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Volume IV

Trade Reform and Liberalisation in China

Australia–Japan Research Centre
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The papers collected in this volume, number four in a series examining China’s entry to the world trade system, are from the final stage of a three-year research project between the Economics Division of the Research School of Pacific and Asian Studies at the ANU in Canberra and the Chinese Academy of Social Sciences (CASS) in Beijing. The project drew together experts from Australia, China, Japan, Korea and Southeast Asia.

In this volume Yang Shengming discusses the development strategy for China’s foreign trade in the 1990s. He argues that the infrastructure provided by increased levels of FDI has shifted China’s focus to producing quality exports of a higher grade, thus improving the momentum of China’s export growth rates. He also predicts that the import growth resulting from the easing of restrictions should help China to achieve greater equilibrium between import and export trade.

Zhong Chuanshui and Yongzheng Yang examine China’s textile and clothing exports in the post-Uruguay Round, a period in which China has emerged as the world’s largest exporter of clothing and second largest exporter of textiles, despite the restrictions it has encountered as a result of the Multi-fibre Arrangement (MFA). The gradual dismantling of the MFA is expected to lead to increases in world trade in textiles and clothing, with China gaining the greatest share.

Feng Lei and Yiping Huang analyse the implications of China’s trade reform for structural change and welfare in China and the rest of the world, finding that China is the biggest gainer from its own liberalisation. They predict that China’s labour-intensive sectors will expand but that others, including agriculture, will contract. Other economies which experience great adjustments are also main gainers. Multilateral trade liberalisation, such as the APEC free trade process, increases the gain for the rest of the world as well as for China.

Pei Changhong analyses the relationship between foreign direct investment and China’s trading system reform, finding that FDI has affected and continues to influence the direction and speed of reform of China’s trading system.

Peter Drysdale
Executive Director, AJRC
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THE WTO AND CHINA’S TRADE STRATEGIES
IN THE 1990S

Yang Shengming
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1. **THE WTO AND CHINA’S TRADE STRATEGIES IN THE 1990s**

**Reforms in the first half of the 1990s**

China instituted extensive reforms to its foreign trade policies in the first half of the 1990s. These reforms are summarised in the following discussion.

*Trading system*

*The legal basis of foreign trade*

On 1 July 1994 China promulgated its Foreign Trade Law. This law was designed to unify national foreign trade behaviour and regulations and to put an end to the old practice by which multiple government departments and regional governments mapped out their own mutually inconsistent foreign trade policies. The law enhanced the transparency of the legal framework of China’s foreign trade and helped to regulate it; it thus represented a milestone in China’s efforts to bring its foreign trade regulations into line with WTO requirements.

To increase further the transparency of China’s foreign trade and investment system, the Chinese Ministry of Foreign Trade and Economic Cooperation regularly publishes bulletins detailing relevant policies and regulations, as well as lists of commodities with and without import quotas, regulations, regulatory authorities for import quotas and duty paragraphs.

*Foreign trade enterprises*

Since 1990 the government has further deregulated foreign trade franchise management. As a result, more local enterprises, including those at the provincial, municipal and county levels, have obtained the right to conduct foreign trade. By the end of 1995 there were more than 8,300 state-owned companies at various levels dealing in foreign trade, creating competition between central and local enterprises. In addition, the 100,000 foreign-invested enterprises already in operation have been granted the right to import equipment and raw materials that are needed for their own use and to export their products.

More importantly, between 1991 and 1993, the central government removed all financial subsidies for exports and most subsidies for imports, thus forcing state-owned
foreign trade enterprises to assume responsibility for their own profits and losses. To speed up the transformation of the managerial mechanisms in those enterprises, the government in 1994 cancelled the mandatory plans and targets of foreign exchange which foreign trade enterprises had to provide to the central government. Foreign trade companies now operate like other enterprises and pay taxes to the government. At the same time, subsidies for imported commodities have also been largely discontinued as part of the effort to push foreign trade companies into the market.

Export control system
Since 1994 the state has issued invitations for bidding for export quotas of a selected number of commodities — based on the principles of openness, fairness and efficiency — with the aim of standardising the management of quotas, introducing fair competition and increasing transparency.

This represents a major departure from the old administrative system of quota management. Under that system, quotas were distributed free of charge by administrative decree. Decisions were based largely on subjective hunches rather than on an objective assessment of actual needs. Enterprises usually requested more than they really needed. The new regulations, under which quotas are distributed through a bidding system and at a price, are effective in curbing subjective decision making and raising efficiency. In 1995 the number of commodities under bidding increased to 24 from 13 in the previous year, accounting for 17 per cent of the total of 138 commodities that required export quota permits.

Import control system
In 1992 China discontinued the practice of listing in detail all the import-substitute commodities and categorising import commodities. Instead, imported commodities are now catalogued. Since 1993 further reforms have been introduced in the management of imported commodities. New policies and regulations were published and old internal regulations terminated. These measures have regularised the order of import trade and increased the transparency of policies.

At the same time, the number of commodities requiring a quota or permit has been slashed, falling from 54 in 1992 to 49 in 1995. In addition, electrical and mechanical products in 171 duty paragraphs have been relieved of quotas and are now automatically registered. In 1996 another 170 imported commodities will be relieved of quota permits.
Foreign trade administration

Apart from formulating the Foreign Trade Law, China is drafting regulations dealing with the administration of imported commodities, exported commodities and anti-dumping measures. Other measures are being taken to readjust drawbacks for import and export duties paid and to improve the exchange mechanism for the renminbi. This indicates that China is switching from direct government control to legal and economic levers in managing foreign trade. At the same time, China has stepped up its efforts to coordinate foreign trade service systems centring around the Chamber of Import and Export by strengthening the supervision of enterprises and government administration.

Drastic reduction of tariffs

Since 1990 China has unilaterally slashed its tariffs repeatedly. In January 1992 it cut tariffs on 225 commodities and cancelled all import regulation duties; in December 1992 it further reduced tariffs on another 3,771 commodities, bringing the total tariff rate down by 7.3 percentage points; in December 1993 tariffs were reduced for 2,898 commodities; in January 1994 import duties were further reduced on another 243 imports, including major raw materials such as pesticides and their intermediaries, as well as machinery and electronic parts and products; and in 1995 tariffs were slashed for cigarettes, liquor, medium-sized buses, and audio- and videotapes.

Before 1992 China’s unweighted average tariff rate was 47.2 per cent. Beginning on 1 January 1992, China standardised the naming and coding of commodities in accordance with international practice. In the same year, the overall tariff rate was brought down to 39.9 per cent, dropping to 36.4 per cent in 1993, 35.9 per cent in 1994 and 35.3 per cent in 1995. Between 1992 and 1995, the unweighted average tariff rate dropped by 25.2 per cent. In April 1996 China’s overall tariff rate dropped to 23 per cent, a decrease of 35.9 per cent. These figures indicate that China is moving towards WTO guidelines and faithfully fulfilling its promises to implement tariff reductions.

Foreign exchange controls

Before the mid-1980s, China exerted rigid control over foreign exchange, after which it began to establish foreign exchange regulation markets. By 1988, a national network was in
place and represented the first step towards reform of the foreign exchange control system. As a result, a dual-rate situation arose, with the official rate set by the state coexisting with the market rate.

Since 1990 the government has allowed foreign trade companies to retain a greater portion of their foreign exchange earnings for their own use. Furthermore, these enterprises are now allowed to trade foreign exchange in the market, thus paving the way for full introduction of the market mechanism into China’s system of foreign exchange control.

On 1 January 1994 the official rate for the renminbi was aligned with the market rate. Meanwhile, foreign trade enterprises were deprived of their right to retain foreign exchange. Instead, a unified settlement and trading mechanism was introduced and a national interbank foreign exchange market was created. As a result, the exchange rate for the renminbi is now based primarily on market demand and supply. Foreign trade companies, relieved of the mandatory task of turning in foreign exchange, now sell their foreign exchange earnings to specially designated banks, and purchase foreign exchange at banks with valid certificates. Thanks to regulation by the state, the renminbi has become convertible on current account.

Since the unification of exchange rates for the renminbi, the central bank now takes part in the purchase and sale of foreign exchange on the regulation market. This, in turn, connects the regulation market with the interbank market. In 1996 the government allowed foreign-invested companies to take part directly in the settlement and sale of foreign exchange by banks.

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Source: Author’s calculations using Chinese customs statistics.
Investment system

Expanding powers for local governments to approve foreign-invested projects

Since 1992 China has opened up its hinterland and a host of cities along major rivers and borders, while expanding the power of these cities to seek economic cooperation with foreign partners. Local governments are now able to approve foreign-invested projects with investment up to a set value, a move that has simplified the procedures for foreign-invested projects.

Increasing access for foreign investors

The reform measures introduced during 1991–95 allow foreign investors to invest in China’s manufacturing and mining industries (the latter on a trial basis). Since 1992 foreign investment has been introduced into land development, real estate, finance, insurance, information and consulting sectors. Pilot investments have also been introduced in commerce, foreign trade, civil aviation, railways, law firms and accounting. In 1995 the government published a directory for foreign investors which encourages foreign investors to invest in infrastructure facilities.

Allowing products by foreign-invested firms to enter the domestic market and increasing market access for foreign products

Statistics show that over half the goods produced by foreign-invested firms are marketed domestically. For some technologically-intensive projects, existing policy is even more favourable, since it permits all such products to be marketed domestically. A sizeable portion of foreign-invested companies enjoy the lion’s share of the domestic market. These preferential policies have effectively compensated for the negative impact on foreign products attempting to enter the Chinese market brought about by non-tariff measures, and increased market access for foreign competitors.

Conditions and timetable for China’s entry into the WTO

As noted above, since applying to re-enter the WTO, China has take a series of steps to reform its foreign trade system, tariff rates, and the foreign exchange control mechanism. The results show that conditions are now ripe for China to be admitted into the General Agreement on
Tariffs and Trade/World Trade Organisation (GATT/WTO). However, China is still being rejected by the WTO due, it would seem, to serious differences among the contracting parties over the conditions and timetable for China’s accession.

**China’s status as a developing nation**

Certain major contracting parties insist that China be admitted as a developed nation, but China is still a developing country and is thus entitled to the rights and subject to the obligations of other developing countries. Any attempts to impose on China obligations incompatible with its present stage of development and beyond its capability are unrealistic and unfair, and can only be detrimental to the development of China’s economy. It is very important for future negotiations, therefore, that China’s current economic conditions be acknowledged by the contracting parties. Firstly, China is the most populous country in the world, with a population of 1.2 billion, increasing annually by more than 10 million. Such a big population represents a huge potential market but at the same time a weighty burden. To ensure the welfare of its people and the stability of the state and society, China has had to endeavour to ensure that no major upheavals occur during this period of reform and market opening.

Second, China is a developing country, with an average per capita income of less than US$500 and with more than 70 million people living in abject poverty. Despite the rapid growth of its national economy since the late 1970s, there are still vast differences between the rural and urban areas and between the eastern and western regions. Any judgements based on observations of only the urban areas and the eastern regions are incomplete. On the whole, China remains a developing country, though this does not necessarily mean that China should be accorded special privileges or exceptions. Rather, the point is that the contracting parties to the WTO negotiations should understand that the obligations to which China should be subject should relate to its level of development rather than its growth rate.

Third, China is making a transition from a highly centralised planned economy to a socialist market economy in a process characterised by wide-ranging and profound reforms. Domestic reforms and opening up to the outside world are two sides of the same coin: sometimes they promote each other, sometimes they inhibit each other. Opening up must be based on reform, without which opening up is impossible; on the other hand, opening up is a pre-condition for reform. Without opening up to the outside world, reform will get nowhere.
China’s reforms have unfolded in a gradual and progressive manner rather than an abrupt one. Opening up and reform should match each other not only in terms of their depth and breadth but also in terms of their timing. During the next few years, the degree to which China opens itself to the outside world will depend largely upon the progress it achieves in instituting domestic reforms.

**China’s market access and transparency**

It should be noted that China has opened its market and increased transparency by a considerable margin in its bid to gain membership of the WTO. Total import volume rose three-fold from US$42.25 billion in 1985 to US$132.08 billion in 1995 — an annual increase of 12.1 per cent. Foreign trade dependence (imports/GDP) grew from 23 per cent in 1985 to 40.5 per cent in 1995. It is a well-established fact that China’s market is open to all countries, no less open than most developing countries.

To enhance market transparency, China has — since 1 July 1994, when the Foreign Trade Law was promulgated — repealed 1,183 internal directives, of which 744 were issued by the central government and 439 by local governments. Now foreign-related laws are for the most part published and only those laws, regulations and rules that have been published are implemented.

China will open up wider and faster if it further opens its market and increases market transparency. This will entail integrating the Chinese economy with the world economy and bringing China’s foreign trade system into line with international practice. China needs the world as much as the world needs China, and with the passage of time, interdependence between China’s economy and the world economy will deepen even further.

It is important to remember, however, that China’s current opening and legal transparency depend on its national conditions, in particular on the reform process.

To feed its 1.2 billion people, the Chinese government must vigorously develop its farm product market, including the world market for farm products. The United States, Canada and Australia are endeavouring to gain access to the Chinese market for farm products. In 1995 China became a major importer of farm products, with net imports of more than 19 million tons of grain. China’s major trading partners are very concerned about future importation of farm products by China. Because of the fragile supply of grain and its inefficient system for distributing farm products, China’s farm product market will remain unstable and murky.
Over the past several years, uneven supplies of grain, cotton and edible oils have meant that it has been difficult for the central government to ascertain the full picture. Chinese scholars
have suggested on many occasions that reforms need to be speeded up to restructure the distribution system for farm products so as to enhance market transparency.

Reform of the services sector, including banking, telecommunications and insurance, took off only recently and has progressed slowly. In market terms, reform is still in its infancy. This places a serious limitation on the opening up of this sector to foreign investors. In other words, this sector can only be opened gradually in parallel with more general deepening of reforms and overall opening up. In the past, the banking, telecommunications and insurance industries fell completely under the central planning mechanism and the market had no role to play. Without reform, it will be impossible to conform with international practice. Accelerated reform and more developed financial markets will provide a precondition for the opening up of the banking, telecommunications and insurance industries.

The import control system, by comparison, is less transparent than other areas. With the exception of tariffs, various government departments — including the State Planning Commission, the State Economic and Trade Commission, the Ministry of Foreign Trade and Economic Cooperation, the General Administration of Customs and the State General Administration for Inspection of Import and Export Commodities — have their own administrative controls on imports. Disputes often arise because of lack of coordination between them.

There are similar problems between the central government and local governments. Even within provinces and municipalities, rules vary, and different commodities are managed differently. Some require a licence, some a quota, and some both. Still others require a special catalogue. These chaotic requirements are baffling even to Chinese. It is true, as many foreign businesspeople have observed, that China’s market regulations are not transparent. The solution lies in reform, not only of the economic structure but also of government institutions. A streamlined government with much less administrative intervention would contribute to increased market transparency.

Timetable for China’s accession to the WTO

On the issue of China’s accession to the WTO, all the signatory parties including the main Western countries realise that China’s entry into the WTO will not only benefit China but also the world. This suggests that China’s accession to the WTO is only a matter of time.

Some of the main negotiators have said that they have no timetable for accession. China too has no timetable; and while it is looking to speed up the negotiation process it is not
over-anxious for quick results. In China’s view, things will be easily settled when conditions are ripe. China does not wish to resolve its specific present concerns through re-entry into the GATT/WTO and does not speculate about when the negotiation that has gone on for 10 years will end. China views the negotiations in terms of its strategy for reform and opening up, and also its integration into the world economy.

Although China’s accession to the WTO will be beneficial to both China and the world, entry sooner rather than later would be best for all. If China’s accession to the WTO occurs soon, international multilateral trade regulations will serve as a point of reference for China’s reform and also in the formulation of its own trade law and regulations. The early settlement of China’s accession to the WTO will prove beneficial not only to the establishment of a good international trade environment but also to the establishment of normal international political relations. The more developed China’s economy, the larger its trade volume. When China absorbs more foreign investment, its contradictions and friction with the outside world will dissipate. All this will depend mainly on the internationally recognised trade regulations and coordination by the WTO. If these frictions are resolved according to the law of the jungle (‘political regulations’), this will surely aggravate the situation.

Internationally recognised regulations not only play an important role in China’s reform, they also provide important norms for its opening up to the outside world. China will therefore make unremitting efforts to implement these regulations.

**Agenda of action for the latter part of the 1990s**

**Deepening and strengthening state foreign trade enterprises**

Reform for the latter part of the 1990s is designed to separate enterprises from administration and reduce the reliance of enterprises on government; to allow non-state enterprises, including some foreign capital enterprises, to enter the field of foreign trade in order to break the monopoly of foreign trade and foster competitiveness through diverse ownership; and to provide incentives for state foreign trade enterprises to continue with amalgamations and mergers. At the same time, enterprises that suffer great losses and are unable to pay their debts can now be sold by auction.

Enterprises will increasingly combine production activities with trade and continue to develop their management practices. These enterprises will undergo corporate reorganisation.
The approval system will be gradually transformed into one involving registration by enterprises. A mechanism will be set up for enterprises with different ownerships to ensure fair entry into the areas of foreign trade together with corresponding mergers, elimination and withdrawal from the mechanism. This will assist foreign trade enterprises to reduce their scale of operation. At present, excluding foreign-capital trade enterprises, there are about 9,000 foreign trade enterprises in China and a number of these have been unable to reach a reasonable scale of business operations. Mergers among them should be accelerated in order to realise enterprise scale economies and to increase their commercial strength.

Reform of the import management system and non-tariff limitation measures

Reduction of controls on import plans

About 40 per cent of the total volume of China’s import trade is controlled by the use of mandatory and guiding plans. In future the proportion of planning management will be reduced and a policy of free import will be promoted. By the end of this century over 80 per cent of China’s import trade will be freely conducted using market coordination.

Government examination and reduction of import approvals

The system of government examination and approval has led to excessive administration. Government examination and approval will in time be greatly reduced and the varieties of import subject to such examination and approval decreased. At the end of this century, this system will in fact be brought to an end. In 1994 the state switched from a system that limited quotas on ordinary mechanical and electronic products and began to use a registration system, and this system will be expanded. This represents a transitional method for an eventual shift away from the examination and approval system.

Optimisation of the licence system

At present, China operates a licensing system for 49 important and sensitive commodities on the international market. Import licences are issued according to the Provisional Regulations of Imports Licences of the People’s Republic of China and their detailed rules and regulations. Localities and departments that import commodities controlled by the licensing system, must apply for approval by the department designated by the state. After the
certification of quotas, prospective importers must go to the designated institutions for licences. Permission to import some major products such as raw oil, finished oil, steel products, grain, cotton and seven other listed products is subject to the approval of the designated companies. Not all imports are subject to an approval system. The state exercises quota control over 18 machinery and electronic products and 26 ordinary commodities. In total, 171 taxable machinery and electronic products are not controlled by quotas and may be automatically registered. While GATT does not forbid this type of licensing system, it does ask that the operation be made transparent, that quotas be kept open and that formalities be kept simple. Future reform will see the variety of commodities controlled by quota licensing further reduced and the introduction of transitional measures including non-quota licence management and bidding for competition. Repetitious cross-management measures will be rationalised and formalities simplified. China’s licensing system will meanwhile move closer into line with international standards according to the Agreement on Import Licence Formalities of the Uruguay Round held in Tokyo.

**Decreasing tariff levels to those of other developing countries**

From January 1992 to the end of 1995 China reduced tariffs on four occasions. According to the records of tariff items, the unweighted average rate decreased from 47.2 per cent to 35.9 per cent during this period. In April 1996 China reduced tariffs on a large scale. The unweighted average tariff rate is set to decrease to 23 per cent. Given average tariff levels of 14–15 per cent among the developing countries, China’s tariff rate will be greatly reduced as a consequence of its introduction of a large number of preferential measures involving exemption from tariffs, and tax exemptions for imported materials and piecework in the processing trade.

The actual tariff rate is lower than the official tariff rate. If the actual number of tariffs is divided by the value of import goods, the actual tariff rate in 1994 was in fact 4 per cent, and 3 per cent in 1995. Even if we incorporate the additional value of taxes levied by Customs, the rate was only 6.4 per cent. The official tariff rate is rather high, but the actual tariff rate is very low. This points to an imperfect tax system and suggests that tax law reform is a serious issue and that tax policy is not transparent.

China will gradually deal with its outdated preferential measures involving tariff reductions and exemptions, and will look to decrease the total level of tariffs to that of the
developing countries — namely, 14–15 per cent. At the same time China will look to safeguard the integrity of its tax laws and regulations so that taxes will be levied according to the appropriate rate set down by law.

**Market access to agricultural products and the services sector**

The price of agricultural products in China has risen greatly due to rapid growth in demand. Some prices already approach or exceed world market prices. Agricultural protection policy has clearly lost its way. Agricultural protection needs to be reduced step by step and the market for agricultural products further liberalised. The structure of Chinese agriculture, especially in the eastern coastal areas, needs to be reformed, and its effectiveness raised through international management.

In the services sector, the Chinese government has allowed some foreign businesses to invest in pilot enterprises which are set to engage in foreign trade in future years. At the same time, in the open coastal cities, pilot foreign-invested enterprises have gained entry into retail commerce. All these pilots will exert a positive influence on China’s opening of its service market. In recent years the progress of financial market development has been dramatic. By the end of November 1995, the People’s Bank of China had approved 470 offices representing foreign banks and 135 foreign financial institutions. Among these are 115 foreign bank branches, five joint–foreign banks, four foreign capital insurance companies and one Sino–foreign joint venture bank. Meanwhile, the People’s Bank of China has announced that Shanghai will be first city to allow foreign capital banks in China to deal in renminbi. This indicates that some trades formerly monopolised by the state have been opened to foreign investors. China needs to ensure that the principles of equal entry and fair competition are upheld for foreign enterprises entering the services sector.

**Reform of the foreign exchange system and convertibility of the renminbi**

Strategically, China would do well to adopt a policy of gradual reform that puts an end to limitations on capital circulation related to trade, long-term foreign direct investment and stock investment, and the short-term capital float. However, the goal of free convertibility requires that some important conditions are met: a significant reduction of the financial deficit and a decrease in the inflation rate; a guarantee that moderate foreign debt is in scale;
tying the domestic interest rate to that of the international monetary market; enhanced competitiveness in the domestic financial system; bringing the capital condition of the domestic financial system into conformity with prescribed standards; strengthening supervision and control over the domestic monetary system; and establishing government guarantee measures for an open monetary system. Given that such conditions take some time to implement, the aim of renminbi convertibility in 2000 should be to realise convertibility on capital account — that is, convertability for selected transactions, for example capital imports and exports related to trade, and convertability for import and export of long-term foreign direct investment including foreign business investment in China and domestic enterprise investments abroad.

**The structure of export commodities and maintaining export growth**

China’s trade strategy will see a gradual change from broad general management of its export trade to a more targeted approach that seeks to enhance the quality of its products. With the abolition of mandatory export plans and requirements to turn over foreign exchange to the authorities, controls on foreign enterprises seeking to increase exports will be greatly reduced. These enterprises will improve the quality of export commodities, reform their organisational structure and thus maximise economic benefits. In this way, China will achieve steady growth and momentum in its foreign trade. And with an end to import limitations, import growth will speed up, thus promoting greater equilibrium between import and export trade. During the Ninth Five-Year Plan (1996–2000), import trade is expected to reach 13 or 15 per cent. Import and export trade will be in balance, while the average annual balance of trade will fall to under US$5 billion. China’s import and export trade will be characterised by stable and coordinated development.

**References**


China’s Textile and Clothing Exports in the Post Uruguay Round

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2. China’s Textile and Clothing Exports in the Post Uruguay Round

Introduction

Since the introduction of economic reform in the late 1970s, China’s exports of textiles and clothing have grown rapidly. By 1994 China had emerged as the world’s largest exporter of clothing and second largest exporter of textiles. This rapid export expansion has been achieved despite the Multi-fibre Arrangement (MFA), which has increasingly restricted China’s exports.

The conclusion of the Uruguay Round multilateral trade negotiations marked a major change in the policy environment for world trade in textiles and clothing. Under the Agreement on Textiles and Clothing reached during the round, quota restrictions under the MFA will be gradually dismantled over a ten-year transition period (from 1 January 1995 to 1 January 2005), at the end of which the textile and clothing sector will be fully integrated into GATT 1994. The Agreement on Textiles and Clothing also provides for accelerated increases in quota volumes during the transition period. In addition, tariffs on textiles and clothing will be reduced in the Quad economies (the United States, the European Union, Japan and Canada), and most developing countries have also pledged significant tariff reductions and bindings.

There is little doubt that the phasing-out of the MFA and tariff reductions will boost world trade in textiles and clothing. GATT (1993) estimated that the largest increases in world trade resulting from the Uruguay Round trade liberalisation would occur in the textile and clothing sector. China is expected to gain the most among developing countries if the MFA is abolished (Whalley 1992). However, there are uncertainties over China’s access to the potential benefits. The result will be heavily influenced by the outcome of China’s negotiations to join the World Trade Organisation (WTO), increasing regionalism, increasing anti-dumping charges overseas, and changes in the rules of origin policy in the United States.

In the long run, the prospects for China’s export growth in textiles and clothing will increasingly depend on China’s ability to maintain its competitive edge in this sector as competition intensifies after the elimination of MFA quotas. In this respect, two factors will have to be considered. One is China’s changing comparative advantage resulting from
continuous rapid economic growth, and the other is the emergence of new textile and clothing exporters in other parts of the world.

This paper analyses the main forces that will influence China’s prospects for trade in textiles and clothing against the background of Uruguay Round trade reform and a changing world economy. The following section gives a brief account of the growth and sources of China’s textile and clothing exports in the past 15 years. The third section provides a brief summary of the achievements of the Uruguay Round in the textile sector and their expected impact on world trade. The fourth section examines the implications of China’s WTO membership for its textile and clothing exports and some new issues. The fifth section carries out some quantitative assessments of the impact of the Agreement on Textiles and Clothing on China, followed in the sixth section by an examination of structural adjustment in relation to textile and clothing exports. The main findings of the study are summarised in the final section.

**China’s exports of textiles and clothing**

China’s overall trade performance since the late 1970s has been remarkable. From 1980 to 1994 total merchandise trade increased from US$38 billion to US$237 billion in nominal terms, a more than six-fold increase. During the same period exports rose from US$18 billion to US$121 billion. By 1994 China had become the world’s 11th largest trading economy, up from the 26th in 1980. Its share in total world exports jumped from 0.9 per cent in 1980 to 2.9 per cent in 1994.

Textiles and clothing have been a major driving force behind the surge in China’s exports (Table 1). From 1980 to 1994, textile and clothing exports rose from US$4.4 billion to US$35.5 billion, a more than eight-fold increase. The share of textiles and clothing in total merchandise exports also rose from 24 per cent in 1980 to nearly 30 per cent in 1994, a significant rise given the rapid growth of total merchandise exports during the period. In fact, textiles and clothing were the single most important export product group from 1986 to 1995, when machinery and electronic products took over the lead. China’s share in world clothing exports rose from 4.4 per cent in 1980 to 17.0 per cent in 1994 and its share in textiles from 4.6 per cent in 1980 to 9.2 per cent in 1994 (WTO 1995).1

China’s remarkable export performance has been achieved despite severe MFA restrictions by industrial importing economies. While early bilateral agreements with the
United States, the European Community (EC) and Canada provided China with quite generous growth rates of quotas compared with other exporters — mainly the newly-industrialising economies (NIEs) — restrictions became increasingly stringent in more recent bilateral agreements in terms of product coverage, growth rates and trans-shipments. The average annual growth rate of quotas in the US market declined from about 4.6 per cent in the first Sino–US textile agreement (1980–82) to 1 per cent in the 1995 agreement. Similarly, quota growth rates have been reduced in other major MFA markets (the European Union and Canada), albeit less drastically than in the US market. As the growth rates of quotas have declined, the commodity coverage of quotas has increased. Initial quota restrictions on China mainly targeted cotton textiles and clothing. The coverage has since expanded to include synthetic, woollen and silk products. At the same time, quota utilisation rates have increased, indicating an increasingly binding effect of quotas on exports (Yang 1992).

The growth of China’s textile and clothing exports has been largely supply-driven. Several factors have contributed to the growth. After the extremely inward-looking approach to development in the 1960s and the greater part of the 1970s, China shifted toward a more export-oriented growth strategy in the late 1970s. Growth in the textile and clothing sector has since been given priority.

This decision made good economic sense. Without severe trade distortions, a densely populated country such as China tends to specialise more in the export of labour-intensive manufactures — such as textiles and clothing — at the initial stage of industrialisation (Anderson 1992). The experience of Japan and the NIEs is a good demonstration of this. In addition, China has retained a large production capacity in the textile and clothing sector since the late 1930s. Even during the period of the Cultural Revolution (1966–76), the sector

Table 1  China’s exports of textiles and clothing (US$ billion)

<table>
<thead>
<tr>
<th></th>
<th>Textiles</th>
<th>Clothing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>2.8</td>
<td>1.7</td>
</tr>
<tr>
<td>1985</td>
<td>3.2</td>
<td>2.1</td>
</tr>
<tr>
<td>1990</td>
<td>7.0</td>
<td>6.8</td>
</tr>
<tr>
<td>1994</td>
<td>11.8</td>
<td>23.7</td>
</tr>
</tbody>
</table>

Sources: China National Textile Council and Customs Statistics of China (various years).
remained large and relatively efficient compared with other industries. While the development of many other light industries was largely ignored in the 1960s and 1970s, the textile industry enjoyed reasonable growth.

Textile and clothing exports greatly benefited from rural reforms in the early 1970s. The dramatic increases in China’s cotton production in the early 1980s provided an abundant supply of raw materials for textile and clothing production. Given that the Chinese economy was still very much closed at the time, domestic inputs were essential to textile and clothing production and hence for exports. Between 1979 and 1984 cotton production nearly tripled, increasing from 2.2 million tonnes to 6.3 million tonnes (China State Statistical Bureau 1985).

The rise of rural enterprises (also called township enterprises) has been both a result of and a driving force behind the economic reform towards decentralisation. As a policy aimed at structural adjustment in urban industries (mainly state-owned enterprises), the government has also been encouraging the relocation of labour-intensive production from urban to rural areas. This has added to the cost advantage of labour-intensive production. Compared with state enterprises, township enterprises are more flexible in production and management. Their production costs tend to be lower than those of their state counterparts. In recent years, most of China’s textile and clothing exports have been supplied by township enterprises (Yang 1995b).

Foreign direct investment (FDI) has also played an important part in China’s textile and clothing exports. Since the late 1970s there has been a rapid inflow of FDI into China. During the period 1979–94 cumulative and realised FDI in China totalled US$95.5 billion (Ministry of Foreign Trade and Economic Cooperation 1994–95). The pace of inflow of FDI into China accelerated from the early 1990s. In 1994 alone, FDI in China amounted to US$32 billion, second only to FDI in the United States in the same year. A significant proportion of the investment has been attracted to labour-intensive sectors such as textiles and clothing. In 1994 foreign-invested enterprises accounted for 28 per cent of China’s total exports and 61 per cent of the increase in exports in the same year (International Trade, March 1995).

The contribution of foreign-invested enterprises to China’s textile and clothing exports cannot be overstated. Low labour costs do not translate to export competitiveness if productivity is low. Foreign investment brings in not only physical capital but also technology, management and marketing skills, and better access to export markets. Foreign investment in China’s textile and clothing industry has mainly come from the NIEs of Hong Kong, Taiwan and South Korea. In many cases, investment is informal, taking the form of
compensation trade, processing and assembly. Compared with formal foreign investments, these investments are quick to become operational and are more flexible in meeting export demand (Yang 1992).

Textiles and clothing have generated much of the needed foreign exchange earnings for China. From 1979 to 1994 textiles and clothing accumulated a surplus of more than US$160 billion, while the trade balance of other products recorded a deficit of more than US$40 billion. The surplus has been often used to finance the import of technology, machinery and equipment. Because of the critical importance of the textile and clothing sector, in 1986 the former Textile Industry Ministry (now the China National Textiles Council) put forward a strategy that gave priority to the export of textiles and clothing. A series of policies has since been adopted to promote the export of textiles and clothing.

Maintaining low prices for raw materials, mainly cotton, has been a policy target. Cotton is the main fibre consumed in China. Its price has been kept low by state monopoly of procurement. The government provides subsidies on inputs for cotton production, such as fertiliser and pesticide. Although this policy is questionable on efficiency grounds, it has nevertheless benefited the textile industry.

While export businesses in other products such as petroleum, cereals, vegetable oils and chemical products are still under state monopoly, the export business of textiles and clothing has been decentralised and liberalised much more significantly since the early 1980s. Local governments, township and foreign-invested enterprises all have substantial participation in the export of textiles and clothing.

For a long time before 1992, mandatory export plans were imposed on state-owned foreign trade enterprises. These were linked with various kinds of preferential treatment. The foreign exchange retention system allowed export enterprises to keep a certain proportion of their foreign exchange earnings for more flexible use or sale at foreign exchange swap markets at a price higher than the official exchange rate. The retention system was abolished in 1994.

Imported materials used for the production of textiles and clothing for export have been exempted from import tariffs and other charges. A fund for textile and clothing exports was established in 1986 (Textile Industry Ministry 1988). A more important policy is probably the exemption of the 17 per cent value-added tax for export production. Delays in payment and cuts in the rate of tax rebate were blamed for the much slower growth of textile and clothing exports in 1995 (7 per cent as compared with 31 per cent in 1994).
The Agreement on Textiles and Clothing

Textiles and clothing have been the main manufactured exports of many developing countries. For more than two decades, however, their exports have been subject to voluntary export restraints (VERs) under the MFA negotiated between industrial importing economies and developing exporting economies.

The Agreement on Textiles and Clothing (ATC) reached during the Uruguay Round represents a major step forward in trade liberalisation in the textile sector. It is a transitional agreement and provides a legal framework for the phasing-out of MFA restrictions over a ten-year period (1 January 1995–1 January 2005). After the transition, the same rules will apply to trade in textiles and clothing as to trade in other goods. In addition, the ATC also requires that restrictions inconsistent with GATT other than those maintained under the MFA must be either brought into conformity with GATT or eliminated. The ATC also provides for increases in quota growth rates for products remaining under restrictions during the transition period.

The integration process has three phases. In the first phase (1 January 1995–31 December 1997), no less than 16 per cent of 1990 trade volumes are to be integrated. In the second phase (1 January 1998–31 December 2001), no less than 17 per cent of 1990 trade volumes are to be returned to GATT, and in the third phase (1 January 2002–31 December 2004), the figure is to be no less than 18 per cent. Altogether, no less than 51 per cent of total 1990 import volumes are to be integrated by the end of 2004. At the beginning of 2005 products remaining under restriction are to be integrated simultaneously. In all three stages, the products to be integrated must include tops and yarns, fabrics, made-up textile products and clothing.

It is clear that integration is heavily loaded towards the end of the transition period. Even the 51 per cent integration, however, is an overstatement of the extent of trade liberalisation. It must be remembered that the percentage of integration in each and every stage is based on 1990 figures for virtually all textile and clothing products, restricted or not, instead of the restricted products only. As not all products are currently restricted by the MFA, importing economies can choose to liberalise products that are not restricted first and postpone the integration of restricted products until the end of the transition period. According to UNCTAD (1995a), such unrestricted products accounted for 47 per cent of total 1990 imports into Canada, 34 per cent in the European Union and 37 per cent in the United States. The share of unrestricted volumes is 93 per cent in Austria, 81 per cent in Finland and 83 per cent in
Norway. Thus most industrial economies do not have to offer substantive trade liberalisation until the end of the transition period.

An examination of the integration programs for the first stage shows that no products integrated by the United States, the European Union, Norway and Canada in the first stage are currently under restriction (UNCTAD 1995a; ITCB 1995). In value terms, the products to be integrated account for 8.7 per cent of total EU imports and 6.9 per cent of total US imports. In other words, although the 16 per cent integration requirement in volume terms is fulfilled, most products that are integrated are low in price. It is yet to be seen what products importing economies (except the United States) will integrate in the subsequent stages. These economies are required to notify the Textile Monitoring Body of these products 12 months before each stage begins (ATC Article 2:11). It should be noted that this provides importing economies with the flexibility to integrate products when they are less restricted. The United States has published its integration programs for the second and third stages. Estimates show that only 11 and 9 per cent of total 1990 US imports in value terms will be integrated in the second and third stages, respectively (UNCTAD 1995a). This means that products accounting for more than 70 per cent of the total 1990 import value will not be integrated by the end of 2004.

Under Article 2 of the ATC, bilateral quotas under the MFA will be enlarged in three stages. In the first stage, the growth rates of quota volumes will increase by 16 per cent. In the second stage, the growth rates will further increase by 25 per cent. In the last stage, growth rates will rise by 27 per cent. For small suppliers (accounting for 1.2 per cent or less of the total volume of the restrictions applied by importing economies as of 31 December 1991), the acceleration of quota growth will be advanced by one stage.

As quota acceleration is based on the quota growth rate effective on 31 December 1994, the initial rates of quota growth are critical in determining the extent of quota enlargement. Exporters with higher initial rates of quota growth will have larger increases in their quota volumes than those with lower initial growth rates. Yang (1996) reported that the standard deviation of quota volumes across exporters increases by 50 per cent in North America and 57 per cent in the European Union as a result of quota acceleration.

Not only do the quota acceleration programs introduce greater disparities among exporting economies; they also increase the variations in quota volumes for different products. As sensitive products have lower quota growth rates under bilateral agreements, their relative quota volumes in the transitional period will slip further, offering even less liberalisation but creating greater distortions in resource allocation.
Does the acceleration reduce the restrictiveness of MFA quotas? On the surface, there seems to be a considerable relaxation, but the supply side has to be taken into account in assessing the net outcome. Several studies have shown that there will be no significant reductions in the extent of quota restrictions during the transition period, especially for clothing (Cline 1995; Hertel et al. 1995; Yang 1996). Thus the ATC is effectively an extension of the MFA for another ten years.

A special safeguard mechanism is stipulated in the ATC (Article 6) for the transition period (referred to as the ‘transitional safeguard’). The ATC has retained most of the safeguard provisions in the MFA (Articles 3 and 4). Under Article 6, a member of the WTO may apply a safeguard measure to a product if its domestic industry faces ‘serious damages, or actual threat of damages’ caused by increased imports.

Safeguard measures can be applied on a member-to-member basis, providing an opportunity for discrimination, but they are applicable only to products not yet integrated into GATT 1994 and not already under quantitative restraint. Safeguard measures can remain in place for a maximum of three years or until the product is integrated into GATT 1994, whichever comes first. The ATC allows all WTO members to use this special safeguard mechanism as long as a member has indicated an intention to retain the right to use this mechanism. Eventually, 49 members did indicate that they wished to retain this right (WTO 1996). There is a possibility of more countries using this discriminatory mechanism, formerly available only to MFA-importing countries, during the transition period. Even more disturbing is the prospect of its use by increasing numbers of developing countries against other developing countries, with some resorting more frequently to such legitimate instruments as anti-dumping and countervailing measures.

Only several months after the ATC went into effect on 1 January 1995, the United States had made 20 ‘calls’ for consultations under the new special safeguard mechanism covering a wide range of textile products exported by developing economies (ITCB 1995). Along with other instruments such as anti-dumping measures, the special safeguard mechanism is likely to be more frequently resorted to by governments under very strong protectionist pressure from vested interests.

Tariffs on the textile and clothing sector have been much higher than those in other sectors and have been characterised by tariff peaks (above 15 per cent) in industrial importing markets. Tariffs in developing markets are even higher. During the Uruguay Round, this sector was also subject to the general market access commitment requirement for the goods
sector. However, the average tariff reduction by the Quad countries was only 22 per cent, making it the only sector that did not fulfil the target of one-third reduction. In comparison, reductions by developing countries are more substantial (Table 2).

### Challenges ahead

Several studies have shown that China will substantially benefit from the phasing out of the MFA (Trela and Whalley 1990; Yang et al. 1997). All these studies, however, are based on the assumption that China will have the full access to the potential benefits resulting from the complete elimination of MFA quotas, including those imposed on China.

The extent to which China can benefit from the ATC is clouded by the uncertainties surrounding China’s WTO accession negotiations. According to the US and EU legislations implementing the Uruguay Round, non-WTO members may not be able to benefit from the ATC even if they were members of the former MFA (UNCTAD 1995b). In addition, the exports of non-WTO members could even be subject to new restrictions without any time limits. If China stays outside the WTO, there is likely to be more friction in its economic and

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### Table 2  Tariff reductions by selected developing economies

<table>
<thead>
<tr>
<th></th>
<th>Bindings (% of imports)</th>
<th>Trade-weighted average tariffs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pre-UR</td>
<td>UR offer</td>
</tr>
<tr>
<td>Argentina</td>
<td>1</td>
<td>100</td>
</tr>
<tr>
<td>Brazil</td>
<td>5</td>
<td>100</td>
</tr>
<tr>
<td>Chile</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Chinaa</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>India</td>
<td>0</td>
<td>61</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0</td>
<td>98</td>
</tr>
<tr>
<td>Peru</td>
<td>5</td>
<td>100</td>
</tr>
<tr>
<td>Philippines</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Thailand</td>
<td>0</td>
<td>94</td>
</tr>
</tbody>
</table>

**Notes:**  
- **a** Data for China are updated according to offers by China in its WTO accession negotiations.  
- na — Not applicable or not available.

**Sources:** Excerpts from UNCTAD (1995b), GATT Secretariat estimates.
trade relations with its trading partners. Mexico, for example, has recently imposed antidumping duties of 54–500 per cent on Chinese textiles and clothing (Moore 1995). China has to rely entirely on bilateral efforts to deal with such problems since it is not a WTO member.

The recent change in the rules of origin concerning textile and clothing imports in the United States is likely to have an adverse effect on China’s exports. In accordance with Section 334 of the US Uruguay Round Agreement Act (implementation legislation), changes in the rules of origin (effective on 1 July 1996) will affect a broad range of products (T-shirts, pants and dresses). The new rules will, in most cases, treat the country of assembly as the country of origin, and quotas will be charged against this country. Countries like China which rely heavily on processing trade will be most affected by such a change. While WTO members may have access to compensation in accordance with WTO agreements (including the ATC), it is unlikely that China will be compensated.

Even if China gained WTO membership in the near future, there exists the possibility that China’s exports would be subject to discriminatory restrictions under a special safeguard provision that is likely to be included in the Protocol of Accession of China. This special safeguard is distinct from the transitional safeguard in the ATC. As China is considered to be a planned economy with broad government interventions in production and trade, the United States and the European Union have been insisting on the inclusion in China’s Protocol of Accession of a special safeguard provision. This provision would allow other WTO members to impose quantitative restrictions specifically against China upon the determination of a surge of Chinese imports and serious damage or threat thereof to industries in destination markets. Such a mechanism is similar to the safeguard mechanism based on the concept of market disruption contained in the MFA. The proposals by the United States and the European Union on the text of such a special safeguard provision also contain a mechanism for third countries to have recourse to such measures on the basis that the imposition of restrictions by other countries has resulted in a diversion and surge of China’s exports to their markets.

There is little doubt that such a mechanism will be applied mostly against China’s most dynamic exports of labour-intensive products, such as textiles and clothing. Furthermore, such a mechanism will be open to use by any member of the WTO, whether developed or developing. Therefore, there is reason to suspect that even if China gains early accession to the WTO, it may continue to face MFA-type restrictions.
Anti-dumping is yet another source of concern for China. By using third-country reference prices in the determination of dumping margins, the actual costs of China’s exports are virtually disregarded. Although strongly opposed by China during the WTO membership negotiations, this practice is likely to continue in the foreseeable future.

Rising regionalism and the spread of preferential trade agreements are further unfavourable developments for China. To some extent, China fears that it has been marginalised. China has not even been granted preferential arrangements in a global feature such as the generalised system of preferences (GSP) in one of its main export markets — the United States. In the textile sector, several recent developments will further affect China: the formation of the North American Free Trade Area (NAFTA); the enlargement of the European Union to include Austria, Sweden and Norway; the European Union’s preferential agreement with Turkey — a rapid expanding exporter of textiles and clothing — eliminating all the quota restrictions on Turkey, effective on 1 January 1996; and the European Union’s preferential agreements with Central and Eastern European economies, eliminating all quota restrictions on them by 1 January 1998 (ITCB 1995). Sweden abolished MFA quotas in 1991, but its accession to the European Union means that this market is under quota restrictions again.

Another important recent development is Japan’s intention to impose quantitative restrictions on China’s textile and clothing exports. Japan has never imposed MFA restrictions on developing exporters. It was a large exporter of both textiles and clothing before the 1970s and remains a significant exporter of textiles today. However, with rising export competition from the NIEs in the 1960s and 1970s (and later from China), Japan has gradually changed from being a large net exporter of textiles and clothing to a large net importer of clothing and a significant importer of textiles. Rising import competition in the domestic market has led to intensive structural adjustment in Japan’s textile industry in the past decade.

Increasing restrictions in the US and EU markets have led to rapid diversification and diversion of Chinese exports to the Japanese market. China’s shares in Japan’s total imports of textiles and clothing has risen dramatically in recent years. For textiles, China’s share increased from 24.6 per cent in 1992 to 32.4 per cent in 1994; and for clothing, from 43.3 per cent in 1992 to 53.8 per cent in 1994 (WTO 1995). As a result, Japan became China’s largest industrial market for textiles and clothing exports in 1994.

Rising import competition has aroused increasing calls from Japan’s domestic textile industry for import protection. Starting in October 1994, at the request of the Japanese
government, several rounds of consultations were held between China and Japan on possible ‘voluntary export restraints’ on a range of textile products by China. On 9 November 1995 the Japanese government decided that restrictions would not be imposed for the time being due to a decline in China’s exports of these products to Japan during the period under investigation.

This development may have far-reaching implications for China. It means that new grey area agreements against China could spread (Yang 1996). This may threaten the newly emerging markets such as the NIEs. The WTO is yet to deal with such arrangements involving non-WTO members.

A quantitative assessment of the ATC

In this section, the GTAP model is used for assessing the effect of the MFA reform. The full GTAP model (Version 2) covers 24 regions and 37 commodities. In this study, a 10x10 version of the model (ten commodities and ten regions) has been used. The ten countries and country groups are Australasia (Australia and New Zealand), North America (the United States and Canada), the European Union, Japan, the NIEs (Hong Kong, the Republic of Korea and Taiwan), ASEAN (Indonesia, Malaysia, the Philippines, Singapore and Thailand), China, South Asia (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka), Latin America, and the Rest of the World (ROW).

As the phasing-out of the MFA is heavily end-loaded, the full impact of the reform will probably not be felt until after the quotas are completely abolished. In addition, rapid economic growth and the expected changes in the structure of the Chinese economy should be taken into account in evaluating the effect of MFA reform on China. For this reason, the world economy is projected to the year 2005 — when the Uruguay Round reform will have been fully implemented — before comparative static analysis of the reform is carried out. The projections are based on Hertel et al. (1996). A modification was made with regard to the projection of China’s labour force. A much higher labour force growth is assumed in this study than in Hertel et al. (1996). This is based on the observation that large unemployment and underemployment exists in both urban and rural China, and hence the effective labour force may grow much more rapidly than the population for the period 1992–2005. In fact, it is projected that China’s labour force will grow as fast as South Asia’s, although its population growth will be substantially slower (Table 3).
China is projected to have the most rapid capital accumulation and GDP growth over the period 1992–2005. This reflects the strong growth performance in the past decade and an optimistic assumption on the stability of the economy in the future. The implied 9 per cent annual growth rate does not seem to be unrealistic if China continues with its reform programs. The rapid growth of capital means that China will become increasingly capital-abundant.

In projecting the world economy to 2005, the current restraints of MFA quotas remain. The projected growth of MFA quotas is based on Hertel et al. (1996) and UNCTAD (1995a). In general, projected quota growth rates for China are slower than for most other developing economies. Since exports to North America and the European Union are exogenously determined, the export tax equivalents of the quotas are allowed to change over time to reflect the changes in the extent of MFA restrictions.

The magnitudes of trade elasticities in the GTAP model are doubled in the projection simulation. This is based on Gehlhar (1997), who showed the past growth and trade patterns in the Pacific Rim were best replicated with the model when these elasticities were doubled. The alteration is primarily based on the observation that terms-of-trade effects seem to be unrealistically strong for small economies when the original GTAP elasticities are used.

China is estimated to gain as much as US$8.6 billion (as measured by equivalent variation) from the phasing out of the MFA despite a considerable deterioration of the terms.

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Table 3  Projected changes in factor endowments and real GDP, 1992–2005 (per cent)

<table>
<thead>
<tr>
<th></th>
<th>Population</th>
<th>Labour</th>
<th>Capital</th>
<th>Real GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>10</td>
<td>8</td>
<td>31</td>
<td>37</td>
</tr>
<tr>
<td>North America</td>
<td>10</td>
<td>13</td>
<td>43</td>
<td>41</td>
</tr>
<tr>
<td>European Union</td>
<td>2</td>
<td>2</td>
<td>19</td>
<td>33</td>
</tr>
<tr>
<td>Japan</td>
<td>4</td>
<td>-2</td>
<td>52</td>
<td>39</td>
</tr>
<tr>
<td>NIEs</td>
<td>12</td>
<td>13</td>
<td>122</td>
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</tr>
<tr>
<td>ASEAN</td>
<td>23</td>
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<td>China</td>
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<td>South Asia</td>
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<td>Latin America</td>
<td>25</td>
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<tr>
<td>ROW</td>
<td>18</td>
<td>36</td>
<td>37</td>
<td>37</td>
</tr>
</tbody>
</table>

Source: Based on Hertel et al. (1996).
of trade which results from the loss of quota rents (Table 4). The benefit results from substantial increases in the export of textiles and clothing. This will lead to the expansion of production in both the textile and clothing industries. However, the clothing industry will expand more than the textile industry because current MFA quotas are much more stringent on clothing exports than on textile exports. Trade liberalisation therefore boosts the clothing industry more than the textile industry.

The welfare gain from MFA reform will account for nearly two-thirds of China’s total benefits from the Uruguay Round trade liberalisation. The elimination of the MFA will also contribute in a major way to increases in GDP, real wages and trade. The non-MFA reforms of the Uruguay Round will reinforce MFA reform. Under the complete Uruguay Round reform scenario, the expansion of clothing production is considerably stronger than under the MFA reform alone. Tariff cuts will induce substantial increases in imports of textiles and clothing. The reduction in the tariffs on textiles will stimulate clothing production and hence exports.

Should the MFA remain for China but be abolished for all other developing economies, China would be significantly adversely affected (Table 4). Whether China continues to face MFA quotas or not makes a difference of nearly US$16 billion to its welfare. The adverse effect on China of continued MFA restrictions would come largely from increased competition from other developing economies when the MFA quotas on them are abolished. North America and the European Union will also lose considerably from China’s exclusion from MFA reform because they would have to pay higher prices for Chinese goods than they would otherwise. Other developing economies, of course, gain from reduced competition from China.

**Implications of structural change for textiles and clothing**

Whether China will continue its rapid growth of textile and clothing exports depends not only on demand conditions but also on its supply potential. There are two major factors which will determine the long-term growth of China’s textile and clothing exports. The first is continued economic reform. In standard neoclassical analysis, reforms will only have one-off effects, and will not accelerate the long-term growth rate of the economy. A growing body of literature has suggested, however, that openness may boost long-term growth rates (Edwards 1992).
The second major factor is the shift in comparative advantage in the world textile and clothing sector. Because textiles and clothing are labour intensive, especially clothing, China’s comparative advantage in textiles and clothing lies largely in its abundant supply of unskilled labour. With rapid economic growth in the past one and a half decades this has begun to change. In some coastal areas, rapid expansion of exports has led to shortages in unskilled labour, inducing large migration from inland areas despite restrictions on migration. At the same time, rental costs for land in coastal areas are also increasing, exerting pressure for production facilities to move west.

Given great variations in labour costs in different parts of China, it will take a considerable time for an overall labour shortage in China to emerge. Large pools of the unemployed and underemployed in most rural areas will provide virtually unlimited labour resources for the coastal areas to draw on. Policies aimed at reducing the costs of migration from the west to the east will enable China to use these vast human resources. Household registration has been a major constraint on migration, although the system is losing its grip.

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**Table 4** The impact of the Uruguay Round trade liberalisation, 2005 (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>The removal of the MFA alone</th>
<th>Complete Uruguay Round</th>
<th>Facing MFA discrimination</th>
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<tr>
<td><strong>Macroeconomic effect:</strong></td>
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<td>Equivalent variation ($US billion)</td>
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<td>13.1</td>
<td>-7.2</td>
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<tr>
<td>Real GDP</td>
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<td>1.8</td>
<td>-0.3</td>
</tr>
<tr>
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<td>0.4</td>
<td>1.0</td>
<td>-0.1</td>
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<tr>
<td>Exports</td>
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<td>-1.5</td>
</tr>
<tr>
<td>Imports</td>
<td>5.9</td>
<td>17.8</td>
<td>-1.5</td>
</tr>
<tr>
<td>Terms of trade</td>
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<td>-2.1</td>
<td>-0.3</td>
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<tr>
<td><strong>Effects on textiles:</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Output</td>
<td>13.8</td>
<td>9.1</td>
<td>-0.8</td>
</tr>
<tr>
<td>Exports</td>
<td>22.8</td>
<td>29.3</td>
<td>6.1</td>
</tr>
<tr>
<td>Imports</td>
<td>19.0</td>
<td>46.5</td>
<td>-3.6</td>
</tr>
<tr>
<td><strong>Effects on clothing:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Output</td>
<td>62.5</td>
<td>76.0</td>
<td>-12.7</td>
</tr>
<tr>
<td>Exports</td>
<td>115.8</td>
<td>142.4</td>
<td>-26.8</td>
</tr>
<tr>
<td>Imports</td>
<td>9.5</td>
<td>72.9</td>
<td>-3.3</td>
</tr>
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</table>

*Source:* Simulations of the GTAP model.
on the rural population. A number of other policies have also hindered effective use of migrant resources in urban areas. For example, migrants are seldom eligible for government housing, medical care and education. There are still restrictions on employment of rural migrants in state enterprises. Restrictions are also imposed on where migrants may live in urban areas, with some cities collecting tolls on migrants.

An alternative policy for tapping China’s human resources is to improve infrastructure in inland areas. This will not only reduce migration costs if farmers choose to migrate east but also provide the necessary conditions for indigenous industries to thrive should would-be migrants decide to remain in the west. This may also attract entrepreneurs to inland areas and is likely to reduce east–west income inequality, which has been growing since the beginning of reform in the late 1970s.

With rapid growth, capital accumulation will continue to be rapid. In fact, the projected growth of capital is more rapid than income growth. This can either be achieved by attracting more foreign investment or increased domestic savings, a continuation of past experience. Land resources are assumed to be constant over the period of projection. Thus, increases in agricultural output will be achieved solely through improvements in productivity and increase in the use of labour and capital.

Table 5 shows two scenarios of projection based on these considerations. In the first scenario, changes in trade policies resulting from the Uruguay Round trade liberalisation are taken into account. The growth of the economy is driven both by factor accumulation and trade liberalisation. Simulation results show that sectors that are more capital intensive tend to grow more rapidly over the period than labour-intensive sectors. Processed food, textiles, iron and steel, other manufactures and services grow much more slowly than the overall growth of the economy. The slower growth in some of these sectors is partly attributed to relatively slow growth in demand because of lower income elasticities for these commodities. The rapid growth of clothing production largely results from the phasing out of the MFA. As the numbers in the parentheses show, without the Uruguay Round trade liberalisation, the increase in clothing production would be more than halved, growing at a much slower pace than the economy as a whole. In general, trade restrictions in industrial economies tend to be more stringent on labour-intensive products than on capital-intensive products. Trade liberalisation resulting from the Uruguay Round tends to favour labour-intensive industries in developing economies.
With Uruguay Round reform, China’s textile production will grow less rapidly than in other Asian economies except South Asia, while without the reform, it will grow more rapidly than in other Asian economies except ASEAN. Despite the boost of MFA reform, China’s clothing production will increase less rapidly than in other Asian economies, although it will expand more strongly than in the NIEs. Without reform, however, China’s clothing production will outperform South Asia’s but will grow less rapidly than in the NIEs and the ASEAN economies.

Export growth shows similar trends (Table 6). With increasing capital abundance, China’s capital-intensive exports will tend to increase more rapidly than labour-intensive

### Table 5 Projected cumulative changes in production in selected developing economies, 1992–2005 (per cent)\(^a\)

<table>
<thead>
<tr>
<th></th>
<th>China</th>
<th>NIEs</th>
<th>ASEAN</th>
<th>South Asia</th>
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<td>(108)</td>
<td>64</td>
<td>(59)</td>
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<tr>
<td>Processed food</td>
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<td>(96)</td>
<td>264</td>
<td>(82)</td>
<td>105</td>
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<tr>
<td>Textiles</td>
<td>110</td>
<td>(96)</td>
<td>264</td>
<td>(82)</td>
<td>105</td>
</tr>
<tr>
<td>Clothing</td>
<td>124</td>
<td>(96)</td>
<td>264</td>
<td>(82)</td>
<td>105</td>
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<tr>
<td>Iron and steel</td>
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<td>(106)</td>
<td>162</td>
<td>(97)</td>
<td>(74)</td>
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<tr>
<td>Transport equipment</td>
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<td>(664)</td>
<td>162</td>
<td>(97)</td>
<td>(74)</td>
</tr>
<tr>
<td>Machinery and equipment</td>
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<td>(263)</td>
<td>115</td>
<td>96</td>
<td>(108)</td>
</tr>
<tr>
<td>Other manufactures</td>
<td>116</td>
<td>(127)</td>
<td>67</td>
<td>98</td>
<td>79</td>
</tr>
<tr>
<td>Services</td>
<td>147</td>
<td>(219)</td>
<td>125</td>
<td>311</td>
<td>96</td>
</tr>
<tr>
<td>GDP</td>
<td>203</td>
<td>(219)</td>
<td>122</td>
<td>135</td>
<td>93</td>
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</table>

*Note: a Numbers without parentheses denote results from the scenario with trade liberalisation and those in parentheses denote results from the scenario without trade liberalisation.*

*Source:* Simulations of the GTAP model.
2.18

exports. Regardless of trade liberalisation, textile exports are likely to grow much more slowly than overall exports. For clothing, the phasing out of the MFA leads to above-average growth of exports. Without MFA reform, export growth can barely keep pace with overall exports.

Although the phasing out of the MFA will take a decade, most of its impact will be felt towards the end of the transition period. Once MFA reform takes full effect, the growth of textile and clothing exports will be likely to resume its long-term trends. The projections in the scenario without Uruguay Round trade liberalisation are more likely to represent such

<table>
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<th>South Asia</th>
<th>Latin America</th>
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<td>Iron and steel</td>
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<td>(87)</td>
<td>(50)</td>
<td>(92)</td>
<td>(111)</td>
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<td>Services</td>
<td>11</td>
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<td>(-16)</td>
<td>(91)</td>
<td>(99)</td>
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</tr>
<tr>
<td>All commodities</td>
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<td>(82)</td>
<td>(8)</td>
</tr>
</tbody>
</table>

*Note:* a Numbers without parentheses denote results from the scenario with trade liberalisation and those in parentheses denote results from the scenario without trade liberalisation.

*Source:* Simulations of the GTAP model.
long-term trends. Thus China’s textile exports will grow relatively slowly and its clothing exports will probably grow more slowly than overall exports once the one-off impact of MFA reform is absorbed. Much will depend on the relative growth of labour and capital. Even with an abundant supply of labour, China will still shift to more capital-intensive exports as long as rapid economic growth is maintained. Nevertheless, given their large export volumes at present, textiles and clothing will remain important to China’s overall exports for a considerable time.

Conclusion

The textile and clothing sector spearheaded China’s industrialisation and even maintained respectable growth during the pre-reform period. Economic reform has put the sector at the forefront of China’s export-oriented growth. Overall improvements in the domestic economic environment have contributed to the rapid growth of textile and clothing exports. In particular, rural reform, foreign investment and the rise of township enterprises have all increased the competitiveness of Chinese exports. Specific policies aimed at promoting textile and clothing exports may also have helped but the significance of their impact is likely to be limited. Large production capacities built up in the past and high labour intensity have given the textile and clothing sector an advantage over other sectors in export.

The Uruguay Round trade liberalisation has provided China with both opportunities and challenges. If China can secure the abolition of MFA quotas on its products, its textile and clothing sector will benefit substantially. If quotas continue to apply to China after the phasing-out of the MFA, the competitiveness of Chinese textile and clothing exports would suffer, and its market share in North America and the European Union would be reduced. Early entry into the WTO will give China a greater opportunity to secure the benefits of the ATC but much will depend on what is included in China’s accession protocol. Current negotiations on China’s accession point to the danger that systematic discrimination against Chinese exports is likely to be legalised.

It is still not clear whether the ATC will lead to liberal trade in world trade in textiles and clothing. Apart from the potentially frequent resort to the special safeguard provisions of the ATC, there is a possibility that importing economies may increasingly use antidumping, countervailing and other safeguard measures to substitute for the MFA. Extensive government interventions in the economy make China a vulnerable target for such measures.
The demand-side uncertainties, however, should not be overstated. China has shown in the past that it can maintain rapid export growth despite increasing protection abroad. The key to such sustained growth has been economic reform. Trade liberalisation will not only strengthen China’s bargaining power in countering dumping and subsidy charges but, perhaps more importantly, improve the efficiency of China’s textile and clothing sector. Phasing out domestic GATT-inconsistent policies and increases in the costs of raw materials, especially cotton, will level the playing field for exports. As a result, access to imports at world prices will be increasingly important for China’s textile and clothing exports.

With rapid economic growth and resulting capital accumulation, China’s comparative advantage is shifting to more capital-intensive products. The phasing out of the MFA will provide a one-off boost to exports in the next decade or so but this is unlikely to reverse the long-term trends in structural change. Nevertheless, the vast untapped human resources in inland areas mean that Chinese textile and clothing exports can remain competitive for a long time to come, as long as policies are put in place to facilitate factor mobility around the country. Rapid skill accumulation will enable coastal regions to move up-market in certain manufacturing activities but traditional labour-intensive production will remain in these regions to absorb large pools of unskilled labour.

Notes

* The research for the study began while one of the authors, Zhong Chuanshui, was visiting the Australia–Japan Research Centre, Australian National University (ANU), from November 1995 to February 1996. The author would like to thank the Australia–Japan Research Centre for making the visit possible. The research benefited from discussions with Professors Peter Drysdale and Ross Garnaut and other colleagues at the ANU.

1 Significant shipments through the processing zones are included.

2 This section draws heavily on Yang (1996).

3 The GTAP model was developed under the Global Trade Analysis Project led by Thomas Hertel of Purdue University. Interested readers are referred to Hertel (1997) for more details of the model.

4 For more elaborate discussions of the supply issues, see Yang and Zhong (1996).

5 This section draws on Yang and Zhong (1996).
References


China’s Trade Liberalization and Structural Adjustments for the World Economy

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and
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Australian National University
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<td>Three sets of experiments of trade liberalisation</td>
<td>3.5</td>
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<td>Overall assessment: Simulation I (percentage change)</td>
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<td>Changes in outputs: Simulation II (percentage change)</td>
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3. CHINA’S TRADE LIBERALISATION AND STRUCTURAL ADJUSTMENTS FOR THE WORLD ECONOMY

While China’s open-door policy has benefited the world economy, there are anxieties, both in China and abroad, about increased competition and the cost of dramatic adjustments. This paper attempts to analyse the implications of China’s trade reform for structural change and welfare in China and the rest of the world. Three sets of experiments are implemented using the GTAP model. The study finds that China gains the most from its own liberalisation and that its labour-intensive sector will expand but that other sectors, including agriculture, will contract. The structural adjustment for other regions is likely to be concentrated on their clothing sectors. But the economies which experience the greatest adjustments also gain significantly. Multilateral trade liberalisation, such as the APEC free trade process, increases the gains for the rest of the world as well as for China.

Introduction

The salient feature of China’s economic reform after 1979 is the gradual transition from a centrally planned to a market economy. The transition involves changes to almost all aspects of the economic regime, from the micro to the macro levels. The replacement of the previous heavy industry oriented development strategy with a comparative advantage oriented or outward-looking strategy is regarded as one of the most successful elements of China’s economic reform. Between 1979 and 1995, China’s total trade grew at an annual rate of 12.5 per cent. This not only made China one of the world’s most important trading partners but also prompted significant growth in domestic income.

To liberalise foreign trade, China has adopted reform measures in three broad areas: gradual elimination of the central plans and introduction of market competition in the export and import sectors; reduction of barriers to trade, including both tariff and non-tariff restrictions; and reform of the foreign exchange regime. In order to integrate more deeply into the world economy, China officially launched its application to resume its GATT/WTO membership in 1986. It is also an active participant in the APEC free trade process. Although it is still not clear when China will be admitted to the WTO and the specific timetable in relation to APEC free trade is yet to be determined, there are all the signs that China will push forward with unilateral trade liberalisation. During the Osaka APEC summit in 1995, for instance, the Chinese President Jiang Zemin announced one further step in trade liberalisation by reducing the existing tariffs by one-third.
China’s rapid growth and trade liberalisation have been applauded both domestically and internationally. Per capita income in China more than tripled between 1979 and 1995. The world economy also benefited, at a minimum, from a more open and growing Chinese market. Anxieties, however, remain about the impact of China’s liberalisation and its ascendancy in the world economy. The international community wonders if the rise of the huge Chinese economy will impose unbearable competitive pressures and adjustment costs on China’s trading partners. At the same time, domestic resistance to liberalisation is by no means weak, as opening up China’s domestic market holds no benefit for industries in which China does not have a comparative advantage. All this scepticism is clearly reflected in the difficulties that Chinese trade negotiators experience in dealing with both the international community and domestic interest groups.

Assessing the consequences of reform is often complicated by the fact that trade liberalisation simultaneously carries a number of opposing effects. A tariff reduction for one commodity, for example, reduces the incentive for domestic producers of that product but increases relatively the incentive for other producers. In policy debates, it is very common for proponents of reform to stress the positive effects while the opponents stress the negative effects. Consensus can only be reached through careful quantitative measurement of all these effects in a general equilibrium framework.

This paper is an attempt to quantify the likely adjustments in the rest of the world as well as in the Chinese economy resulting from China’s trade liberalisation. It applies a multi-region computable general equilibrium model, the GTAP model. Three sets of shocks are designed. First, a unilateral tariff reduction of 33 per cent by China is simulated, corresponding to Jiang Zemin’s Osaka commitment. Second, productivity growth of 1 per cent in China’s manufacturing sector is then added to the first experiment, capturing the fact of China’s fast growth. Finally, based on the second simulation, trade liberalisation by other APEC members is introduced on top of the second experiment, reflecting the possible progress of the APEC free trade program.

The paper is organised as follows. The next section introduces the GTAP model. The section which follows discusses three sets of shocks for experiments. In the fourth section, the simulation results are presented. The final section presents some conclusions.
The GTAP model

A number of analytical frameworks can be applied to analyse the effects of China’s trade liberalisation, from partial to general equilibrium models. General equilibrium models are usually preferable for cases in which indirect and secondary round effects play important roles. Trade policy reform is one such case. Zhang and Warr (1995) apply a computable general equilibrium model of the Chinese economy to investigate the consequences of further trade reform in China. While their analysis produces deep insights into changes in domestic economic structure, it fails to draw direct implications for other economies.

The model applied in this study, the GTAP model, is a conventional multi-region computable general equilibrium model developed by Hertel (1997). It has been applied in a wide range of studies, particularly in the areas of trade policy analysis. Yang (1995a), for instance, applies the GTAP model to analyse the implications of the Uruguay Round settlement for the Chinese economy.

The version used in this study contains ten regions and ten sectors (Table 1). The ten regions are China, Australasia, Japan, North America, the European Union, Asian Newly Industrialising Economies (NIEs), ASEAN (excluding Singapore and Vietnam), South Asia, Latin America and the rest of the world. The ten sectors include agriculture, mining, processed food, textiles, clothing, iron and steel, transport equipment, machinery and equipment, other manufacturing and services. This region and sector classification reflects our attempt to separate out particular countries, such as China, and particular commodities, such as textiles and clothing, for special attention in this study.

The model is static in the sense that we can only predict the changes between two time points. It is of the Johansen type with all the variables being in percentage change form. Following Armington (1969), commodities are differentiated according to the place of production.

For each economy in the model, there are ten representative producers (one for each sector) and one representative household. The producers are assumed to maximise profits while consumers are assumed to maximise utilities. Perfect competition is assumed for all the markets in the model and each of the factor and goods markets clears at equilibrium. However, this does not necessarily imply that there is full employment in the labour or capital market in each region.
The database for the GTAP model was largely drawn from the SALTER model developed by the Industry Commission of Australia (Zeitsch et al. 1991). The benchmark data for the version applied in this study are for 1992. The model has some limitations in modelling policy change. Most importantly, it is a static model and assumes no adjustment costs between the two points of equilibrium. This calls for particular caution in interpreting the results. First, the simulation results of a trade liberalisation experiment may fail to capture the productivity gains from policy change (Yang 1996). Second, while the model always predicts a smooth transition from one equilibrium to another, the real adjustment could be costly and time-consuming. This latter point is extremely important and must be always kept in mind when making policy recommendations.

### Designing the experiments

To analyse the likely effects of China’s trade liberalisation in an interdependent world economy, three sets of experiments are designed (Table 2).

The first experiment involves a 33 per cent reduction in China’s tariffs for all the commodities. This experiment is consistent with President Jiang Zemin’s Osaka commitment to reduce China’s tariff rates to an average level of 23 per cent from 1 April 1996. As the reform process is already underway, it is interesting to see the impact of this change on the

<table>
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The rest of the world, especially on China’s major trading partners, as well as on domestic economic structure and welfare.

The experiment is also consistent with China’s past unilateral trade liberalisation and its continuing efforts to join the WTO. Since 1979, China has changed from a virtually closed economy to one that participates extensively in world markets. Yet trade barriers in China — an average tariff rate of 35 per cent before April 1996 or 23 per cent thereafter — are still very high compared with most industrialised countries and neighbouring economies in East Asia. Further substantial reduction of border barriers to trade is necessary before China is able to join the WTO and before it can be well integrated into the world economy. This first experiment, therefore, provides some indication of the likely directions and magnitudes of adjustments resulting from further such reforms.

The second experiment adds a 1 per cent productivity growth for China’s manufacturing sector to the first simulation. This added productivity change can be justified on two grounds. On the one hand, China has been growing rapidly for more than one and a half decades. The average growth rate of real GDP for the 1979–95 period was 9.5 per cent. This was a remarkable achievement, especially in comparison with the world norm for growth rates of between 3.5 and 4 per cent per annum. Many studies have predicted that China will probably be able to sustain this rapid growth for another one to two decades (Lin, Cai and Li 1994; Lardy 1994; Garnaut and Huang 1995). This suggests that China’s future trade liberalisation

<table>
<thead>
<tr>
<th>Simulation</th>
<th>Exogenous shocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Experiment I</td>
<td>Unilateral tariff reduction of 33 per cent in China</td>
</tr>
<tr>
<td>Experiment II</td>
<td>Unilateral tariff reduction of 33 per cent in China plus 1 per cent productivity growth for China’s manufacturing</td>
</tr>
<tr>
<td>Experiment III</td>
<td>Unilateral tariff reduction of 33 per cent in China plus 1 per cent productivity growth for China’s manufacturing plus 10 per cent tariff reduction by other APEC members</td>
</tr>
</tbody>
</table>
will be carried out against a background where its economy is growing much faster than that of the rest of the world.

Another factor relates to the causal connection between trade liberalisation and rapid economic growth. Feder (1980) demonstrates that export growth yields externalities to the economy’s overall growth. Yang (1996) attempts to build this mechanism into a CGE model framework in analysing the impact of the Uruguay Round settlement. A 1 per cent increase in productivity in China’s manufacturing sector can be justified if trade liberalisation induces productivity growth because of more efficient resource allocation and increased competition resulting from trade policy reform.

There are some grounds for both of these arguments. Because the model we apply is static, the productivity shock imposed in the experiment only suggests that productivity growth in the Chinese manufacturing sector may be 1 per cent faster than in other sectors of the economy and sectors of other economies, holding productivities in all the other sectors constant.

The final experiment introduces trade liberalisation by other APEC members on top of the second experiment. At the Osaka summit in 1995, APEC leaders agreed to push forward with the APEC free trade process. Although a detailed timetable has yet to be settled, developed members are required to achieve free trade by the year 2010 and developing members by the year 2020. This indicates that all APEC members will experience a greater or lesser degree of trade liberalisation in the next 10 to 20 years. Not only will China be a part of that general process, but China’s reform will be carried out within a liberalising APEC environment. This dynamic aspect of the reform has important implications for the impact of China’s trade liberalisation on the rest of the world.

Simulation results

These three experiments are carried out using the GTAP model. Our discussion focuses on economic structural changes in, and the overall impact on, China and the other regions.

Experiment I

The structural adjustments to the Chinese domestic economy, resulting from a 33 per cent tariff reduction, are relatively significant (Table 3). Both the clothing and the transport equipment sectors experience booms after the reform. Total domestic output will increase by

3.6
Table 3 Changes in output: Simulation I (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>AGR</th>
<th>MNG</th>
<th>PFD</th>
<th>TXL</th>
<th>CLG</th>
<th>I-S</th>
<th>TRE</th>
<th>M-E</th>
<th>OMN</th>
<th>SER</th>
</tr>
</thead>
<tbody>
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<td>Australasia</td>
<td>0.07</td>
<td>1.06</td>
<td>-0.13</td>
<td>-1.65</td>
<td>-3.36</td>
<td>-0.15</td>
<td>0.52</td>
<td>-0.44</td>
<td>-0.14</td>
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</tr>
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<td>0.08</td>
<td>-0.50</td>
<td>-1.11</td>
<td>0.02</td>
<td>-0.51</td>
<td>0.10</td>
<td>-0.03</td>
<td>0.02</td>
</tr>
<tr>
<td>European Union</td>
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<td>-0.06</td>
<td>0.01</td>
<td>-0.30</td>
<td>-1.94</td>
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<td>0.15</td>
<td>-0.04</td>
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</tr>
<tr>
<td>Japan</td>
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<td>-0.06</td>
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<td>-0.31</td>
<td>-0.02</td>
<td>0.04</td>
<td>0.02</td>
</tr>
<tr>
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<td>0.13</td>
<td>3.64</td>
<td>-2.98</td>
<td>-0.10</td>
<td>2.24</td>
<td>0.32</td>
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<td>-0.16</td>
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<td>-0.18</td>
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<td>0.03</td>
</tr>
<tr>
<td>China</td>
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<td>-0.78</td>
<td>-0.36</td>
<td>-4.84</td>
<td>14.79</td>
<td>-2.68</td>
<td>6.28</td>
<td>-3.36</td>
<td>-0.59</td>
<td>0.83</td>
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<tr>
<td>South Asia</td>
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<td>0.21</td>
<td>0.02</td>
<td>-0.43</td>
<td>-1.52</td>
<td>0.13</td>
<td>0.04</td>
<td>0.05</td>
<td>0.03</td>
<td>0.02</td>
</tr>
<tr>
<td>Latin America</td>
<td>0.05</td>
<td>0.03</td>
<td>0.04</td>
<td>-0.28</td>
<td>-0.77</td>
<td>0.20</td>
<td>0.01</td>
<td>0.00</td>
<td>-0.04</td>
<td>0.01</td>
</tr>
<tr>
<td>Rest of World</td>
<td>0.06</td>
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<td>0.04</td>
<td>-0.65</td>
<td>-1.40</td>
<td>0.10</td>
<td>-0.16</td>
<td>0.06</td>
<td>-0.06</td>
<td>0.02</td>
</tr>
</tbody>
</table>

Note: Simulation I involves a reduction of 33 per cent in China’s tariff rates for all commodities. For meanings of the abbreviations in this table, see Table 1.

Source: Authors’ simulations applying the GTAP model.

14.8 per cent for clothing and 6.3 per cent for transport equipment. Services is another sector experiencing an expansion but of much smaller magnitude (0.8 per cent).

The expansion of the clothing and services sectors is relatively easy to comprehend. While the former is a labour-intensive industry in which China still has a strong comparative advantage, the latter benefits from liberalisation, probably through a relative increase in terms of trade for non-tradeable goods. The rise of the transport equipment industry is a complicated case. Our speculation is that this expansion will probably be concentrated in the production of relatively simple transport equipment like bicycles, tractors and other parts (rather than the production of modern cars).

Other sectors of the Chinese economy will contract as a result of economic restructuring. These are mostly in sectors in which China does not have a comparative advantage. Agricultural and mining production, for instance, will decline by 0.3 and 0.8 per cent, respectively. The textile industry, together with the iron and steel and machinery equipment, are among the sectors that will experience the largest contractions.

For the other economies in the model, the Newly Industrialising Economies is the group that experiences the most significant structural adjustments in their domestic economies. The biggest gain for ASEAN occurs in transport equipment (expanding by 2.9 per cent) and that
for the NIEs occurs in the textile industry (expanding by 3.6 per cent) and the transport equipment industry (expanding by 2.2 per cent). The NIEs experience some contraction in their agricultural production while ASEAN experiences some expansion in agricultural production, reflecting different comparative advantages in agriculture. The biggest losses for both regions are in the clothing sector — clothing output will decline by 3.0 per cent in each region.

This is also true for other regions, although the extent of adjustment is much less. Clothing output falls by 3.4 per cent in Australasia, by 1.9 per cent in the European Union, and by 1.5 per cent in Japan and South Asian economies. Australasia, however, gains in the agricultural, mining and transport equipment industries. North America gains in the agricultural, mining, food processing, iron and steel, machinery equipment and services sectors. The European Union gains in the iron and steel, machinery equipment and services sectors. This clearly indicates that economies will be restructured according to their comparative advantages. If there are adjustment problems for other regions resulting from China’s liberalisation, it is most likely to occur in their clothing industries.

As a result, China will increase greatly its imports from the rest of the world, most significantly in clothing (110 per cent), textiles (38.6 per cent), other manufacturing (21.4 per cent), machinery equipment (20.1 per cent), transport equipment (19.7 per cent) and agricultural products (17.2 per cent). Other regions will experience a decline in their exports of clothing but increases in exports of other commodities — Australasia in mining (1.9 per cent) and transport equipment (6.5 per cent); North America in agriculture and processed food (0.9 per cent), iron and steel (0.7 per cent) and services (0.6 per cent); the European Union in machinery equipment (0.7 per cent); Japan in processed food (1.6 per cent), textiles (5.0 per cent), iron and steel (1.3 per cent) and other manufacturing (1.0 per cent); the NIEs in processed food (2.2 per cent), textiles (8.5 per cent), transport equipment (9.5 per cent), machinery equipment (1.3 per cent) and other manufacturing (2.0 per cent); and ASEAN in agriculture (0.6 per cent), processed food (1.1 per cent) and transport equipment (9.2 per cent).

Overall, China’s trade expands significantly — exports increase by 15.7 per cent and imports by 21.7 per cent (Table 4). Household income increases by 0.7 per cent. The welfare gain from the tariff reduction is large. The Equivalent Variation (EV) is US$6,229 million. Most other regions also gain from China’s trade liberalisation: the EV is $162 million for Australasia, $977 million for the European Union, $1,123 million for Japan, $111 million for North America, $1,584 million for NIEs and $34 million for ASEAN.
According to the modelling results, South Asia, Latin America and the rest of the world experience welfare losses. This is explained as being a result of increased competition from China. While this may be partly true, the negative impact on these developing economies is obviously overestimated because it ignores the likely positive effects on productivity resulting from tougher competition.

**Experiment II**

When 1 per cent productivity growth for China’s manufacturing sector is incorporated into the above experiment, the structural adjustment is magnified for almost all the economies (Table 5). The productivity improvement benefits a number of sectors and China’s expanding sectors now include clothing (27.8 per cent), transport equipment (11.1 per cent), services (1.2 per cent) and textiles (1.4 per cent). Contraction of other sectors, however, is more significant. Agricultural production declines by 0.7 per cent, mining declines by 5.2 per cent, machinery equipment by 2.0 per cent, and iron and steel falls by 2.9 per cent. Again, this change in economic structure conforms with China’s true comparative advantage.

### Table 4 Overall assessment: Simulation I (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>Export volume</th>
<th>Import volume</th>
<th>Household income</th>
<th>EV ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>0.20</td>
<td>0.43</td>
<td>0.17</td>
<td>162</td>
</tr>
<tr>
<td>North America</td>
<td>0.02</td>
<td>0.01</td>
<td>0.00</td>
<td>111</td>
</tr>
<tr>
<td>European Union</td>
<td>0.04</td>
<td>0.27</td>
<td>0.08</td>
<td>977</td>
</tr>
<tr>
<td>Japan</td>
<td>0.12</td>
<td>0.52</td>
<td>0.10</td>
<td>1123</td>
</tr>
<tr>
<td>Newly industrialised</td>
<td>1.63</td>
<td>1.64</td>
<td>0.50</td>
<td>1584</td>
</tr>
<tr>
<td>ASEAN</td>
<td>0.01</td>
<td>0.00</td>
<td>0.04</td>
<td>34</td>
</tr>
<tr>
<td>China</td>
<td>15.72</td>
<td>21.74</td>
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<td>6229</td>
</tr>
<tr>
<td>South Asia</td>
<td>-0.35</td>
<td>-0.23</td>
<td>-0.07</td>
<td>-134</td>
</tr>
<tr>
<td>Latin America</td>
<td>-0.06</td>
<td>0.00</td>
<td>0.02</td>
<td>-52</td>
</tr>
<tr>
<td>Rest of World</td>
<td>-0.12</td>
<td>-0.07</td>
<td>0.02</td>
<td>-163</td>
</tr>
</tbody>
</table>

*Note:* Simulation I involves a reduction of 33 per cent in China’s tariff rates for all commodities.

*Source:* Authors’ simulations applying the GTAP model.

According to the modelling results, South Asia, Latin America and the rest of the world experience welfare losses. This is explained as being a result of increased competition from China. While this may be partly true, the negative impact on these developing economies is obviously overestimated because it ignores the likely positive effects on productivity resulting from tougher competition.

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When 1 per cent productivity growth for China’s manufacturing sector is incorporated into the above experiment, the structural adjustment is magnified for almost all the economies (Table 5). The productivity improvement benefits a number of sectors and China’s expanding sectors now include clothing (27.8 per cent), transport equipment (11.1 per cent), services (1.2 per cent) and textiles (1.4 per cent). Contraction of other sectors, however, is more significant. Agricultural production declines by 0.7 per cent, mining declines by 5.2 per cent, machinery equipment by 2.0 per cent, and iron and steel falls by 2.9 per cent. Again, this change in economic structure conforms with China’s true comparative advantage.
Correspondingly, the magnitudes of structural adjustment in other economies are also larger. The declines in clothing output are 5.7 per cent for Australasia, 2.1 per cent for North America, 3.3 per cent for the European Union, 2.7 per cent for Japan, 5.2 per cent for NIEs, 5.1 per cent for ASEAN, 2.8 per cent for South Asia, 1.4 per cent Latin America and 2.6 per cent for the ROW.

Again, the biggest adjustments will occur in the NIEs. NIEs experience a significant boom in textiles (1.8 per cent) and transport equipment (2.4 per cent) but a contraction in mining (0.9 per cent), and a large contraction in clothing. Similarly, ASEAN expands its production of transport equipment (2.8 per cent), agricultural products (0.3 per cent) and reduces production of textiles (3.4 per cent), machinery equipment (0.3 per cent) and clothing.

Australasia is another economy which experiences important structural change as a result of China’s reform and productivity growth. Interestingly, the magnitudes of adjustment for Australasia are greater than those for Japan, North America and South Asia.

China’s exports and imports grow at about 18 and 23 per cent, respectively (Table 6). Its household income increases by 3.0 per cent and the welfare gain, measured by EV, is

### Table 5  Changes in outputs: Simulation II (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>AGR</th>
<th>MNG</th>
<th>PFD</th>
<th>TXL</th>
<th>CLG</th>
<th>I-S</th>
<th>TRE</th>
<th>M-E</th>
<th>OMN</th>
<th>SER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>0.26</td>
<td>1.27</td>
<td>-0.17</td>
<td>-2.49</td>
<td>-5.69</td>
<td>-0.29</td>
<td>0.36</td>
<td>-0.59</td>
<td>-0.21</td>
<td>0.00</td>
</tr>
<tr>
<td>North America</td>
<td>0.40</td>
<td>0.06</td>
<td>0.11</td>
<td>-0.94</td>
<td>-2.10</td>
<td>0.01</td>
<td>-0.55</td>
<td>0.07</td>
<td>-0.04</td>
<td>0.02</td>
</tr>
<tr>
<td>European Union</td>
<td>0.10</td>
<td>-0.03</td>
<td>0.04</td>
<td>-0.60</td>
<td>-3.29</td>
<td>0.09</td>
<td>-0.03</td>
<td>0.15</td>
<td>-0.04</td>
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</tr>
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<td>-0.33</td>
<td>-0.01</td>
<td>0.03</td>
<td>0.02</td>
</tr>
<tr>
<td>Newly industrialised</td>
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<td>-5.24</td>
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<td>0.44</td>
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<td>-0.13</td>
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<td>0.20</td>
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<td>-5.08</td>
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<td>2.76</td>
<td>-0.25</td>
<td>0.00</td>
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<td>China</td>
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<tr>
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<td>0.08</td>
<td>-0.19</td>
<td>0.05</td>
<td>-0.08</td>
<td>0.02</td>
</tr>
</tbody>
</table>

**Note:** Simulation II involves a reduction of 33 per cent in China’s tariff rates for all commodities and faster productivity growth by 1 per cent for China’s manufacturing sectors. For meanings of the abbreviations in this table, see Table 1.

**Source:** Authors’ simulations applying the GTAP model.
Table 6  Overall assessment: Simulation II (percentage change)

<table>
<thead>
<tr>
<th>Region</th>
<th>Export volume</th>
<th>Import volume</th>
<th>Household income</th>
<th>EV ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>0.21</td>
<td>0.51</td>
<td>0.19</td>
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<td>0.01</td>
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<td>-0.01</td>
<td>-113</td>
</tr>
<tr>
<td>Rest of World</td>
<td>-0.17</td>
<td>-0.08</td>
<td>-0.01</td>
<td>-272</td>
</tr>
</tbody>
</table>

Note: Simulation II involves a reduction of 33 per cent in China’s tariff rates for all commodities and faster productivity growth by 1 per cent for China’s manufacturing sectors. For meanings of the abbreviations in this table, see Table 1.

Source: Authors’ simulations applying the GTAP model.

$13,557 million. Again, the NIEs’ exports and imports rise by 1.6 per cent and 1.7 per cent, respectively, and their welfare gains are also the largest of all world regions, at $1,322 million. The EV is $206 million for Australasia, $258 million for North America, $666 million for the European Union and $716 million for Japan. Surprisingly, the welfare change for ASEAN is negative in this case. This probably reflects the fact that both China and some ASEAN economies are competing in the same world markets. China’s faster productivity growth disadvantages the ASEAN economies in these markets. This is illustrated by a decline of 0.3 per cent in ASEAN’s exports. Again, this prediction ignores the possible positive effects on productivity in ASEAN brought about by tougher competition.

Experiment III

The final experiment incorporates the APEC free trade process on top of the second experiment. The APEC free trade process is simulated by modelling a tariff reduction of 10 per cent for all APEC members (except China): Australasia, the North America, Japan, NIEs, and ASEAN.
This broader trade liberalisation process increases significantly the extent of structural adjustments. Again, China experiences expansion in some sectors, such as clothing (28.9 per cent), textiles (0.9 per cent), transport equipment (10.2 per cent) and services (1.2 per cent) (Table 7). Production declines are much greater in machinery equipment (2.6 per cent), the mining (5.3 per cent) and iron and steel sectors (3.2 per cent) but not in the agricultural sector (0.6 per cent).

### Table 7  Changes in outputs: Simulation III (percentage change)

<table>
<thead>
<tr>
<th>Region</th>
<th>AGR</th>
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<th>PFD</th>
<th>TXL</th>
<th>CLG</th>
<th>I-S</th>
<th>TRE</th>
<th>M-E</th>
<th>OMN</th>
<th>SER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>1.04</td>
<td>2.55</td>
<td>0.42</td>
<td>-4.54</td>
<td>-7.85</td>
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<td>-4.92</td>
<td>-3.36</td>
<td>-0.84</td>
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</tr>
<tr>
<td>North America</td>
<td>0.92</td>
<td>0.24</td>
<td>0.14</td>
<td>-2.27</td>
<td>-6.02</td>
<td>-0.14</td>
<td>-0.08</td>
<td>-0.29</td>
<td>-0.08</td>
<td>0.05</td>
</tr>
<tr>
<td>European Union</td>
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<td>-0.11</td>
<td>0.09</td>
<td>-0.79</td>
<td>-3.81</td>
<td>0.16</td>
<td>-0.42</td>
<td>-0.08</td>
<td>-0.03</td>
<td>0.05</td>
</tr>
<tr>
<td>Japan</td>
<td>-2.61</td>
<td>0.29</td>
<td>-0.27</td>
<td>-0.70</td>
<td>-3.61</td>
<td>0.42</td>
<td>0.22</td>
<td>0.29</td>
<td>0.05</td>
<td>0.12</td>
</tr>
<tr>
<td>Newly industrialised</td>
<td>-1.77</td>
<td>-1.90</td>
<td>1.15</td>
<td>6.65</td>
<td>1.00</td>
<td>-0.89</td>
<td>1.16</td>
<td>0.50</td>
<td>0.53</td>
<td>-0.10</td>
</tr>
<tr>
<td>ASEAN</td>
<td>-0.26</td>
<td>-3.06</td>
<td>0.00</td>
<td>-1.04</td>
<td>2.30</td>
<td>-0.12</td>
<td>0.76</td>
<td>5.98</td>
<td>0.02</td>
<td>0.06</td>
</tr>
<tr>
<td>China</td>
<td>-0.58</td>
<td>-5.30</td>
<td>0.00</td>
<td>0.86</td>
<td>28.91</td>
<td>-3.21</td>
<td>10.17</td>
<td>-2.59</td>
<td>-0.46</td>
<td>1.16</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.08</td>
<td>0.61</td>
<td>0.05</td>
<td>-1.17</td>
<td>-2.68</td>
<td>0.11</td>
<td>-0.21</td>
<td>-0.05</td>
<td>0.02</td>
<td>0.02</td>
</tr>
<tr>
<td>Latin America</td>
<td>0.24</td>
<td>-0.04</td>
<td>0.11</td>
<td>-0.70</td>
<td>-1.22</td>
<td>0.15</td>
<td>-0.59</td>
<td>-0.12</td>
<td>-0.04</td>
<td>0.02</td>
</tr>
<tr>
<td>Rest of World</td>
<td>0.23</td>
<td>0.35</td>
<td>0.07</td>
<td>-1.66</td>
<td>-2.92</td>
<td>0.08</td>
<td>-0.57</td>
<td>-0.20</td>
<td>-0.06</td>
<td>0.03</td>
</tr>
</tbody>
</table>

**Note:** Simulation III involves a reduction of 33 per cent in China’s tariff rates for all commodities, faster productivity growth by 1 per cent for China’s manufacturing sectors and 10 per cent tariff reduction by other APEC members. For meanings of the abbreviations in this table, see Table 1.

**Source:** Authors’ simulations applying the GTAP model.

NIEs will experience booms, not only in textiles (6.7 per cent), transport equipment (1.2 per cent), machinery equipment (0.5 per cent) and other manufacturing (0.5 per cent), but also in clothing (1 per cent). They will continue to lose ground in agriculture (1.8 per cent), mining (1.9 per cent) and the iron and steel industry (0.9 per cent). Similarly, ASEAN increases its production of clothing (2.3 per cent) and machinery equipment (6 per cent) but reduces its production of agricultural (0.3 per cent) and mineral products (3.1 per cent).
This rise of the clothing industry in the NIEs and ASEAN as well as in China indicates a large potential market for clothing if trade barriers are reduced. Compared with other regions, both the NIEs and ASEAN still have a comparative advantage in clothing production, with the NIEs producing higher quality products.

Australasia will gain significantly from China’s reform and the APEC liberalisation process, particularly in agriculture (1 per cent), processed food (0.4 per cent) and mining (2.6 per cent). Its textile (4.5 per cent), clothing (7.9 per cent), transport equipment (4.9 per cent) and machinery equipment (3.4 per cent) sectors experience sharp declines. Japan experiences a contraction in agriculture (2.6 per cent), processed food (0.3 per cent), textiles (0.7 per cent) and clothing (3.6 per cent). It gains, however, in the iron and steel (0.4 per cent), transport equipment (0.2 per cent), machinery equipment (0.3 per cent) and other manufacturing (0.1 per cent) sectors. Both North America and the European Union will experience some contraction in most of their manufacturing production but are likely to achieve some expansion in agricultural and processed food production.\(^8\)

This experiment predicts increases in exports for all APEC members in a wide range of commodities. China’s exports of agricultural products will decline (9.1 per cent) but its exports increase significantly in clothing (44.1 per cent) and textiles (24.5 per cent). ASEAN exports increase, with the exception of mineral products (declining by 2.9 per cent). Both Australasia and North America enjoy export expansion in processed food, and agricultural and mineral products, reflecting their strong comparative advantages in resource-intensive products.

Overall, China’s total exports increase by 18.5 per cent and its imports by 23.4 per cent. Household income also rises by 3.3 per cent while the EV is $14,260 million (Table 8). Australasia will clearly benefit from the policy change, with growth rates for its exports and imports of about 3.2-3.5 per cent. The EV for Australasia is $415 million. NIEs are another group that benefits significantly from the change, with an estimated EV of $3,554 million. The ASEAN economies experience great increases in both total exports and total imports and the welfare gain for them is $1,071 million.

One interesting finding, in comparison with the two earlier experiments, is that the European Union, South Asia, Latin America and the ROW all benefit greatly from the additional APEC free trade process.
Concluding remarks

The findings of this study can be summarised as follows.

First, the welfare gain from trade liberalisation for China is significant. The benefits increase if other APEC economies join with China in unilateral trade liberalisation. This, on the one hand, suggests the great benefit China has derived from its past trade reform and, also points to important reasons why China should push forward its reform toward free trade. China is the biggest gainer from its own liberalisation.

This result of large gains from trade liberalisation is driven mainly by the neoclassical features of the model. Incentive distortions, whether reflected in export taxes or import tariffs, distort resource allocation (the protected and uncompetitive sectors holding more productive resources) and thus reduce total effective output by reducing the overall efficiency of resource use (Vousden 1990). Abolition of such distortions, therefore, will increase the real output and total welfare of the economy by allocating resources in accord with the economy’s comparative advantages. This issue has been explored by Drysdale and Garnaut (1993) in the context of Pacific economic integration.

Table 8  Overall assessment: Simulation III (percentage change)

<table>
<thead>
<tr>
<th></th>
<th>Export volume</th>
<th>Import volume</th>
<th>Household income</th>
<th>EV ($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australasia</td>
<td>3.13</td>
<td>3.45</td>
<td>0.10</td>
<td>415</td>
</tr>
<tr>
<td>North America</td>
<td>2.37</td>
<td>2.25</td>
<td>0.02</td>
<td>1054</td>
</tr>
<tr>
<td>European Union</td>
<td>-0.03</td>
<td>0.66</td>
<td>0.17</td>
<td>2006</td>
</tr>
<tr>
<td>Japan</td>
<td>1.72</td>
<td>2.81</td>
<td>0.04</td>
<td>3965</td>
</tr>
<tr>
<td>Newly industrialised</td>
<td>4.28</td>
<td>3.84</td>
<td>0.65</td>
<td>3554</td>
</tr>
<tr>
<td>ASEAN</td>
<td>3.39</td>
<td>3.23</td>
<td>0.36</td>
<td>1071</td>
</tr>
<tr>
<td>China</td>
<td>18.49</td>
<td>23.39</td>
<td>3.34</td>
<td>14260</td>
</tr>
<tr>
<td>South Asia</td>
<td>-0.40</td>
<td>-0.06</td>
<td>-0.02</td>
<td>-177</td>
</tr>
<tr>
<td>Latin America</td>
<td>0.17</td>
<td>0.39</td>
<td>0.14</td>
<td>292</td>
</tr>
<tr>
<td>Rest of World</td>
<td>-0.15</td>
<td>0.01</td>
<td>0.09</td>
<td>121</td>
</tr>
</tbody>
</table>

Note: Simulation III involves a reduction of 33 per cent in China’s tariff rates for all commodities, faster productivity growth by 1 per cent for China’s manufacturing sectors and tariff reduction by other APEC members. For meanings of the abbreviations in this table, see Table 1.

Source: Authors’ simulations applying the GTAP model.
Second, structural adjustment in China following trade liberalisation is expected to be significant. This is the cost that China has to pay to realise the gains from freer trade. In all three experiments, while the clothing sector is predicted to expand between 14.8 and 28.9 per cent, significant contraction also occurs in other industries. Agriculture is one such industry and its decline is predicted to be between 0.3 and 0.7 per cent.

Although small in percentage terms, this implies that millions of farmers may lose their jobs, even ignoring productivity changes. It is, therefore, important to recognise the inevitability of structural adjustment, and to make efforts to smooth the adjustment process.

A related implication concerns China’s future food problems. Although there is no explicit food sector in the model, the predicted decline of agricultural production in the course of trade liberalisation and growth suggests a limited potential for increasing the domestic food supply. If China is determined to feed its growing population by itself, there are only two choices: either to raise the productivity of its food production or to distort incentive structures in favour of food production. While the former requires a substantial investment in agricultural technology and infrastructure, the latter implies a significant misallocation of resources and welfare losses.

Third, for China’s trading partners, it is evident that, from a static perspective, China’s growth and liberalisation will hurt developing countries which compete directly with China in some international markets. But, as stressed before, a static approach is not sufficient to capture the dynamic impact of trade liberalisation. In particular, it ignores the possible positive effects of liberalisation on productivity growth through increased competition.

The most significant adjustments for other regions/countries, especially the industrialised economies, occur in the textiles industry. The decline of output for Australasia, North America, the European Union and Japan ranges from 1.1 to 7.9 per cent. This sector, therefore, presents the greatest adjustment problem. Countries wishing to benefit from China’s growth and its opening markets should be prepared to accept this associated domestic adjustment. More importantly, the most significant adjustments occur in the NIEs, whose trade with China is the most intensive. These are also the economies that will derive large gains from the adjustments. These economies have already experienced significant adjustment in the past 15 years in the process of China’s rapid growth and reform. They were able to accommodate the emerging Chinese economy smoothly, and benefited greatly as a result of China’s impact on their own economic growth and welfare. Other regions should also be able to reap the same benefits.
Finally, the adjustment requirement is greater when the shocks increase from a single 33 per cent tariff reduction in China to tariff reductions, productivity growth and APEC trade liberalisation. But the benefits are also greater. This should encourage other APEC economies to participate actively in the process of trade liberalisation, thereby deriving greater benefit. Comparing the simulation results of Experiment III with those of the first two experiments, we find that the broader APEC free trade process turned the other developing economies from net losers into net gainers. This indicates that, even from a static perspective, a broader world market (resulting from APEC trade liberalisation) can accommodate the other developing economies as well as China.

The findings of this study, like others that apply this type of model, are subject to a number of qualifications. One has already been discussed above: the static feature of the GTAP model misses the important dynamic effects of liberalisation including possible externalities on productivity. Another important qualification relates to the assumption of immobility of capital across regions. While capital flows across borders in the form of portfolio and direct investment are already a common phenomenon, this specification may under- or overestimate the adjustment tasks required in individual economies.

The general implication of the study is clear. While structural adjustments are inevitable in both China and the rest of the world in the wake of China’s continued open-door policy and rapid growth, there are some costs which all partners must incur to achieve an overall benefit. China’s experience of economic reform from 1979 is a history of significant reform, dramatic structural adjustments and rapid income growth. Further reforms will require more structural adjustment, but that is manageable. The international community has already accommodated the rise of Japan in the 1960s and 1970s and the NIEs in the 1970s and 1980s. The Chinese economy may be several times bigger than those of Japan and NIEs decades ago, but the world economy is also several times bigger now (Garnaut and Huang 1995). It should not be an unbearable challenge for the rest of the world to accommodate China. More importantly, history demonstrates that those with closer economic relations with China, such as the NIEs, experienced the most dramatic adjustment, along with the rise of the Chinese economy, but they also extracted the most significant gains from the reforms. Furthermore, active participation in the liberalisation process may magnify the gains and ease the task of adjustment.

This perspective, of course, does not lessen the difficulties for policy makers in implementing the structural adjustments. Special attention must be paid to declining sectors,
such as the clothing industry in the rest of the world and the agricultural sector in China. Carefully designed measures to assist these adjustments, such as credit assistance and the creation of new employment opportunities, can smooth the process and reduce the costs to individuals and industries.

Notes

* We are grateful to Yongzhen Yang, Warwick McKibbin, Ray Trewin, Justin Yifu Lin, Peter Drysdale and an anonymous referee for helpful suggestions and comments. The Australia–Japan Research Centre of the Australian National University provided financial support for this research.

1 The average growth rate for real GDP was 9.2 per cent for the same period.

2 This involves tariff reductions for more than 4,000 items and is expected to bring down the average tariff rate to 23 per cent.

3 This does not necessarily involve an increase in absolute prices for non-tradeable goods since, in economic choice, only relative prices matter.


5 It is not able to reveal the transitional paths between the two points.

6 For labour, for instance, a total employment level is exogenously set for each region. This level could either be equal to total labour supply (implying full employment) or be less than total labour supply (implying the existence of unemployment).

7 All references are to US$.

8 The case of the European Union is more complicated considering the fact that they have relatively high levels of agricultural support and they are not involved in the APEC free trade process.

References


FDI AND CHINA’S TRADING SYSTEM REFORM

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4. FDI AND CHINA’S TRADING SYSTEM REFORM

Introduction

China’s preferential foreign direct investment (FDI) policies towards Sino–foreign joint ventures led to a significant inflow of FDI and a substantial advancement in reform of the Chinese trading system. This FDI inflow, in turn, led to an expansion in that sector of the domestic market which was open to the world and weakened the extent of tariff and non-tariff restrictions in the market. It also directly promoted reform of the foreign exchange system and propelled the renminbi (RMB) towards the status of a convertible currency. The expansion of the scope of FDI and the increasing number of joint ventures and wholly foreign owned firms accelerated the progress of marketisation in every economic sector in China, providing the necessary basis for the acceptance of national treatment in foreign economic relations. It is useful to bear in mind future developments in China’s FDI policy when considering the relationship between FDI and trading system reform.

Some features of the relationship between FDI and reform

By the end of 1995, China had approved foreign investment contracts totalling US$258.903 billion, with an actual realisation of overseas funds of US$133.37 billion. China has become the largest recipient of FDI among developing countries. There are more than 120,000 joint ventures in operation, employing 1.6 million workers. Industry, especially manufacturing industry, is the most important sector for FDI inflow. According to 1994 statistics, production from joint ventures in the industrial sector comprised 13 per cent of total national industrial production. However, a sectoral breakdown of FDI inflow demonstrates a wide dispersion of FDI with quite a high proportion of FDI in the tertiary (services) sector.

Some features of FDI to date demonstrate that it is closely related to trading system reform.

First, most of the FDI inflow has occurred since the 1990s. In the 17-year period from 1979 to 1995, FDI inflow was concentrated most in the four years from 1992 to 1995.

Table 1 shows that during the four-year period from 1992 to 1995, FDI contracts made up 83.8 per cent of the total foreign capital value, expressed as signed contract agreements,
4.2

constituted 86.7 per cent of the total, and 82.5 per cent of capital value used. If we add the amount for 1990 and 1991, the proportion for the whole of the 1990s is even greater in each category. This is likely to continue in the years to come as the pace of trading system reform accelerates.

Second, joint ventures have become the main force behind the growth of foreign trade in China. In 1988, the proportion of the total value of national foreign trade held by joint ventures was only 8.1 per cent, while the proportion of exports was only 5.2 per cent. These proportions had increased to 12.5 per cent and 9.4 per cent, respectively, by 1989, further increasing to 17.4 per cent and 12.6 per cent, respectively, by 1990. During the five-year period from 1991 to 1995, there was further growth (Table 2). In this period, the total value of foreign trade for the whole country increased 1.07 times while the value of trade in both directions by joint ventures increased 2.79 times.

Meanwhile, the trade deficit originating from joint ventures constituted a long-term liability, reaching US$18.2 billion in 1994. It was inevitable that it would have an influence on the overall trade balance and therefore have some important implications for the reform of the Chinese trading system — for example tax reform due to the growing importance of joint ventures in China’s foreign trade.

Third, FDI became China’s largest source of surplus in the capital account. Since the 1990s, China’s foreign trade has roughly been in surplus, with the exception of 1993, when there was a large trade deficit in the international current account as shown in Table 3. Even then, it was possible to achieve a balance in international payments and set aside US$1.77 billion in the form of reserve assets owing to the massive inflow of FDI and the large surplus.

Table 1  Number of contracts, value of foreign capital expressed in signed agreements and capital value of FDI (US$ billion)

<table>
<thead>
<tr>
<th>years</th>
<th>number of contracts</th>
<th>foreign capital value through signed contract agreements</th>
<th>capital value used</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979–91</td>
<td>42027</td>
<td>52.34</td>
<td>23.34</td>
</tr>
<tr>
<td>1992–95</td>
<td>216876</td>
<td>342.53</td>
<td>110.03</td>
</tr>
<tr>
<td>1979–95</td>
<td>258908</td>
<td>394.87</td>
<td>133.37</td>
</tr>
</tbody>
</table>

Sources: China Statistical Yearbook; Economic Reference Daily.
in the capital account. When a greater surplus in the capital account occurred in 1994 as a result of FDI inflows and the increased value of the reserve assets reached an historic peak of US$30 billion, it was clear that FDI had become the major source of surplus in the balance of payments.

China’s foreign trade produced a large surplus in 1995, resulting in a surplus in the current account. At the same time, there was also a large capital account surplus because of the continuous inflow of FDI. However, the capital account was still one of the most

Table 2  Proportion and increase in the import–export value of joint ventures, 1991–95 (US$ billion)

<table>
<thead>
<tr>
<th>year</th>
<th>import–export value of joint ventures</th>
<th>total trade value of China</th>
<th>%</th>
<th>export total value of joint ventures</th>
<th>%</th>
<th>import value total of joint ventures</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>43.76</td>
<td>166.53</td>
<td>26.3</td>
<td>17.33</td>
<td>20.5</td>
<td>26.38</td>
<td>32.7</td>
</tr>
<tr>
<td>1993</td>
<td>67.07</td>
<td>195.71</td>
<td>34.3</td>
<td>25.24</td>
<td>27.5</td>
<td>41.83</td>
<td>40.2</td>
</tr>
<tr>
<td>1994</td>
<td>87.65</td>
<td>236.90</td>
<td>37.0</td>
<td>34.71</td>
<td>28.7</td>
<td>52.94</td>
<td>45.8</td>
</tr>
<tr>
<td>1995</td>
<td>109.82</td>
<td>280.85</td>
<td>39.1</td>
<td>46.88</td>
<td>31.5</td>
<td>62.94</td>
<td>47.7</td>
</tr>
</tbody>
</table>

Source: Foreign Economy and Trade Yearbook of China; International Business Daily.

Table 3  Balance of China’s international revenues and expenditures, 1991–94, (US$ billion)

<table>
<thead>
<tr>
<th>year</th>
<th>current account balance</th>
<th>capital account balance</th>
<th>errors and losses</th>
<th>changes in reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>11.997</td>
<td>3.256</td>
<td>−3.131</td>
<td>−12.122</td>
</tr>
<tr>
<td>1992</td>
<td>6.402</td>
<td>−0.25</td>
<td>−8.274</td>
<td>−2.122</td>
</tr>
<tr>
<td>1993</td>
<td>−11.902</td>
<td>23.472</td>
<td>−9.804</td>
<td>−1.767</td>
</tr>
<tr>
<td>1994</td>
<td>7.658</td>
<td>32.644</td>
<td>−9.775</td>
<td>−30.527</td>
</tr>
</tbody>
</table>

Note: Reserve increases are negative.

Source: China Statistical Yearbook.
important sources of the increase in reserve assets. It is clear that this remarkable improvement in international revenues and expenditure provided extremely advantageous conditions for reform of the foreign trading system and the progress of the renminbi (RMB) towards convertible currency status.

Fourth, FDI spread to all industries and sectors. Before the end of the 1980s, FDI in the tourism and hospitality sector made up a large proportion of the total, comprising one-third in 1985 and 34.3 per cent in 1987. At the same time, the industrial sector was also attracting large amounts of foreign capital, and the foreign capital value as expressed in signed contract agreements made up 45 per cent of all sectors during 1984–88. Since 1988, the Chinese government has encouraged foreign investors to invest in export oriented and new technology industries. Thus it was inevitable that FDI would expand into the industrial sector in the early 1990s. The rate of foreign capital as expressed in signed contract agreements on FDI entry in the industrial sector increased to 80.3 per cent in 1991. It held at 79 per cent in 1992. However, since 1992, the government has liberalised many investment sectors. In particular, areas that had hitherto operated as state monopolies were opened to allow the entry of FDI, resulting in a new phase during which FDI spread into all industries and sectors.

Table 4 shows that the industrial sector is still the largest sector in terms of utilising FDI, but that its proportion is decreasing, due in part to the boom in FDI in the services sector after 1993. Growth in the finance and insurance industries has been the most noticeable. By the end of November 1995, the People’s Bank of China had approved the establishment by foreign financial institutions of 135 business institutions and 470 representative offices. Among them there were 115 branches of foreign banks, five Sino–foreign joint banks, five wholly owned foreign banks, five financial companies with foreign or joint ownership, four branches of foreign insurance companies and one investment bank which was a Sino–foreign joint venture.

In all there were 123 foreign banks in operation, their gross assets amounting to US$17.19 billion, attracting US$2.94 billion worth of deposits and providing an accumulated credit of US$26.14 billion within the domestic sphere, where they accounted for 51.9 per cent of total banking activity. The expansion of FDI into the manufacturing and services sectors had a marked influence on China’s market openness in terms of product sales and service activities.
Table 4  Sectoral distribution of FDI through signed contract agreements, 1992–94  
(US$ ten thousand)

<table>
<thead>
<tr>
<th>Sector</th>
<th>1992 FDI — signed contracts agreements</th>
<th>1993 FDI — signed contracts agreements</th>
<th>1994 FDI — signed contracts agreements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>67813</td>
<td>119147</td>
<td>97245</td>
</tr>
<tr>
<td>Industry</td>
<td>3266673</td>
<td>5117368</td>
<td>4389890</td>
</tr>
<tr>
<td>Construction</td>
<td>183858</td>
<td>387837</td>
<td>239353</td>
</tr>
<tr>
<td>Transportation</td>
<td>154343</td>
<td>148991</td>
<td>203001</td>
</tr>
<tr>
<td>Merchandise and restaurant</td>
<td>144383</td>
<td>460647</td>
<td>392189</td>
</tr>
<tr>
<td>Real estate and public utilities</td>
<td>1807964</td>
<td>4377115</td>
<td>2386151</td>
</tr>
<tr>
<td>Health, sports and social welfare</td>
<td>39526</td>
<td>47748</td>
<td>197904</td>
</tr>
<tr>
<td>Science, technology, education and culture</td>
<td>15822</td>
<td>103948</td>
<td>88197</td>
</tr>
<tr>
<td>Finance and insurance</td>
<td>754</td>
<td>7852</td>
<td>43574</td>
</tr>
<tr>
<td>Others</td>
<td>285256</td>
<td>364860</td>
<td>230473</td>
</tr>
<tr>
<td>Total</td>
<td>5812351</td>
<td>11143566</td>
<td>8267977</td>
</tr>
</tbody>
</table>

Source: Statistics from relevant ministries.

The impact of FDI on tariff reduction

The increase in FDI had a significant influence on tariff reduction, since that was one element of the preferential policies designed to attract foreign capital. It led to real tariff reductions, thereby preparing the way for reductions in official nominal tariffs (Table 5). The ‘Implementation Regulations of the Sino–foreign Joint Venture Law’, enacted on 20 September 1983 by the State Council, included preferential treatment including tax exemption on import materials for Sino–foreign joint ventures as a means of attracting FDI.

‘Regulations for the Encouragement of Foreign Investment’, enacted by the State Council on 11 October 1986, provided further supplementary and specific explanations about preferential treatment, and there have been numerous supplements to and improvements on the policy of preferential treatment since that time. Finally, a system of preferential tariffs for the imports of foreign investors was established before the end of 1995.

The two key points of the policy can be roughly summarised in the following way.
Table 5  Comparison between nominal tariffs and real tariffs, 1991–95 (RMB100 million; US$ billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>nominal tariff %</th>
<th>levy value (RMB)</th>
<th>import-linked taxes (RMB)</th>
<th>total imports (US$)</th>
<th>exchange rate RMB/US$</th>
<th>real tariff %</th>
<th>tariff &amp; import-linked taxes/imports %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>47.2</td>
<td>189.3</td>
<td>149.1</td>
<td>637.9</td>
<td>5.32</td>
<td>5.6</td>
<td>10.0</td>
</tr>
<tr>
<td>1992</td>
<td>39.9</td>
<td>215.4</td>
<td>166.3</td>
<td>805.9</td>
<td>5.51</td>
<td>4.9</td>
<td>8.6</td>
</tr>
<tr>
<td>1993</td>
<td>36.4</td>
<td>259.5</td>
<td>188.2</td>
<td>1039.5</td>
<td>5.76</td>
<td>4.3</td>
<td>7.5</td>
</tr>
<tr>
<td>1994</td>
<td>35.9</td>
<td>286.5</td>
<td>336.1</td>
<td>1157.0</td>
<td>8.61</td>
<td>2.9</td>
<td>6.2</td>
</tr>
<tr>
<td>1995</td>
<td>35.3</td>
<td>298.0</td>
<td>400.7</td>
<td>1320.8</td>
<td>8.30</td>
<td>2.7</td>
<td>6.4</td>
</tr>
</tbody>
</table>

Source: China Statistical Yearbook; the General Administration of Customs.

First, imported goods that were purchased by foreign investors and used as physical capital, such as machinery and equipment, parts, materials, office equipment and automobiles, were exempted from tariffs and unified taxes on industry and merchandise. Second, raw materials, additional materials, components, elements and packaged materials that were imported from abroad by joint ventures but used in the production of exports were also exempted from tariffs and unified taxes on industry and merchandise. In addition, local governments made supplements and additions to these preferential rules for foreign investors, such as the rules concerning tariffs on establishment in special economic zones, open cities and economic development zones. This policy of preferential treatment broke down the existing tariff system, effectively reforming high tariffs and preparing the ground for general reductions in tariff levels.

As Table 2 showed, the import value of joint ventures made up 32.7 per cent of total national imports in 1992, and exceeded 40 per cent in 1993. This large proportion of imports inevitably had a significant impact on tariffs. In addition to its favourable treatment of foreign investors, the government also practised other preferential tariff policies. The proportion of goods which were exempt from tariffs was increased. The scope for levying tariffs on imported goods had become smaller and smaller. In 1991, it did not exceed 20 per cent, so the prospects for increasing real levies through customs measures were slight. If real levies
are divided by import values to determine real tariffs and compared to the official tariffs, a large gap emerges.

The main reason for the previously high tariff regime in China was to protect domestic industry. However, tariff exemptions on the goods imported by joint ventures had not only kept domestic purchases down, they also kept down the production costs of the joint ventures. Furthermore, because of the existence of other exemptions and reductions in tariffs, real tariffs were kept at a much lower level. So although the nominal rate of tariffs remained high, domestic industry had really already been exposed to tariff reductions and had proved that it could withstand the pressures. This made for conditions conducive to official tariff reductions.

During 1992–95, China reduced its tariff rates four times, to 25.2 per cent. The team negotiating China’s re-entry to GATT submitted a list of suggestions for tariff reductions, pledging that it would reduce its average tariff rate to 19.2 per cent, representing a reduction of 56.9 per cent. China had already reduced its average tariff rate to 23 per cent, achieving a 35.9 per cent reduction, thereby greatly narrowing the gap between it and the WTO developing country average.

The influence of FDI on the relaxation of import restrictions

A large volume of goods had entered the Chinese market along with FDI. In addition, many products which were produced by joint ventures were sold on the domestic market. As we have seen, foreign products were able to avoid non-tariff restrictions aimed at domestic market protection, generating the conditions for a relaxation on import restrictions. For example, the market coverage for machine tools manufactured by domestic enterprises has decreased since 1990. The domestic product market coverage reached 67 per cent in 1990, decreasing to 38 per cent in 1994. The main reason was that the production costs of joint ventures were lower than those of domestic firms, resulting in their occupying a dominant position in domestic market competition. This was because machinery and equipment, as well as material and component imports by joint venture firms, were tariff free. For other machinery products such as excavators, about 80 per cent of engineering firms had become joint ventures, of which more than half had a majority shareholding by the foreign investor, and their products effectively covered the domestic market. The production of forklifts is a case in point, with one large joint venture in Xiamen dominating the domestic market. In automatic instruments, firms owned by foreign investors also held market sway.
In the electronic and telecommunications production sector, the domestic market in colour televisions, program controlled exchange machines, telex communication and mobile phones was held by joint ventures; in the light industrial sector, there are 13 joint ventures producing detergent products. Their production occupies 35 per cent of total national production and it will reach 65 per cent by the year 2000. There are three large joint venture firms making perfumed soap and their products occupy 40 per cent of gross production for the whole country. It is estimated that this will reach 50–60 per cent by 2000. Two hundred joint venture firms produce cosmetics, with their products occupying 36 per cent of the sector as a whole. Throughout the country, the large beer plants are all basically joint ventures. Their market coverage exceeds 50 per cent of the entire domestic market.

In the traditional textile sector, some large state-run firms also participated in the establishment of joint ventures. Their motivations for establishing joint ventures were to avoid import restrictions and to meet their need for capital. Such enterprises can import cheap materials and reduce their production costs through the establishment of joint ventures. Imports of cotton and cotton yarn were controlled by licence quotas, with the domestic price an average of 30 per cent higher than it was on the world market. Imports of cotton and cotton yarn increased, corresponding to the increase in the number of joint ventures in the cotton textile industry. In the chemical fibre sector, the production capacity of joint ventures made up 20 per cent of the national total.

In the automobile sector, there are five joint ventures among the six major engine firms. These ventures were organised by the State Planning Department. The brand names are Jiefang, Dongfang, Shanghai, Beijing, Tianjin and Guangzhou. The one exception in Tianjin’s Xiali, which is a state-run enterprise. In addition, there are many joint venture parts and components firms all over the country. The automobiles and components produced by these joint ventures enjoy a high coverage rate in the domestic market.

The expansion of the domestic market coverage by products made by joint ventures had the benefit of providing domestic enterprises with competitive experience, enhanced their ability to adapt, and produced conditions which allowed for the relaxation of import restrictions. On the other hand, as the experience and lessons of other developing countries demonstrate, relaxation of import restrictions and the introduction of greater competition are also important in preventing the emergence of new monopolies created through the goods produced by joint ventures in the domestic market. If import restrictions are excessive and protection is pursued for too long, it can cause the joint ventures to become ineffective and sluggish.
In the event, FDI was able to avoid non-tariff import restrictions and this facilitated the development of truly liberal entry to the Chinese market with the result that the state had no option but gradually to relax all import restrictions. China abolished its entire list of import substitution goods in 1992 and promulgated ‘Management Measures for the Import and Export of Electronic Machinery Products’ and ‘Management Measures for Import Quotas on Common Goods’, in line with international trade practice in 1993. Compared with the series of internal rules governing management practices which had been in place, the import management system for electronic machinery products was a big step forward. The government abolished the limited quota system on general electronic machinery products which were imported under approval and moved to a system of registration management in 1994. At the same time, the central government published ‘Temporary Provisions for the Management of Electronic Machinery Product Imports’ with regulations, ‘Temporary Provisions on an Import Quota System of General Goods’ with regulations and ‘Temporary Provisions for an Automatic Registration System for Special Commodities’. These new rules further regularised the provisions governing import trade and enhanced the level of policy transparency. In particular, the automatic registration system for specified goods was to replace the controlled licence quota system and was intended as a transition towards the abolishment of the system of licence quota controls. The number of items which came under commodity licence controls was reduced from 54 in 1992 to 49 in 1995. A hundred and seventy-one items of electronic machinery products were transferred from quota control to non-quota control, or automatic registration. At the same time as tariffs were reduced in 1996, quota licences for more than 170 taxable import commodity items were also abolished.

**The promotion of FDI through reform of the foreign exchange system**

The first important aspect of reform of the foreign exchange system was the establishment of the swap market in China. FDI inflows directly facilitated the establishment and development of the foreign exchange swap market. Like the foreign trade system, the Chinese foreign exchange system operated under a high degree of centralised planning. Foreign exchange was distributed through administrative means, the RMB exchange rate was adjusted by the authorities and Chinese currency was not convertible. In the early period of reform and opening up to the global economy, the government intended that joint ventures would achieve their own balance of foreign exchange revenue and expenditure because of the shortage of foreign exchange reserves held by the state, and because it was not possible
to buy foreign exchange from official reserves. In the early 1980s, many joint ventures were unable to achieve a foreign exchange balance solely relying on their own resources and found it difficult to continue operations. This system dampened the enthusiasm of foreign investors.

After the State Council published its ‘Rules Governing the Encouragement of Foreign Investment’ in 1986, the flow of FDI expanded rapidly, but many firms were not able to overcome the problem of foreign exchange shortages. The government acted quickly to review the situation, adopting a policy which stipulated that foreign exchange would be allowed among joint venture firms through the establishment of foreign exchange administrations in special economic zones and major coastal cities, thus creating an embryonic form of a foreign exchange swap market.

In fact, foreign exchange redistribution had occurred before 1986. The government had allowed foreign exchange to be redistributed among state- and collective-owned units through branches of the Bank of China. Most of the foreign exchange redistributed originated from foreign exchange accumulated by state-run foreign trade enterprises. The foreign exchange which was redistributed in this way was used to import raw materials, instruments and equipment which were urgently needed for scientific research, economic construction and education. But the volume of foreign exchange redistributed was small, its value reaching only a few hundred million dollars in 1985. When the government allowed joint ventures to participate in foreign exchange swaps in 1986, the value of the foreign exchange swap market suddenly increased to US$1.89 billion, further increasing to US$4.2 billion in 1987. The government limited the peak price of foreign exchange swaps at that time, only allowing the swap price to be one yuan higher than the official exchange rate.

The government intended to establish foreign exchange swap centres throughout the country. By 1989 a total of 109 swap centres had been established, initially forming a unified national foreign exchange swap market. Regional discrepancies among swap prices were narrowed. The government then relaxed the limited peak price to two yuan above the official exchange price in 1988 and 1989. After 1990, pressure to increase the swap price intensified, along with an increase in the value of foreign exchange, leading to a liberalisation in swap prices. From 1990, the price has been determined by market supply and demand.

After 1991, joint ventures became as important a source of foreign exchange as FDI inflows. Joint ventures provided a continuous enhancement of foreign exchange capacity.

A second important move in the reform of the foreign exchange system was the establishment of a unified foreign exchange market among the banks. A national integrated
dual-track exchange rate for the RMB was established in 1994. The net inflow of foreign exchange provided by foreign investors facilitated the implementation of this reform.

Table 6 demonstrates that since 1991, the outflow of foreign exchange from joint ventures has exceeded 25 per cent of the total outflow of the swap market. Since 1988 joint ventures have become the major players in the net outflow of foreign exchange. An examination of swap market prices shows that, except for the second half of 1993 when domestic demand was overheated, leading to speculation in prices in the swap market, the trend has been towards a narrowing of the gap between prices in the swap market and the official fixed price. From 1991 to 1992, the gap was narrowing, the difference between the two price systems reaching RMB 0.5, creating the conditions for the integration of dual-track pricing.

After the integration of the dual-track exchange rate for the RMB in 1994, the operation of foreign exchange accounts settled by banks under the current account proceeded smoothly. Revenues exceeded expenditures and, in particular, foreign exchange supplies maintained their stability in the swap market. According to statistics from the state-run Foreign Exchange Administration, from January to November of 1994, the net outflow of foreign exchange from joint ventures reached US$4.4 billion, contributing significantly to meeting domestic demand for foreign exchange and stabilising the RMB exchange rate. Since the 1990s, the capital account balance has become the most important source of surpluses in international revenues and expenditures as a result of FDI inflows. China’s foreign exchange reserves netted just US$30 billion in 1994, US$25 billion in 1995 and now stand at US$75 billion, creating the conditions for the free convertibility of the RMB under the current account. Along with the gradual relaxation on import restrictions, it is certain that free convertibility of RMB under the current account will be achieved in the near future.

**FDI policy and foreign trade reform**

Real tariffs in China have been reduced, and non-tariff restrictions have been weakened due to the inflows of FDI. Nevertheless, it remains a problem that nominal tariffs are on the high side and that rules governing non-tariff restrictions are still in place. The expansion in the rate of coverage of the domestic market due to massive imports which have accompanied the inflow of FDI in the form of products and services provided by joint ventures has accelerated the transformation of most economic sectors in China towards a market economy. The earlier
advantages enjoyed by state-run enterprises in terms of protection in the purchase of raw materials, marketing and service payments have been eroded to a large extent, or have virtually disappeared. Until 1996, however, foreign investors continued to enjoy preferential treatment in tariff exemptions, a situation which differed markedly from the early period in the open door policy when preferential measures were introduced in order to allow joint ventures to compete on a fair basis with domestic enterprises. Some probable further reforms are outlined below:

- China will gradually reduce its official tariff rates to the average level for developing countries. Non-tariff barriers will also be cut. The levels of permissible market entry will be lifted and laws and regulations will be amended, allowing for greater transparency and a matching of the nominal with the actual situation.

- China will gradually abolish the current excessive ‘supra-national’ treatment of joint ventures, allowing them to compete on a fair basis with domestic enterprises. In April 1986, the Chinese government abolished most of the preferential policies on imports whereby newly established joint ventures would not enjoy preferential tariff exemptions on the import of raw materials and equipment. There will be reconsideration of fair business rules relating to investment sectors, some of which were opened to foreign investors in advance of domestic investors.

4.12

Table 6  Foreign exchange swaps involving joint ventures in 1987–93 (US$ billion)

<table>
<thead>
<tr>
<th></th>
<th>outflow value of foreign exchange from joint ventures</th>
<th>inflow value of foreign exchange to joint ventures</th>
<th>net outflow of foreign exchange from joint ventures</th>
<th>occupied % of total swap value in whole country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>2.7</td>
<td>2.8</td>
<td>-0.1</td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>8.4</td>
<td>4.3</td>
<td>4.1</td>
<td></td>
</tr>
<tr>
<td>1989</td>
<td>17.3</td>
<td>5.9</td>
<td>11.4</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>22.4</td>
<td>12.4</td>
<td>10.1</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>38.4</td>
<td>21.9</td>
<td>16.5</td>
<td>26.5</td>
</tr>
<tr>
<td>1992</td>
<td>59.4</td>
<td>35.4</td>
<td>24.2</td>
<td>37.7</td>
</tr>
<tr>
<td>1993</td>
<td>100.7</td>
<td>40.1</td>
<td>60.6</td>
<td>62.0</td>
</tr>
</tbody>
</table>

Source: *Foreign Economy and Trade Yearbook of China*, various years.
Clauses in laws and regulations which do not conform with the requirements for national treatment, and which have had little real impact, will be revised. For example, requirements about the proportion of Chinese-made materials to be used and the requirement for a balance in foreign exchange have had little real impact on joint ventures and will be revised accordingly.

National treatment will be provided for payments to joint ventures by public utilities and service sector industries. China has practised a subsidy system over a long period in many areas such as public utilities and services as a form of domestic welfare provided by the government. In recent years, government subsidies have gradually been withdrawn in accordance with the policy of marketisation, or steps have been taken towards the introduction of market prices. This has created the basis for the practice of national treatment regarding payments to foreign investors in these sectors.

China will further relax its current account restrictions creating the conditions for the convertibility of the RMB. The government will continue to act with caution, gradually relaxing its control of the capital account. While China’s reform of the financial system is incomplete and there are imperfections in the foreign exchange market, these factors will compound the problems surrounding RMB convertibility. By the year 2000, the short-term aim for China will be to allow partial convertibility of the RMB under the capital account. In short, the goal of completely free convertibility will not be achievable in the near future.
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