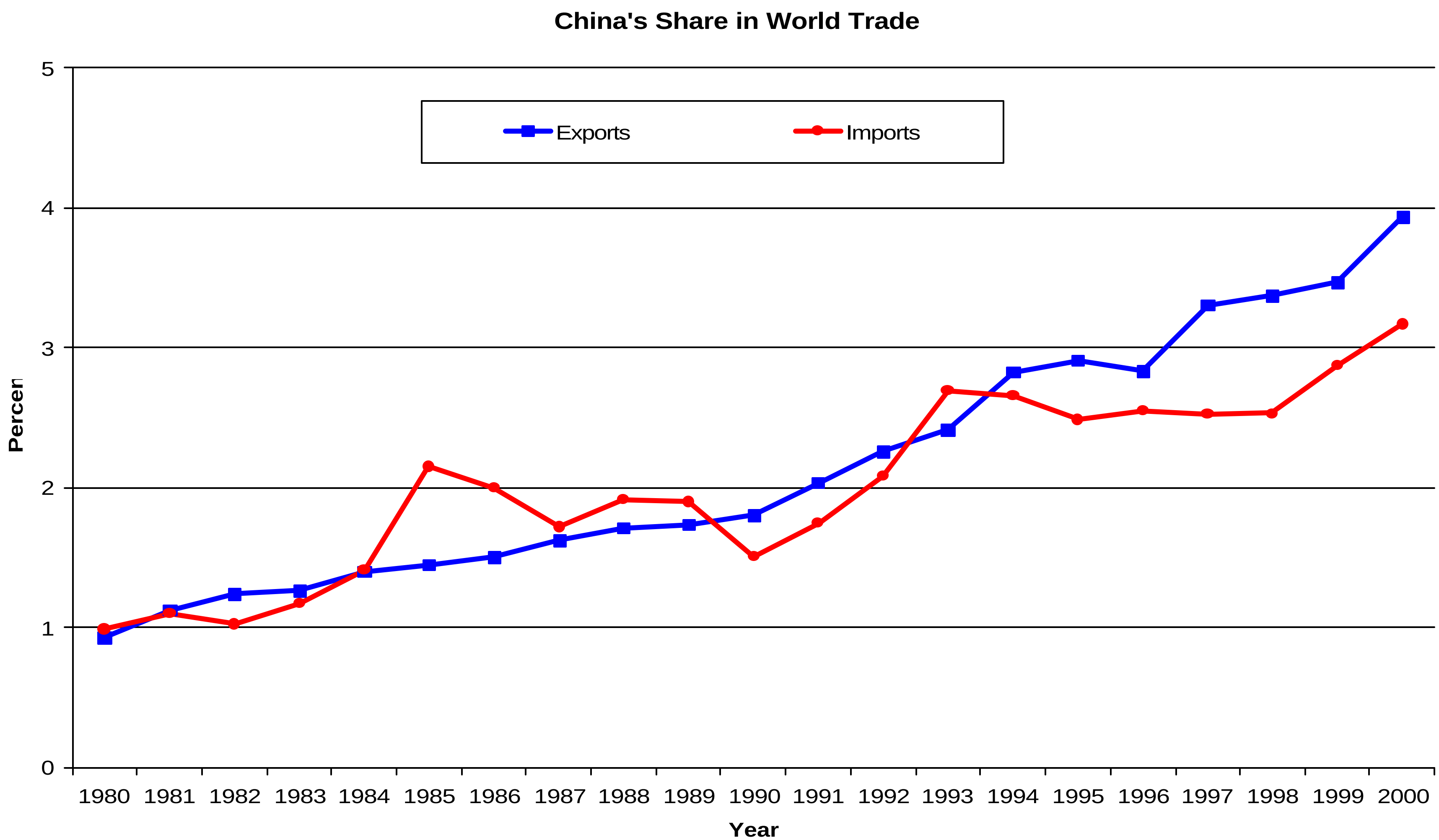
Rates of Growth of Total World Imports (US$) with and without China



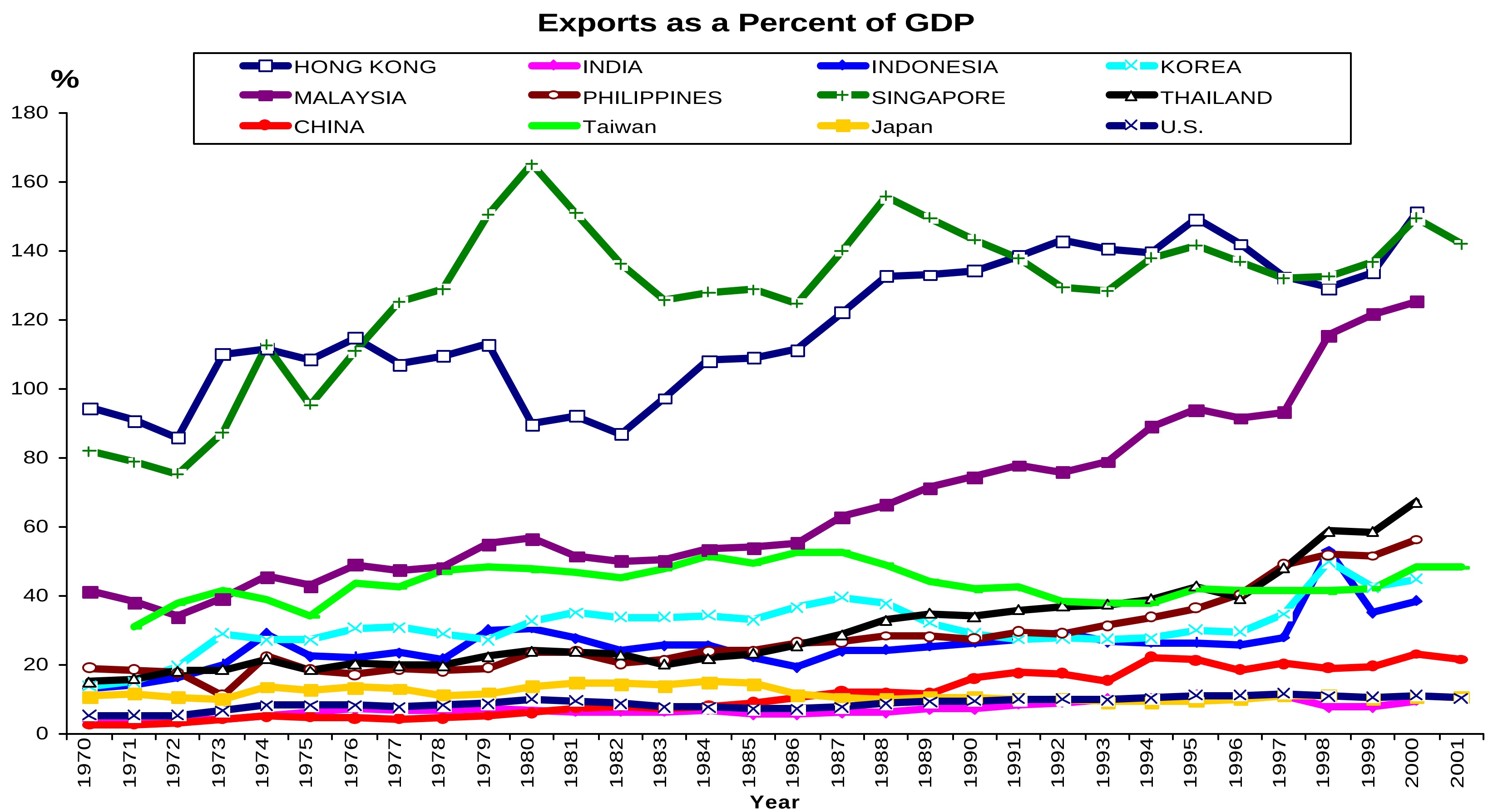
Rates of Growth of Total World Exports and Total Chinese Exports



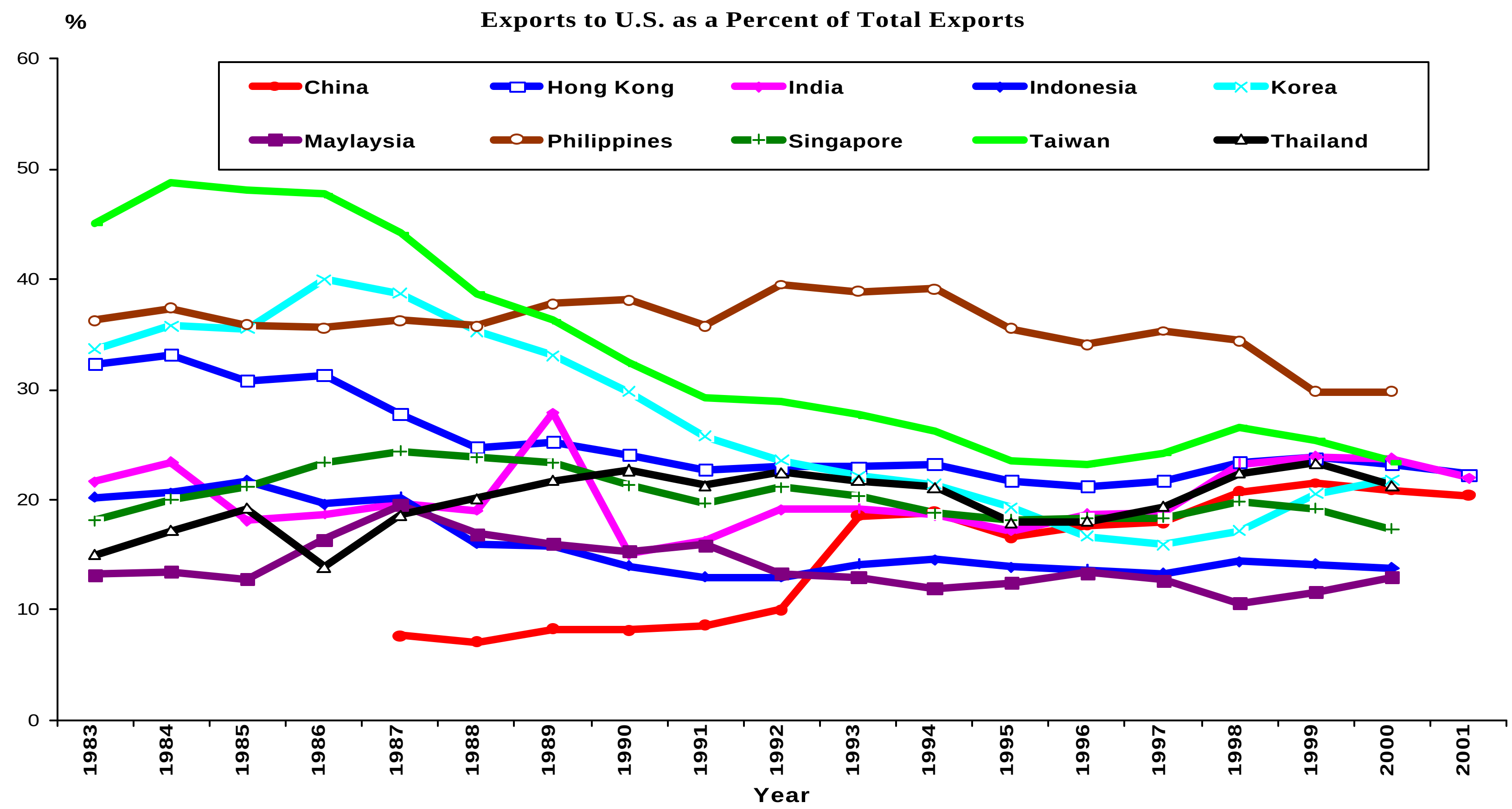
China's Shares of Total World Trade



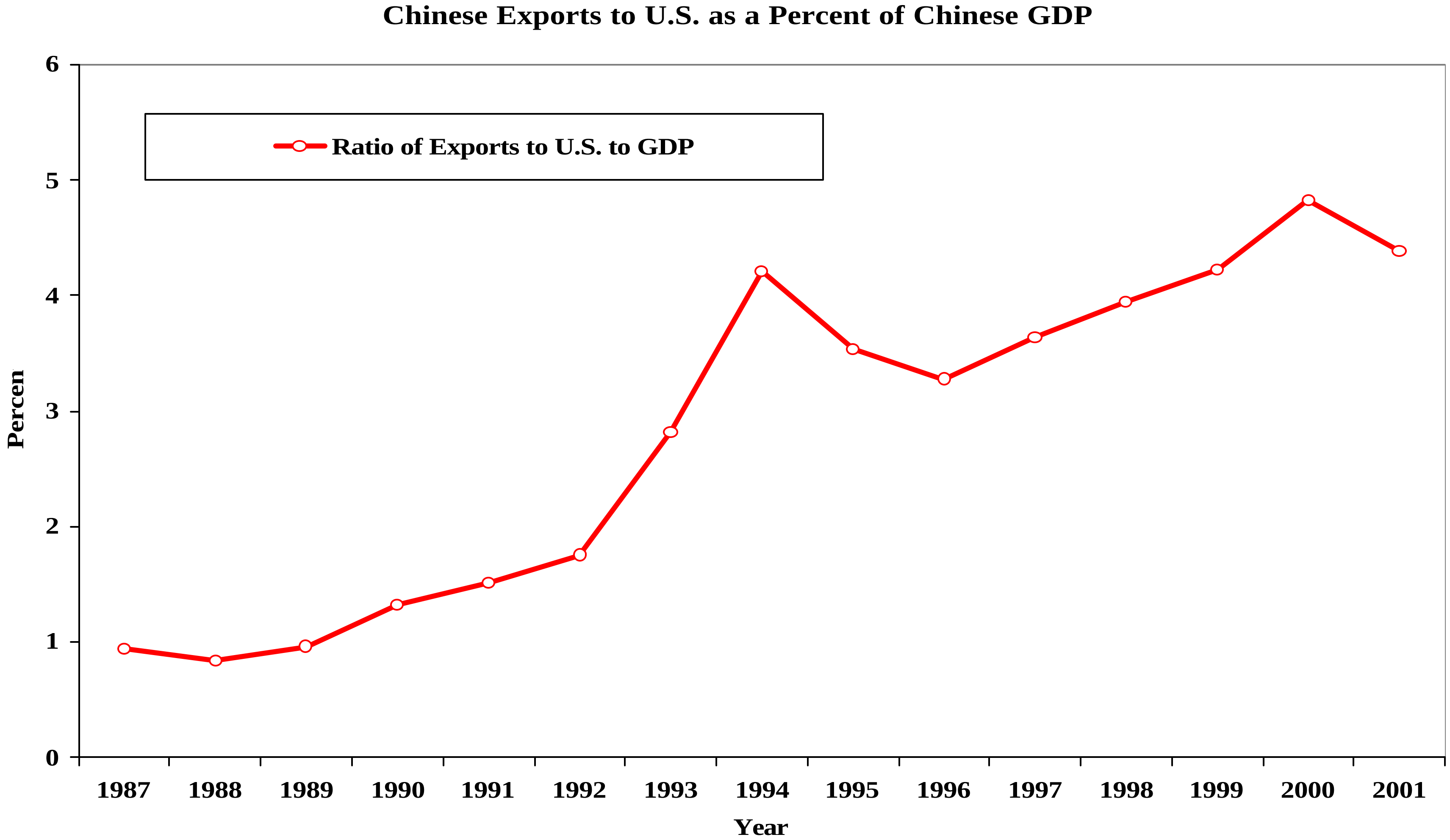
Exports as a Percent of GDP: Selected East Asian Economies and U.S.



Exports to U.S. as a Percent of Total Exports



Chinese Exports to the United States as a Percent of Chinese GDP (Chinese Data)



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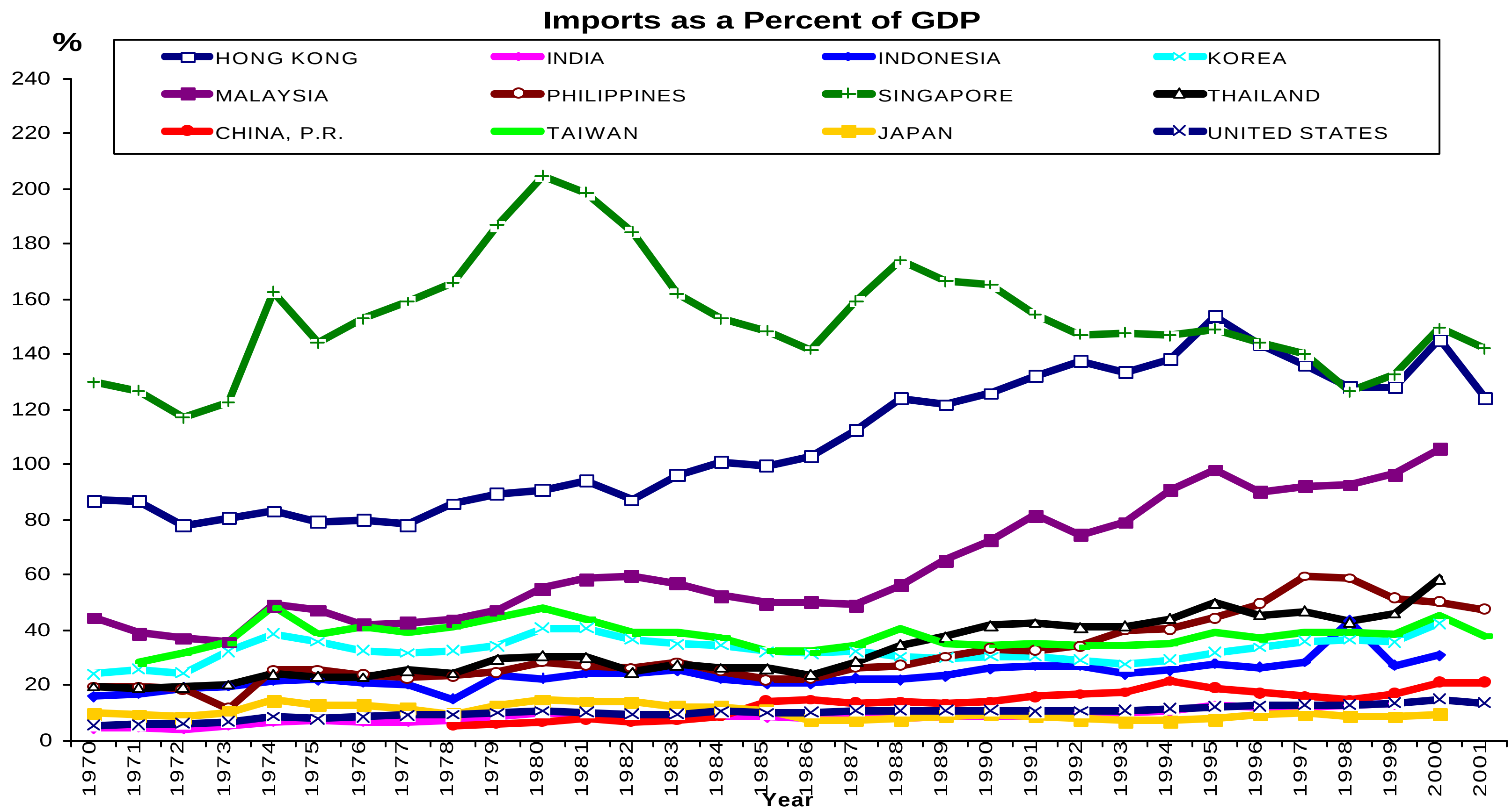
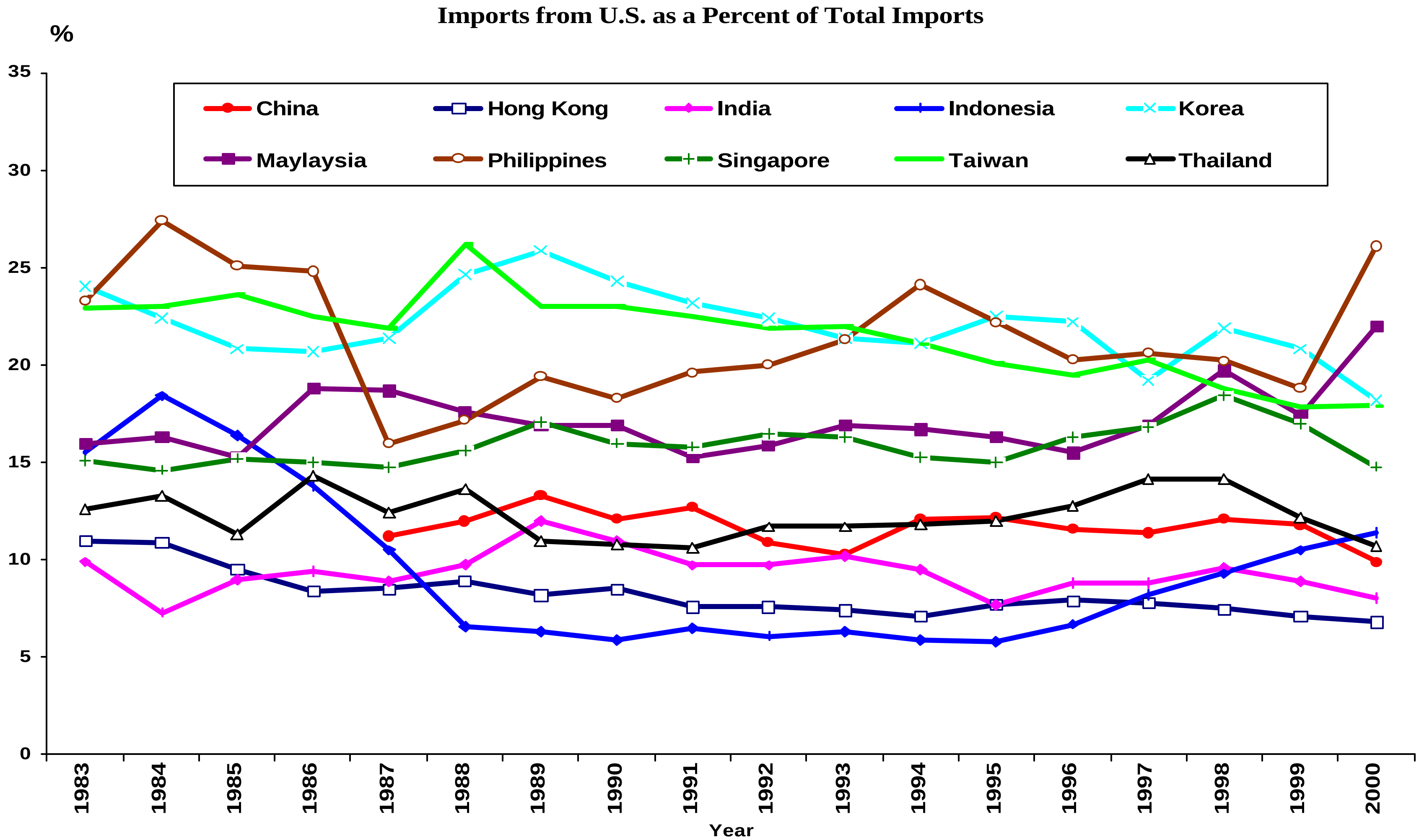


Imports from U.S. as a Percent of Total Imports



Exports, Imports and Foreign Exchange Reserves

- In 2000, exports rose 27.8% to US$249.2 billion; imports rose 35.8% to US$225.1 billion; with a trade surplus of US$24.1 billion
- In 2001, exports rose 6.8% Y-o-Y to US$266.2 billion and imports rose 8.2% to US$243.6 billion with a trade surplus of US$22.5 billion
- All these data confirm a slowdown in the growth of exports and a narrowing of the trade surplus—export growth, especially net exports growth, is likely to be low in the near term
- Chinese tourists traveling abroad exceeded 10 million in 2000; the tourism component of the balance of payments turned negative in 2000
- Official foreign reserves continued to rise, reaching US$212.2 billion at year end 2001, an increase of US$46.6 billion over year end 2000 (larger than the trade surplus of US$22.5 billion), and surpassing total outstanding external loans by a wide margin
- The exchange rate of the Renminbi vis-à-vis the U.S. Dollar has remained stable since 1994 (in fact, there has been a slight appreciation from 8.7 Yuan/US$ to 8.3 Yuan/US$)

Chinese Exports by Major Destinations

Chinese Exports by Major Destinations: Billion US$

Rank in 2001	Country	Exports 2000 Value	Share	2001 Value	Share
1	United States	52.104	20.91%	54.283	20.40%
2	Hong Kong	44.52	17.87%	46.547	17.49%
3	Japan	41.654	16.72%	44.958	16.89%
4	Korea	11.292	4.53%	12.521	4.70%
5	Germany	9.278	3.72%	9.754	3.66%
	Total Exports	249.2		266.154	

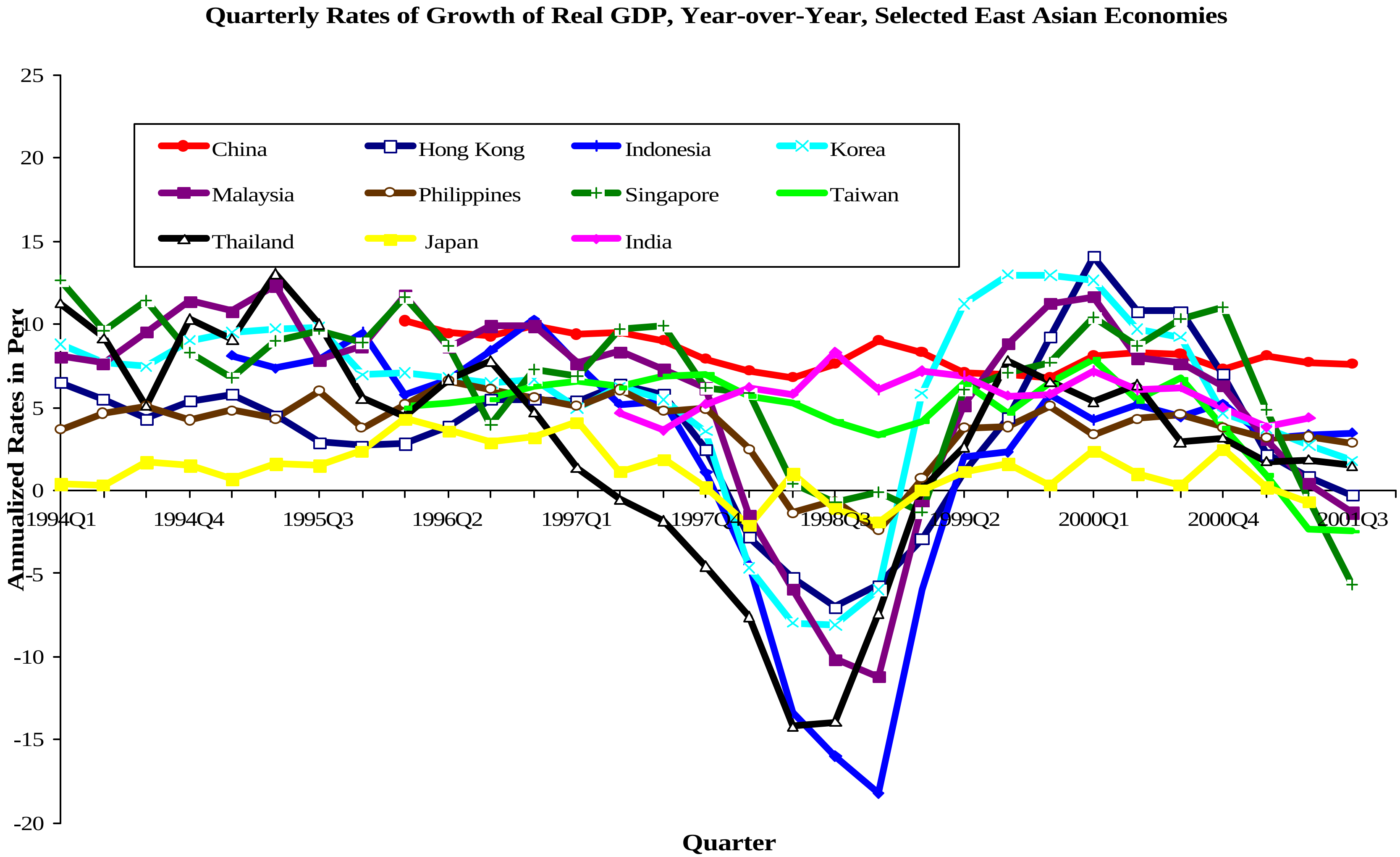
Chinese Imports by Major Origins

Chinese Imports by Major Origins: Billion US$

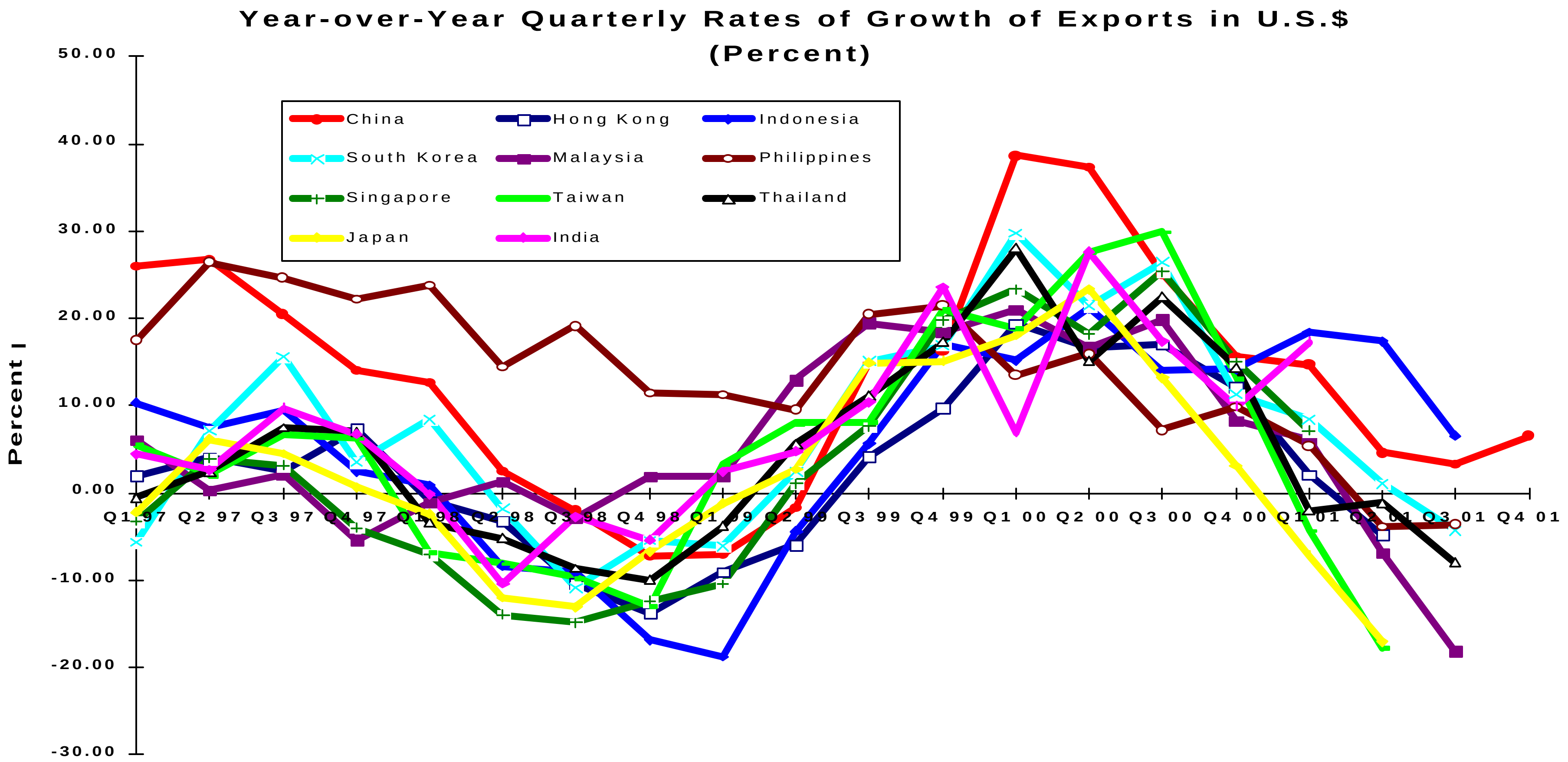
Imports

Rank in 2001	Country	2000 Value	2000 Share	2001 Value	2001 Share
1	Japan	41.512	18.44%	42.797	17.57%
2	Taiwan	25.494	11.33%	27.339	11.22%
3	United States	22.363	9.93%	26.202	10.76%
4	Korea	23.207	10.31%	23.389	9.60%
5	Germany	10.409	4.62%	13.772	5.65%
	Total Imports	225.094		243.613	

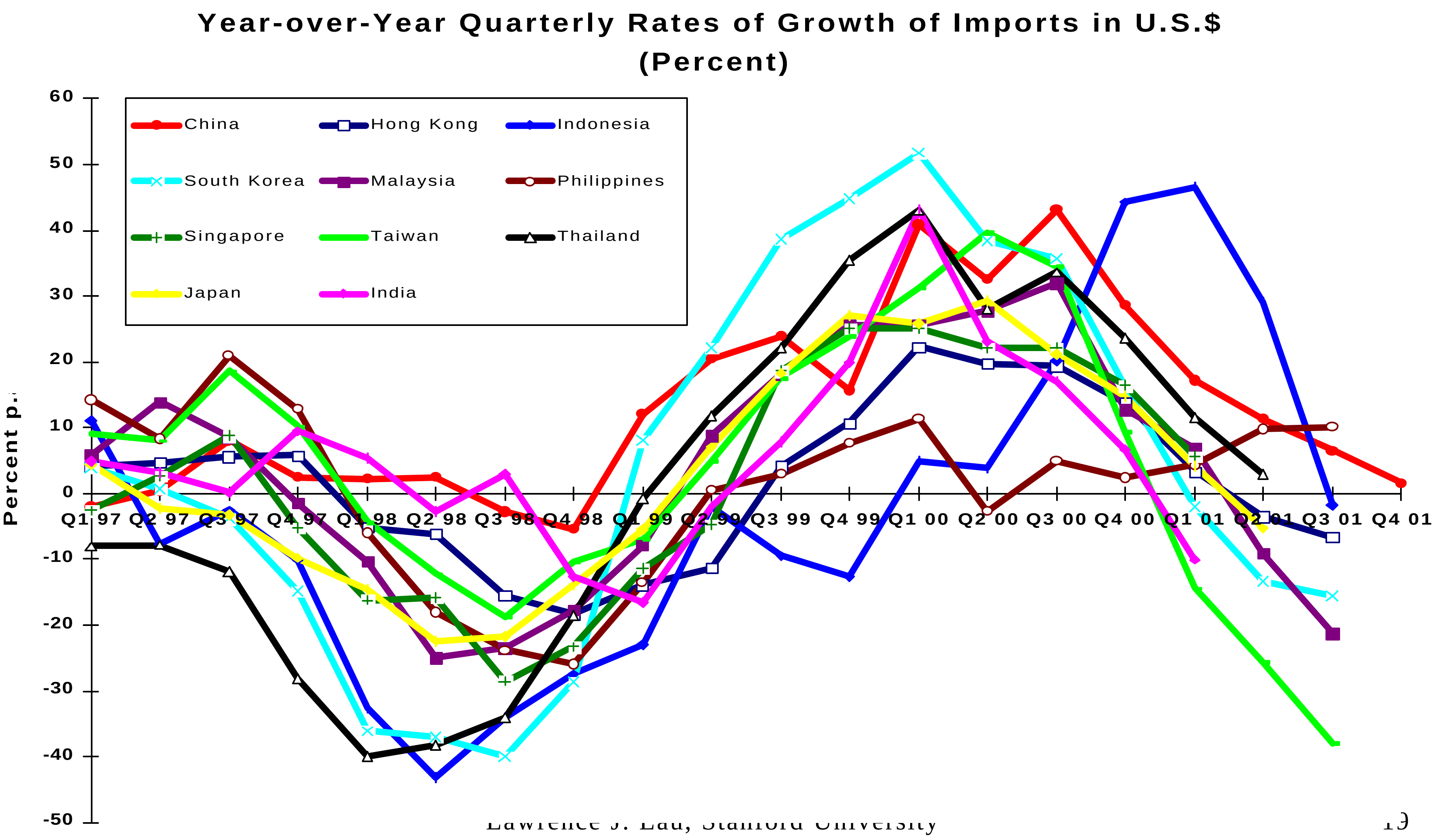
The Rates of Growth of Real GDP: Selected East Asian Economies



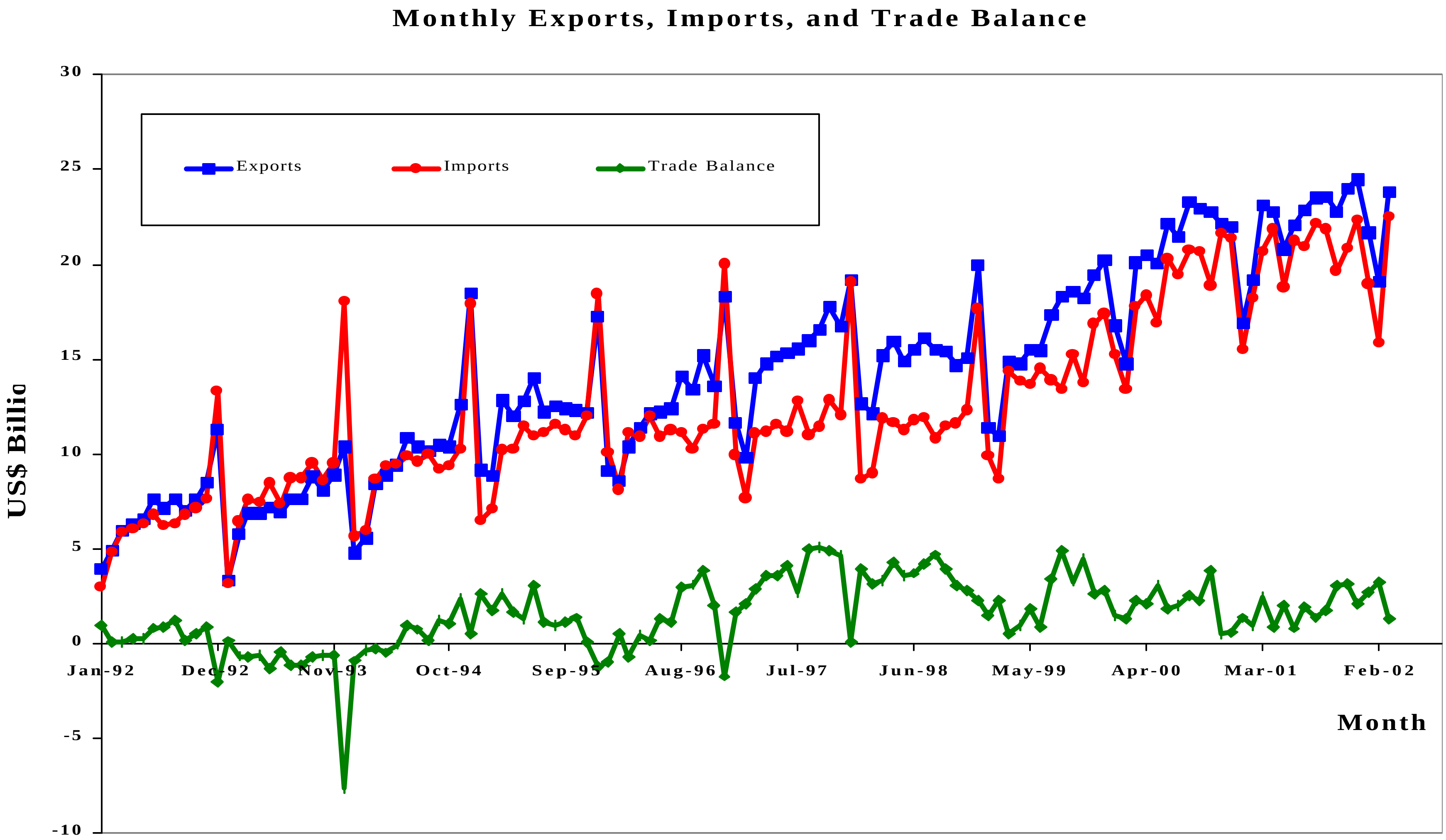
Quarterly Rates of Growth of Exports



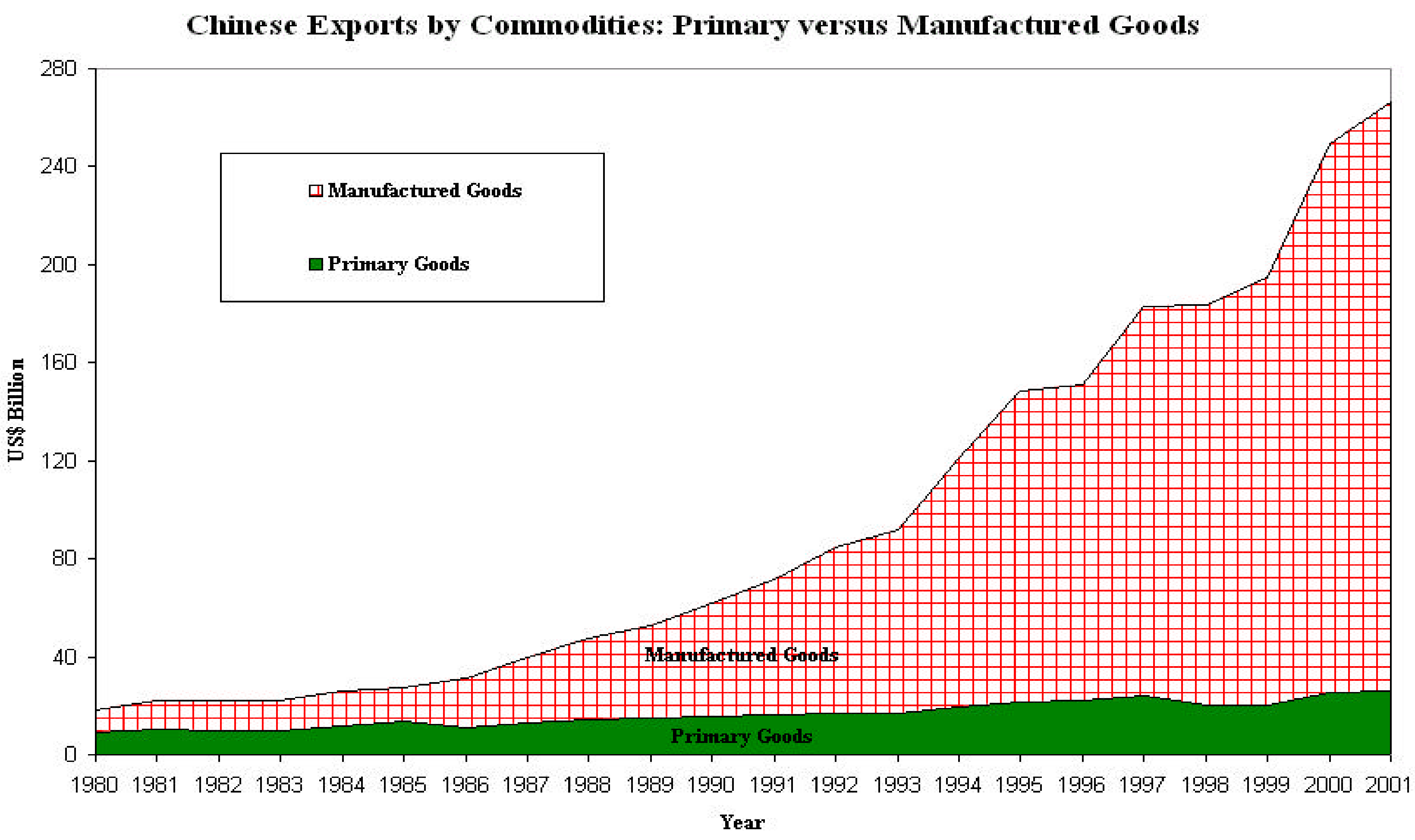
Quarterly Rates of Growth of Imports



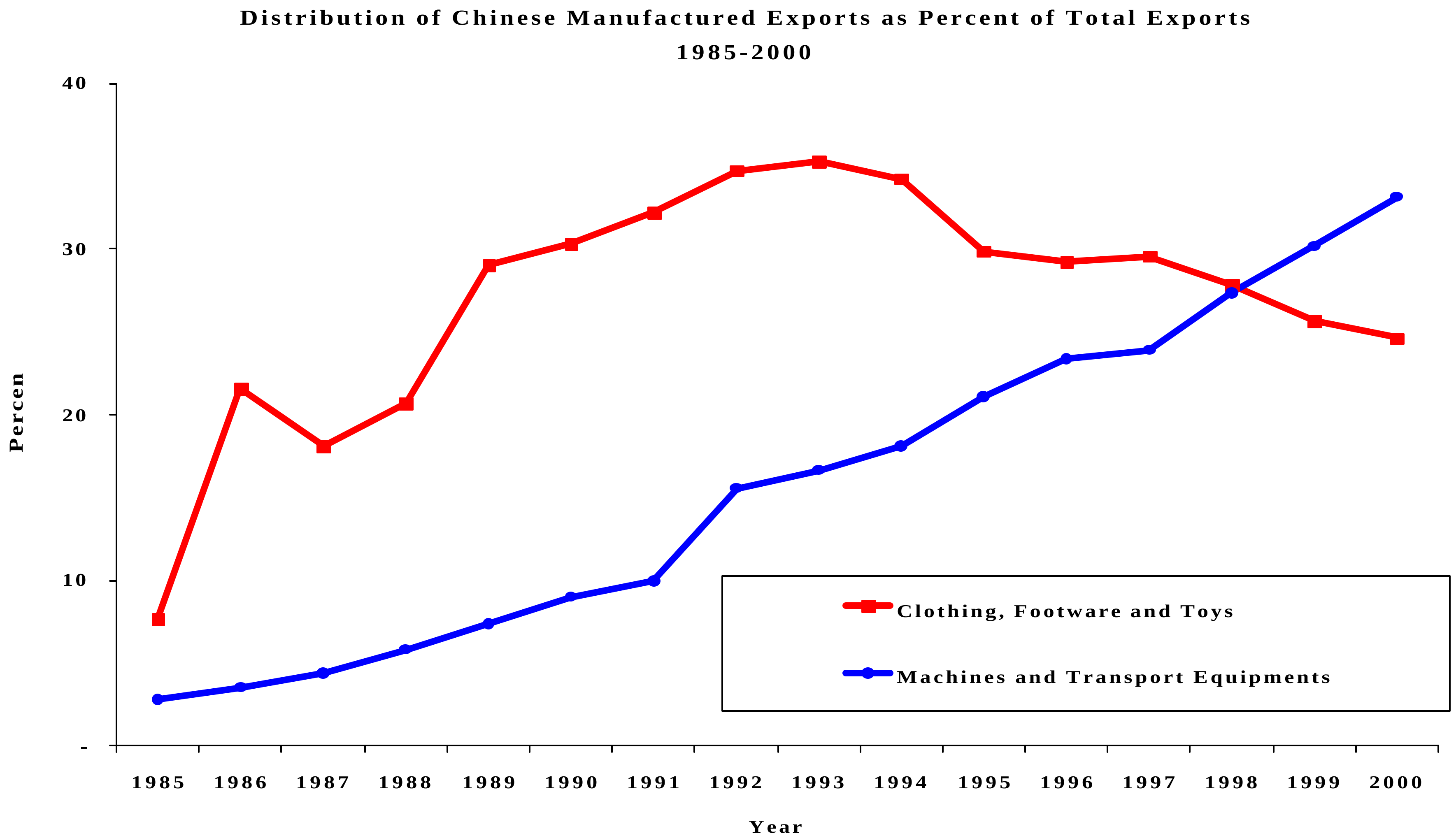
Monthly Exports, Imports and Trade Balance
Official Chinese Data



Composition of Chinese Exports by Primary Commodities versus Manufactured Goods



Manufactured Exports as a Percent of Total Chinese Exports



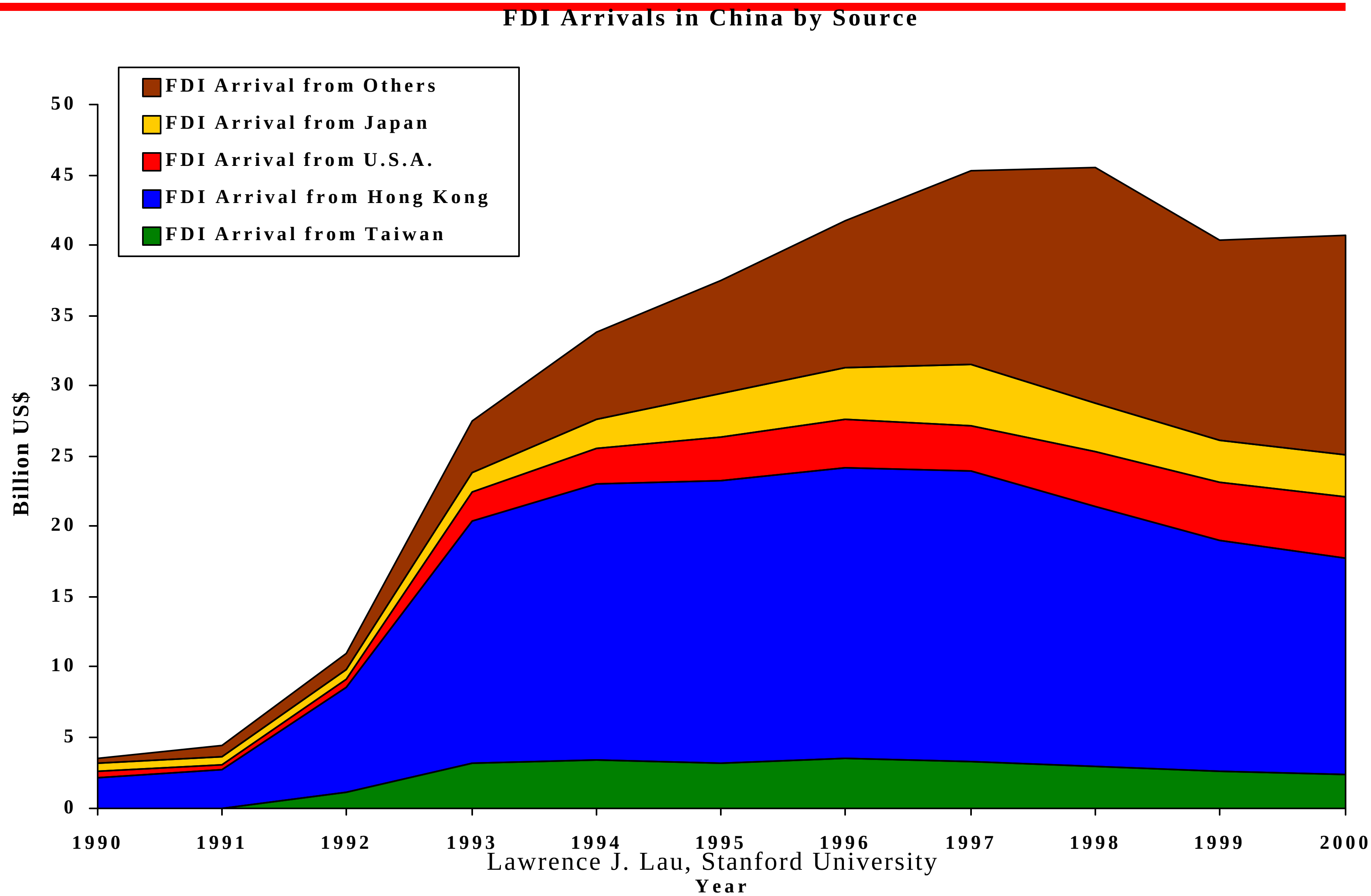
Foreign Direct Investment (FDI)

- FDI, at US$45 billion a year, amounts to approximately 10% of the annual Chinese aggregate gross domestic investment of approximately US$450 billion. Moreover, a significant proportion of it is what is known as "recycled" or -tripped" investment ultimately originated by Chinese entities and individuals. Quantitatively, FDI is not critical to the Chinese economy.
- Qualitatively, FDI is probably more important because it brings in technology, know-how, business methods, management techniques and markets that will otherwise be unavailable in China.
- FDI arrivals totaled US$40.39 billion in 1999, an 11% decline from 1998--however, the sources of the FDI were different--real FDI probably rose if "round-tripped" capital were excluded
- FDI commitments amounted to US$41.24 billion in 1999, a decline of 20.9%
- FDI arrivals totaled US$40.7 billion in 2000, a 1% increase over 1999; in 2001, FDI arrivals reached an all-time high of US$46.85 billion, a 14.9% rise from 2000
- FDI commitments amounted to US$62.4 billion in 2000, a 51.3% increase over 1999, partly in response to expected Chinese accession to WTO; in 2001, FDI commitments amounted to US$69.19 billion, a 10.43 rise from 2000
- Cumulative FDI at year end 2001 amounted to US$395.47 billion
- The nature of FDI has also changed--from export-oriented to domestic-market oriented; from light industry to heavy and high-technology industries; and from small projects to large projects.

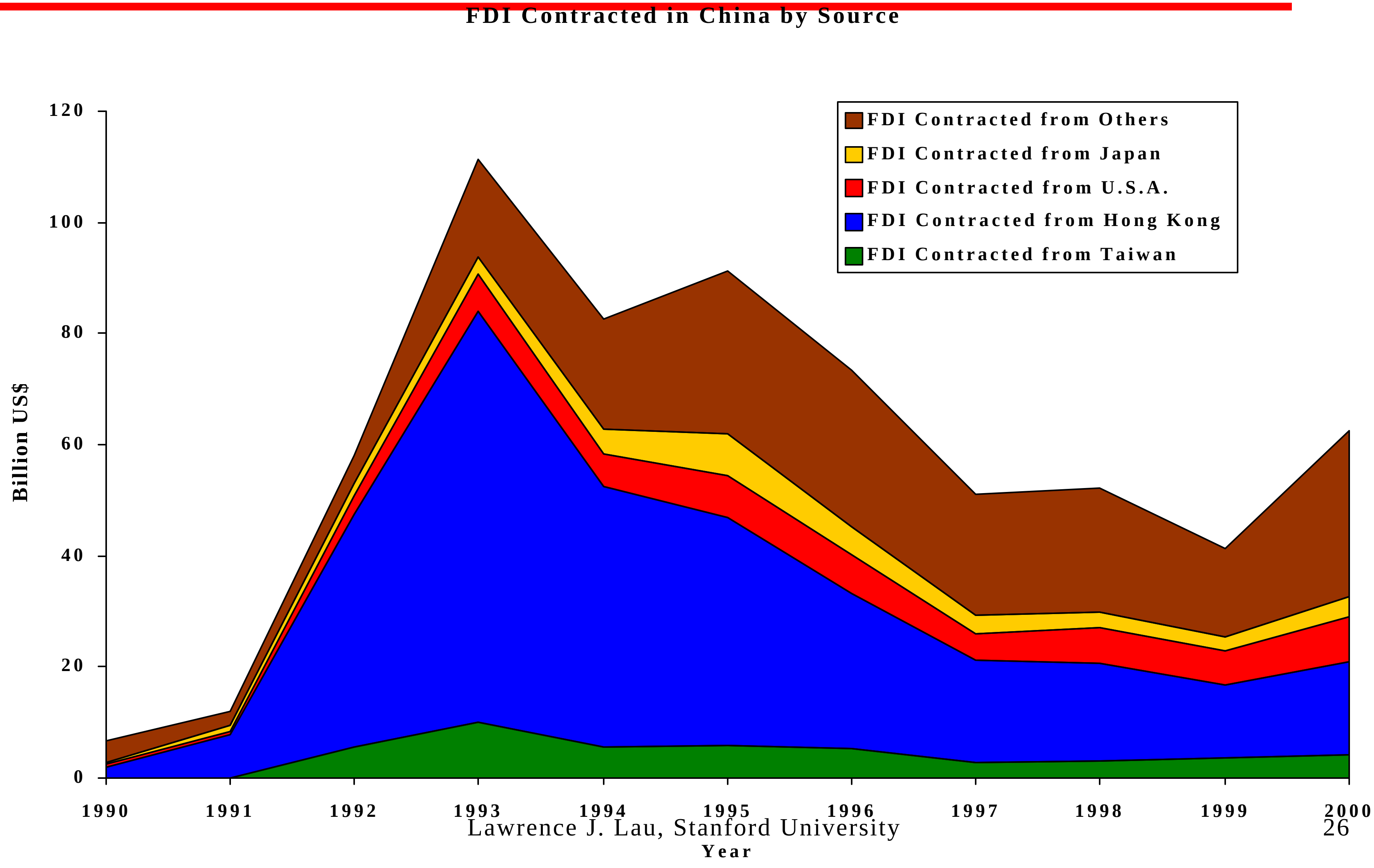
Foreign Direct Investment (FDI)

- Collateralized loan program as a natural hedge for foreign direct investors
- Initial public offerings (IPOs) and listings on Chinese stock exchanges (the second board) as a potential exit strategy for foreign direct investors

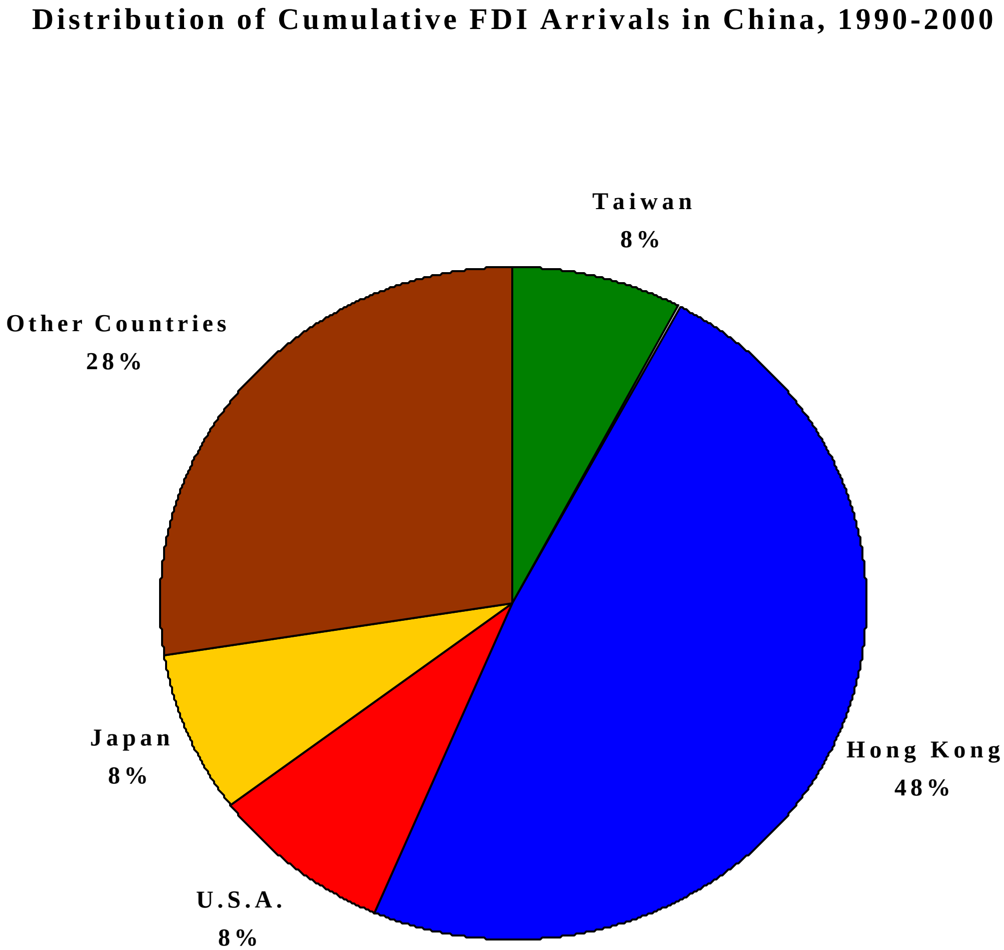
FDI Arrivals in China by Origin



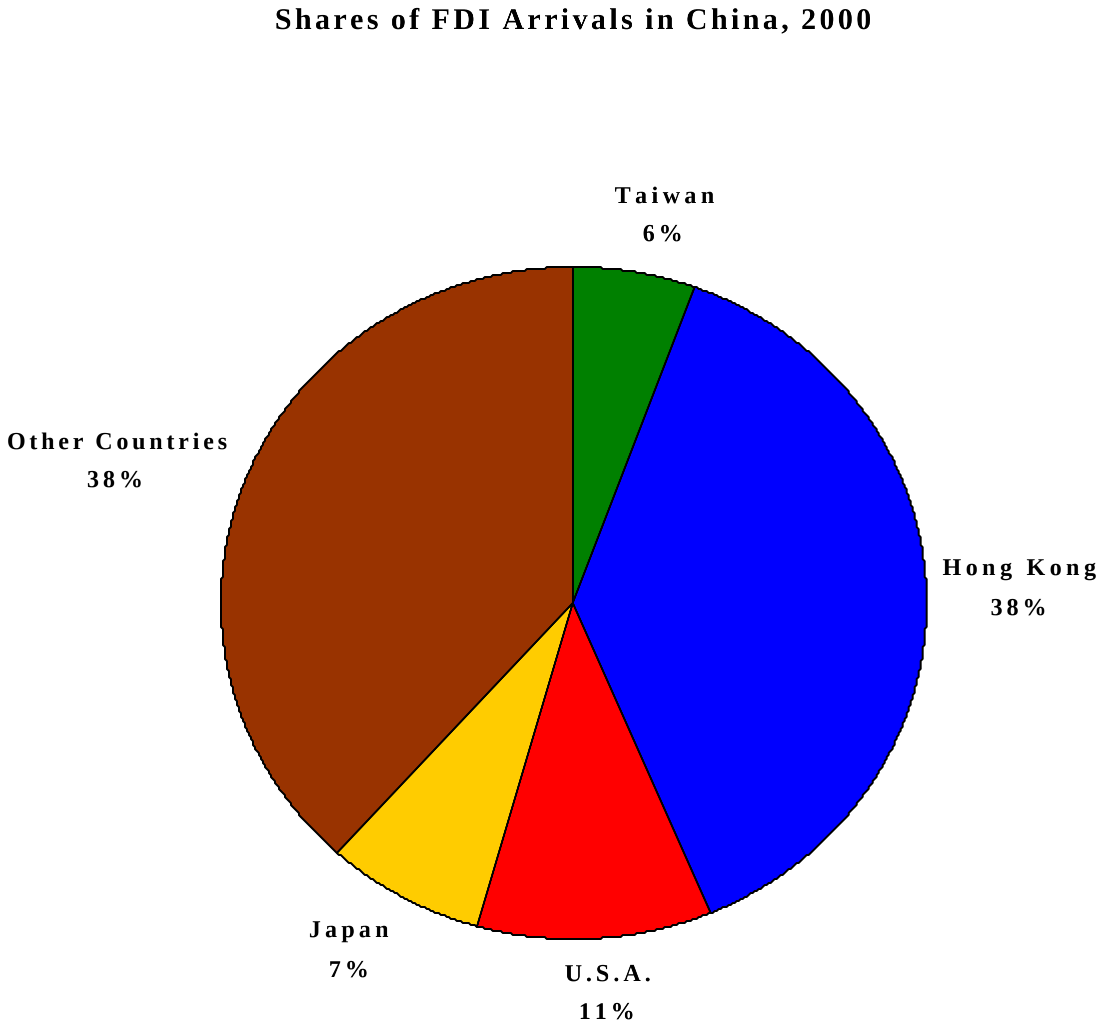
FDI Contracted by Origin



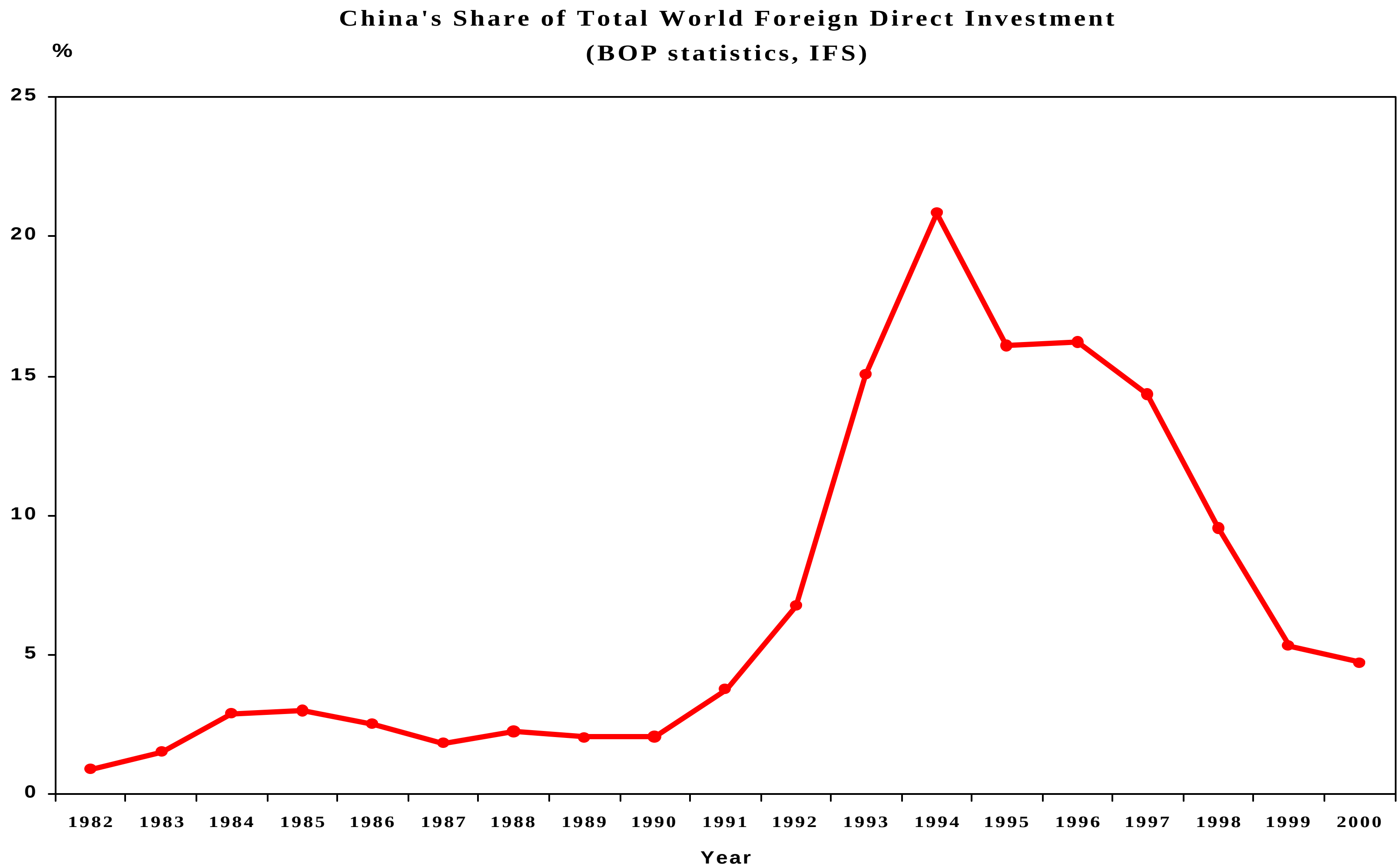
Distribution of Cumulative FDI Arrivals



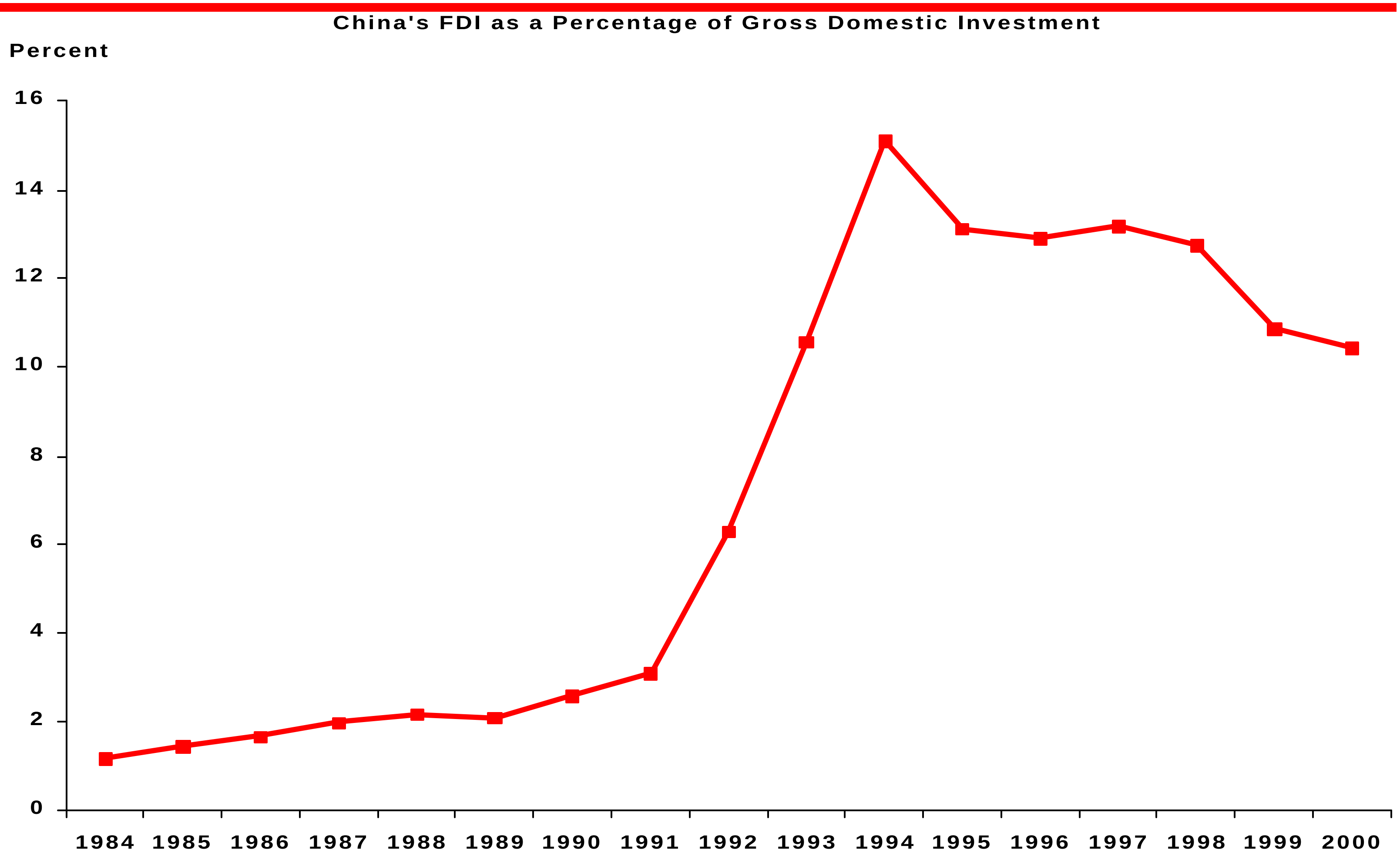
Distribution of FDI Arrivals in 2000



China’s Share of World Foreign Direct Investment

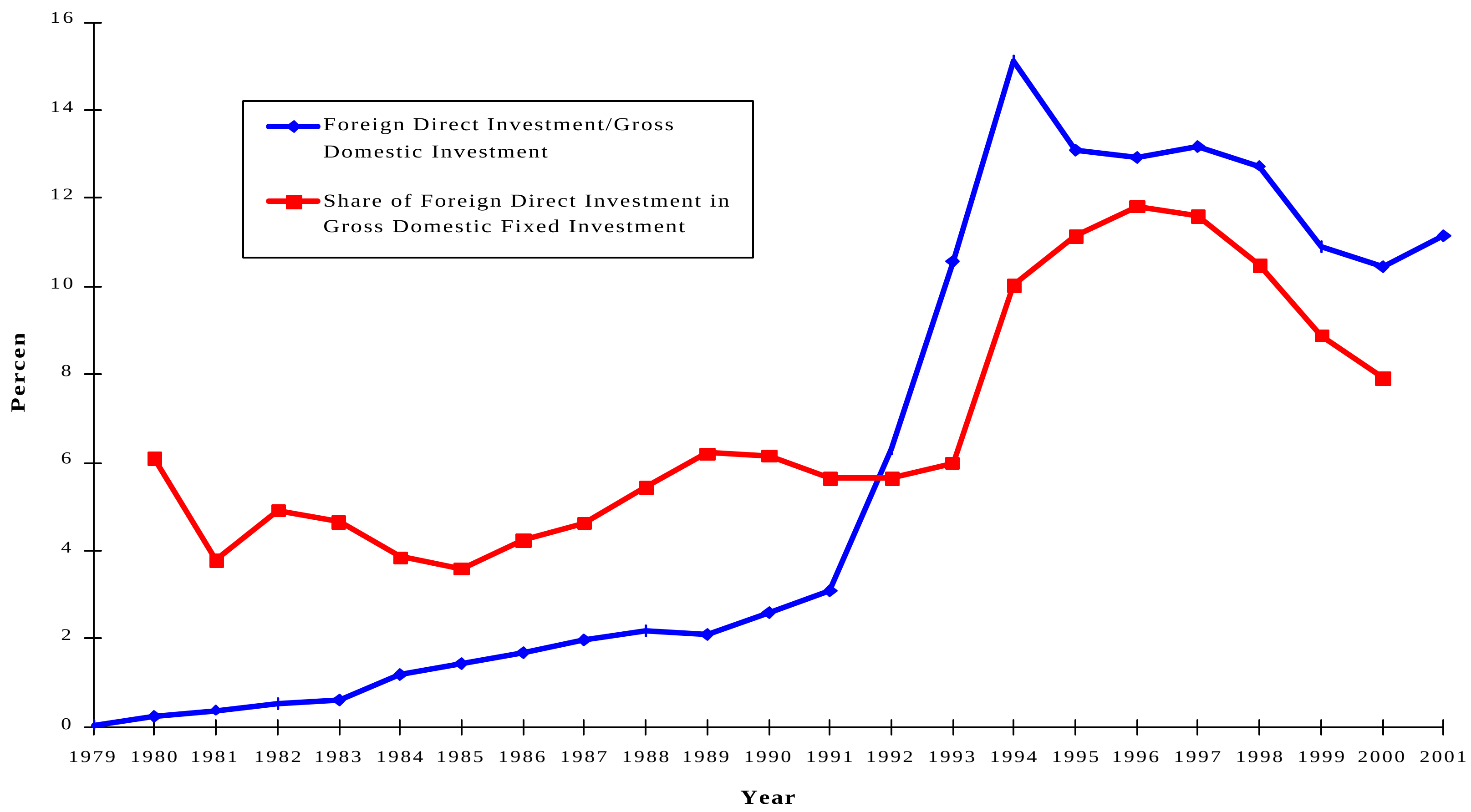


China’s FDI as a Percent of Gross Domestic Investment



The Shares of FDI in Chinese Gross Domestic and Gross Domestic Fixed Investment

Fig. 1.2. The Share of Foreign Direct Investment in China (Percent)



Globalization and Investment Diversification

- Geographical diversification has to be re-thought because of globalization
  - Diversification by multinational corporations: e.g., IBM is not a U.S. risk because of its significant business around the globe; similarly, Nestle is not a Swiss risk; these are all globally diversified corporations
  - Covariance due to supply-chain connections, e.g., Dell, and its sub-contractor in Taiwan, Quanta Computer, face the same risks—Quanta is not really a Taiwan risk
  - Covariance of markets—the stock markets have in recent years tended to move together
- There are gains from geographical diversification only if the economic performance of the different regions of investment are uncorrelated or negatively correlated
- The apparent "home bias" of the portfolios of domestic investors may be due to legal restrictions (both outbound and inbound), explicit or implicit restrictions on foreign ownership, transactions costs (including information acquisition and monitoring), corporate governance (and available float for the general public), competitiveness and fairness of the stock market, and exchange rate risks.
- China, India, and potentially Latin America are candidates for investment if diversification is the objective because they are large economies the rates of growth of which are not very sensitive to what happens outside

Investment in China by Foreign Investors: Considerations

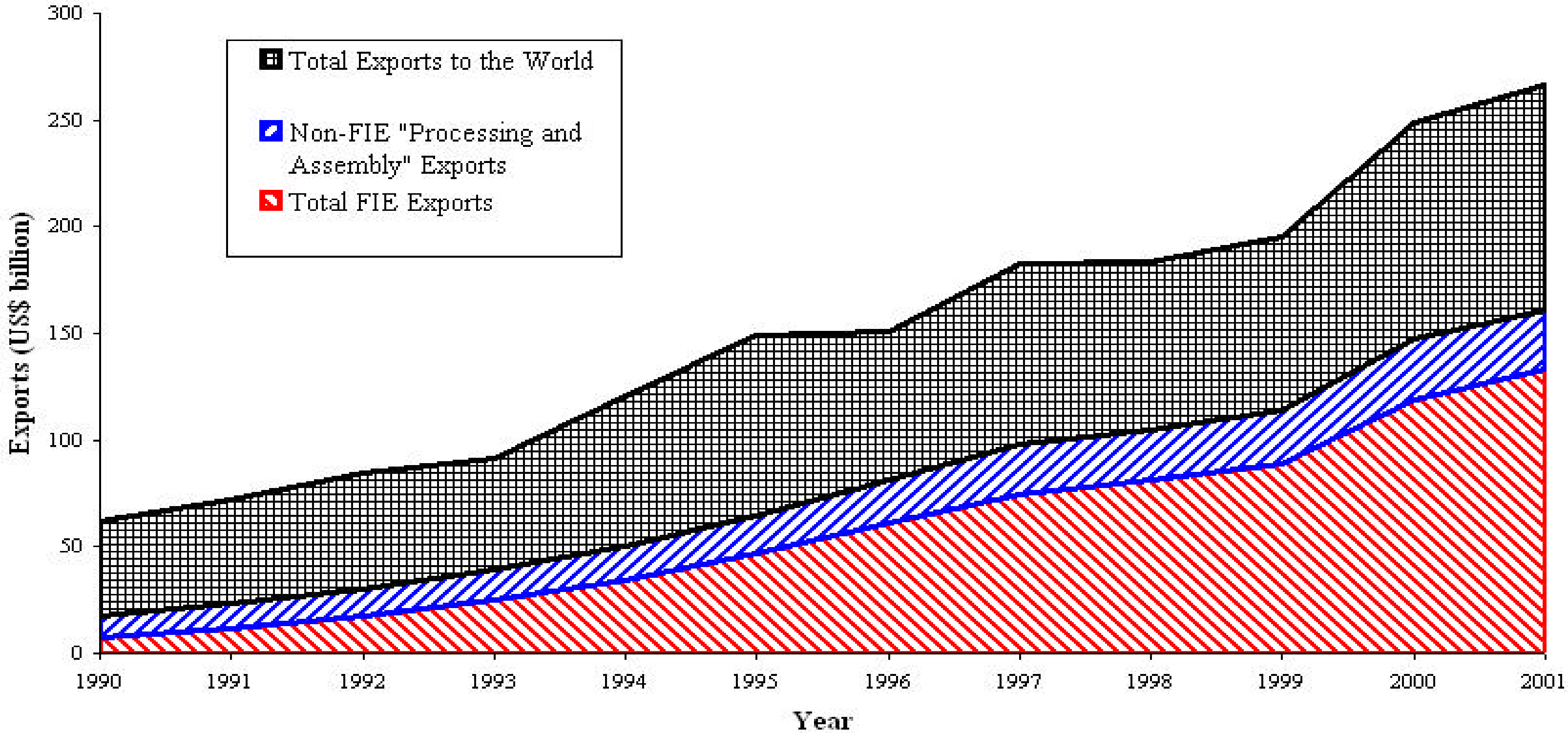
- Covariance between East Asian and U.S. markets
  - Covariance increased by globalization
  - The high-technology sector versus the traditional and the non-tradable sectors
  - Covariance between U.S. and China is small, hence maximum gain from diversification
- Public versus private markets
  - Credibility of public markets (insider trading, manipulation, protection of minority shareholders, disclosure and transparency)
  - Ease and necessity of direct financial monitoring
  - Casino mentality of public markets
- Portfolio versus direct investment
  - Possibility of capital control and other forms of restrictions on short-term capital flows
  - Necessity of continuous active direct monitoring
  - Choice of joint-venture partner(s), if any, critical
  - Availability of depositary receipts in liquid, transparent and well-regulated markets with no capital control
- Competitive advantage
  - Money alone is not sufficient because of relative abundance of domestic savings—foreign direct investors must have superior technology, know-how, knowledge or control of markets

Investment in China by Foreign Investors: Considerations

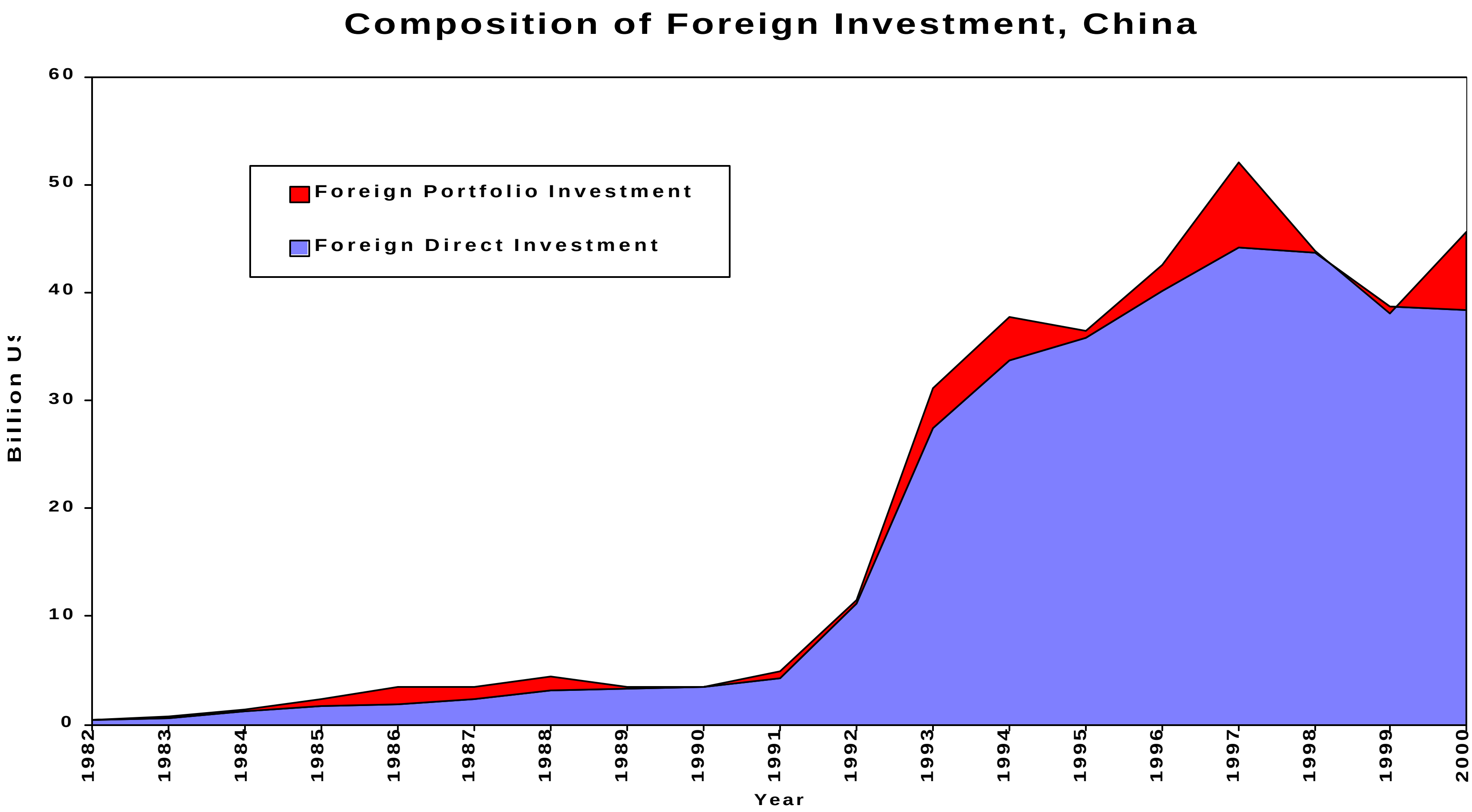
- The nature of foreign direct investment (FDI) in China has been undergoing a transformation
  - The nature of FDI has changed gradually from export-oriented to domestically oriented, taking advantage of the large Chinese domestic market; from light industry to heavy and high-technology industries, and from small projects to large projects
  - Foreign direct investors increasingly view China not so much as an export base but as a market for their finished products--e.g., BASF, General Motors, Motorola all plan to market at least a significant proportion of the products they produce in China in China itself

Chinese Total, Foreign-Invested Enterprises (FIEs) and Non-FIE “Processing and Assembly” Exports

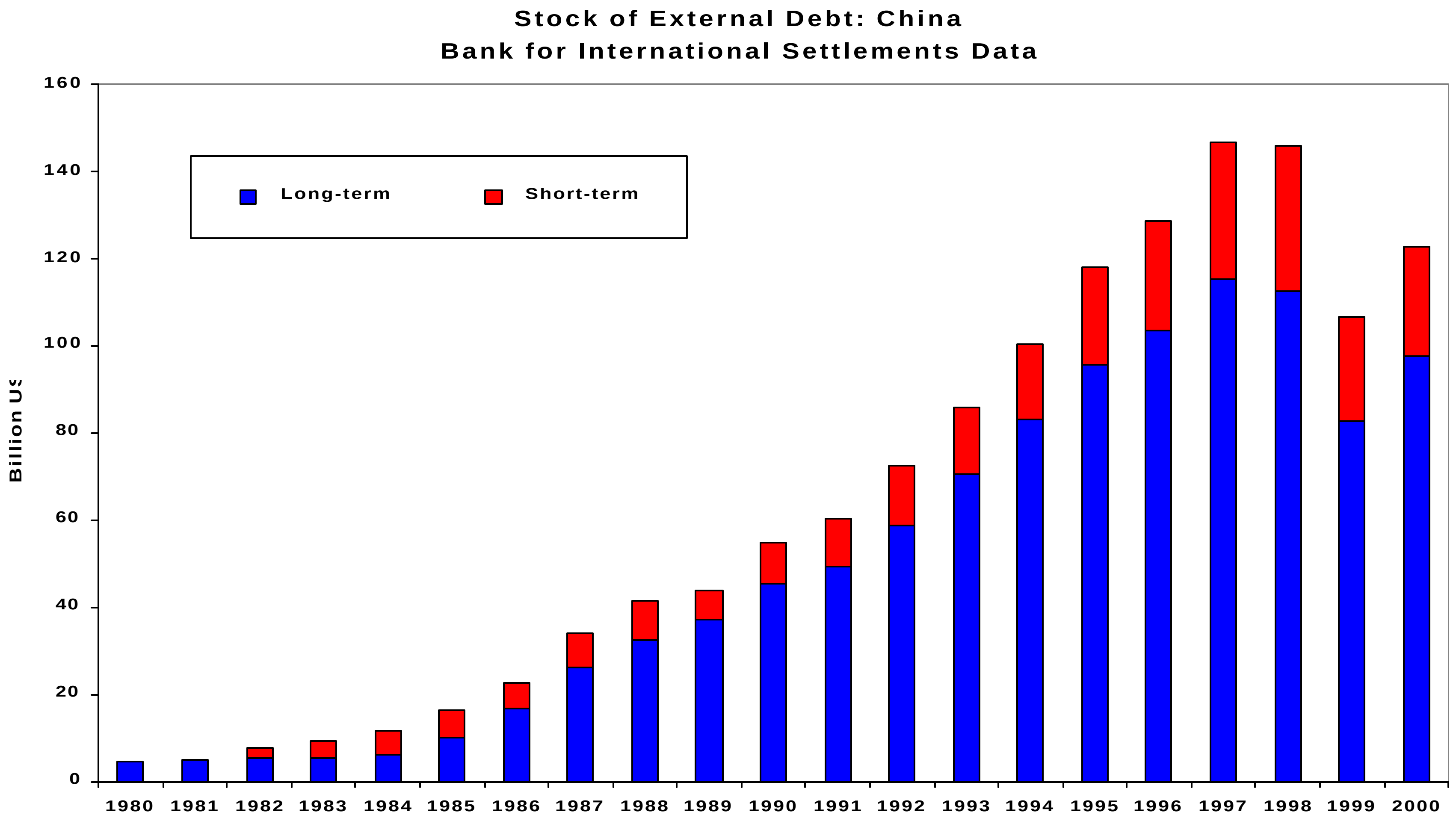
Figure 1.1: Total FIE Exports, Non-FIE "Processing and Assembly" Exports, and Total Exports of Goods to the World



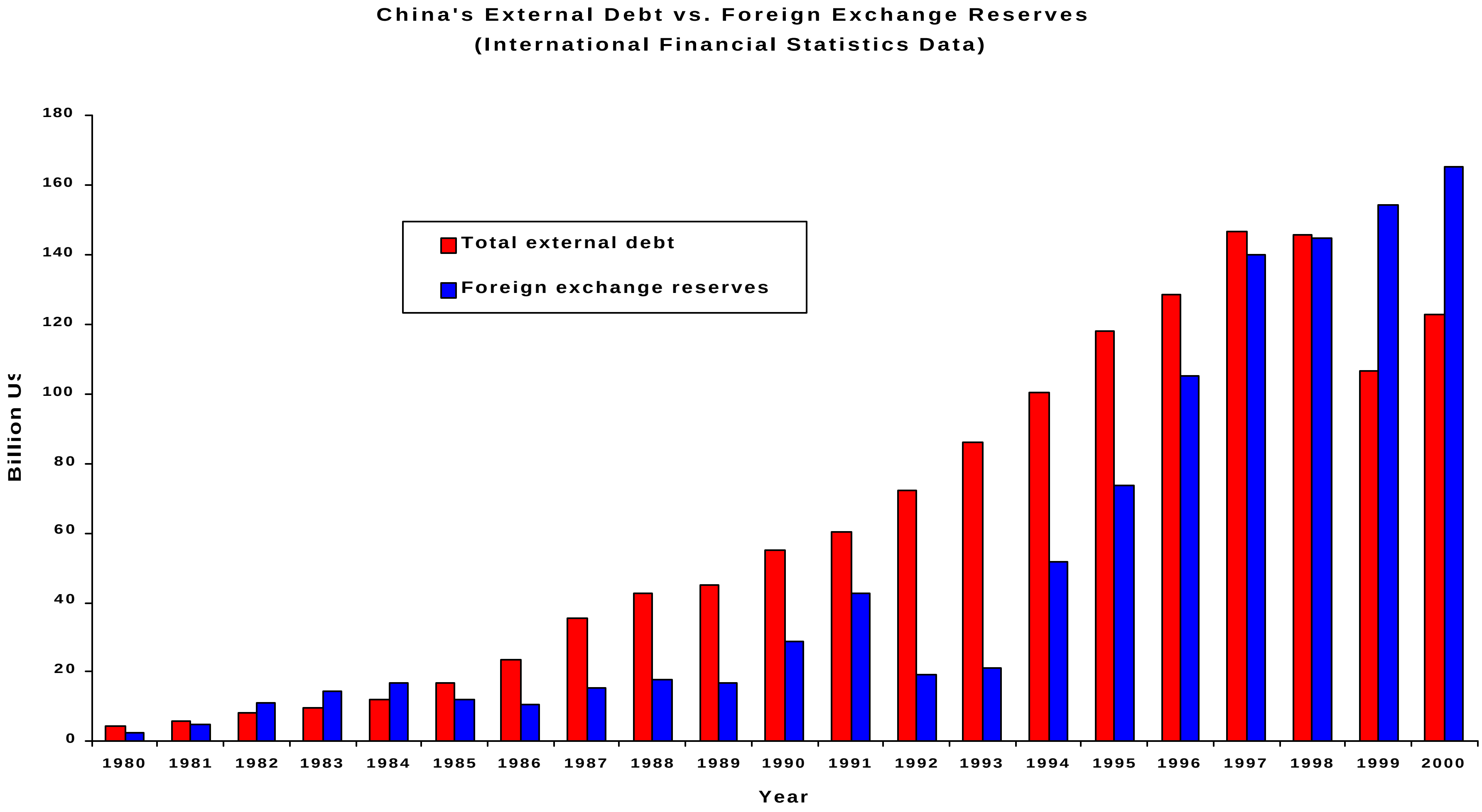
Composition of Foreign Investment—Portfolio vs. Direct: China (Annual Data)



Composition of External Debt—Short-Term (Less Than a Year) vs. Long-Term: China



External Debt and Official Foreign Exchange Reserves: China



Chinese Commitments under the WTO

- Reduction of tariffs on all imported goods, including high-technology and agricultural products
- General tariff rates to fall to 10% by 2005 (they have already been reduced from 15.3% to 12% on Jan. 1, 2002, involving more than 5,300 categories of imports) ; Automobile tariffs to fall to 25% from the current 80-100% by 2006
- Removal or reduction of non-tariff barriers
- Elimination of export subsidies, if any
- Anti-dumping provisions to apply to Chinese exports for 15 years
- Transparency of economic procedures, laws, rules and regulations
- Opening of the government procurement process
- Opening of service sectors to foreign investment and participation—international trade, distribution sectors, financial sectors (banking, insurance and securities), telecommunication and transportation sectors
- Enforcement of intellectual property rights, including patents, copyrights, brand names and trade secrets
- National treatment for all foreign direct investors

Chinese Commitments under the WTO: Opening of Service Sectors to Foreign Investment

- International trade
- Distribution sectors—retail by foreign firms will be permitted with some exceptions (books, periodicals, pharmaceuticals and pesticides)
- Financial sectors
  - Banking—local currency business open to foreign banks in 2003; retail business open in 2006
  - Insurance—additional licensees and expansion into health and group insurance within 3 years (2004)
  - Securities—33% ownership of asset management companies, increasing to 49% in 3 years; 33% ownership in underwriters
- Telecommunication sectors—49% ownership permitted in 6 years (2007); 100% ownership permitted for internet content providers
- Transportation sectors
- Professional services
  - Foreign accountants can obtain Chinese licenses through examinations
  - Foreign legal firms may operate without restrictions to locations and number of offices within one year of accession (2002)

Chinese Benefits under the WTO

- Permanent “Normal Trade Relations” status (most-favored-nation treatment) with all member countries and territories of WTO—no discriminatory tariffs and non-tariff barriers
- Reciprocal rights for trade and investment in services
- The right to use the WTO dispute settlement mechanism
- Chinese textile industry will benefit from the phasing-out of the quota restrictions of the Multi-Fibre Agreement (MFA) in 2005 (for the U.S., in 2009; in addition, U.S. can adopt anti-surge measures for another 12 years)
- Joining the World—assuming its rightful place in the community of nations

The Direct Economic Impacts of Chinese Accession to the World Trade Organization (WTO) on China (1)

- Immediate impacts are relatively small; but it will lead to a change in long-term expectations about the Chinese economy
- Rates of growth of real GDP and retail and consumer price indexes

	Real GDP	RPI	CPI
1997	8.8	0.8	2.8
1998	7.8	-2.6	-0.8
1999	7.1	-2.9	-1.3
2000	8.0	-1.5	0.4
2001	7.3	-0.8	0.7
2002Q1	7.6		-0.6

- Despite fluctuations in exports and imports, the rate of growth of real GDP has remained remarkably stable at 7-8%. Exports are approximately 20% of GDP, but the value-added component is only approximately 30%, resulting in an export-generated value-added to GDP ratio of 6%. Chinese exports to the U.S. is approximately 7.3% of Chinese GDP (according to adjusted U.S. data), with a value-added content of 20%, resulting in a value-added to GDP ratio of 1.5%.
- The Development Research Center of the State Council has estimated that accession to WTO will increase the rate of growth of the Chinese economy by 0.5% per annum; the U.S. International Trade Commission has estimated that real GDP would be 4% higher in 2010 than otherwise.
- The National Bureau of Statistics (NBS) projected that the award of the 2008 Summer Olympic Games to Beijing should add 0.3-0.4% to the average annual growth rate

The Direct Economic Impacts of Chinese Accession to the World Trade Organization (WTO) on China (1)

- Impacts on international trade
  - Exports and imports should rise moderately in the short and intermediate term, with the major positive impact on Chinese exports coming in 2006 when the quota restrictions on Chinese textile exports imposed by the Multi-Fibre Agreement expire
  - There should be increased trade in intermediate goods in both directions
  - Reduction of tariffs on technology imports would put some pressure on Chinese domestic producers but should also increase Chinese competitiveness in the global high-technology supply chain

The Direct Economic Impacts (2): International Trade

- Massive increases of imports of agricultural commodities are unlikely in the absence of long-term supply contracts because of the limitations of the sizes of the total international markets in these commodities.
  - For example, annual Chinese production of grains is approximately 500 million metric tons, compared to an annual global total international trade of approximately 100 million metric tons so that any significant increase in Chinese annual imports to, say, 25 million metric tons (5 percent of Chinese domestic output), will cause significant increase in the world market price of grains and make imports uncompetitive with domestic Chinese production. In any case, for security reasons, in the absence of long-term supply contracts that can be credibly enforced against possible political interruptions, it is unlikely that Chinese imports of grains will increase much beyond 5 percent of annual production/consumption.
  - Moreover, there is currently excess production of grains in China, due in part to the procurement policies of the Chinese Government. If the procurement policy is changed from unlimited purchases to fixed quota purchases, the aggregate annual supply will decline, with the marginal, high-cost grain producers shifting into the production of other crops. Those producers who remain in grain production will have a lower cost structure on the margin that can be competitive with imports.
- However, there is also room for China to specialize in accordance with its comparative advantage, e.g., to grow fruits and vegetables and other higher value-added cash crops such as asparagus and mushrooms, and to diversify away from producing beef, which can be more inexpensively imported from Argentina, Australia and the United States
- Government-sanctioned national standardization and grading can greatly increase the market for Chinese agricultural products, such as cotton and rice and other higher-value-added ones, both domestically and overseas

The Direct Economic Impacts (3): State-Owned Enterprises in Non-Agriculture

- The accession to WTO sets an implicit deadline for the reform and restructuring of the SOEs and the commercial banks
- Inefficient SOEs can no longer be protected either directly, through tariff and non-tariff barriers, or indirectly, through subsidies and preferential government procurement, and de facto local monopoly privileges
- The SOEs must therefore be restructured so that they can survive on their own in the post-WTO competitive market. This implies labor force reduction, assumption of historically inherited liabilities such as the unfunded pension for past and current employees by the central government, either directly or through the Social Security Fund, reduction of debt (e.g., debt-to-equity swap), transfer of responsibility for social services such as education, health care and housing to either the local government or to the individual workers themselves.
- In other words, social security (including pension benefits) and social services must be "socialized," that is, become the responsibility of society or government rather than the enterprises.

The Direct Economic Impacts (3): State-Owned Enterprises in Non-Agriculture

- Moreover, going forward, a new, viable and sustainable social security and pension scheme must be put in place. Otherwise the same problem will occur again, and given the demographic situation in China, much sooner than expected.
- Those SOEs that cannot be made viable through restructuring will have to be closed down, with the government or the Social Security Fund providing "subsistence" (welfare) benefits and if necessary, retraining and placement, to the displaced workers (the pension liabilities will be assumed by either the government or the Social Security Fund).
- It should be noted that restructuring, closure and consolidation of the inefficient SOEs are likely to occur even without WTO accession; e.g., there are more than 100 automobile manufacturers in China; even in the absence of WTO, the overwhelming majority of these firms, more than 90 percent, will have to be closed down because of competition from the more efficient firms in China that have managed to achieved the minimum economic scale. WTO accession merely makes them more urgent as they cannot be delayed any more with imports threatening to take over whatever markets that are left to the SOEs.
- Restructuring of the SOEs is the essential pre-condition for the restructuring of the banking system and the commercial banks with high "non-performing loans" ratios.

The Direct Economic Impacts (4): Domestic and Foreign Investment

- An increase in domestic fixed investment in anticipation of the increased trade and investment, as well as the increase in competition, resulting from WTO accession
- A quantum increase in foreign direct investment (FDI), currently running at approximately US$45 billion annually, is expected upon WTO accession, further boosting Chinese economic growth. The post-WTO FDI should be on the order of US$60 billion a year
  - Foreign manufacturers are no longer subject to export requirements
  - Investment opportunities open up in the services sector—e.g., distribution, finance, and telecommunication
- Increases in investment lead to increases in real GDP and in employment—it is critical for more new jobs to be created with Chinese accession to WTO so that new entrants as well as the re-entrants caused by the inevitable restructuring of the state-owned enterprises into the labor force can be absorbed

The Direct Economic Impacts (5): The Financial Sector

- The arrival of foreign commercial banks in China should not have an overwhelming impact on the domestic banking industry if appropriate adjustments are made. The adjustments should mostly consist of leveling the playing field between the domestic and foreign banks. In any case, the domestic commercial banks have the home court advantage.
- The predominant client base of the foreign commercial banks will be foreign and joint-venture enterprises in China. It will be very difficult for the Chinese commercial banks to hang on to this business. Most enterprises like to be able to deal with a single principal bank that can serve their global needs. Most likely this will be a commercial bank headquartered in their respective home countries.
- The foreign commercial banks are also likely to compete with the domestic Chinese commercial banks for business related to international trade for both foreign and joint-venture enterprises and for domestic Chinese enterprises by offering superior service.

The Direct Economic Impacts (5): The Financial Sector

- However, it is also unlikely that the foreign commercial banks will be able to take away significant deposits from the Chinese depositors. This is because deposit-taking is a very local business and the cost structure of the foreign commercial banks is higher than that of the domestic commercial banks. Thus, the foreign commercial banks will not be able to offer higher rates of interest on deposits than the domestic commercial banks. This has been borne out by experience in Hong Kong, Taiwan, and elsewhere in Southeast Asia.
- Moreover, as long as there is either explicit or implicit deposit insurance that is credible, the fact that the Chinese commercial banks have higher ratios of non-performing loans than foreign commercial banks will not disadvantage the domestic banks in terms of deposit-taking.
- Furthermore, the experiences of these countries and regions also indicate that even under the freest circumstances, such as in Hong Kong, the proportion of total bank deposits taken by foreign commercial banks is on the order of 20 percent.

The Direct Economic Impacts (5): The Financial Sector

- The foreign commercial banks will also have a disadvantage in terms of microeconomic credit information. It is therefore likely to charge a higher rate of interest for loans, holding credit quality constant.
- Foreign commercial banks are also unlikely to make unsecured loans to small and medium enterprises in China, or to make loans to state-owned enterprises without very strong balance sheets.
- They are also unlikely to lend to Chinese consumers in the first instance because of the difficulty of obtaining useful credit information. On mortgage loans, the constraint is the ability to find sources of long-term funds.
- The net result is that the domestic commercial banks will be able to maintain a significant proportion of their current domestic business.
- Moreover, the competition between domestic and foreign banks may actually lead to new banking services and an overall expansion of the entire market.

The Direct Economic Impacts (5): The Financial Sector

- The biggest threat of foreign commercial banks on Chinese commercial banks is the poaching of their existing staff. For foreign commercial banks, the easiest thing to do is to offer double, triple or even ten times the salaries of current employees of the Chinese commercial banks to induce them to work for the foreign commercial banks instead. This would decimate the manpower of Chinese commercial banks.
- In order to counter this threat, the Chinese commercial banks must begin to pay market wage rates, monetize the total compensation, and de-link their wage and salary scales and practices from the civil servants salary scale and practices. They must begin to use incentives such as portable and fully vested pension plans, profit-sharing as well as low-cost mortgages and other fringe benefits that are conditional on the continuing employment of the employees.

The Direct Economic Impacts (5): The Financial Sector

- Should China permit one-bank holding companies and/or universal banking, i.e., allow the same financial institution to engage in commercial banking, investment banking, insurance and securities? Should China continue to maintain a form of Glass-Stegall Act?
- The information disclosure and transparency in China, the degree of compliance with and enforcement of laws, rules and regulations, and the quality of prudential regulation are not sufficiently high for the time being to warrant removing the separation between these various financial activities. The probability of moral hazard is simply too high.
- If the policy of separation is to be continued post-WTO accession, new legislation and regulations must be formulated so as to assure compliance by foreign banks, most of which are permitted to engage in all of these business lines, so that they do not put Chinese commercial banks at a competitive disadvantage.

The Direct Economic Impacts (6): The Role of the Central Bank

- With the entry of foreign commercial banks into the Chinese market, the role of the People's Bank of China will be slowly transformed. It will have to regulate all the banks, domestic and foreign, in a fair and uniform manner.
- The People's Bank of China should assume the responsibility of clearing and settlement.
- The People's Bank of China should be responsible for the monitoring and enforcement of capital and reserve requirements.
- The People's Bank of China, or the Deposit Insurance Corporation, should begin to charge all banks, domestic and foreign, deposit insurance premia and specify the limits of such deposit insurance.
- The People's Bank of China has to monitor and enforce compliance with rules and regulations on foreign exchange transactions, so that capital control remains effective.
- Up to the present, the People's Bank of China has underwritten and assumed most, if not all, of the risks of long-term fixed rate loans on mortgages and other projects by re-discounting these loans. This is potentially very risky and cannot be expected to continue, especially with the foreign commercial banks entering the Chinese market in a substantial way after accession to WTO. A market must be developed so that these long-term fixed rate loans can be securitized, transferring the risks from the banks and the banking system to institutional (e.g., the newly established Social Security Fund) and individual investors other than the banks themselves. Securitization is the only way to spread the risks away from the financial institutions. No one wants a repeat of the U.S. Savings and Loan Associations debacle in the early 1980s.
- Financial regulation must be clear, transparent, uniform and enforceable.

Can Capital Control Remain Effective after Accession to WTO?

- There is a whole spectrum of what is meant by capital control—the capital control that is practiced in China today has three principal features:
  - Short-term inflows and outflows of foreign capital (whether belonging to individuals or institutions) is regulated and is currently largely limited to commercial bank loans
  - Individual Chinese citizens are not permitted to export capital (either short-term or long term) by exchanging Renminbi into US$. They are however permitted to hold foreign exchange that they are able to obtain independently.
  - Long-term inflows of foreign capital, principally in the form of foreign direct investment, and the subsequent repatriation of the principal and profits, if any, are permitted but must go through an approval process.
- Post-WTO accession there must be clearly defined and completely transparent and enforceable regulations apply to all commercial banks, domestic and foreign
- A clear distinction must be made between capital account and current account transactions—current account transactions are always allowed provided no contraband is involved; only selected capital account transactions, as indicated above, are permitted
- A system should be put in place so that foreign exchange transactions can be reported in real time
- A nation-wide system of identification numbers for financial and tax purposes, such as the social security and taxpayer's identification numbers of the United States, should be introduced so that deposits, withdrawals, cash transactions, wire transfers, can all be linked together. Chinese citizens, enterprises and other institutions should be required to disclose any accounts maintained outside of China. The financial institutions will be required to maintain information, such as a date of birth and an address, on and verify the real identities of their customers. Nominees should be outlawed.

Longer-Term Implications--The Challenges and the Opportunities (1): Commitment

- Reaffirmation of the resolve for the continuation and deepening of economic reform (the "open door", marketization, devolution of economic power and creation of non-state modes of organization for production)
  - Chinese accession to the WTO is testimony of the enormous success of Chinese economic reform which has transformed China from a stagnant centrally planned economy to an open and dynamic market economy
  - Accession to WTO reinforces urgency of continuing and accelerating the reform process—much-needed but difficult and possibly painful reforms can no longer wait—e.g., labor market reform, social security reform, pension reform, state-owned enterprises reform, banking reform, housing reform, and legal reform; it also signals the commitment of the Chinese Government to continuing the economic reforms that have proved to be both successful and popular among the Chinese people
- Permanent commitment to an open economy
  - Chinese accession to the WTO represents a commitment to lock in permanently the links of the Chinese economy to the global system of market economies, making irreversible the economic reforms already implemented in China over the past two decades—including the "open door" to the world economy for trade and investment, marketization, devolution of economic decision-making, and creation of the non-state-owned sector—and to an economy based on rules
  - Chinese accession also accelerates the process of globalization, and in particular, Chinese participation in the international specialization and division of labor

The Challenges and the Opportunities (2): The Emergence of a Unified National Market in China

- Chinese accession to the WTO, together with the Western Development Plan, provide additional incentive and pressure to accelerate the emergence of a large, truly integrated and unified national market in China, not only for goods and services, but also for factors, especially capital.
- It is this one single national market that will enable Chinese and foreign firms alike to benefit from the economies of scale.
- However, the rule of law must be strengthened in at least two areas before these benefits can be realized.
  - Elimination of provincial and local barriers to the movement of goods and factors
  - Establishment of a centralized and unified National Commercial and Tax Court system to handle all economic and tax disputes, including intellectual property rights issues
- These two measures, if adopted, will lead to significant economic benefits to China and will also avoid many potential legal disputes between and among foreign and domestic firms and provincial and local governments in China

Elimination of Provincial and Local Barriers to the Movement of Goods and Factors

- First, the Central Government must make the elimination of provincial and local barriers to trade in goods and services, and to investment; a first priority. It must strive to realize and maintain a fully unified national market—with free flows of goods, services, capital and labor. Under existing Chinese laws, the provincial and local authorities are not supposed to be able to restrict the flows of goods, services and capital. But in fact, it is often difficult for factories in one province to sell their products to another province. If steps are not taken to eliminate these barriers, China will not be one large market, but will become more than thirty, perhaps even 2,000, small fragmented markets.
- It is interesting to note that the "Interstate Commerce Clause" of the U.S. Constitution is intended precisely to outlaw such similar activities by state governments in the United States.
- A new "federalism," aimed at the definition and division of obligations and responsibilities for social services and the sources of revenue between the central and provincial/local governments (this removes the incentives to establish and maintain provincial and local barriers). The institution of a system of comprehensive individual and corporate income taxation is probably required to make this work.
- In order to spur this effort, the provincial and local governments will have to realize that their primary economic objectives should be the creation and continuous maintenance of durable employment and the generation and increase of resources under public control through taxation rather than through profit. Then they should not care who makes the money as long as it provides gainful, unsubsidized employment and pays taxes. They should welcome and protect investment from any source, foreign or domestic.

Establishment of a Centralized and Unified National Commercial and Tax Court

- Second, the Central Government should establish as soon as possible a centralized and unified system of National Commercial and Tax Courts, reporting directly to and controlled directly by the central government for the expeditious, fair and non-discriminatory adjudication and settlement of all commercial (including intellectual property rights) and tax disputes (like the U.S. National Tax Court). This has the great advantage of making judgments, decisions, standards and practices uniform and transparent and legal precedents applicable and binding in all regions across the entire country. Firms, both domestic and foreign, will no longer be subject to the vagaries and variability of the local court systems. The judgments of these courts will be enforced by the central government if necessary.
- The new system of courts will be responsible for the enforcement of contracts and the prosecution of commercial fraud—implementation of the rule of law in the economic sphere.

The Development of the Great West: Three Paradigms of Economic Growth

- Growth through domestic demand--the domestic market paradigm a la the United States in the 19th century. China is a continental economy--International trade will never be as important as other, smaller countries and China must rely on internal demand for further economic growth. Value-added from exports constitutes only 6 percent of Chinese GDP.
- Industrial migration over time--the "wild-geese-flying pattern" metaphor applied to Chinese provinces and regions
- Privatization is not always necessary--shrinking the state sector without privatization--the experience of Taiwan
- What does it take?
  - Availability of infrastructure (transportation and communication, including the internet)
  - Continued marketization of the economy
  - Maintenance of a domestically open economy (the equivalent of the "interstate commerce" clause of the U.S. constitution)
  - Affirmation of property rights and the rule of law—a national commercial and tax court?
  - The role of the "open door"--WTO

The Challenges and the Opportunities (3): Reforms in the Regulatory Infrastructure

- Replacement of the current discretion-based system by a more transparent and rule-based system in economic regulation; implementation of the rule of law in the economic sphere
- Maintenance of a competitive market environment with free entry and exit (use of anti-trust and fair trade laws to prevent unfair competition and monopolistic practices)
- Regulation as well as deregulation of the public utilities sectors—transportation, communication, power, etc.--promotion of lower and more competitive rates for universal access--prevention of monopoly rents (maintenance of standards and mutual communicability and promotion of competition)
- The welfare of the consumer rather than the profit of the state-owned enterprises as the objective of regulation

Longer-Term Implications: The Challenges and the Opportunities (4)

- National treatment for all
  - Foreign direct investors in China will be granted full national treatment--a "level playing field" for all—as well as Chinese domestic non-state-owned enterprises, the "unintended beneficiaries"
- Insurance for domestic economic efficiency through open global competition--inefficient domestic monopolies will no longer be able to continue to operate under protection
- The protection of intellectual property rights will spur a major investment in R&D, branding, and other forms of intangible capital
- Trade (accession to WTO) is not a zero-sum game—it is a positive-sum game—expansion of the entire market.

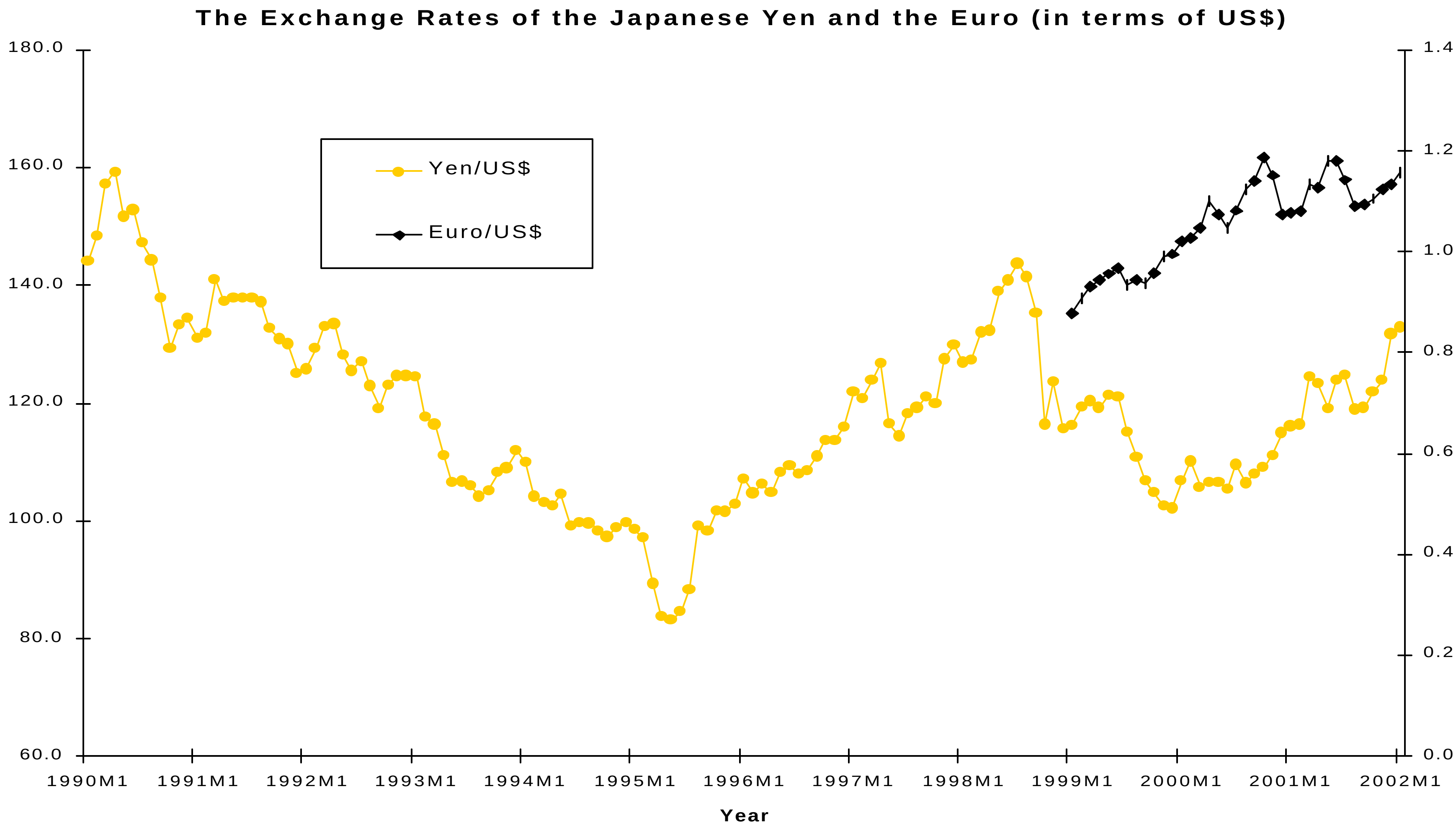
Are Fears of Globalization/WTO Justified?

- The Chinese economy is a net beneficiary of its WTO accession
- International trade is not a zero-sum game but a positive-sum game—everyone can be a net beneficiary—one country's net benefit does not have to be another country's net cost, the entire world market can expand.
- However, there will be transitional pains as global production is re-allocated in accordance with the principles of comparative advantage (Note that it is not necessarily from the less efficient to the more efficient producers)
- Moreover, looking ahead to the future, globalization of supply chains and the information and communication technology revolution imply that production will be footloose as ever. Jobs that come to China today can just as easily leave China for India or Africa when the circumstances change. One lesson that is being learned very quickly is that no industry, and no enterprise, in any given country can assume that it will last forever.
- Lifetime employment will become a thing of the past. No employer can guarantee or offer it (except possibly the government); and no employee should expect it.
- Thus, both the labor market and the participants in the labor market must maintain flexibility so that adjustment can be made quickly. This implies in turn that human capital, especially the more general and less enterprise-specific kind, will become much more important.

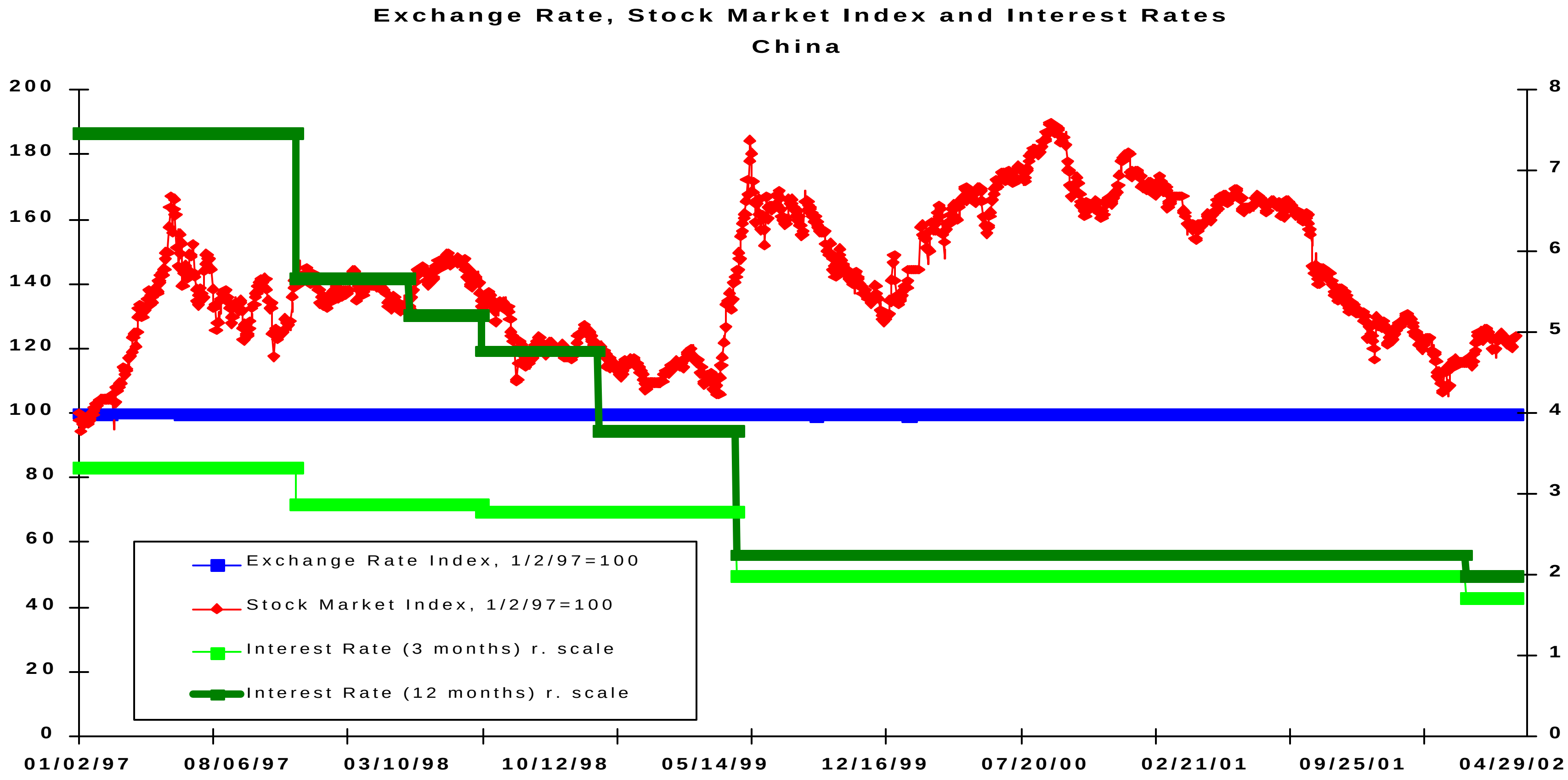
China Can Maintain Its Competitiveness without Devaluation

- China, with its own large domestic market, almost unlimited supply of labor, high savings rate, rising investment in human capital, can maintain its competitiveness over time not through devaluation, but through
  - Maintaining price stability
  - Upgrading continuously the quality of manpower
  - Maintaining flexible labor markets (wage rates)
  - Opening up new regions with lower labor, land and other costs
  - Socializing and establishing a viable and sustainable social security (including unemployment) system
  - Providing infrastructure, tangible and intangible
  - Investing in intangible capital, including R&D and intellectual capital (protection of intellectual property rights is a must)
  - Exploiting the “new economy”

The Exchange Rates of the Japanese Yen and the Euro



The Exchange Rate, the Interest Rates and the Stock Market Index



The Devaluation of the Japanese Yen

- An ineffective policy for solving Japanese domestic economic problems
- A potential for causing another round of competitive devaluation in East Asia, and pushing the region into even deeper recession in the short run, which cannot be beneficial to the Japanese economy
- Inconsistency with the spirit of the rules of the World Trade Organization if not the letter
  - A devaluation can be viewed as a unilateral simultaneous increase in the rates of tariffs on all imports and subsidies on all exports, Japan, with a large and rising current account surplus, and the world's largest official foreign exchange reserves, and as the world's largest net foreign creditor, has no strong justification for a devaluation of its currency at this time
- Possible Counter-Strategies of East Asian Economies
  - A countervailing tariff on Japanese imports and perhaps even a countervailing subsidy on exports to Japan, offsetting any advantage gained by Japan.
  - Voluntary boycotts of Japanese goods in the affected East Asian economies

The Devaluation of the Japanese Yen

- An ineffective policy
  - Unlikely to help the Japanese economy in any significant way—the Yen has been as low as 155 Yen/US$ and has not helped.
  - Japanese exports constitute less than 10 percent of Japanese GDP. It will take a huge devaluation as well as a huge increase in exports, without a corresponding increase in imports, to make a significant difference in the rate of growth of Japanese GDP. Moreover, the whole world is in recession—Japanese exports are not likely to be significantly increased by a price reduction through devaluation. The potential customers of Japanese goods are not buying not because of price, but because of the reduction in their incomes and the uncertain economic outlook. Furthermore, the import content of Japanese exports is also significant—oil, coal, other raw materials--and the demand for some Japanese exports, such as automobiles, are not price-elastic (in part because of the voluntary export restraints).
  - Overall, Japan is unlikely to benefit very much even with a steep devaluation, especially taking into account the likely reaction of other East Asian economies.

The Devaluation of the Japanese Yen

- A devaluation of the Japanese Yen is going to put pressure on the Korean Won, which would in turn put pressure on the New Taiwan Dollar. If all of these relatively stronger East Asian currencies devalue, it would put tremendous psychological as well as speculative pressure on the other, relatively weaker, East Asian currencies, such as the Indonesia Rupiah, the Malaysian Ringgit, the Filipino Peso, the Singapore Dollar, the Thai Baht, and eventually even on the Chinese Yuan and the Hong Kong Dollar.
- The pressure does not come so much from the trade side, even though the Northeast Asian countries are now significant importers of goods from Southeast Asia, as from the expectation of a large reduction, even withdrawal, of the portfolio as well as direct investment flow form Northeast Asia and the rest of the world to Southeast Asia.
- Thus, a further devaluation of the Japanese Yen has the potential of causing another round of competitive devaluation in East Asia, and pushing the region into even deeper recession in the short run.
- A collapse of the East Asian currencies cannot be beneficial to the Japanese economy.

The Devaluation of the Japanese Yen

- The Governments of South Korea, Malaysia and China have all spoken out publicly against the Japanese devaluation. However, merely words of displeasure and threats to devalue competitively may not be enough to persuade the Japanese Government to stop the Yen devaluation, because they may not be credible.
- Japan, with a large and rising current account surplus, and the world's largest official foreign exchange reserves, and as the world's largest net foreign creditor, has no strong justification for a devaluation of its currency at this time. A devaluation certainly violates the spirit of the rules of the World Trade Organization if not the letter, since a devaluation can be viewed as a unilateral simultaneous increase in the rates of tariffs on all imports and subsidies on all exports. It is just mercantilism, pure and simple.
- If any other country in a similar position as Japan today devalued its currency, it would have been roundly condemned as pursuing a policy of "beggaring thy neighbor."
- What is needed is additional concerted action on the part of the other East Asian countries.

The Devaluation of the Japanese Yen: Possible Counter-Strategies of East Asian Economies

- One possible counter-strategy is to threaten to impose a countervailing tariff on Japanese imports and perhaps even to grant a countervailing subsidy on exports to Japan, of a magnitude to offset precisely the advantage gained by Japan through any further devaluation of the Yen. While imposing the country-specific increases in tariffs and subsidies may technically be in violation of WTO rules, it is justifiable because it is not intended to gain any trade advantage vis-à-vis Japan, but merely to maintain the status quo ante. Moreover, it also helps to maintain competitive parity for imports from countries in other regions, e.g., Europe and North America, in the East Asian markets.
- An alternative counter-strategy, given that the Japanese devaluation in the face of adverse economic conditions prevailing in the fragile East Asian economies has amply demonstrated its utter disregard for the economic welfare of its neighbors, is to rely on the voluntary boycotts of Japanese goods in the affected East Asian economies, which are bound to rise spontaneously once it is clear that the Japanese "beggar thy neighbor" policy is the source of further economic woes in East Asia.
- This counter-strategy poses a credible threat, especially if adopted in concert by the affected East Asian countries. The hope is that none of these counter-strategies will prove to be necessary.

WTO and the Global Digital Divide—The Internet as an Equalizer

- The new economy levels the playing field between large and small firms
  - Small firms can have access to services and supplies heretofore only available to large firms
    - E.g., Charles Schwab and E-trade benefit small investors by bringing down the cost of securities trading proportionally much more than large investors
    - Rapid delivery services and warehousing facilities, e.g., FedEx, are available to both large and small firms
  - Small firms can also become more accessible to their customers and potential customers through the Internet with only marginal expenditures on advertising and public relations
  - Small firms have access to large firms as potential suppliers and customers in a global supply chain
- The Chinese economy with its high and potentially even higher concentration of smaller firms and more primitive information infrastructure (and thus the potential for leap-frogging) may benefit much more from the new economy than other more developed economies
  - E.g., B2B dot.coms seem to have relatively greater success in East Asia than in the United States

The New Economy and China: The Advantages of Backwardness and Size

- The possibility of leap-frogging--there are no vested interests to protect; no existing businesses to be cannibalized; there can be “creation without destruction”
  - e.g., facsimile machines instead of telexes; video compact discs instead of VCRs; a new keyboard layout; mobile and wireless telephones instead of fixed lines; debit and credit cards instead of checks
- The possibility of influencing/setting standards--the markets are potentially large enough in China for the benefits of economies of scale to be realized and for it to have a significant influence on future standards
  - e.g., Linux; wireless telephone standards (CDMA)
- The possibility of local adaptation--taking advantage of local conditions
  - e.g., the Legend story—language; local supply and demand conditions, e.g., stability of the voltage of the electric power supply
- Transformation of the “Old Economy” through the information and communication technology

The New Economy Levels the Playing Field between Large and Small Firms

- Small firms can have access to services and supplies heretofore only available to large firms
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WTO Accession and U.S.-China Relations

- A win-win situation--both U.S. and China stand to gain from Chinese accession to WTO
- Complementarity between U.S. and Chinese economies—The U.S. does not export anything that China exports and China does not export anything that the U.S. exports; moreover, the U.S. has not been making the products it imports from China for decades (e.g., garments, shoes) and China does not make the products it imports from the U.S. (aircraft, microprocessors, semi-conductor manufacturing equipment)
- U.S. is now the second largest trading partner of China and the second largest foreign direct investor (11%), after Hong Kong—trade and investment are likely to increase in both directions post WTO accession
- Increased exchange and economic interdependence should improve U.S.-China relations in both the long-run and the short-run
- Short-term friction between U.S. and China is reduced because
  - The annual renewal of "normal trade relations (NTR)" is no longer necessary
  - Trade disputes can now be settled through WTO dispute settlement mechanisms, which tend to be much less politicized
  - Chinese commitments in the areas of national treatment, transparency, and intellectual property right protection

WTO Accession and Cross-Strait Relations

- No major impact
- Unlikely to be a forum for political dialogue
- Depends on ability to avoid ideological issues
    - E.g., Charles Schwab and E-trade benefit small investors by bringing down the cost of securities trading proportionally much more than large investors
    - Rapid delivery services and warehousing facilities, e.g., FedEx, are available to both large and small firms
  - Small firms can also become more accessible to their customers and potential customers through the Internet with only marginal expenditures on advertising and public relations
  - Small firms have access to large firms as potential suppliers and customers in a global supply chain
- Expansion of Chinese exports to Taiwan
- Greater investment by firms in Taiwan on the Mainland

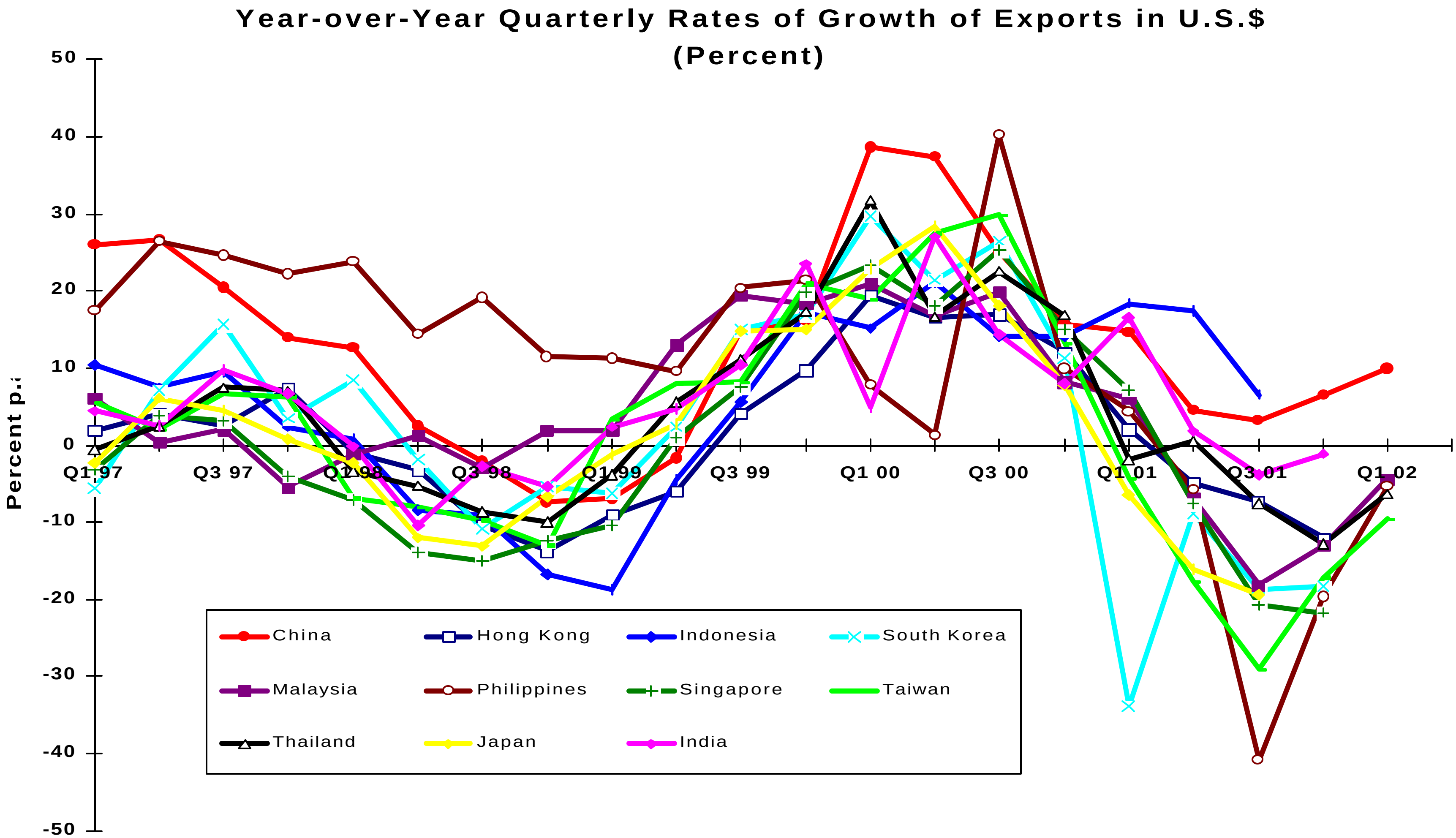
The ASEAN Free Trade Area (AFTA)

- Intra-ASEAN tariff rates have been lowered to 5% on Jan. 1, 2002 with the inauguration of the ASEAN Free Trade Area (AFTA) among Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand. The goal is to reach zero tariff rate within AFTA by 2010. The reduction in tariffs applies to 90% of products provided the ASEAN content of the product exceeds 40%.
- Khmer Republic, Laos, Myanmar and Vietnam are expected to join AFTA in 2006 and reach zero tariff rate within AFTA by 2015.
- Specific protection on manufactured and agricultural products still remains.

The China-ASEAN Free Trade Area

- Chinese Premier ZHU Rongji proposed in Brunei in November, 2001 a new free trade area, covering China and the ASEAN (Brunei, Indonesia, Khmer Republic, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), to be created within ten years
- A 3 trillion US$ market and 1.7 billion consumers
- Complementarity (primary raw materials) and competition (light manufactures)
- Opening the economies for trade—China will become a major export market for the ASEAN and vice versa
- The free trade area will promote foreign direct investment in the ASEAN region itself through the enlargement of the potential market
- A mutual support program for the currencies of one another, leading possibly to a currency area
- Simultaneous, coordinated expansions among the East Asian economies can help accelerate the recovery of the depressed economies of East Asia
- Significant political implications

Quarterly Rates of Growth of Exports: Selected East Asian Economies



Quarterly Rates of Growth of Imports : Selected East Asian Economies