Reform of China's Foreign Trade Policy

Research Paper
No. 19 1995–96

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Reform of China's Foreign Trade Policy

Dr Weiguo Lu
Foreign Affairs, Defence and Trade Group
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Reform of the foreign exchange system

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Major Issues

The last fifteen years have seen enormous changes in China's foreign trade policy. The thrust of these changes has been a shift in the development strategy from import substitution toward export promotion. This has led to a sharp increase in China's foreign trade and a deeper integration into the world economy.

Reform in China's foreign trade policy has largely focused on improving the export regime but advances in the reform of the import regime have been relatively slow. Although import planning has been more or less phased out and progress has been made in reducing various import barriers, China's imports are still subject to a set of overlapping restrictions such as high tariffs, import quotas and licensing and import monopolies.

The emergence of China as a larger economy and trader underscores the need for China to take further bold steps in reforming its foreign trade system in order to gain its legitimacy in the international trade arena. A bold program of further import liberalisation could contribute to China's success in its bid to join the World Trade Organisation (WTO).

Accommodating China's growth is now a big challenge for the international trading community. It would not be desirable either for China or for the international community for the current impasse in the negotiations on the conditions for access to drag on. A more pragmatic approach to resolve the issue of China's WTO membership would be for China to commit to the rules of the world system but not be expected to meet all its rules immediately upon entry, as long as it adopts a definite timetable for meeting its commitments.

Australia's exports to China have grown substantially but have been affected by China's restrictive trade policy. While giving support to China for an early accession to the WTO, Australia needs to make sure that China makes a firm commitment to reduce trade barriers, especially those which directly affect Australia's exports.
Introduction

With the abandoning of the Maoist legacy of self-sufficiency and import substitution in favour of a policy of 'openness' that has encouraged foreign trade and investment since the late 1970s, China has become one of the most dynamic trading countries in the world. Total value of foreign trade grew from US$21 billion in 1978 to US$237 billion in 1994, a spectacular ten-fold increase. Actual direct foreign investment into China grew from nil to US$33.8 billion over the same period of time. China has now become firmly integrated into the world economy with its trade dependence ratio (share of total value of foreign trade in the total national output) having increased to over 30 per cent in 1994, a figure which is much higher than what would be expected for a large country.¹

The rapid increase in foreign trade and investment was due to successful reforms of China's economic and foreign trade systems. Economic reform has led to increases in productivity (through better allocation of economic resources and improvement in efficiency) and hence to a higher growth rate of the Chinese economy. Real GNP has quadrupled since 1978 providing an increasing amount of products for export and creating both an increasing capacity and an ever growing need for imports. Reform of the foreign trade system has led to an improvement in institutional supporting systems for foreign trade and an incentive framework.

Despite the fact that much has been achieved in reforming China's foreign trade system, China still has a long way to go in replacing direct administrative intervention with indirect price-based instruments for managing its trade policy, particularly with respect to imports.² Trade liberalisation has now become one of the top priorities in the marketisation of the Chinese economy.³

China has become a much more important player in the international economy and trade since reform and opening began in 1979. This raises an important issue about the need for China to undertake further reform in its economic and foreign trade system in order to advance its credentials in the international trading community. It also raises a related issue about the need of investment of efforts by the international trading community in the accommodation of internationally-oriented growth in China. In fact, these two issues are inter-related as the accommodation of China's growth by legitimating China's status in the World Trade Organisation (WTO) will put pressure on, and provide assurances for, the continuing economic and trade reform in China.

In recent years, there have been a growing number of studies which examine the issues of economic and trade reform in China (for example, World Bank 1990; Drysdale and Elek 1992; Lardy 1992; Martin 1992a and b; Chai and Haishun 1993; World Bank 1994; Drysdale and Song 1994; Garnaut and Huang 1994).⁴ This paper provides a snapshot survey of these studies. Key issues of interest in this survey are:
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- the main features of China's trade performance during the reform period including the growth trends, changes in commodity structure and geographical distribution, the degree of integration into the world economy and future growth prospects for trade.

- the evolution of China's foreign trade system including reform of China's economic system in general and of foreign trade and exchange system more specifically, areas subject to further reforms and possible strategies for implementing these reforms.

- China's participation in global and regional economic cooperation, particularly China's re-entry into GATT/WTO and its role in APEC.

The issues covered by this survey have important policy implications for Australia. Bilateral trade between Australia and China rose from US$1.29 billion in 1980 to US$3.9 billion in 1994, with China becoming a more important destination for Australia's exports. But Australia's share of total Chinese imports declined over the same period, reflecting in part the fact that Australia's exports are largely based on primary commodities whose real price has showed a declining trend and whose trade with China has been affected by US and European Union (EU) agriculture trade policy, and in part, the trade restrictions imposed by China on such commodities as wool in which Australia has a distinctive comparative advantage. It is important that Australia ensures China makes a firm commitment to reduce these trade restrictions as part of its negotiations for accession to the WTO.

Performance of foreign trade

Since launching the reform program in the late 1970s, China has experienced high growth in its economy and trade. China's GNP growth rate reached, on an annual average basis, over 9 per cent during 1978-94. The Chinese economy, if measured in a comparable manner to other developing countries, is already the world's fourth largest after the US, Japan and Germany.

China's foreign trade has grown faster than its GNP, with exports having increased elevenfold and imports more than ninefold during 1978-94 (Figure 1). Particularly impressive is the fact that the pace of trade expansion in recent years has accelerated despite the higher base already achieved at the end of the last decade. In 1994, China became the world's 11th largest trader, having ranked only 34th in export trade and 58th in the import trade at the end of 1970s. The World Bank ascribes the remarkable growth of China's export trade to institutional decentralisation, foreign investment, depreciation of the real effective exchange rate and duty-free access to imported inputs for export assembly. Increases in exports have also enhanced China's capacity to import, but China's imports tended to fluctuate more than exports mainly because of swings in domestic economic activity and in policies.
The rapid expansion of China's foreign trade has been accompanied by a significant shift in the commodity structure which is now more in line with China's relative resource endowment (Table 1). China's exports are now more concentrated on labour intensive products such as textile and clothing products, in which China has a distinctive comparative advantage. During 1978-92, the share of labour intensive products rose from 31.3 per cent to 55.7 per cent mainly at the expense of exports of agricultural and mineral intensive products. China's import trade is dominated by capital intensive products in which China has a comparative disadvantage. The pattern of China's foreign trade indicates that China has now been following a typical 'export-led growth' path many developing countries have already taken.

Changes were also observed in China's export and import destinations. In the case of export markets, Asia-Pacific countries as a group have become a more important destination for Chinese exports with their share having increased from 60.5 per cent in 1980 to 72.9 per cent in 1994 (Table 2). Within that group, Hong Kong was the most important export destination for China, but a substantial portion of exports to Hong Kong are re-exported (about 60 per cent since the 1990s). Japan's share of China's total exports has declined since 1980 while that of the US has increased substantially, especially since 1990. Australia's share in China's total exports has increased since the mid 1980s but the absolute value has remained relatively small.
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Table 1  China's exports and imports by groups of commodities (per cent)

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural intensive</td>
<td>36.1</td>
<td>26.3</td>
<td>21.7</td>
<td>12.5</td>
<td>10.6</td>
</tr>
<tr>
<td>Capital intensive</td>
<td>15.2</td>
<td>15.6</td>
<td>12.8</td>
<td>26.7</td>
<td>27.0</td>
</tr>
<tr>
<td>Labour intensive</td>
<td>31.1</td>
<td>30.2</td>
<td>35.4</td>
<td>50.9</td>
<td>55.7</td>
</tr>
<tr>
<td>Textile and clothing</td>
<td>19.8</td>
<td>20.8</td>
<td>27.0</td>
<td>37.8</td>
<td>40.0</td>
</tr>
<tr>
<td>Mineral intensive</td>
<td>17.0</td>
<td>27.3</td>
<td>28.8</td>
<td>9.4</td>
<td>5.9</td>
</tr>
<tr>
<td>Imports</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agricultural intensive</td>
<td>29.0</td>
<td>33.8</td>
<td>10.8</td>
<td>16.3</td>
<td>10.8</td>
</tr>
<tr>
<td>Capital intensive</td>
<td>59.0</td>
<td>52.8</td>
<td>73.3</td>
<td>60.5</td>
<td>65.7</td>
</tr>
<tr>
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<td>8.1</td>
<td>9.7</td>
<td>16.0</td>
<td>14.8</td>
</tr>
<tr>
<td>Textile and clothing</td>
<td>1.7</td>
<td>4.3</td>
<td>5.2</td>
<td>9.3</td>
<td>9.5</td>
</tr>
<tr>
<td>Mineral intensive</td>
<td>7.0</td>
<td>4.2</td>
<td>5.1</td>
<td>5.1</td>
<td>7.3</td>
</tr>
</tbody>
</table>

Note:  The shares do not sum to 100 due to the rounding errors.

Source: Garnaut and Huang (1994).

Asia-Pacific countries have also become a more important source of Chinese imports. Within the Asia-Pacific economies, Japan has the largest share of China's total imports, but that share has tended to fluctuate considerably and trend downwards since the mid 1980s. The large drop in imports from Japan reflects the sharp rise of the yen and the resultant shift in the import source of producers' goods from Japan to "Other APEC". The US share of Chinese imports remained quite stable at around 12 per cent during the past decade. Unlike exports, Hong Kong has been a much less important source of Chinese imports, accounting for only 8.2 per cent in 1994. Chinese imports from Australia increased from US$1.1 billion in 1980 to US$2.5 billion, but Australia's share in Chinese imports decreased from 5.3 per cent to 2.1 per cent over the same period. This indicates that Australian exporters were outperformed by exporters from other countries.

One important development in China's bilateral trade relations since 1990 has been a shift in China's trade with the US from a deficit into a surplus. According to Chinese figures, China's trade surplus with US reached US$7.5 billion in 1994. The US figures put this number even higher, at US$30 billion. However, Figure 1 suggests that there was no general tendency towards surplus in China's overall current account balance.
Table 2  China's trade by partner (million US$)

<table>
<thead>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value</td>
<td>Share %</td>
<td>Value</td>
<td>Share %</td>
</tr>
<tr>
<td>Exports</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>4,032</td>
<td>22.3</td>
<td>6,109</td>
<td>22.3</td>
</tr>
<tr>
<td>U.S</td>
<td>983</td>
<td>5.4</td>
<td>2,352</td>
<td>8.6</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>4,401</td>
<td>24.3</td>
<td>7,206</td>
<td>26.3</td>
</tr>
<tr>
<td>Australia</td>
<td>224</td>
<td>1.2</td>
<td>187</td>
<td>0.7</td>
</tr>
<tr>
<td>Other APEC</td>
<td>1,319</td>
<td>7.3</td>
<td>3,581</td>
<td>13.1</td>
</tr>
<tr>
<td>APEC total</td>
<td>10,959</td>
<td>60.5</td>
<td>19,435</td>
<td>71.0</td>
</tr>
<tr>
<td>EU</td>
<td>2,135</td>
<td>11.8</td>
<td>2,367</td>
<td>8.7</td>
</tr>
<tr>
<td>Rest of world</td>
<td>5,025</td>
<td>27.7</td>
<td>5,562</td>
<td>20.3</td>
</tr>
<tr>
<td>Total</td>
<td>18,119</td>
<td>100.0</td>
<td>27,364</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Notes:  EU refers to EU12. EU for 1980 covers France, West Germany, Italy and U.K. only.

Sources:  Statistical Yearbook of China, various issues; China's Customs Statistics, December 1994.

Since the beginning of the 1990s, booming foreign direct investment (FDI) has become an important factor behind the successful expansion drive of China's foreign trade. Foreign direct investment, both pledged and actual, has grown rapidly in recent years (Figure 2). The growing FDI has greatly improved China's export performance through the provision of new technology and marketing skills. During 1990-94, the share of exports from firms, in which there was foreign investment, in the total value of the country's exports rose from...
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17.4 per cent to 28.4 per cent. Because there is a higher import intensity (imports as a share of total output) of firms in which there is foreign investment,10 FDI has also contributed significantly to the growth of imports in recent years.

Figure 2  Foreign direct investment in China
(1980-94)

Source: Statistical yearbook of China, various issues; People's Daily March 1, 1995.

On the whole, China's economy has become increasingly open. This can be seen not only in the increasing share of foreign trade in China's gross national product (GNP) but also in the growing importance of China in the world's total trade. Growth in foreign trade has been faster than that in GNP resulting in an increase in China's trade dependence ratio. As shown in Figure 3, the real trade dependence ratio11 went up from 15 per cent in 1978 to over 30 per cent in 1994, with imports accounting for 15 per cent. In 1994, China's share of the world's total imports reached 2.7 per cent compared with less than 1 per cent in the late 1970s.12

One question is whether the momentum of growth in China's foreign trade will continue in future. Lau predicts that the share of exports in GNP will fall in future because the world economy will have some difficulty in adjusting to a continued rapid expansion of China's exports and there is a scope to increase the relative importance of internal demand.13 However, this view is challenged by Garnaut and Huang who argue:14

...within an effective, rule-based international trading system, and with continued trade liberalisation in the framework of the Uruguay Round settlement, China's foreign trade will continue to grow more rapidly than output, although the average trade growth rate of the reform era so far might reasonably be considered an upper limit to future growth.
Applying this upper limit for growth rate, Garnaut and Huang estimate that China's share in the world's trade of goods and non-factor services would increase from 1.6 per cent in 1990 to 2.9 per cent in 2000, and to 5.3 per cent in 2010. Garnaut and Huang further show that the challenge which China poses for adjustment in industrialised economies would be no greater than that which has already been faced in the rise of Japan in the 1960s or the newly industrialised economies (NIEs) in the 1970s.

Garnaut and Huang's view is supported by Drysdale and Song whose argument is, however, based on an understanding of the nature of industrialisation in the East Asian economies. Drysdale and Song stated:  

"Chinese economic modernisation is not an independent event. In all major East Asian economies, domestic market growth as well as openness to international market disciplines have been key elements in the development of dynamic comparative advantage and internationally competitive economies. China is far from reaching its full potential in the development of externally oriented activities and will continue to realise significant gains through trade, investment and technology flows and integration into the international economy."

In sum, despite the large size of its domestic market, foreign trade appears now to have become the main engine of growth for China and will continue to be so for some time to come. Therefore, trade policy within and outside China is critical to the growth prospects for China's foreign trade and economy.
Reform of China's foreign trade policy

Reform of foreign trade policy has played an important role in boosting China's foreign trade since the late 1970s. The major thrust of trade reform was to turn away from a policy of self-sufficiency or an import-substitution strategy towards a strategy of export-led growth.

China's pre-reform foreign trade regime was an extreme example of import substitution. Under that regime, foreign trade was regarded as a necessary evil which had no merit in itself and which could not contribute substantially to a viable strategy for China's development. The main role of foreign trade was to make up for domestic shortages by imports and to smooth out excessive supplies of domestic goods by exports within the framework of the national economic plan. Foreign trade was heavily controlled by the central government with a very limited number of foreign trade corporations (FTCs) allowed to be in the foreign trade business. Prices, including the foreign exchange rate, had virtually no role in resource allocation.

Trade reform has been closely related to broader economic reform in China which was initiated in December 1978 at the Third Plenum of the 11th Central Committee of the Chinese Communist Party, when Deng Xiaoping assumed power. There are two major components in the Chinese economic reform program: one is decentralisation of economic decision-making power and the other is rationalisation of prices based on market forces. These two elements, interacting with each other, have contributed to the transformation of China's economic system from one in which, at the start of the reform period, nearly all economic activities were planned, to one in which the market mechanism now plays a major role in determining prices both for consumer and producer goods. Recent reports show that as a result of successful economic reform over the past fifteen years the state's share of total national output now accounts for less than 50 per cent. In addition, over 90 per cent of consumer goods and 85 per cent of producer goods are now transacted at prices set by the market.

Trade reform has followed basically the same strands of broader economic reform. It has involved decentralisation of trading rights and restoration of price-based incentives mainly through reform of the foreign exchange system.

Decentralisation of foreign trade rights

Trade reform in China started with the decentralisation of trading rights to local authorities, industrial ministries and production enterprises. This also has been accompanied by a substantial reduction in the scope of direct foreign trade planning.
Historically, China's foreign trade was monopolised by only a dozen FTCs through a rigid state planning system. However, this situation has changed rapidly since 1979 when reform in China's foreign trade system began. By 1986 there were already 1,200 FTCs in operation. This number was further increased to over 8,000 in 1994 of which 30 per cent were productive enterprises. In addition, there were 174,000 foreign-invested enterprises which enjoyed foreign trade rights.

Simultaneously with the decentralisation of trading rights, there was a reduction in the importance of the national foreign trade plan. Prior to economic reform, the foreign trade plan governed nearly 3,000 export commodities. The import plan was similarly comprehensive, covering 90 per cent of Chinese imports. However, after successive reductions in the scale of the foreign trade plan over the past fifteen years, the number of plan-controlled export commodities has been reduced to 38 and import commodities to 11.

For the limited number of commodities which were still subject to foreign trade planning, the nature of planning has also changed. Mandatory planning was subsided and replaced by guidance or indirect planning which is less specific and non-binding.

In the process of decentralising its foreign trade activities, the Chinese government has strengthened macroeconomic control and improved the administrative system governing foreign trade, including the implementation of a more rational approach to the regulation of foreign trade through more effective management of exchange rates, custom duties, taxes and credits.

Reform of the foreign exchange system

A further element in the reform of China's foreign trade system was to provide incentives to firms for engaging in foreign trade. This was achieved mainly through the reform of China's foreign exchange system.

Before the 1980s, there was stringent control of foreign exchange in China. The exchange rate had little role in influencing the allocation of resources and performed largely an accounting function. Under this system, Chinese enterprises had little incentive to export. They were paid in domestic currency for the goods delivered to foreign trade corporations. The price they received was the same regardless of whether goods were sold abroad or at home. Enterprises gained no explicit claim to the use of any of the foreign exchange earned.

Since 1979, there have been substantial reforms in the foreign exchange system in China. Wu, in his analysis of China's foreign exchange regime since 1979, identified three distinctive stages of reform: the foreign exchange retention and adjustment system within
the planning framework from 1979 to 1986; the planning-market double track system from 1987 to 1993; and unification of foreign exchange rates after 1994.

1979-86: Reforms within the planning framework

There were two major elements in the reform of the foreign exchange system in this period: one was the introduction of a foreign exchange retention system and the other was the devaluation of RMB yuan (Chinese currency unit, A$1=6.4 RMB yuan in 1994) for trade-related transactions.

The foreign exchange retention system was first introduced in 1979. Under this system, exporting enterprises and their superordinate level of government administration were allowed to retain the right to use a certain portion of the foreign exchange they earned above the level set by the plan. But the amount of retained foreign exchange was small during this period and its use was heavily regulated.

Although the relaxation of foreign exchange control was modest, there was substantial devaluation of RMB yuan during this period. In 1981, instead of devaluing the official exchange rate, the Chinese government introduced a shadow rate known as the Internal Settlement Rate for Trade. This rate was calculated from the average cost of earning a US dollar through exports and was set at RMB yuan 2.8 to one US dollar (Figure 4). This

Figure 4  The yuan-dollar exchange rate, 1980-94

Note: Exchange rate is in annual average.

represented an 80 per cent *de facto* devaluation as the official rate was only RMB yuan 1.55 to one US dollar at that time. The difference between the official and shadow rates, however, had to be financed by the government as a subsidy. Initially this subsidy only applied to exports but later also to imports because of the lag in adjusting the domestic price for importables. The rapid increases in subsidies as a result of growth in foreign trade led to successive devaluation of the official rate from 1982. In 1985, the official rate merged with the shadow rate. The overall effects of reform on trade in this period appeared to be relatively small. This is reflected in a much slower growth of foreign trade in this period than the period after 1986 (Figure 1). The main reasons for this were that reform of the whole economic system was at that time in its early stage and planning still dominated the system. Moreover, there was a lack of well-developed secondary markets, which undermined the effectiveness of the incentive system.

1987-93: Dual foreign exchange system

More market-oriented reforms to China’s foreign exchange regime began with the formal introduction of a swap market or secondary market in late 1986. This was the beginning of the transition from a planned foreign exchange regime towards one which was more market oriented.

Although there were substantial devaluations in the first half of 1980s, the foreign exchange rate in China was still overvalued in the mid 1980s. This can be seen in the substantial devaluation of RMB yuan on the swap market from 1986 (Figure 4).

After the introduction of the swap market, its importance grew substantially. By 1993, 80 per cent of foreign exchange earnings were priced at the swap rate. This clearly indicated that market forces had already played a dominant role in determining the foreign exchange rate.

At this stage, China continued to apply the foreign exchange retention system and to increase retention rates. Considerably higher rates were applied to corporations trading in priority sectors — light industries, arts and crafts, clothing, machinery, and electronic products — and to open coastal cities and special economic zones such as Guangdong, Fujian and Shenzhen. Incentives provided by this system for firms to participate in foreign trade were because: (1) the emergence of the swap market and the devaluation on that market allowed firms to make higher earnings on their exports; (2) the declining importance of the plan in the national economy and in foreign trade meant that there were less import restrictions, which allowed firms to import technology and raw materials in their export-oriented production or to import items which sold well on the domestic market and hence allowed them to make even higher returns than those on the swap market.
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The double-track foreign exchange rate regime is systematically analysed by Martin who shows that the system has the characteristics of an overvalued official rate and an undervalued swap rate. An overvalued official rate constituted an implicit tax on exports and an undervalued swap rate an implicit duty on imports. Martin simulated the effects of depreciation of the official rate by 10 per cent using a Computable General Equilibrium (CGE) model of the Chinese economy. The results show an appreciation of the swap rate (6.6 per cent) and dramatic expansion of GNP, trade volumes and labour intensive industries.

Despite the shortcomings of the double-track foreign exchange system, reform in this period greatly enhanced China's export performance. Within just seven years China's total exports tripled, rising from US$31 billion in 1986 to US$92 billion in 1993 (Figure 1).

After 1994: Foreign exchange rate re-unification

At the beginning of 1994, China took another bold step in reforming its foreign exchange regime. The main features of this round of reform included (1) unifying the official and market exchange rate by merging the former with the latter; (2) abolishing the foreign exchange retention system and replacing it with a RMB settlement system for all export earnings; (3) replacing the swap system by an inter-bank foreign exchange market with a system of managed float; and (4) the abolition of approval procedures for acquiring and using foreign exchanges for current account transactions.

Since the unification of the double-track system, the exchange rate for RMB has remained basically stable and has even appreciated slightly thanks to improvements in the reserve position due to stronger growth in exports (in 1994, China's exports grew by over 30 per cent and in the first eight months of 1995 by 37 per cent) and continuing inflows of foreign capital (Figure 2).

The 1994 reform constituted a watershed in China's efforts to bring the Chinese currency towards full convertibility. In view of the remarkable export performance following unification and achieving a stable unified exchange rate, Chinese officials are now talking about achieving full convertibility of RMB yuan by the year 2000.

One important implication of the 1994 reform is that foreign exchange control will no longer be a major instrument for controlling imports. With market forces dominating the economy and increasing responsiveness of firms to price signals, other measures (such as quotas and tariffs) will become more important factors influencing China's future foreign trade.
Future reform agenda

Past reform of China's foreign trade and exchange system has been concentrated on introducing measures to stimulate exports. Reform of the import regime, particularly with respect to reduction in trade barriers, has remained comparatively neglected and is now taking on some urgency.34

Since the late 1980s, as a part of China's bid to attain full membership status in the GATT and as part of its bilateral trade negotiations with the US, China unilaterally undertook several cuts in its import tariffs. In 1991, China reduced tariffs on 265 import commodities. Regulatory duties on imports were abolished in 1992. From December 1993, China adjusted import tariffs on 2,898 commodities, reducing the average tariff rates by 9 per cent.

Despite these reductions, import tariffs remain high by international standards (Table 3). China's 1992 average rate, measured on a trade weighted basis, was equal to that of Brazil and was the third highest among the listed countries.

Table 3  The tariff systems of China and other large developing countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Unweighted mean (%)</th>
<th>Trade weighted mean (%)</th>
<th>No. of rates</th>
<th>Standard deviation (%)</th>
<th>Duty collection rate (%)</th>
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</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1987</td>
<td>21.8</td>
<td>17.1</td>
<td>37.0</td>
<td>24.3</td>
<td>16.1</td>
</tr>
<tr>
<td>Brazil</td>
<td>1987</td>
<td>47.8</td>
<td>31.9</td>
<td>34.0</td>
<td>17.1</td>
<td>6.9</td>
</tr>
<tr>
<td>China</td>
<td>1992</td>
<td>42.8</td>
<td>31.9</td>
<td>69.0</td>
<td>30.0</td>
<td>5.6</td>
</tr>
<tr>
<td>Colombia</td>
<td>1992</td>
<td>16.4</td>
<td>15.1</td>
<td>26.0</td>
<td>20.3</td>
<td>16.7</td>
</tr>
<tr>
<td>Egypt</td>
<td>1991</td>
<td>31.0</td>
<td>na</td>
<td>16.0</td>
<td>31.0</td>
<td>17.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>1989</td>
<td>15.1</td>
<td>na</td>
<td>78.0</td>
<td>13.7</td>
<td>9.6</td>
</tr>
<tr>
<td>India</td>
<td>1986</td>
<td>99.6</td>
<td>54.8</td>
<td>13.0</td>
<td>50.1</td>
<td>51.2</td>
</tr>
<tr>
<td>Kenya</td>
<td>1987</td>
<td>40.0</td>
<td>na</td>
<td>22.0</td>
<td>21.5</td>
<td>15.6</td>
</tr>
<tr>
<td>Pakistan</td>
<td>1990</td>
<td>64.8</td>
<td>35.9</td>
<td>15.0</td>
<td>41.4</td>
<td>30.8</td>
</tr>
<tr>
<td>Philippines</td>
<td>-</td>
<td>27.9</td>
<td>na</td>
<td>8.0</td>
<td>15.1</td>
<td>15.6</td>
</tr>
</tbody>
</table>


One point worth noting about Table 3 is that the rate of actual duty collection (total tariff revenue divided by total value of imports) is low, at 5.6 per cent. This was mainly due to high levels of duty exemption in China. Raw material imports which were used in
producing export goods were duty free; foreign-funded enterprises received a 50 per cent duty concession; a range of imports for priority projects was also exempted. However, the duty collection rate cannot be used as an indicator of effective protection as the method of calculation biases it downwards. The duty collection ratio depends on the commodity import structure as well as on tariff rates. If the low proportion of manufactured consumer good imports is caused by high effective tariff rates, the calculated duty collection ratio reminds nothing about the true degree of protection. An example illustrates this point clearly. Table 4 shows the commodity pattern of tariff systems in China and some other developing countries. Like many other developing countries, China imposes a much higher tariff rate on manufactured consumer goods than producer goods. In some cases (for example private passenger cars), tariff rates are so high that they sometimes become prohibitive. In the extreme case, there could be zero imports. This is obviously a source of bias, if the duty collection ratio is used as an indicator for effective protection.

On the other hand, price comparison data suggest that there appears to be considerable 'water in tariff' (which means that tariffs are not binding constraints on imports) for many products as Chinese industries in a broad range of import categories are globally competitive.35 While this tariff redundancy indicates that the effective protection rate is lower than suggested by the nominal rate, the existence of such tariff barriers could become a threat to China's trading partners in future.

Table 4 The commodity pattern of tariff systems in China and other large developing countries (Unweighted average tariff rates)

<table>
<thead>
<tr>
<th>Country</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Consumer</td>
</tr>
<tr>
<td>Argentina</td>
<td>20.9</td>
<td>27.2</td>
<td>13.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>38.7</td>
<td>21.8</td>
<td>66.0</td>
</tr>
<tr>
<td>China</td>
<td>35.0</td>
<td>20.0</td>
<td>65.0</td>
</tr>
<tr>
<td>Colombia</td>
<td>19.7</td>
<td>14.1</td>
<td>39.7</td>
</tr>
<tr>
<td>Egypt</td>
<td>22.0</td>
<td>14.0</td>
<td>50.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>11.7</td>
<td>5.4</td>
<td>16.8</td>
</tr>
<tr>
<td>India</td>
<td>76.6</td>
<td>84.2</td>
<td>101.8</td>
</tr>
<tr>
<td>Pakistan</td>
<td>62.7</td>
<td>35.5</td>
<td>88.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>32.5</td>
<td>13.0</td>
<td>38.3</td>
</tr>
</tbody>
</table>

Reform of China's Foreign Trade Policy

In line with its bid to obtain full WTO membership, China has also made some advances in reducing quantitative restrictions. For instance, China abolished import licences and quotas on more than 280 commodities in 1993, reducing the number of commodities subject to quantitative restrictions to 1300.\textsuperscript{36} China announced a plan to reduce the number of these commodities to 200 by the year 2000, but this number is still large.

In addition to tariff and quota restrictions, administrative controls are still pervasive. The most important method of administrative control is to assign import rights to one or a few FTCs. The World Bank called this process 'canalisation'.\textsuperscript{37} Currently there are 12 categories of commodities subject to canalisation, including such important items as wheat, fertilisers, rubber, steel products, timber, wool, acrylic fibre and cotton. These products accounted for 32 per cent of total imports in 1993.\textsuperscript{38}

Although in most cases trading rights are assigned to more than one FTC, it is not unusual for FTCs to be in collusion with the government administration. This is because canalisation gives FTCs import monopolies and FTCs have a vested interest in retaining this power by adopting a cooperative approach.

In sum, despite substantial decline in trade planning since 1979, China still operates a relatively complex trade regime particularly with respect to imports. As the importance of import planning has shrunk and foreign exchange control has been relaxed, border restrictions and administrative controls stand out as the main instruments for controlling imports. The need to have a further reform in China's import regime has been recognised by the Chinese government as well as by China's major trading partners.

The World Bank suggests that China is currently well positioned to implement bold measures in the area of import liberalisation because of:

- its comfortable reserve position;
- the advanced state of price reform;
- the expanding role of the non-state sector and growing flexibility in domestic resource allocation; and
- evidence of tariff redundancy which implies that cuts in tariffs and non-tariff barriers (NTBs) will not entail major contractions even in the most protected sectors such as textiles and machinery.

The World Bank also argues that the early implementation of a bold program of import liberalisation will contribute to the growing momentum of China's drive to become a full member of the international trading community. It can also help improve the efficiency of state-owned firms which has been a mounting concern. Furthermore, given China's positive outlook on exports and the availability of external capital, including FDI, the favourable balance of payments situation leaves much scope for increasing imports.
Reform of China's Foreign Trade Policy

There are signs that China has begun to move in the right direction. China has promised at the recent APEC summit in Osaka in November 1995 a sweeping reduction in trade barriers from 1996. Under the plan, China will remove quotas and licensing on 170 items accounting for more than 30 per cent of the commodities now subject to import quotas and licensing requirements. China will also reduce its overall tariff level by a margin of no less than 30 per cent. The tariff cuts would be applied to more than 4,000 of the 6,000 items that China imports and would mean that the nation's average tariffs will be lowered to about 22 per cent from a current 35.9 per cent.39

China's entry into the WTO and its role in APEC

With deeper integration into the world economy, China has shown a strong interest in seeking global and regional economic and trade cooperation through mechanisms such as WTO and APEC.

China made its formal application for re-joining the GATT (now the WTO) on 10 July 1986. WTO membership is desirable for China as it will cement non-discriminatory trade relations with its trading partners and give China access to a rules-based system of dispute settlement.

Since lodging its application for WTO membership, China has accelerated reform in its economic and trade system. China has also started to proceed unilaterally with its trade liberalisation program as discussed earlier.

China's bid for WTO membership was rejected in December 1994 when the United States, leading other members, contested China's claim that it should be admitted as a developing country with reduced commitments on the pace and extent of trade liberalisation. Western nations have insisted that China's accession must be based on respect for WTO rules and the achievement of meaningful market access.

Failure to enter the WTO was a stunning setback for China as it had put a high priority on becoming a founding member of WTO on 1 January 1995. Perhaps more significant is the fact that liberal forces within China which had intended to use the WTO-entry as a means of assurance for continuing reforms found themselves politically exposed.

China now seems to be in no hurry for accession and some voices even query the value of membership.40 Accession to the WTO requires that China make substantial concessions in terms of foreign access to its domestic market and this could be politicised in the current uncertain political and economic transition period.41 It appears that at present none in the Chinese leadership could risk taking a clear stand on the extent of Chinese concessions because of the difficulty of building a coalition of support. The current standstill, if
prolonged, could add to future uncertainty not only for China but also for the world trading system given the increasing impact China now has on world economy and trade.

Currently, issues affecting China's accession to the WTO include whether special safeguard measures should be applied to Chinese exports, whether China should be allowed to protect its infant industries, whether it should be mandatory or voluntary for China to join some multilateral agreements such as the Government Procurement Agreement and Civil Aviation Agreement, and the time period for implementation of new rules on, for example, intellectual property rights would be met. However, the key issue in the negotiation of China's membership is whether China should be admitted to the WTO as a developing or developed country.

There are some major differences in the entry requirements between a developing and developed country. Membership based on a developing country status means that China has to commit much less in terms of extent and pace of trade reform. On the other hand, China's entry based on a developed country basis would require a larger extent and faster pace of trade liberalisation. But if China's admission to the WTO has to be based on a developed country basis, some of the entry requirements may simply be impractical. For instance, under the Uruguay Round, rules for intellectual property rights are to be strictly enforced, and developed countries are committed to meet new requirements within one year. But China does not at the moment have the institutions to comply in this time frame.

It seems now critical to define an end point to China's achieving equal status within GATT/WTO. The definition of such an end point is by no means an easy task as no precedent exists by which to set the standards for China's entry. For that reason, Drysdale and his colleagues believe that the resolution of terms of entry requires a considerable measure of trust and understanding which will not be achieved at the high political level. They propose negotiating a binding agreement at the outset, which provides for full membership in the WTO, in return for agreement to a protocol based on actual reforms or set out the timetable for reforms steps such as further removal of quantitative restrictions to trade.

A key argument behind this idea is that 'China has a good record in terms of adhering to international undertakings, so that any agreement to a future program of reform towards full compliance with GATT can be expected to be honoured'.

Another argument is that in view of the 'gradualist' approach being taken to reform of the Chinese economic system and its apparent success in the past, the international trading community should allow some time for China to adjust its trade policy to the full application of WTO principles.
Reform of China's Foreign Trade Policy

Drysdales and his colleagues believe that locking China into its own self-declared reform agenda through the negotiations on the terms of entry is an important means for assuring continuing economic reform in China and for avoiding retrogression towards a costly 'import-substitution' development strategy which is the last thing the world trading community wants to see.

Alongside efforts made in seeking an early entry into the WTO, China has also actively participated in APEC activities. Akira and Hiromi\(^{46}\) outlined three major reasons why China has a special interest in APEC. First, as discussed earlier, APEC includes China's major trading partners, covering 73 per cent of its exports and 65.5 per cent of imports. The bulk of foreign direct investment also comes from the region which was 80 per cent in 1993 (Wu 1994). Second, APEC could potentially provide a mechanism for settling trade disputes (currently under discussion), even if more limited than the WTO. As China is not yet a WTO member, APEC provides an alternative framework for solving trade disputes. Third, APEC adopts a 'concerted unilateralism' approach to trade liberalisation, which China feels more comfortable with in determining the pace and scope of its own trade liberalisation.

Klintworth\(^{47}\) notes that China's APEC diplomacy is aimed, in large part, at dealing with the US which has been a main obstacle for China's WTO entry. By using the tactic of coalition building among most APEC member countries, China hopes to moderate America's tough stance on China's WTO entry. Some member countries are now suggesting that APEC should play a complementary role in defining the terms of China's accession to the WTO, for example, the development of the idea that China commits to the rules of the world trading system but not need to meet all those rules immediately upon entry while adopting a definite timetable for meeting its commitments.

In sum, the emergence of China as a large economic power poses a major challenge for both global and regional trading communities. China's participation in global and regional economic cooperation will greatly affect the world trade system. Negotiation of the issues of China's involvement in the world system is important to successful management of the adjustments involved, both for China and the rest of the world.

Implications for Australia

China's success in implementing economic reform and the open-door policy and in generating high growth and increased trade and investment has had a significant impact on the world economy, particularly on the countries in the Asia-Pacific region including Australia. Trade between Australia and China has grown rapidly, especially since 1990. Total trade between the two countries more than doubled between 1990 and 1994 making China Australia's sixth largest trading partner. There is still a huge potential for bilateral trade growth given the close economic complementarity between the economies.
Findlay and Song, in their review of the China-Australia commodity trade between 1985-94, note two important features of Sino-Australian trade: 38

- there were two opposite trends with regard to the relative importance of bilateral trade in each country's total trade. China has become more important in Australia's total trade (from 2.5 per cent in 1985 to nearly 5 per cent in 1994) while the bilateral trade has become slightly less important in China's total trade (from 1.8 per cent in 1985 to 1.7 per cent in 1994).

- China's exports to Australia were dominated by labour-intensive products (accounting for 65-74 per cent during the period) while China's imports from Australia were mainly agriculture- and mineral-intensive products (accounting for over 60 per cent of the total in most years).

The decline in the importance of Australia in China's total trade is worthy of note. As indicated in Table 2, the main source of this decline was the result of a drop in Australia's share of China's total imports. While there were many factors assumed for the decline in Australia's share of China's imports (for example, the decline of real commodity prices and heavily subsidised agricultural exports from the US and EU), China's restrictive import policy was clearly one contributing factor.

China's import control policies have a direct impact on Australia's exports. The most important example is wool. Wool has been Australia's top export commodity to China, accounting for over 20 per cent in 1994. But import of wool into China has been constrained by both tariff and non-tariff measures such as import quotas and import monopolies.

Negotiations between Australia and China over the issue of market access for wool in the context of China's GATT/WTO entry has been going on for some time, but has proven to be difficult. The Chinese government has proposed a tariff-quota regime for wool imports on the grounds that domestic wool producers need to be protected for political reasons. This scheme raises domestic prices, decreases demand and also imposes an automatic quantitative upper limit to imports from the world market.

The main issue that has arisen in the recent bilateral negotiations between China and Australia is how to set the quota base. Despite the rapid increase in wool imports in the past two years, China is still seeking a quota for wool imports based either on the three year average of imports for 1991-93 or five year average between 1990-94. These periods include some years of relatively low imports which means that a substantial portion of the current import demand would be unmet. If this eventuates, the proposed tariff-quota arrangement for wool imports would be more restrictive than the current arrangement and the Australian wool industry would be left worse-off than before Sino-Australian negotiations began. 49
Reform of China’s Foreign Trade Policy

Australia's exports are also indirectly hurt by China's high import barriers. Iron ore and steel products provide a good illustration of how. Since the economic reform, China's demand for steel products has grown strongly and imports of both iron ores and steel products have increased rapidly. Labson, Goody and Manson predict that China's imports of iron ores will rise from 37 million tonnes in 1994 to 50 million tonnes by the year 2000 and imports of steel products from 12 million tonnes to 26 million tonnes.

Like many other countries, China's tariff structure on steel escalates by degree of processing. While there are relatively low trade barriers for raw materials and these allow Australia to expand its iron ore market in China, there are more restrictive policies on the finished steel products and these reduce imports of finished products, which in turn could lead to a reduction in demand for Australia's iron ores from other East Asian suppliers of steel products.

In summary, the choice of trade policy regime in China has important implications for Australia. While giving support to China for an early accession to the WTO, it is important for Australia to receive a firm commitment from China to reduce trade barriers, particularly those which directly affect Australia's exports.

There may be interest in lifting the negotiations of Australia's trade interests related to China's accession to the WTO, to a higher political level in the relationship, given their importance to Australia directly and indirectly and given the importance of China's accession to the future of the regional and global trade system.
Endnotes

1 Large economies such as the US and Japan usually have a trade dependence ratios of 15-20 per cent. Australia, a small economy, has a trade dependence ratio of around 40 per cent.


11 Drysdale and Song 1994.


13 Garnaut and Huang 1994.

14 Drysdale and Song 1994.


9 US figures include items that originate in China but are subjected to further processing in places such as Hong Kong.

10 Chai and Haishun 1993.

11 The calculation of the real trade dependence ratio is based on a constant price basis. If we use nominal values, the calculated share of foreign trade in GNP is much higher (45 per cent) mainly because of sharp depreciation of the Chinese currency in the reform period.


14 Garnaut and Huang 1994, p. 4.

15 Drysdale and Song 1995, p. 13

16 Chai and Haishun 1993.


20 A 'foreign-invested enterprise' (FIE) denotes any business entity in which a foreign company controls some, or all, of the equity. FIE can be an equity joint venture, wholly foreign-owned venture, cooperative venture or a compensation trade arrangement.

21 Liu, X. 1994, China's reform in the foreign trade regime and policy for the utilisation of foreign funds, a speech at the seminar on China's Economic Reforms Policy at the 5th Asia-Pacific International Trade Fair, Beijing.


24 Chai and Haishun 1993.


28 Swap market is the officially sanctioned secondary market for foreign exchange.


31 Martin 1992b.
CGE modelling is a form of quantitative economic modelling. Its characteristics are that it is economy-wide, it is multisectoral, and it gives a central role to the price mechanism. These characteristics differentiate it from partial equilibrium modelling (not economy-wide), macroeconomic modelling (not multisectoral), and input-output modelling (agents don't respond to price signals). CGE has gained considerable popularity since 1980s. Martin was the first to build a CGE model for the Chinese economy.

Wu 1995.

Asia Pacific Economic Group, Asia Pacific Profiles 1995, the Research School of Pacific and Asian Studies, The Australian National University.

For an excellent discussion of the problems associated with the transition, please refer to Martin, B.G. 1995, China in transition: the politics of economic reform and political succession, Research Paper 17, Parliamentary Research Services, Department of the Parliamentary Library, Canberra.

Asia Pacific Economic Group 1995.
Garnaut and Huang 1994.
Drysdale and Elek 1992; Drysdale and Song 1995.
Drysdale and Song 1995, p. 9.
Akira and Hiromi 1995.


Labson, S., Goody, P. and Manson, A. 1995, China Steel: China's emerging steel industry and its impact on the world iron ore and steel market, ABARE Research Report, 42.014.

Findlay and Song 1995.