China's Position in APEC

By Hirata Akira and Yamamoto Hiromi

Trade as engine of growth

Despite the large size of its domestic market, trade is now the main engine of growth for China. Trade plays several roles, with their importance going beyond the relatively low trade ratio (trade/GDP) which is common to large economies.

First, it provides the foreign exchange necessary for imports, machinery and equipment, raw and processed materials, and above all, technology. Second, trade opportunities stimulate and facilitate ongoing economic reforms and deregulation. In addition, expanded exports provide job opportunities for un- and under-employed workers, smoothing the process of social transformation. Lastly, increased exposure to the world market helps improve production and management efficiency.

China's trade expansion in recent decades has been very impressive. The World Bank estimates China's real annual export growth between 1980 and 1992 at 11.9%. The performance compares very favorably with the world average of 4.9%, and ranks with such high performers as Thailand (14.7%), South Korea (11.9%), Malaysia (11.3%), and Singapore (9.9%). Imports also grew rapidly at 9.2% during the same period.

The expansion pace appears to be maintained even after having attained much higher bases (Table 1). Total exports in 1994 stood at $US121 billion, a 32% increase over 1993 (current prices). It is noteworthy that 90% of China's exports are now manufactured goods. Imports also expanded rapidly to $US116 billion in 1994, a 13% increase over 1993. Considering China's large population and still low income (and wage) level, further expansion at a rapid pace looks feasible.

The strategic role that imports play is worth mentioning. China has high technology capabilities in some industries—especially in the military area—but it still lacks the wide range that comes with modern large-scale production technology. Such technology is embodied in machinery, equipment, and intermediate goods, most of which must be imported. Indeed, machinery and transport equipment occupied 45% of China's total imports in 1994. Thus imports, or the capacity to import to be more exact, critically regulates the pace of economic growth. In this context, China appears to be following the "export-led growth" path many developing countries have already taken.

China's future growth perspective, therefore, critically hinges on export expansion. To consider export perspectives, two broad-based questions, one on the supply side and the other on the demand side, should be explored.

Economic reforms and trade

The supply question revolves around domestic economic reforms. "Socialist Market Economy" may well be considered an endeavor to build an economic stimulus to enhance microeconomic efficiency into the whole system.

Economic reforms in China began in December 1978 at the Third Plenum of the 11th Central Committee of the Chinese Communist Party, when Deng Xiaoping assumed power. Agriculture led the general reform trend, with possibly the most significant consequences. The "household responsibility" system was introduced to the agricultural sector in 1978, and released individual farm households from collective management. By the end of 1984, the people's commune system had all but totally collapsed.

The "open door" policy also led economic reforms in China. The Joint Ventures Law was passed in 1979 to introduce foreign capital into the country, and four special-economic zones were established the following year. Fourteen coastal cities were opened to foreign investment in 1984. Shortly, additional cities and provinces followed suit, proving to be a major force in China's trade expansion.

In the industrial sector, the reforms have led to denationalizations. In 1979 greater autonomy in operating state-owned enterprises was instituted; in 1980 businesses were allowed to retain a percentage of the profits generated and production bonuses were implemented.

The new "tax for profit" (virtually corporate income tax) system started in 1982 on a trial basis and was fully implemented in 1985. There has been discussion regarding complete privatization of state-owned enterprises, although practical difficulties (potential large-scale unemployment among other things) appear too serious to surmount at present.

Economic reforms have "marketized" China's economy significantly, the best indicator being price reform. As of 1983, 87.5% (in terms of purchased value) of agricultural commodities were under market price, while 10.4% were under government procurement price and 2.1% under guidance price. The shares in 1978 were 5.6%, 92.6%, and 1.8% respectively. A similar trend can be observed in other types of commodities; for example, 81.1% of producer's goods were under market price in 1993, 13.8% under government procurement price, and 5.1% under guidance price.

In connection with trade expansion, reforms in foreign exchange control were necessary. In December 1980 the Provisional Regulations Governing Foreign Exchange Control was promulgated upon which a dual exchange rate system went into effect early the following year.

In 1988 a foreign exchange adjustment center was established, facilitating the buying of the yuan at market rate. The dual exchange rate system was finally abandoned when the yuan was officially devalued in January 1994.

Steady progress has been made towards the creation of a Socialist Market Economy, and China has been increasingly integrated into the world economy. Further efforts, however, are needed.

The Chinese Communist Party in November 1993 approved the "Decision on Certain Questions Regarding Establishment of a Socialist Market Economy System," which emphasizes: (1) establishment of a modern corporate system, (2) making and developing a market system, (3) improvement in the functions of government and firm control system of the macroeconomy, (4) rational distribution of personal incomes and establishment of a social safety net, (5) deepening of rural economic reforms, (6) reforms of foreign trade and economic relations, (7) reforms of education and science and technology, and (8) enactment of economic laws. The announcement demonstrates the willingness and commitment on the part of the Chinese government to continue with the economic reforms of the last 15 years; yet the acknowledged tasks look so fundamental as to show that the "Long March to Marketization" still has a long way to go.

Table 1: China's Trade by Commodity (1980-1994)

	1980	1985	1990	1993	1994
Exports ($US million)					
Total	18,119	27,350	62,091	91,763	121,038
Primary goods	9,114	13,828	15,886	16,675	19,707
Manufactured goods	9,005	13,552	46,265	75,088	101,331
Chemicals and related products	1,120	1,358	3,730	4,624	6,234
Light and textile industrial products, rubber products, minerals and iron products	3,999	4,493	12,576	16,396	23,218
Machinery and transport equipment	843	772	5,588	15,285	21,927
Miscellaneous products	2,836	3,486	12,686	38,783	49,938
Imports ($US million)					
Total	20,017	42,252	53,345	103,950	115,692
Primary goods	6,959	5,289	9,853	14,215	16,468
Manufactured goods	13,058	36,963	43,492	89,735	99,224
Chemicals and related products	2,909	4,469	6,648	9,708	12,130
Light and textile industrial products, rubber products, minerals and iron products	4,154	11,898	8,906	28,545	28,084
Machinery and transport equipment	5,119	16,239	16,845	44,987	51,564
Miscellaneous products	542	1,902	2,103	6,495	6,766

Source: *Statistical Yearbook of China*, 1994; *China's Customs Statistics*, December 1994

Access to the international market

The demand side question basically focuses on China's continued access to the international market. To be more specific, the most favored nation (MFN) treatment from major trade partners is the key issue. China is not (yet) a member of the newly created World Trade Organization (WTO, formerly GATT), and is susceptible to the real risk of being discriminated against.

The China-U.S. trade arrangement is an interesting case. The U.S. at present grants MFN status to China, but it is subject to yearly approval from Congress. Uncertainty, therefore, hangs over China's exports to the U.S., making long-term decisions difficult. If MFN status is cancelled, or discontinued, the prohibitive Smoot-Hawley tariffs will be placed on China's exports, resulting in serious damage.

To begin with, the U.S. is the largest export market for China, taking up 18.5% of the total in 1993 (Table 2; note that figures exclude re-exports from Hong Kong). In addition, the strength of China's exports lies in their low prices; high tariffs would seriously disadvantage Chinese producers against third country exporters. The possibility of China's growth process being thrown "back to square one" cannot be ruled out.

Standing outside the WTO, China also faces additional disadvantages in quantitative restrictions. The WTO rule bans the use of quantitative restrictions, but non-members are exempt. Also, such "gray" measures as voluntary export restraints are wide spread. Whether China actually faces greater obstacles than other exporters at these negotiations is unclear, but non-member status potentially places China in an unstable situation.

Participation in the WTO would be the best safeguard against market uncertainty. One bedrock of the WTO is mutual recognition of MFN status among signatories. Even then, a new member must go through country-by-country accession negotiations, so membership does not automatically assure non-discrimination, not at the beginning anyway. But membership still provides an important guarantee that at least future inequitable treatment is barred. It also serves as a basis to negotiate the rolling back of existing discriminatory trade practices.

Table 2: China's Trade by Partner ($US million)

	Exports				Imports			
	1980	1985	1990	1994	1980	1985	1990	1994
Japan	4,032	6,109	9,011	21,573	5,169	15,035	7,588	26,321
U.S.	983	2,352	5,179	21,461	3,830	5,090	6,588	13,970
Other APEC	5,944	10,974	32,516	45,166	3,183	8,712	22,716	35,443
EU	2,135	2,367	5,830	14,580	2,726	6,390	8,350	16,939
Total	18,119	27,364	62,091	121,038	20,017	42,252	53,345	115,693

Notes: "Other APEC" excludes Chile and Mexico. EU refers to the EU12. EU for 1980 covers France, West Germany, Italy and the U.K. only. The large drop in imports from Japan between 1985 and 1990 reflects the sharp rise of the yen and the resultant shift in import source of producers' goods from Japan to "Other APEC."
Source: *Statistical Yearbook of China*, various issues; *China's Customs Statistics*, December 1994

Indeed, China has already unilaterally reduced tariff rates on many commodities to conform with WTO principles, however, China's admission into the WTO requires meeting more basic prerequisites. Some are political, as demonstrated during human rights discussions in the U.S. Congress. Also the visit of Lee Teng-hui, the Taiwanese president, a short while ago to the U.S. has soured Sino-American relations and affected the bilateral trade talks with implications on the WTO issue.

On economic grounds, intellectual property rights, especially copyright, protection is another example of "irritation" on both sides. Indeed, China accepted the principle and has committed to respect international copyright arrangements. It was recently reported, however, that the very quick reopening of Chinese factories earlier closed down on the ground of "copyright piracy" angered the U.S. government. It appears that the issue will continue as a major source of trade friction.

Participation in the WTO, therefore, fundamentally boils down to China's "level of commercial behavior." The WTO system presumes free operation of market forces domestically as well as internationally. In spite of the economic reforms accumulated in the last 15 years, China's Socialist Market Economy still lacks elements of international economic methods. Almost 50% of production is still state owned, and many of these enterprises do not have the right to conduct trade on their own. Access to domestic distribution channels by foreign firms is also restricted.

It is small wonder, therefore, that some major traders are reluctant to accept China as a new WTO member until it allows more freedom of action to its counterparts. Their claims sometimes sound like "reciprocity" arguments, but it may well be an expression of a more basic suspicion as to whether China is a "respectable citizen" in the world economic community. The market access question, on this account, goes back to the issue of domestic economic reforms.

Future of foreign investment

Direct foreign investment is another important growth factor for China and shares some of the same problems as trade. That foreign investment significantly contributes to China's growth is self-evident. The accumulated amount of direct investment was estimated at around $US1,100 billion in 1993. An impressive expansion was registered in the former half of the 1990s in spite of a recession in major investing countries and the consequent decrease of total direct investment (Table 3). In 1993 the disbursed foreign direct investment inflow was as much as $US27.5 billion. (There is some suspicion that the direct investment figures are much overvalued; foreign investment received special privileges and many domestic investors have changed their investment status to that of foreign.) Most of the foreign investors are APEC members.

The continued expansion of direct investment into China reflects the changing industrial climate in Southeast Asia. Shortage of industrial sites and/or infrastructure is reported as one of the major factors in this shift of location. In some cases, wages rose sharply, providing an incentive to look for alternative production sites.

Direct foreign investment is also responsible for a sizable proportion of China's exports. Indeed, it spearheaded export growth in the early 1980s shortly after the opening up of the special economic zones. Today all coastal provinces are designated economic zones where foreign investment is promoted. The recent appreciation of the yen will spur Japanese factories to further invest overseas, and China will certainly be a major recipient.

In spite of this apparent success, the very strong link between foreign investment and export expansion is sometimes viewed with concern. China is seen to welcome direct foreign investments only as far as they promote exports. Entry into the expanding domestic market, however, unless justified by technology transfer, is very difficult.

The legal position of foreign capital has also long been a source of concern in spite of significant improvements. Too much appears to depend on government discretion, leaving foreign firms in uncertainty. This does not necessarily mean discrimination against foreign investors. The "national treatment" principle may be largely respected, for Chinese nationals also face similar uncertainties. The real issue, therefore, is the "level of commercial behavior."

China has so far enjoyed an advantage in attracting direct foreign investment, with low labor costs as the main strength. Without further improvements in its investment climate, the advantage may erode to even newer rivals, especially India and other developing countries in South Asia.

APEC promotes China's integration

While China awaits the green signal to be admitted to the WTO, efforts have been made to strengthen its position through alternative channels. Participation in APEC is one of the most significant, and successful, of those efforts.

Membership itself could work as a strong deterrent against possible trade disputes. Since members of APEC are China's major trading partners—covering 73% of its exports and 65% of imports, and most of the direct foreign investment inflow—the risk reduction is sizable. It may also indirectly help enhance China's position among third country markets, of which Europe is the most important, by improving its credibility.

APEC can also provide a mechanism for settlement of trade disputes, currently under discussion, though more limited than the WTO. With closer economic relations, China will inevitably face more and more trade conflicts. Formerly, bilateral negotiations were the only approach to trade disputes, where less attention tends to be paid to international rules. A settlement mechanism at hand, therefore, would be another significant advantage for China.

APEC, however, is not simply a substitute for the WTO. APEC's trade liberalization formula differs from the WTO's in an important aspect: "concerted unilateralism" recognizes wider room for discretion for individual member governments in trying to achieve freer trade in the region. More emphasis is placed on persuasion that liberalization will eventually benefit the liberalizing country, rather than negotiation. Members from developing countries reportedly welcome this "soft" approach to liberalization since it provides them with more time for absorbing the cost of domestic adjustment. This is especially welcome in China due to the enormous economic reforms still to be undertaken.

APEC has several WTO-plus aspects which can help pave the path for China's further integration into the world economy. As APEC is sometimes referred to as the "OECD in the Pacific," policy coordination may well increase its importance in future activities. Already 10 working groups have been established and are undertaking study of policy issues ranging from trade promotion to protection of marine resources. Such a forum for policy coordination is bound to become even more necessary as an outcome of closer regional transactions, and can fill the gap left from trade negotiations.

China may also benefit from the development cooperation side of APEC. This aspect has not so far attracted too much attention, but it has been a part of the APEC concept from the beginning. The "Partners for Progress" is an embodiment of such an initiative, and has the potential, if and when properly expanded, for lower income developing members such as China.

Table 3: Direct Foreign Investment in China (Disbursement)

($US million)

	1992	1993
Hong Kong, Macao	7,709	17,861
Taiwan	1,051	3,139
U.S.	511	2,063
Japan	710	1,324
Singapore	122	490
South Korea	119	374
Thailand	83	233
U.K.	38	221
France	45	141
Canada	58	137
Others	561	1,532
Total	11,008	27,514

Source: *Almanac of China's Foreign Economic Relations and Trade*, various issues

Japan and China in APEC

Having the U.S. and China in APEC poses important advantages for Japan, but for different reasons. The U.S. is Japan's most important trading partner, albeit frequent conflicts arise. Policy coordination is clearly necessary, and the U.S. is very often inclined to resort to bilateral and sometimes unilateral solutions. Because of its WTO-plus character, APEC can seek alternative solutions by expanding the rules for regional trade and other transactions.

China is a very different case. Diplomatically and politically China has long been considered a disruptive element for Japan. The start of China's open door policies and its subsequent integration into the regional and world economy has lowered the tension level, and is very welcome. The situation further improved as rapid development increased China's importance as a product market and investment destination. Clearly, from Japan's viewpoint China should be encouraged to more fully integrate into the world economy, and to enhance its "level of commercial behavior." The APEC forum is an important avenue toward realizing this goal.

The practical difficulty arises in trying to deal with the U.S. and China simultaneously. Japan's position "in the middle" potentially gives her intermediary capabilities. To approach the two extreme cases with the same regional set of rules and principles, however, is not an easy task, and doubly so as Japan itself often engages in trade disputes with the two countries. To be an honest middleman would be to Japan's advantage, but that calls for more import expansion through liberalization and deregulation inside Japan. Since there is only very limited room for liberalization in Japan's traditional trade policy mechanisms, new measures must focus on structural adjustment. It is more difficult, but after all it is what APEC and liberalization are all about.

Hirata Akira is a senior research fellow at the Institute of Developing Economics (IDE). Yamamoto Hiromi is a senior research fellow and professor of economics at IDEAS.