Journal of People to People trip to China, June-July 2001:

Meeting 1

On June 25 the delegation met with Professor Wu Jia-huang (Director of the WTO Negotiation Team) and Dr. Tong Zhiguang (Chair of the WTO Research Institute and former Minister of Foreign Trade in charge of GATT and Property Rights Negotiation).

After brief introductions, members of the delegation asked a series of questions about China's accession to the WTO. Professor Deardorff began by asking about the problems that have arisen as China has opened up. He also wondered what difficulties China would face in the future after it entered the WTO.

Professor Wu was adamant that China gains more than it loses by opening up. Nevertheless, China faces significant adjustment problems. Each year seven million workers lose their jobs in the state-owned sector and 10 million farmers leave rural areas for urban centers. Trade liberalization that comes with entry into the WTO will only increase the number of displaced workers. This problem "haunts" the Chinese government. Dr. Tong concurred that unemployment was the most difficult problem. He added that China needed to improve its safety net and social security systems so that they could better deal with the unemployment problem. Social stability is necessary for economic development. However, some unemployment is good, just like in the U.S.

One member of the delegation asked our hosts about their views on policies of market access, particularly in the area of agriculture.

Dr. Tong responded that there is enormous subsidization of agriculture in the United States, Japan and Europe. In contrast, China subsidizes agriculture very little. Nevertheless, agriculture is very important to the Chinese because it is such a large part of the economy. However, as a WTO issue, Dr. Tong seems to have suggested that this issue had been settled.

One delegation member asked what it was that China wanted from the developed world.

Dr. Tong responded that China sought foreign direct investment, personnel training and better terms of trade. He also asserted that the developed countries should help countries like China by not asking them to open up faster than they should. He also suggested that existing members of the WTO keep raising the price tag for China to enter.

Another delegation member remarked that the WTO has become a “dirty word” in many parts of the west and that many view globalization as a threat.

Dr. Tong responded that the current trend toward globalization is something that no country can turn its back on if it wishes to develop. The WTO has many shortcomings, but it also serves many important purposes. For example, every member must abide by principles such as equal treatment of all trading partners. The WTO is the economics version of the United Nations. It is not perfect. We need more rounds to negotiate new regulations—to make them more beneficial to the developing world. Professor Wu added that accession to the WTO is part of the continuous process of opening up for China. He suggested that China should reassess the situation five years after in joins the WTO.

Questions were raised about China's trade surplus. Was it part of a deliberate policy? What are China's plans for imports in the future?

Dr. Tong argued that we should not be concerned with short-run movements in the trade balance for several reasons. First, it is difficult to have an accurate idea of what the balance is given that the U.S. and Chinese governments report different numbers. Second, countries that run large and persistent trade deficits (i.e., the U.S.) have experienced excellent economic growth. Third, a large part of U.S. imports from China reflect sales of U.S. firms that are producing in China (e.g., Nike, which has its largest operation in China) and this contributes to U.S. income. Fourth, current bilateral trade imbalances will be reversed in the future because services trade is growing faster than that for manufactured goods and the U.S. has an advantage in services (i.e., U.S. law firms sell services to China, but China does not sell them to the U.S.). Given the growth of service trade, the U.S. trade deficit with China will fall. He concluded that we should worry more about expanding gross trade flows than trade balances.

Several delegates were interested in China's policy toward the exchange rate. Was there an Asian Euro in the future?

Dr. Tong argued that the policy of pegging the Yuan to the dollar has been a successful one. China suffered a loss of competitiveness during the Asian crisis because it did not devalue. But these losses were more than offset by the gains that accrued from the increase in regional stability that helped China's neighbors. Regarding an Asian Euro, it is too early to say. However, some type of regional arrangement is necessary. But regionalism can be destructive.

Finally, one member of the delegation asked about the China's capital flow restrictions.

Dr. Tong asserted that capital flows are very important to China. The free flow of capital, with some regulatory arrangement, is good for the world economy. Capital flows are desirable for entrepreneurs and firms, but not for stock market speculation.

Meeting 2:

A meeting was held with the University of International Business and Economics on the afternoon of June 25. Representing the university were Dr. Lin Guigun, Dean and Professor of Economics; Dr. Cui Fan, head of WTO research; Dr. Ming Men, Director of the Department of Finance; Dr. Xia Haiquan, head of the international exchange program; Assistant Professor He Ziyun, a financial economist; and three other faculty.

Dr. Lin opened the discussion with a welcome and an explanation of the history of the school. Dr. Deardorff also gave a welcome and opened the discussion by asking about possible adverse effects on China from its joining the WTO. Dr. Cui explained that the most serious impact will be deterioration of the terms of trade. Based on a Purdue University Global Trade Analysis Program analysis, he concludes that lowering tariffs and quotas in China will lower prices of Chinese exports relative to the prices of goods that China imports. Furthermore, decreasing import restrictions will increase competitive pressure on China's domestic enterprises. In most economies, this would be good because competition drives out weak firms. But in China's case, many firms are state-owned enterprises (SOEs) that the government will not allow to fail. The government will continue to subsidize some weaker SOEs. This, along with falling Chinese export prices due to increased domestic competition, will make China subject to antidumping claims in the WTO. China has an anti-fail law, but no antitrust law. Chinese firms will have less to invest in new technologies and R&D because foreign competition will decrease their profits.

Given these potential negative impacts on China, Dr. Cui was asked whether it was to China's benefit to be part of the WTO. He said the WTO is necessary for China to continue its market reforms. The WTO will provide outside pressure on China to increase opportunities for the private sector, for example. Outside pressure is the most effective means of effecting economic reforms in China because it is difficult for reformed-minded leaders alone to change policy. Also, the WTO provides a check on interest groups that oppose reforms and adds its voice to those voices in China that want more private business.

Regarding China's barriers to trade, Dr. Cui said the most problematic barrier is the value-added tax. The value-added tax disadvantages domestic producers because products assembled in China are subject to the tax, but final goods imported to China are not. Moreover, some capital goods imported by "foreign-invested enterprises" are given special lower tariffs, which hurts competing domestic producers. He added that in its WTO negotiations with the US, China insisted on being allowed to subsidize agriculture even though China does not currently have such subsidies. China believes that open trade in agricultural products will widen the income gap between China's agricultural and non-agricultural sectors and that subsidies may be necessary to lesson the gap. Dean Lin and Dr. Cui explained that subsidies can be difficult to implement without distorting incentives, so subsidies may be indirect.

Dean Lin said there are two challenges with China's accession to the WTO. The first challenge is the reallocation of resources that will occur with more open trade. The resulting dislocations of workers and enterprises will harm import-competing firms. This will create controversy and it is not known how the government will respond. The second challenge will be expected pressures on government. The government will need to decrease its control of markets under the WTO. It is unclear how the government will do this and how it could do it while decreasing corruption.

Both Drs. Lin and Cui addressed labor and human rights issues. They believe China's record is relatively good in these areas and, to the extent there are issues, these issues should be kept separate from trade talks. Dr. Cui expressed concern that labor standards will be used as an excuse for other nations to apply projectionist measures against China.

Dr. Cui explained that privatization is different in China than elsewhere. China first allows private business access to markets. Selling state assets comes later.

Dr. He explained financial sector reforms. China's nine small "shareholder" banks (created between 1992 and 1994) are losing customers to the four large state-owned banks because of a loss of customer confidence. This loss of confidence resulted from the 1997 Asian crisis and from government closures of banks during 1995-1997. There is no deposit insurance in China and customers have more confidence in the state-owned banks because customers believe that the government will not allow them to fail. International competition is needed, especially to provide capital to small and medium-sized business. Foreign investment in banking is not happening at this time, but the sector will be opened under the WTO agreement. Private ownership of banks will increase transparency with respect to the health of the financial sector. Today, no one knows the magnitude of non-performing loans threatening the state-owned banks.

Competition in banking is difficult because the state-owned banks have special obligations. Dr. He said that banking will be the last sector to be reformed. Nonetheless, he believes the China banking system will not be victim of an Asian-like financial crisis because: 1) China's state-owned banks enjoy high consumer confidence; 2) banks are generally not allowed to make risky investments; and 3) lending officers must personally guarantee the loans they make. There are too few loans being made because of this third item, so it is being eliminated. In conclusion, Dr. He said he believes that China's accession to the WTO will be extremely valuable in opening up China's banking sector.

Meeting 3

Delegation Meeting 27 June 2001 9am-noon at CITS

The delegation met with:

- Professor of Economics Wang Yuesheng from the School of Economics, Peking University. Professor Wang is Deputy Director of the Institute of International Economics, and Vice Dean of the Department of International Economics and Trade, at Peking University. Teaches comparative economic systems and international business.
- Director Zou Choon Zhu, of the Enterprises Research Center Training (ERCTD) Department and China WTO Training Courses representative at Peking University.
- Madam Zhou Xiao-Hong, Training Director, at the State Economic and Trade Commission Training Center (SETCTC). (Prime Minister Zhu Rongji was previously SETC Head).
- Miss Sun Xin, Manager of Education, Service Center for International Exchange, Beijing Normal University.
- Miss Chao, Enterprises Research Center Training Department Peking University.
- Mr. Zi Ce Lee, Director and Chief Representative Asia Office, Technology and Trade, Inc.
- Miss Sun Jiang-Young, China Market Economic News.
- Miss Wu, Shandong Province, agent for trade in medical equipment and telemedicine.

<u>Perceptions of the public and yourselves regarding globalization and joining WTO?</u>

The ERCTD is producing a TV program called "China and the WTO" to educate people about the WTO and how to deal with it. Most people think of WTO as part of an historical trend, though some are still resistant. Officials are somewhat more welcoming than the working people (who don't fully understand it.). China has had limited contact with the world for the last 1000 years, and needs to develop common understanding with the rest of the world. With a GDP 7th largest in the world, Chinese think they should be in it. WTO is a benefit to China, but WTO will force state-owned enterprises to improve. A lot of industries will hurt – but there will be long-term benefit. China generally welcomes the idea that everyone should play by the same principles. WTO can help China move from a planned to a market economy. Tariffs on its exports will be reduced. With its cheaper labor China will be competitive. The SETCTC is responsible for helping enterprises adjust to WTO, and it has a cooperative agreement with Beijing University to educate about WTO. We say to state enterprises "the wolf is coming".

<u>Which groups in China think "the wolf is coming" and expect negative consequences? Discussion on private and state non-agricultural enterprises</u>

In Chinese, the wolf has a different connotation than in the west. Not thought of as a solitary animal, but rather part of a hard working, knowledgeable team. So the implication is more one of intense competition from a group of competitors in terms of capital, technology and people. Entrepreneurs will find it easier to dance with the wolves than state enterprises. Telecommunications, power companies, national banks are more afraid. State enterprises, comprising 40% of non-agricultural GDP, are less ready to compete. They need to reconstruct and change as quickly as possible. Also, the private sector in China needs to be developed as quickly as possible, as it has more power to compete. Restructuring in this sense can include JVs with foreign partners as part of the process. Managers need to have shares in the enterprises so they have a profit incentive. Some "pre-retired" employees need to be bought out. Also needed – more modern management practices to make people more efficient. About 40% of non-agricultural labor is in state-owned enterprises. Private enterprises can pay as much as 200% more than state-owned – over time more people will move to work in the private area.

<u>Discussion on the future outlook</u>

Looking ahead 5, 10, 20 years. There will be more competition and cooperation with foreign companies. The standard of management will improve. There will be learning about the right way to improve products. There will be cooperation and learning about software. It will not be completely open. Some industries – government encourages investment, some – the government is neutral, some – foreign investment is not permitted. China will over the long run be competitive in some high-tech (like PCs), automobiles, electronics and engineering, textiles, agriculture. It will be less competitive in some other tech-tech, in raw materials, and telecommunications.

In some industries, foreign companies have already set up in China, and WTO will not make a big difference – for example in medical products, medical equipment, the integration of media products and medical equipment – the same technology is available to everyone – marketing skill and consumer perception matters more for success than tariff issues.

Close with thanks and gifts.

Meeting 4

Thursday, June 28, 2001

Chongqing Hi-Tech Industry Development Zone, Chongqing, China

Chinese personnel:
Ms. Chen Yong, Deputy Director of the Administrative Committee of the Chongqing Hi-Tech Industry Development Zone.

Ms. Chen opened her presentation by remarking that she had hosted a delegation of business people from San Francisco the day before our group arrrived.

People to People Delegation Leader Alan Deardorff introduced the delegation and said a few words about the composition of the group and the focus of our group on international economics and issues surrounding the accession of China to the World Trade Organization. He then invited Chen to tell the group about the Chongqing Hi-Tech Industrial Development Zone (hereafter referred to as the Zone), including its establishment, its key objectives, and its vision for the future.

Ms. Chen first presented a 10-minute video of the Zone. The Zone was established in 1991; today there are over 400 enterprises in the zone and there are investments by 24 countries in the Zone. The major industrial products produced in the Zone are automobile components, bio-chemicals and bioengineering products, and electronic information products. The Zone is situated in a city with over two dozen colleges and universities and numerous science and technology institutes. Ms. Chen claimed that the Zone has a "lean" administrative structure, thereby guaranteeing quick approvals of business proposals. Approximately 50,000 people are employed in the Zone; the average monthly income of workers in the Zone is 800 RMB, with some workers earning as much as 100,000 RMB per year. In addition to manufacturing firms, banks and venture capital firms were also located at the Zone..

Ms. Chen noted that the central government established the zone. The Government had launched a "Torch Project" in 1991 to develop the hi-tech sector and Chongqing was part of that development. The motivation behind the establishment of the Zone was a desire to develop a hi-technology base, open new fields of industrial activity, deepen China's open door policy, and train people with skills and knowledge.

In the last 10 years about 52 hi-tech development zones have been established in China, but Ms. Chen claimed that Chongqing was "special". Chongqing's Zone was trying to develop enterprises with the capacity to generate their own innovations.

Deardorff asked what inducements were given to foreign firms to come to Chongqing?

Chen responded by saying that the central government sets policies for both domestic and foreign firms. One key provision of the inducements provided to foreign firms was the business income tax reduction for foreign firms – domestic firms pay 33% tax on their profits, foreign firms pay only 15%. In addition, newly established hi-tech firms in the Zone pay no income tax for 2 years. There are no restrictions on the repatriation of profits by foreign firms. Any components that are imported by firms in the Zone get preferential tariff treatment. There is also a five-year preferential tax policy in effect – there is no business income tax for the first 2 years and for the subsequent 3 years only one-half of the tax rates apply to all firms.

Products related to the hi-tech sector are mainly sold in the domestic market. There was $77 million worth of exports from the Zone in the past year out of about $2 billion worth of total sales from the Zone.

After WTO accession there will be no need to make a distinction between the zones since foreign and domestic firms will be treated at par.

Question asked of Ms Chen – any labor standards for firms in the Zone? She responded by saying that there were no "special" standards; national labor laws applied to firms in the Zone. Ms. Chen claimed that the Asian financial crisis of 1997 did not have much of an impact on Chongqing. There has also been no impact yet arising from the decline in values of hi-tech stocks in the US. Ms. Chen noted that there are no restrictions on mergers and acquisitions at the Zone. The Zone contains both "free-standing" firms and subsidiaries of domestic and foreign firms.

Ms. Chen claimed that while, on the whole, joining the WTO is controversial, the Zone will gain as a result of WTO membership. In her view, the IT industry, pharmaceutical processing, environment and energy-saving industries, and the automobile component industries would all gain after WTO accession. The Zone will also be able to provide regional firms opportunities to grow. After China joins the WTO, all firms will be on the same playing field.

Meeting 5: Meeting with Dr. Yuanhe Liao

2:00 PM Thursday, June 28, 2001

Eighth Floor Marriot Hotel Conference Room

Chongqing, China

(Recorded by Tom Fomby)

At 2:00 PM on June 28 the delegation meet with Dr. Yuanhe Liao in the eighth floor conference room of the Marriot Hotel, Chongqing. Dr. Lio holds the positions of Vice Director of the Development Research Centre of Chongqing Municipal Government, Vice President of the Chongqing Academy of Social Sciences, and Chief Editor of Reform journal.

By way of introduction Dr. Liao reviewed some basic economic facts about the City of Chongqing. The population of the city (broadly defined) is approximately 30.2 million contained in an area of 82,000 square kilometers. The current GDP of Chongqing is 6 Billion Yuan. There are three major industries in Chongqing: Agriculture (19% of GDP), Manufacturing & Construction (41% of GDP), and others including Commercial, Transportation, and Services (40% of GDP). Dr. Liao pointed out several economic advantages enjoyed by Chongqing: (1) Chongqing is at the transportations crossroad linking eastern and western China, (2) Chongqing accommodates all major modes of transportation: river, air, and road, and (3) Chongqing has abundant water resources (630 square kilometers of reservoir). Since the beginning of the ninth 7-year plan, more thant 30 top enterprises have set up operations in the Chongqing area. Major industries, include automobile, motorcycle, pharmaceutical, construction materials, and the fruit processing industry. Many products are exported from Chongqing including engineering, electronic, and silk products.

Dr. Liao then took questions from the delegation. One of the delegates asked him if he would tell the delegation the source of funds for the recent construction projects in Chongqing. Dr. Liao stated that funds for roads and bridges came from the local government while commercial buildings were funded several ways – some private, some government, and some joint ventures. With respect to residential construction, Dr. Liao commented that funds came from government, cooperatives, joint ventures, and private individuals and companies.

Meeting 6:

Journal entry, International Economics Delegation
People-to-People Ambassador Program
July 2, 2001 (AM meeting)
Shanghai, China

On the morning of July 2, 2001, the People-to-People Ambassador Program international economics delegation met with representatives of the Institute of World Economy, which is part of the Shanghai Academy of Social Sciences (SASS). Our Chinese hosts were:

Mr. Kang Xie (Senior Research Fellow in Economics)
Professor Jin Fang (Associate Research Professor)
Professor Tu Qiyu (Assistant Director and Associate Professor)

Mr. Tu told us that the SASS is not a university, but rather a think-tank for the Shanghai municipal government consisting of 15 institutes and many research centers.

International capital flows were an important focus of our meeting. Professor Jin explained that foreign direct investment (FDI) by multinational corporations (MNCs) is now a heated topic in China, as is the impact on China's foreign policy and trade of its expected World Trade Organization (WTO) entry. Although China has made great progress toward economic liberalization in the last 20 years, many state-owned enterprises (SOEs) remain, and China's accession to the WTO will require further decreases in SOEs and increases in private ownership. Professor Jin said that this will be difficult, because the government still regards SOEs as pillars of China's economy. In her view, the position of SOEs after China's entry into the WTO represents a key challenge.

Our hosts talked extensively about the conditions that MNCs now face in China. Although MNCs receive investment incentives from all levels of government, particularly in the "special economic zones," they still encounter impediments when trying to borrow money here. For example, our hosts said that MNCs doing business in China cannot obtain bank loans from Chinese banks, nor can they open an account in banks that are SOEs. They were not clear about whether these MNCs are allowed to obtain loans from banks in their mother country, in light of China's desire to place restrictions on MNCs' business activities. In general, the Chinese government seems to prefer that MNCs obtain inflows to their Chinese operations by exporting a lot. MNCs can, however, bring in money from their parent company. Although Mr. Kang indicated that MNCs face no extra tax if they repatriate their profits, he said that many firms reinvest their profits in China, and that the government encourages them to do so.

Regarding contracts signed between China's government and foreign MNCs doing business here, we were told that no formal dispute-resolution mechanisms exist.

A major theme was that Chinese capital markets still are not very open, with foreign banks now allowed to establish subsidiaries only in China's special economic zones. Interest rates are restricted for all banks, SOE and private. Only a few foreign banks are allowed to do business in RMB, due in part to the government's desire to maintain currency controls. The relative inefficiency of China's state-owned banks and the government's aversion to competition from private banks also play a role. Although WTO accession will require greater openness in China's capital markets, the government still fears reducing its control in this area, believing that existing capital and currency controls enabled China to avoid much harm from the 1997 Asian currency crisis.

In addition, while China has opened most manufacturing to MNCs, restrictions on MNCS' operations in China's service sector continue. Only during the past three years have such fields as law, accounting, and consulting started to open. While existing commitments require China to open the service sector totally in 2-5 years, opening this sector to MNCs will pose another big challenge for China. Professor Jin does not think that China now has a comparative advantage in service sector exports, although she believes that may change in 20 years.

Mr. Kang spoke extensively about Shanghai's economic prospects, predicting that Shanghai's exports and imports will continue to grow due to the city's excellent location as well as its planned development of a deep sea port within the next 5-10 years. His forecast is that Shanghai will become a world manufacturing center and that more and more service firms will come to Shanghai after China's WTO entry, causing Shanghai to become ever more competitive. When asked about concerns regarding increasingly concentrated investment in Shanghai relative to China's Western region, Mr. Kang said that the Shanghai investment is good for China, but that the central government is worried about MNCs causing concentration of industry (e.g., Kodak film) and causing SOEs to lose market share. Although the central government encourages MNCs/FDI in the West, firms must choose to do what they need to do to make money. Mr. Kang noted that Shanghai now has the advantage of designation as a "special economic zone," an advantage that will disappear when such zones are eliminated after China's entry into the WTO.

One of our delegates asked about economic rivalry between Shanghai and Hong Kong. Our hosts replied that the two cities are complements and can cooperate, that they are "brothers." The opening of China in the past ten years has increased opportunities in Shanghai relative to Hong Kong, but Hong Kong's return to the mainland has increased that city's opportunities in such areas as real estate, textiles, and light industrial products. To finance Shanghai's increasing need for infrastructure investments, the municipality now increasingly relies on efforts to raise money domestically (within China) by a variety of methods, including the sale of real estate.

Asked about China's foreign exchange rate policy, our hosts' comments diverged from statements made by other officials in prior meetings--a discrepancy that may reflect China's emerging shift from a fixed exchange rate system to something more akin to a managed float. We had been told previously that China had a fixed exchange rate combined with currency that is not convertible on world markets. Our hosts for this meeting, however, emphasized that China has an active foreign exchange market. Questioned further, they acknowledged that China's central bank does intervene to keep the foreign exchange rate within a narrow range. In response to a subsequent question about reforms leading to a surge of imports into China that would put pressure on the RMB, our hosts stated that, with freer capital flow, China's government should maintain reserves. They said that, although the Asian crisis made the Chinese central government proceed more slowly toward marketization of foreign exchange rates, WTO entry will cause the government to accelerate movement toward free convertibility of the Chinese currency.

Questions also arose regarding China's trade surplus with the U.S. Professor Jin noted that most of China's big exports (e.g., textiles, light industry) are complements to U.S. industries, not substitutes . Professor Tu noted that in a globalized economy, U.S.-Chinese joint ventures allow the U.S. partner to enjoy part of the profit from exports from China.

Toward the end of our meeting, our hosts stated that WTO entry poses both economic and political challenges for China. Existing non-tariff barrier to trade (NTBs) will be reduced under WTO rules, and they expect a surge of investment into China after WTO entry. Yet China remains an agricultural nation, with roughly 3/4 of the Chinese people still working as farmers. Overall, the professors with whom we spoke at the Shanghai Academy of Social Science saw great opportunities for China from opening its economy, but also great challenges in the short run.

Meeting 7