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## WTO and China's Economic Transformation: Institutional Perspectives and Policy Options

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### Introduction

On 15 November 1999, China completed a critical step towards becoming a member of the World Trade Organization (WTO) by signing a bilateral trade agreement with the United States (US) on the terms of China's accession to the WTO. Under the Sino-American accord, China agreed to reduce average import tariffs from the current 22.1% to 17% upon entry and open substantially telecommunications, financial services and other industries to foreign investors within a transitional period of about five years. In return, the US agreed to grant the "permanent normal trade relations" (PNTR) status to China and support China's accession to the WTO.

During the 14 years of negotiations on China's accession to the WTO, policy-makers, scholars and the media have focused on the specific terms of China's market opening commitments and their impact on China and the rest of the world. These detailed commitments, their enforcement and their economic, social and political implications would deserve careful study for the next few years or even next few decades and are beyond the scope of

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this chapter. Instead, we focus here on the broad impact of China's entry into the WTO on its own economic transformation. In particular, the analysis provides some perspectives based on new institutional economics and also discusses some relevant economic policy options for China to cope with the coming challenges of competition for best institutions in an open and global economy.

### Commitments in Bid for WTO Accession

According to the Sino-American trade accord,<sup>1</sup> China has made substantial market access commitments covering the agricultural, industrial and service sectors:

*Agriculture:* Average tariffs for agricultural products will be lowered from 22%, the current level, to 17% by 2004. Foreign companies will have the right to directly import and distribute agricultural products.

*Industrial Products:* Average import tariffs will be lowered from 17%, the current level, to 9.4% by 2005. Import quotas, licences and other quantitative restrictions will be eliminated for US priority products on accession and for most other products by 2002 with all quotas, including automobiles, abolished by 2005. Foreign companies will be given trading and distribution rights, which will be phased in over three years.

*Services:* China will relax foreign investment restrictions on many important service industries, including distribution services, telecommunications, financial services, professional services, audio-visual and tourism services. In particular, the telecommunication service sector, which

**Table 1. Historical Changes in China's Average Tariff Rates**

Prevailing average in each year	All products %	Primary products %	Manufactures %
1992	42.9	36.2	44.9
1993	39.9	33.3	41.8
1994	36.3	32.1	37.6
1996	23.6	25.4	23.1
1997	17.6	17.9	17.5
1998	17.5	17.9	17.4
WTO*	10	15	9.4

Source: *China Economic Quarterly*, First Quarter 2000.

\* Estimates based on November 1999 Sino-American bilateral accord on WTO accession.

includes the Internet, will be opened to foreign participation for the first time. Market access enjoyed by existing foreign investors will be safeguarded. China will also accede to the WTO Basic Telecommunications and Financial Service agreement.

### **Institutional Challenges upon WTO Entry**

China is presently a relatively closed and small economy with low productivity, large population, backward institutions and high transaction costs. China's foreign trade is currently less than 3% of the total world trade. The recent Asian financial crisis had hardly any impact on the country's currency and output growth due to the relative isolation of its economy from the rest of the world. Although China has attracted a large amount of foreign direct investment in recent years (second only to the US), the share of loss-making foreign invested firms is as high as that of loss-making state-owned enterprises, which shows the high hidden costs of doing business in China. It is widely expected that the accession to the WTO would change the present situation and put China on to an irreversible path towards an open and large economy with growing productivity, falling transaction costs and improving economic, social and political institutions. Many, including the governments of China and the US, have seen this transformation as a "win-win" process for people in China and in the rest of the world. Most would also agree that competition would be intensified in a more open China and global economic environment. How to put the competition among China and the rest of the world into perspectives? What are the key factors behind the competitiveness of economies? These are the questions we need to address before discussing China's policy options to cope with the competitive challenges of an open world economic community governed by the WTO.

Based on the new institutional economics, the competitiveness of an economy would be determined by the sum of two kinds of costs, i.e., factor costs and transaction costs.<sup>2</sup> The costs of factors (i.e., prices of inputs such as labour, capital and land) are determined by supply and demand in the market, while the transaction costs are hidden and intangible. Transaction costs depend on institutions. Good institutions created by societies by design, or most frequently through practice, could greatly cut down transaction costs. Transaction costs, therefore, are not a concept directly derived from the traditional neoclassical market equilibrium analysis. When

transaction costs are reduced, mutually beneficial and voluntary transactions among people increase, leading to rapid wealth creation.

Hong Kong is an excellent example illuminating the importance of low transaction costs in enhancing competitiveness. While almost all factor costs are extremely high by international standards, Hong Kong has been repeatedly ranked top in competitiveness among all economies. The absence of hidden and human-made costs of doing business has boosted the volume of free business transactions, which in turn have brought considerable economic returns to the local people. As a result, the Hong Kong service industry has accounted for 84% of its gross domestic product (GDP) and the majority of people in Hong Kong rely on buy-and-sell for their living. In contrast, the transaction costs are prohibitive in China, and mutually beneficial transactions are seriously deterred although China obviously enjoys a competitive edge in labour and land costs. So, high transaction costs in China are a major obstacle to improving its economic competitiveness.

A related factor hindering China's competitiveness is the lack of a sound private property right system to deal with the risk and uncertainty of an open and free market environment. Chinese policy-makers and scholars often pay too much attention to the strength of specific regions, sectors, projects, enterprises and products. For example, high technology and internet communication, which have become the hottest areas of investment in the advanced economies in recent years, receive also the favour of the Chinese government. The government is anxious to invest in these priority sectors in anticipation of the competitive pressure after entry in the WTO. As we will argue in the next section on policy options, it is the institutions not the investment into specific sectors or projects that would determine the competitiveness of Chinese industries in an open global economy. The role of market-oriented institutions is to diversify the risks among private investors so that the private sector can deal with the risks and uncertainty more efficiently than the state sector.

There is also a widely spread misunderstanding about the impact of freer and larger amount of imports into China on the welfare of the Chinese people and the competitiveness of the Chinese economy after its WTO entry. Many believe that the opening of China's market would lead to the bankruptcy of many state-owned enterprises and lay-off of many workers. This is indeed true, but only for a limit number of inefficient and non-reforming enterprises, which have already been bankrupt before the opening of China's market. Like the old Chinese saying, "dead pigs do not fear

boiling water," the opening of China's market will have little effect on the loss-making enterprises. The real impact on China's market opening will be felt by the best performing enterprises and the one-billion Chinese consumers. China's best enterprises have to compete with the best in the world after the market opening, but they can also enhance their competitiveness through improved access to imported technology, materials, human resources, services as well as outside markets. China's consumers will benefit from the market opening through access to cheaper products, and, more importantly, better services of high quality and variety.

To turn challenges into opportunities, China needs to focus on the competition for the best institutions that are able to create and maintain the competitiveness of the Chinese economy in an open and global economic environment governed by the WTO or WTO principles. The next section discusses some specific policy options for the Chinese government after entry in the WTO in the agriculture, industry and service sectors.

## **Policy Options in an Open and Global Economy**

### **Agriculture**

China's agricultural development has been handicapped by its centrally controlled farm-product circulation system. The circulation of farm products, especially grain, is subject to a state monopoly whereby major agricultural commodities are purchased and distributed by highly centralized state-owned grain-purchasing firms. The government has to subsidize substantially those grain-purchasing firms so as to purchase all the grain from the peasants at the government-fixed prices, which has turned out to be a serious fiscal burden.

After China becomes a WTO member, all non-tariff barriers protecting its agricultural products will go away, and the tariff rate will also be lowered. For decades, access of agricultural products to the Chinese market has been controlled by non-tariff measures. For instance, quotas and import licensing have restricted the import of grain, cotton, edible oil and sugar. Obviously, the lifting of these barriers will make the agricultural market much more exposed to foreign agricultural products. According to the evaluation of the Development Research Center of the State Council, at present local market price for land-intensive commodities, such as wheat, corn and rice, are 20% to 70% higher than international prices while labour-intensive commodities, such as vegetables, fruit and meat products,

have a competitive edge in the international marketplace.<sup>3</sup> So, Chinese government should encourage the structural change in agriculture from land-intensive to labour-intensive products, so as to keep China's comparative advantage and prevent Chinese peasants from being driven out of the market after joining the WTO.

As for China's rigid and inefficient grain circulation system, the solution is to integrate the country into the international grain market. One key issue during industrialization is how to transform Chinese peasants into workers. The precondition of the transformation is to guarantee a sufficient grain supply and maintain a stable price level. Facing a rather low Engel's index, the Chinese people have generally kept food as a very important portion (around 50%) of their total consumption. Therefore, a stable grain supply and low price mean low costs for industrialization.

Like the rest of the world, the country has to face an intrinsic problem in grain production and circulation: while the production and technological issues could be solved quite easily, the fluctuations in grain price and supply will continue due to the asymmetric nature of grain supply and demand elasticity.

The supply elasticity of grain is very high, implying that a small rise in price can lead to a large increase in output supply. This is partly due to the fact that Chinese agriculture has been organized as a household-based small-scale operation. Millions of peasant households make production decisions independently without much direct coordination. Unlike farmers in other parts of the world, the Chinese peasants do not have a functioning grain futures market to guide their production decisions. On the other hand, the stable Chinese diet habits and consumption structure have made the demand elasticity of grain very low and stable, implying that a rise in price would not lead to a sharp drop in consumption. When the grain supply and demand curves are combined together, we get a typical "diverging cobweb model" in standard microeconomic analysis. The model tells us that price and quantity adjustment would not lead to equilibrium. Instead, both price and quantity would fluctuate wildly. The past experience of China's grain circulation system has already manifested such a diverging circulation. When the government set the price too low, we had a shortage in grain supply and inflation, as in the period around 1988–1989 and 1992–1994. When the government set the price too high, we got a grain surplus and deflation as in the last few years.

For the sake of macroeconomic stability, the central government has to keep the supply and price of grain as stable as possible. The current

practice of the government is very much like a government-led grain "futures market," i.e. a circulation system run by government instead of a true market. In a market economy, the futures market functions in much the same way the stock market does to allocate and absorb risks and losses. However, losses cannot be really absorbed in a government-led futures market since all the losses in fact belong to the state. Unlike the individuals (natural persons), government cannot itself shrink consumption and investment or extricate itself from the futures trading. Without a true futures market predicting and adjusting the grain prices, the government cannot possibly set a system of grain prices that would clear the market. Instead, the government is forced to create an artificial set of stable grain procurement prices by fiscal subsidies.

In summary, it is almost impossible for the government to solve the grain circulation problem within the context of a closed and centrally controlled large agricultural economy. However, once we put China's agricultural sector in the context of an open, global and market-oriented economic system, it would have more and better options. It could then use the international futures market to maintain a stable grain supply and price. In almost every country, the supply elasticity of grain is higher than the demand elasticity. It is the futures market that allows people to predict, coordinate and determine the reasonable price of farm produces. The international grain futures markets are much more efficient and dependable than its counterpart in China because of less government intervention and better institutions and regulations. China should allow itself to be incorporated into the international grain supply and distribution system, especially by opening up the importation of the land-intensive grains on which China has no comparative advantage. China should also start to liberalize the grain circulation system to enhance efficiency, once it can use the international grain supply and distribution system as an alternative to stabilize the grain price and supply.

### **Industrial Sector**

Over the past two decades, China has become highly competitive in labour-intensive manufacturing. Around one-third of all suitcases and handbags, a quarter of the toys and one-eighth of the footwear and clothing sold in the world are made in China. One of the chief beneficiaries of the entry in the WTO is the labour-intensive sectors, such as the textile and clothing industry. As the largest developing exporter of textile products in the world, the

textile and clothing industry is highly dependent on exports. Upon WTO entry, China will face less quota restrictions on its textile and clothing exports and can thus expand its market substantially. It is forecast that exports will increase from the present level of US\$45 billion to US\$60 billion within five year, though competition will remain fierce.<sup>4</sup>

Other industries, such as electronics, telecommunication equipment, home electrical appliance and pharmaceuticals, will also benefit from access to the WTO because market access will facilitate the import of advanced technology and equipment. The import tariff reduction on equipment and technology will help upgrade Chinese basic manufacturing capability and enhance the competitiveness of industry.

However, some less competitive industries are expected to encounter considerable pressure after China opens its market. For example, the automobile sector is one of the most vulnerable industries to WTO accession. Some experts predict that this industry will be the hardest hit. Fortunately, some auto companies have done quite well in international cooperation with big companies, such as General Motors of the US and Volkswagen of Germany. They have long prepared themselves for the accession and will not be caught off-guard. Meanwhile, the elimination of backward small-scale auto enterprises will be conducive to the healthy structural adjustment of the industry.

In the long run, the competitiveness of industrial enterprises depends on the progress of state-owned enterprises' reform. In general, the government has followed a necessary policy of "taking hold of the big and letting go the small" for the reform of the SOEs. However, this is not enough. Big is not the equivalent of efficiency, while small may be beautiful. Similarly, there is no strong rationale behind the government's heavy investment in the high-technology industries. Today's star-enterprises may fall from the top just overnight. Many high-tech products have a life cycle of only a few months and can be outdated very quickly in an open global economy. Hence, the government should not worry too much about where the investment goes. Instead, it should focus on building a sound institutional infrastructure to facilitate private investment. To achieve this objective, the government should speed up its privatization of state-owned enterprises.

However, the privatization of SOEs does not mean that the government cannot own a significant amount of state-owned assets. There is a sharp difference between a sole ownership of an enterprise and an ownership of 10% share of the same enterprise. As a sole owner, especially when the sole

owner is at the same time the government, one has to assume all the liability (unlimited liability) of the enterprise and may not secure all the profits of the enterprise. As it happens frequently in Chinese SOEs, managers and workers often take the profits into their pockets and leave the liability to the state banks. In order to break up such incentive mismatch, the government's share in any enterprise should not exceed 30% if the government would like to own any asset. Such arrangement should be able to limit the risk to state-owned assets by allowing the private investors with majority shares to choose and monitor the management. The policies enacted by the Central Committee of the Chinese Communist Party in September 1999 were actually consistent with this state as minority shareholder proposal, although the term "various forms of public ownership" was used instead of "privatization." However, the vested interest of the managers and government officials may block the implementation of this kind of reform. Hence, it is necessary to introduce some legislative measure to force the risk diversification of state-owned assets. For instance, the National People's Congress can enact relevant laws to stipulate that the government's share in any one enterprise cannot exceed 30% so as to control the government's risk exposure to investment in industry. This would send a clear signal to the outside world and the private investors so that they have more confidence in their future participation in the SOE reforms.

As to the entry-withdrawal mechanism as regards state-owned assets, the Hong Kong government has provided a very vivid example. When the Hang Seng stockmarket index slumped to 6,000 in 1998, the Hong Kong government decided to enter the stock market. At the end, it became a special shareholder of all the 38 blue-chip companies on Hong Kong's stock market, holding nearly a 10% share of each company. The stock index went back up to about 16,000 in 1999. The Hong Kong government gained considerable profits and started to sell gradually its assets back to private investors in early 2000. In this way, the Hong Kong government safeguarded against the systematic risks of the stock market during the Asian financial crisis and obtained as a by-product a handsome capital gain. Such prompt action is relatively easy to launch because of the low transaction costs in Hong Kong's financial market. Many people regarded the Hong Kong government's intervention in the stock market as retrogressive since it deviated from the non-intervention free market tradition. However, in the case of China, were the central government to reduce its share in each of its SOEs from 100% to 30%, that ownership reform

would definitely be regarded as a great leap forward towards a market economy.

The most difficult challenge in the withdrawal of the state from industry is how to deal with the laid-off workers from bankrupt SOEs. These workers usually have served for the state for 20, even 30 years, so the government has the responsibility of safeguarding their basic living standard. Some have argued that the overall benefits owed to so many workers are an unbearable burden to the government at various levels. It is estimated to be higher than 20%, even 40%, of China's GDP. But, most of the laid-off workers may still look for a new job and work for another ten or 20 years. If the total costs for laid-off workers are spread over a 20- to 30-year period, the short-term burden of the central government is no longer unbearable. After the workers' basic living standard is secured and the liabilities of the SOEs are frozen, it would be much easier then for government to sell its SOEs. The state needs to complete these basic reform measures within the next five years to meet the challenge of a fully open economy under its WTO commitment.

### **Service Sector**

China's service sector is relatively underdeveloped. In 1998, it accounted for only 33% of the country's GDP, a low proportion even by developing country standards.<sup>5</sup> Although China began to reform and open up its economy in the late 1970s, the service sector remained largely protected throughout the 1980s and foreign investment was limited. In 1992, the State Council decided to accelerate the development of the service sector by opening a small number of service industries to foreign investors, though mostly on a trial basis. In the past few years, around 30% of all contracted foreign investment in the country went into the service sector.<sup>6</sup> The fact that the bulk of this investment went into property development is an indication of numerous constraints, usually in the form of operational restrictions, on foreign participation in the sector. This is largely because of the trial nature of the reforms, whereby limits are set on the number of foreign companies to be allowed in each sector, on the geographic location of offices and on the type of business that can be carried out. The backwardness of China's service sector is a reflection of the high transaction costs. The service sector is mainly about exchanges or transactions. This is particularly true for financial services. China's WTO accession will eliminate most of the current restrictions on foreign investment in its service

sector within five years, which is going to have a great impact on the reduction of transaction costs. As foreign investment into services helps to reduce the overall transaction costs of doing business, China's industrial and agricultural sectors should benefit and the overall competitiveness of the Chinese economy be enhanced.

The transaction cost perspective is particularly useful in understanding the opening of the financial sector to foreign investment. The ultimate goal of reform and opening of the banking and securities industries is to reduce the transaction costs and systematic risks in China's financial market.<sup>7</sup>

The banking sector is currently dominated by large state-owned commercial banks. Although they have made some progress through market-oriented reform, most banks are still operating in the absence of outside competition. Chinese banks, particularly the big four state-owned commercial banks, have already established a good network of banking services throughout the country. In this sense, they have a leading edge in domestic deposit-taking service, while foreign banks have advantages in risk managing and returns on lending because of their hard-budget constraints. Therefore, in basic banking transactions, the opening of lending services to foreign banks is more useful to the Chinese economy than the opening of deposit-taking services. As we all know, the competition for savings among state-owned banks is fairly effective. However, state-owned banks usually cannot extend loans on market terms because of state ownership. If the foreign, private and other banks are free to extend loans on market criteria, they will help to improve the efficiency of investment significantly. At the same time, the state-owned banks can lend their deposits absorbed from millions of households and enterprises to foreign and private banks through the inter-bank market or other channels. Then, foreign and private banks would be able to channel loans to the projects with the best return and risk combination. Such low risk and partial financial opening arrangements should be implemented as soon as possible so as to ensure the stable transition of China's financial sector in the next five years.

The scale of the securities markets is far smaller than that of matured markets, such as New York, London and Tokyo. At the end of 1998, only 851 companies were listed at the Shanghai and Shenzhen stock exchanges, with a total issued capital of RMB 234 billion and a total market value of RMB 1,950 billion. The proportion of securitization in the national economy is also far smaller than that in developed countries and even in some developing countries. In 1998, the total market value of China's securities market only accounted for 24.4% of GDP, and the value of securities in

circulation was 7.26% of GDP. By comparison, the securitization rate was close to 100% in developed economies.<sup>8</sup> The most serious problem for China's securities market is that investors can hardly find a really good listed company to make long-term investments. Although improvement in supervision and regulation is essential, it is even more important that really good companies are listed on the market. One way to make this happen is to let foreign-funded enterprises in China to be listed locally. Some may argue that the country should not let its own money flow to the foreign companies when it is short of capital. Such arguments, though quite popular, come from pure myopia. When a significant amount of well-run multinational enterprises and other high-quality companies are listed in China, the reputation of its stock market will undoubtedly improve, attracting not only domestic, but also foreign investors from all over the world. From a globalization perspective, the nationality of business in terms of ownership is no longer as important as in a closed economy. As long as the enterprises can provide employment and contribute to economic growth and development, why should anyone care about their ownership?

The entry in the WTO will also have a significant impact on the telecommunications industry. China only introduced competition into its telecom sector in 1994. Its existing administrative and operational mechanisms still fall short of the requirements of a full market economy. After becoming a WTO member, China must comply with the WTO's Basic Telecommunications Agreement and open its door to foreign competitors, which will bring a competitive environment to the local telecom industry and benefit Chinese consumers and producers. The transformation of the industry has profound implications for the reduction of transaction costs of doing business in China. The internet and the mobile phone have the power to eliminate the barriers of time, location, border, institutions and, even, language. With proper regulation and risk management, the cost of business transaction could be reduced dramatically using today's telecommunication technology.

### **Concluding Remarks**

At the time of writing this chapter, US Congress has already passed a bill to grant China PNTR status, and China has also signed an agreement with the European Union on its WTO accession terms, making a slightly stronger commitment than in the Sino-American agreement. It is now almost certain

that China will enter the WTO late in 2000. As a result, foreign investment and trade are expected to boom in the next few years. A more open market will import more foreign technology, materials, services and know-how. These imports, combined with China's rich human resources, both skilled and unskilled, will turn the country into one of the most important manufacturing bases in the world, at least for the first half of this century. This is good news for millions of unemployed peasants and laid-off workers. They can now have a dream of a better life in the future and for their children. The study by the Development Research Center of the State Council suggests that GDP in 2005 would be 1.53% higher in real terms than it would otherwise be if China did not join the WTO. According to the US International Trade Commission, taking into account growth from market liberalization and increased efficiency, China's GDP can be 4.1% bigger when tariff reduction is fully implemented.<sup>9</sup> To turn the Chinese people's dream into reality, the government, together with its people, has to face the challenge of competition for the best institutions in an open and global economy.<sup>10</sup> Searching for better institutions is the key to reducing transaction costs and enhancing the competitiveness of the Chinese economy. The principles of the WTO provide China with direction, contents, procedures, disciplines and commitment for the search for the institutions.

## Notes

1. Sources: Hong Kong Trade Development Council, *China's WTO Accession Special Issue*, December 1999, and the full text of the US-China Market Access Agreement is available at the US-China Business Council website: <http://www.uschina.org/>
2. Please refer to G. Xiao, *Property Rights and Economic Reform in China* (Beijing: China Social Science Press, 1997) (in Chinese). Also, see G. Xiao, "Reforming the Governance Structure of China's State-owned Enterprises," *Public Administration and Development* (London), Vol. 18, No. 3 (1998), pp. 273–80.
3. Please see *The Research Report on China's Entry into WTO: The Analysis of China's Industries* (Social Science Documentation Publishing House, 2000), pp. 89–145.
4. *Ibid.*, pp. 150–213.
5. According to the World Bank, the average share of services in GDP for low-income countries was 43% in 1997.
6. See *Services Liberalisation in China*, 1999, Hong Kong Trade Development Council.

7. See G. Xiao, "Options of China's Current Financial Reform," *International Financial Review* (Beijing), Nos. 5-6 (1998), pp. 43-47; G. Xiao, "Financial Reform in China: Evolution, Theory, and Policy," in *International Financial Market in North-East Asia: Assessment and Prospect*, edited by Nam and Pyo (Seoul: Kore Development Institute and Seoul National University, 1994), pp. 129-56. The Chinese version published in *Chinese Social Sciences Quarterly* (Hong Kong), No. 12 (Autumn 1995), pp. 52-65.
8. See *China's WTO Accession Special Issue*, December 1999, Hong Kong Trade Development Council.
9. Ibid.
10. See G. Xiao, "The Real Challenge Is the Competition of Institutions," *Twenty-First Century*, June 2000 (in Chinese).