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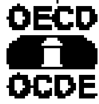

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RÉSUMÉ

En dépit du maintien par les autorités chinoises d'une pléthore de restrictions à l'accès au secteur tertiaire, la Chine a connu au cours des années 90 une explosion des importations de services, en particulier des services de communication, d'assurance et d'autres services liés aux affaires. Cette tendance soulève des doutes sérieux quant à l'efficacité des mesures actuellement en vigueur. Elle pose également des problèmes socio-économiques importants en ce qui concerne l'accès à ces marchés.

Ce document fait le point sur les réformes destinées à ouvrir l'économie chinoise depuis 1994, et notamment sur les principales mesures concernant le secteur des services, avant d'examiner les avantages et les inconvénients de la libéralisation de ce secteur. Selon les auteurs, pour créer un secteur tertiaire plus viable et plus dynamique, la Chine doit poursuivre la libéralisation, afin de tirer tous les avantages de la mondialisation. Les mesures protectionnistes imposées pour répondre à des préoccupations politiques de court terme font plus de mal que de bien. Pour sortir de ce problème d'« incohérence temporelle », il convient de prendre un engagement ferme sur le principe et la mise en œuvre d'une « libéralisation progressive », laquelle est explicitement admise dans le cadre du GATS. Contrairement à l'approche graduelle et expérimentale souvent annoncée mais auto-imposée, une approche sous contrôle multilatéral permet de garantir la réalité de l'accès au marché et de promouvoir la libéralisation d'une manière prévisible, tout en assurant aux producteurs nationaux la flexibilité nécessaire pour s'adapter à un nouvel environnement concurrentiel.

SUMMARY

During the 1990s, China has experienced a surge in imports of services, particularly those of communication, insurance and other business services, despite the fact that the authorities have maintained a plethora of restrictive measures limiting access to the service sector. Not only does this cast strong doubt over the effectiveness of these measures currently in place but also raises some important political-economy questions regarding the market access issues related to this sector.

Following a brief review of the country's efforts made since 1994 to sustain its open-economy reforms, the paper takes stock of major policy developments in the service sector and discusses the pros and cons of liberalisation of services.

The paper argues that a further liberalisation of services would be imperative for China to develop a more viable and dynamic service sector and stands to gain the full benefits of globalisation. The protective measures imposed for short-term, political considerations would do more harm than good. One way out of this “time inconsistency” problem is to make firm commitment to the principle and *modus operandi* of “progressive liberalisation” which is explicitly recognised under the GATS. Quite contrary to the often proclaimed but self-imposed “experimental, step-by-step approach”, this multilaterally-sanctioned approach serves to secure effective market access and promote liberalisation in a predictable manner, while at the same time guaranteeing flexibility needed for domestic producers to adjust to a new competitive environment.

PREFACE

The liberalisation of trade and investment in services, for example in such areas as telecommunications, finance, insurance and distribution, has come to the fore as a challenging policy issue for several large developing countries. Notable among these countries is China, which, in the context of its bid for WTO membership, is actively seeking reform of its service sector. Historically among one of the most heavily protected sectors, the opening up of the service sector is expected to yield substantial welfare gains but at the same time require large-scale domestic adjustment.

Despite the economic and political importance of this issue for China and its major trade and investment partners, there has been little research on this topic. This paper attempts to fill this gap by not only examining the current situation and the prospects for the opening up of the service sector in China but by also exploring the political and economic consequences of such reform. The authors argue that the restrictive policies currently in place in China are harmful to the healthy development of the service sector. They also underscore the role that the WTO, specifically the GATS Agreements, can play in "locking in" the liberalisation measures and in promoting market access.

Prepared under the Centre's 1998 Programme of Work on "Reform and Growth of Large Developing Countries", the paper makes a timely contribution to the need to better understand this issue of growing importance.

Ulrich Hiemenz
Director
OECD Development Centre
April 1999

I. INTRODUCTION

China's reform and opening-up process has made substantial progress. Prior to the 1978 reform, trade was simply a balancing item in the national plan, and the economy was virtually closed to foreign investment. Twenty years later China has joined the ranks of the world's leading trading nations and recipients of foreign direct investment (FDI)[1]. During this period the Chinese government has dismantled the state monopoly over trade, lowered tariffs, reduced non-tariff barriers and abolished direct export subsidies. At the same time, it has gradually opened up some segments of the service sector to foreign investors. While the degree of economic openness has been a topic of academic debate[2], there is little disagreement among analysts that foreign trade and investment play an increasingly important role in the country's efforts to sustain development (Table 1). Yet, China's past efforts and commitment to market reform have not rendered the country its long-awaited membership of the World Trade Organisation (WTO). While the reasons for this involve some highly political issues[3], one of the major stumbling blocks still lies in the domain of market access, particularly access to the country's lucrative service markets[4].

Table 1. **Opening Up of the Chinese Economy**

Year	Trade in Goods as % of GDP	Trade in Services as % of GDP	FDI Inflows as % of GFCF
1982	13.1	6.7	0.5
1983	12.8	6.9	0.7
1984	15.5	8.6	1.4
1985	21.2	13.8	1.8
1986	20.7	13.2	2.1
1987	22.5	12.9	2.3
1988	22.1	13.0	2.6
1989	21.1	12.2	2.9
1990	24.5	12.6	3.5
1991	27.3	14.3	3.9
1992	28.6	15.7	7.6
1993	27.1	16.3	12.2
1994	36.2	20.5	17.3
1995	33.5	18.2	14.7
1996	33.9	18.2	14.3
1997	34.8	17.5	14.3

1) Trade in goods: exports plus imports in goods on the f.o.b. basis.
2) Trade in services: credit plus debit in the service account.
3) FDI inflows: as defined in the balance of payments statistics.
4) GFCF: gross fixed capital formation in the national account.

Source: IMF, *IFS 1998 Yearbook.*

Chinese policy makers and academic researchers are well aware of the potential benefits — and costs — arising from market opening in the context of the country's accession to the WTO membership. A recent report prepared by a government think tank clearly states that China would enjoy substantial *net* gains in economic welfare by joining the WTO (Development Research Centre of the State Council, 1998). At the same time, the report also highlights the urgent need for establishing government policies aimed at facilitating structural adjustment and easing the burden of adjustment which would be unevenly distributed across sectors and regions. The results of policy simulation suggest that China's proposed offer for market access in agricultural and industrial products could result in as many as 9.6 million workers from the agricultural labour force being transferred to manufacturing and service sectors, with significant distributional implications (Zhai and Li, 1998). Developing a dynamic and more competitive service sector is a *sine qua non* for China to reap the maximum benefits from trade and investment liberalisation, while at the same time mitigating the ensuing adjustment difficulties. The manufacturing sector alone can not cope with a growing population moving out of agriculture. Even without any major shift in commercial policy, employment in the service sector is expected to reach 35 per cent of total work force by 2005, compared with 18 per cent in the manufacturing sector, (DRC, *Ibid.*).

It is well documented that the growth of the service sector is positively correlated with economic development[5]. For many industrial countries the service sector has become the most important provider of output and jobs; it accounts for as much as 70 per cent of gross domestic product (GDP) and around 60 per cent of total employment in high-income economies and regions. In addition, this sector has been the most important source of *new* employment during the post-war period[6]. As for developing countries, too, the adequate provision of services has been increasingly recognised as one of the preconditions for — rather than results — of development. For instance, inadequate infrastructure services, such as poor telecommunication and transport networks or a weak financial system, are perceived as a critical bottleneck for development. R&D, marketing and distribution, trade finance and after-sales support are complementary to the healthy growth of industrial activity. However, the Chinese government had failed, until recently, to recognise such important roles the service sector plays for its economy. This partly reflects the ideological bias of the past dominated in the thinking of central planners that services only provide the redistributing function and should be treated as "unproductive". As a result, the country's service sector remains underdeveloped and its structural weaknesses have become a major constraint for China's sustained development in the coming years.

On the external front, services have become a driving force of globalisation and world trade growth since the 1980s (Ghosh, 1997). In 1997, services accounted for roughly 19 per cent of world trade in goods and services combined, and for several industrial countries they contributed to more than 20 per cent of their total trade (Tables 2 and 3)[7]. Given the institutional changes that have occurred recently, the relative standing of services in world trade is likely to increase. As a result of the successful conclusion of the Uruguay Round trade negotiations in December 1993, trade in services has been brought under the framework of multilateral trade agreements for the first time. The *General Agreement on Trade in Services* (GATS) seeks to liberalise trade in all services, except those "supplied in the exercise of governmental authority", through all modes of delivery in cross-border supply, consumption abroad, commercial presence and the presence of natural persons.

It also provides the member countries with a rule-based multilateral framework on general obligations and disciplines (e.g. MFN treatment, transparency, and domestic regulation), specific commitments (market access, national treatment and additional commitments) and progressive liberalisation as well as institutional arrangements, such as dispute settlement and enforcement[8]. By December 1997, WTO member countries had successfully reached two sectoral agreements, one for financial services[9] and the other for basic telecommunication services[10]. The combination of rapid technological and institutional changes at both national and international levels has opened the door for a new era of international competition in finance, telecommunication and other service sectors.

Table 2. **Trade in Commercial Services by Major Economy: Exports**

1997 Ranking	Economy	Value (Billion dollars)		Percentage Share in World Total		Percentage Share in the Economy's Total Trade	
		1987	1997	1987	1997	1987	1997
1	United States	87.0	229.9	16.3	17.5	25.5	25.0
2	United Kingdom	42.0	85.5	7.9	6.5	24.2	23.3
3	France	49.1	80.3	9.2	6.1	24.9	21.7
4	Germany [a]	33.9	75.4	6.4	5.7	10.3	12.8
5	Italy	28.8	71.7	5.4	5.5	19.8	23.1
6	Japan	28.9	68.1	5.4	5.2	11.1	13.9
7	Netherlands	20.0	48.5	3.8	3.7	17.7	20.0
8	Spain	21.4	43.6	4.0	3.3	38.5	29.5
9	Hong Kong, China	11.7	37.3	2.2	2.8	19.4	16.5
10	Belgium-Luxembourg	16.5	34.0	3.1	2.6	16.5	16.8
11	Singapore	5.7	30.4	1.1	2.3	16.6	19.6
12	Canada	12.4	29.3	2.3	2.2	11.2	12.0
13	Austria	14.7	28.5	2.8	2.2	35.1	32.8
14	Switzerland	15.2	25.6	2.9	2.0	25.1	25.2
15	Korea	6.3	25.4	1.2	1.9	11.8	15.7
16	China	4.2	24.5	0.8	1.9	9.7	11.8
17	Turkey	3.8	19.2	0.7	1.5	27.2	42.2
18	Australia	5.9	18.2	1.1	1.4	18.1	22.5
19	Chinese Taipei	4.1	17.0	0.8	1.3	7.1	12.3
20	Sweden	8.7	17.6	1.6	1.3	16.4	17.5
	World Total	532.8	1311.5	100.0	100.0	17.5	19.4

a) 1987 figures refer to the former Federal Republic of Germany only.

Source: WTO, *Annual Report 1998*.

Table 3. **Trade in Commercial Services by Major Economy: Imports**

1997 Ranking	Economy	Value (Billion dollars) 1987	Value (Billion dollars) 1997	Percentage Share in World Total 1987	Percentage Share in World Total 1997	Percentage Share in the Economy's Total Trade 1987	Percentage Share in the Economy's Total Trade 1997
1	United States	73.9	150.1	13.8	11.6	14.8	14.3
2	Japan	49.3	122.1	9.2	9.4	24.6	26.5
3	Germany [a]	52.7	120.1	9.8	9.3	18.8	21.4
4	Italy	25.7	70.1	4.8	5.4	17.0	25.2
5	United Kingdom	30.9	68.6	5.8	5.3	16.7	18.2
6	France	38.7	62.1	7.2	4.8	19.6	18.8
7	Netherlands	21.5	43.8	4.0	3.4	19.1	19.8
8	Canada	16.9	35.9	3.2	2.8	15.5	15.2
9	Belgium-Luxembourg	16.1	32.1	3.0	2.5	16.2	17.1
10	China	2.3	30.1	0.4	2.3	5.1	17.4
11	Korea	4.4	29.0	0.8	2.2	9.6	16.7
12	Austria	9.6	27.4	1.8	2.1	22.6	29.7
13	Spain	7.7	24.3	1.4	1.9	13.5	16.5
14	Chinese Taipei	7.1	24.1	1.3	1.9	17.0	17.6
15	Hong Kong, China	6.5	22.7	1.2	1.8	11.4	9.6
16	Sweden	10.6	19.5	2.0	1.5	20.6	22.9
17	Singapore	5.7	19.4	1.1	1.5	15.0	12.8
18	Brazil	3.7	19.0	0.7	1.5	18.1	22.6
19	Russian, Fed.	n.a.	18.7	n.a.	1.4	n.a.	27.7
20	Australia	8.3	18.2	1.5	1.4	22.1	21.6
	World Total	536.5	1295.9	100.0	100.0	17.3	18.7

a) 1987 figures refer to the former Federal Republic of Germany only.
Source: WTO, *Annual Report 1998.*

As we will discuss below, the Chinese authorities have maintained a plethora of restrictive measures in the service sector. Despite that, the country has lately experienced a surge in imports of services, particularly those of communication, insurance and other business services. As Table 3 shows, service imports accounted for over 17 per cent of China's total imports (goods and services) in 1997, up from only 5 per cent in 1987. This certainly casts strong doubt over the effectiveness of those measures currently in place. At the same time, it raises the following questions:

— why is China so unwilling to liberalise the service market?

— are the current policies are consistent with the government's desire to develop dynamic and competitive service sectors?

— what is the role the GATS can play to this end?

It is the purpose of this paper to discuss these questions from the political-economy point of view. In the next section, we first review the country's efforts since 1994 to sustain its open-economy reforms. That year marks the beginning of the new policy initiatives on which the government has embarked with the aim of establishing a "socialist market economy". This is followed by a stocktaking of policy developments in the service sector. In Section III, we discuss in more detail the pros and cons of liberalisation of services. Finally, conclusions and policy implications are presented in Section IV.

II. OPENING UP THE SERVICE MARKETS

Table 4 highlights key aspects of reform measures undertaken before and after 1994 in the areas of trade policy, foreign exchange management, foreign investment policy and policies related to Special Economic Zones (SEZs). These areas are collectively called "open-economy" reforms (Fukasaku, Wall and Wu, 1994). By the early 1990s, the Chinese government had decentralised the trading rights, reduced the scope of trade planning, abolished direct export subsidies, lowered tariffs, devalued successively the official exchange rate, and established foreign exchange transaction markets. Foreigners were first allowed to invest in China in 1979, and foreign investment has since been encouraged by laws and polices. At the same time, five SEZs[11] were established along the Southeast coast of China where preferential policies were implemented to attract foreign investment and to expand exports. SEZs were intended to serve as "windows" of opportunity and "bridges" for co-operation between domestic and foreign investors, and to experiment with market practices before they could be recommended and implemented in the whole country.

In the Annex, we review and briefly discuss major policy developments after the landmark 3rd Plenary Session of 14th Congress of the Chinese Communist Party (CCP) held in November 1993. For the first time in history, the CCP dropped the word "plan" from the definition of China's economic system and called for the nation to build a "socialist market economy with Chinese characteristics". Such policy change symbolises China's determination to steer away from its previous patchwork of repairing the old plan system and to launch formally reforms aimed at establishing a market system. The 3rd Plenary also set the course for the country's next phase of open-economy reforms. However, the actual process of deregulation and liberalisation has been far more complicated than one could imagine. The service sector is a case in point.

It should be noted at the outset that foreign investment in China's service sectors has been highly regulated from the outset of its reform and opening-up. This situation began to change in 1992 when significant efforts were made in liberalising the service sectors. This corresponds with the resumption of China's GATT accession negotiations that had been suspended after the Tiananmen Square incident in June 1989. First, foreign insurance companies were allowed on an "experimental" basis to operate in Shanghai. In addition, retail joint ventures were opened in 11 cities and joint-venture travel agencies were permitted in the state-designated tourist areas. Railway construction was also opened to foreign investors.

A second important development in the light of government policy was the 1995 publication of the first *Guiding Catalogue of Industries for Foreign Investment.* However, most of services were still listed as restricted projects (Appendix Table 1). In spite of strong requests from the country's major trading partners to further open up its service markets, China's foreign investment policy was — and remains — rather closed or at best cautious even in the latest version of the *Guiding Catalogue* issued in December 1997[12]. In the rest of this section we briefly describe and discuss the main features of liberalisation of services.

Table 4. **A Summary of China's Opening-Economy Reforms**

Four Major Areas	Before 1994	After 1994
Foreign Trade Regime	• Decentralise the trading rights • Reduce the scope of trade planning • Abolish export subsidies • Lower industrial tariffs and non-tariff barriers	• Further decentralise the trading rights • Abolish mandatory export plans • Further reduce industrial tariffs and non-tariff barriers • Issue the first Foreign Trade Law
Foreign-Exchange Management	• Create the foreign-exchange retention system • Establish foreign-exchange adjustment centres • Devalue successively official exchange rates	• Unify official and market exchange rates • Achieve the current account convertibility
Foreign Investment Regime	• Welcome foreign investment • Introduce laws, rules and regulations • Establish fiscal and other incentives	• Improve legal environment • Open more sectors to foreign investors
Special Economic Zones	• "Windows and bridge" • "Economic laboratories" • A vehicle for export expansion	• Preferential policies to be gradually rationalised • The "Shenzhen Experiment" — granting foreign enterprises national treatment • Give priorities to capital and technology-intensive industries.

Source: Fukasaku, Wall and Wu (1994), Kleinberg (1990) and Yang (1996).

Financial Services

Liberalisation of financial services has been gradual in an attempt to keep in harmony with the speed and process of the country's overall economic reform. Banking was the first financial sector to allow the involvement of foreign investors, followed by insurance. The securities sector is still closed to foreigners. By April 1997, there were 510 foreign financial representative offices in China, among which 276 were banks, 151 insurance companies and 54 investment banks and securities companies[13]. Foreign financial institutions are currently allowed only in certain regions and areas of business.

Banking

Before the 1978 reform, banks in China functioned as the accounting and cash department of the Ministry of Finance. Since then, a progressive reform of banking and other financial institutions has been implemented in terms of decentralisation of management and the scope of banking operations. The current Chinese banking system consists of three "policy" banks, four solely state-owned commercial banks, other commercial banks (including foreign-owned banks and joint-venture banks), urban/rural credit co-operatives, and non-bank financial institutions[14]. At the same time, large state-owned and other commercial banks have begun to expand overseas operations since the 1980s. By the mid-1990s those banks, such as China Transportation Bank, Industrial and Commerce Bank of China, Agricultural Bank of China, People's Construction Bank, and the Bank of China, had opened about 500 branches outside mainland China, of which about 80 per cent were located in Hong Kong China, Macao, and Singapore.

The first representative office of a foreign bank was opened in China in 1979. Then, in 1982, foreign banks were allowed to operate in five SEZs, followed by Shanghai in 1990 and seven other cities in June 1992[15]. In 1995, an additional eleven inland cities were added to the list of places allowed to host foreign financial institutions, and the first international foreign-funded investment bank, China International Capital, was established in Beijing. By February 1997, forty-six foreign financial institutions had established branch offices in China.

Foreign financial institutions can invest and provide services in four ways: banks, branch offices, joint-venture banks, and joint-venture finance companies or wholly foreign-owned finance companies. They were restricted to only foreign exchange business[16] until April 1997 when eight foreign banks[17] were allowed to conduct *renminbi* businesses in Shanghai Pudong Area. Starting in May 1998, these eight banks were allowed to enter the inter-bank foreign exchange transaction market. In addition, Shenzhen has recently become the second city to allow foreign banks to conduct local-currency businesses. Foreign banks have also been allowed to take the lead in arranging syndicated loans denominated in *renminbi* for infrastructure projects[18].

In its most recent offer submitted to WTO (July 1998), China proposed to eliminate, upon accession, all geographical restrictions on the establishment of foreign banks and further to relax restrictions on local currency operations and insurance services.

Insurance

The state-owned People's Insurance Company of China (PICC) was established in 1949. However, ten years later the government decided to suspend domestic insurance businesses, which reflected the negative view of services as "non-productive". PICC was back in business only in 1980. Insurance services include foreign-related insurance, overseas operations, marine cargo insurance, inward reinsurance, reinsurance by overseas offices, and agency business[19]. Yet, the size of the external operations of insurance has remained stagnant due to the lack of efficiency in domestic insurance institutions.

China's Insurance Law was enacted in October 1995. The law promises to grant foreigners permission to open representative offices, and PICC (with 5 000 branches and 120 000 employees) will be split into one holding company (of consulting and investment firms) and three separate companies specialising in life, property, and accident insurance and reinsurance. PICC now has a market share of around 70 per cent, down from 90 per cent two years ago. By 1996, there were 29 insurance companies in operation besides PICC, yet 70 other domestic and foreign hopefuls are in a queue to obtain operating licenses.

The first foreign insurance company[20] was invited to Shanghai in September 1992, followed by Guangzhou in 1995. By the end of 1997, China had approved 10 foreign insurance companies in these two cities. They are allowed to conduct foreign-related insurance businesses, assets insurance for foreign companies and life insurance for foreign residents and Chinese citizens in China. The Chinese government has promised to allow foreigners to set up insurance businesses in all major cities in China's coastal regions by the year 2000.

The ongoing enterprise reform in China aims to relieve SOEs of their responsibilities for providing housing, pensions, and other social securities for their employees. The western system of social security and unemployment insurance will eventually replace state welfare. The Chinese now spend $2 per head each year on insurance, compared with $3 457 per head in Japan. With a population of more than 1.2 billion, China is an alluring market for international insurers. The value of insurance premiums doubled from 1991 to 1995 to $11.6 billion, and is expected to grow at a rate of between 20 to 30 per cent in the next several years[21].

Accountancy

According to China's *1994 Regulations on Foreign Financial Institutions*, foreign accountancy firms are allowed to set up branches within China. In practice, however, foreign accountancy firms are restricted to 50-50 joint ventures. Their business scope is limited to foreign exchange transactions and credit evaluations. The representative offices of the accounting companies in China are barred from performing auditing work.

Major foreign accountancy firms are now demanding operations that are free from geographical limitations and restrictions on equity participation or management control[22]. In return, they are offering intensive and broad training programmes for Chinese employees. The potential business opportunities offered by China's ongoing SOE reform are immense: the restructuring of 300 000 state-owned enterprises within the next three years, if this is to be materialised, would lead to an enormous demand for high-quality accounting and auditing skills.

Tourism[23]

In 1978, Deng Xiaoping called for the development of China's tourism industry. Since then, China's tourism industry has been expanding rapidly at an average annual rate of 20 per cent. In 1997, China's total tourism income was about $38 billion, of which $12 billion was from international tourism.

Such phenomenal growth of China's tourism industry is benefiting from the inflows of foreign investment. Among all services sectors, tourism offers foreign investors the highest level of market access. Foreign companies are now allowed to own and manage hotels and restaurants, build work-related residential apartments and houses, and invest in vacation resorts. Foreign-invested tourism companies can freely hire employees.

Since 1992, joint-venture travel agencies have been permitted in the state-designated tourist areas. However, the first joint-venture travel agency was not approved until six years later (May 1998) in Yunan province. The policy to allow joint-venture travel companies in all major cities is expected to be put into practice soon.

According to the government plan, the tourism industry is expected to achieve an annual revenue equal to 5 per cent of GDP by year 2000. Foreign investment will be further encouraged in exploration and better utilisation of tourism resources. The government has also put an emphasis on an even geographical distribution of foreign investment in tourism by encouraging its westward extension.

Distribution

Foreigners are allowed to do business in retail trade, but excluded from wholesale trade. Geographically, coastal areas have been opened to foreign investment earlier than inland areas. Before 1992, foreign companies were prohibited even from conducting retail trade. Only in July 1992 were Beijing, Tianjin, Shanghai, Dalian, Qingdao, Guangzhou and five SEZs allowed to host (one to two) joint-venture investment or co-operation companies in retail business. In October 1995, two joint-venture chain retail stores were opened up for the first time in China. So far the Chinese government has formally approved 17 joint-venture department stores and two chain stores. However, the total number of "joint venture" or "joint co-operation" retail stores has already amounted to more than ten times that formally approved for the whole country. This is because they were approved by local governments, circumventing the national rule for the sake of local benefits.

Total sales of joint-venture retail stores in China still account for only 1 per cent of the national aggregate of retail trade. Even in Shanghai they are only about 10 per cent of total sales at the municipal level. China has expressed its willingness to eliminate restrictions on foreign investment in most areas of distribution within five years of accession to WTO membership, but restrictions will remain for important sectors such as cars, pharmaceuticals, liquor and cigarettes. Perhaps what is most important is to set up a transparent regulatory framework regarding the involvement of foreign investment in retail and wholesale trade, particularly, in terms of geographical and business regulations.

Transport

The railway sector in China was opened to foreign investment in 1992. Joint ventures in road transport have also been permitted. In the case of maritime transport foreign firms

are allowed to set up joint ventures for international shipping operations. In air transportation as well, joint-venture air maintenance companies are encouraged. Foreigners are allowed to invest in civil airport services up to 49 per cent of shares (except air traffic control). Joint ventures in air cargo are permitted as well[24].

Telecommunications Services

Telecommunications services in China are provided by two state-owned companies: China Telecom and Unicom. Foreign operators are still prohibited from providing telecommunications services[25] and holding equity stakes in telecommunications operating ventures. They are restricted to revenue-sharing agreements with Chinese operators in exchange for investment and technical assistance. Foreign operators, such as Bell South, Hong Kong Telecommunications, Singapore Telecommunications and Sprint, are serving as technical consultants, financial backers, and network integrators for both MPT (Ministry of Post and Telecommunications)[26] and non-MPT operators. Almost all major international equipment suppliers are involved in China's telecommunications market from system transmission equipment and terminals to components and materials. They also sell their own products, transfer technology and know-how and provide value-added services through cross-border supply.

China's Telecommunications Law, with its first draft proposed 10 years ago, has yet to be enacted. Although telecommunications services are considered as a strategic sector by the Chinese government, further deregulation and liberalisation in this sector will be inevitable for two reasons. First, international equipment suppliers and service companies are demanding a more liberal telecommunications policy through the negotiations of China's WTO accession. This strong political pressure cannot be dismissed easily.

Second, China Telecom's competitors such as Unicom, Ji Tong, and other domestic operators, major manufacturing and user ministries are also pushing forward further liberalisation. Local governments and firms are also eager to modernise their networks and introduce new services in order to attract investment and sustain local economic development. In July 1998, Unicom's local telephone lines in Tianjin were successfully connected to China Telecom's telephone network. As a result, the installation (or connection fee) of a telephone line was immediately reduced by 50 per cent from 2000 to 1000 RMB. Having noticed such an alluring benefit, telephone service users are also urging a more liberal regulatory regime. More importantly, strong market pressures arising from an expected high growth of user demand for telecommunications services will be instrumental in pressing ahead for further reform in this sector. China's Ninth Five-Year Plan (1996-2000) set its target at 64 million new telephone line subscribers (bringing the total to about 105 million), raising the mainline density per 100 inhabitants to 9.0 from 3.4 in 1995[27]. To achieve this ambitious goal, the Chinese government will be obliged to approve more service providers other than China Telecom and Unicom into the network of telephone services.

In its most recent offer at the WTO membership negotiations (July 1998), China promised to open up the paging services market upon accession and mobile telephony and value-added telecommunications services such as data transmission within five years of accession. Foreign telecommunications operators would be limited to a 30 per cent equity stake for value-added services and a 25 per cent stake for paging or mobile services, though these limits were negotiable.

III. POLITICAL ECONOMY OF LIBERALISATION OF SERVICES

A stocktaking of recent policy developments in the service sectors reviewed in the previous section shows that liberalisation of services, as in the case of goods, has been gradual, and progress uneven across sectors. It also highlights the fact that the government is currently applying a wide range of restrictive measures in terms of the extent and conditions of market access. These measures may be broadly classified into five types of instruments:

1) limitations on the sector in which foreign service suppliers are allowed to operate — e.g. no foreign firms are allowed to operate in telecommunication services;

2) limitations on the type of business allowed within each service sector — e.g. foreign accountancy firms are barred from conducting auditing services;

3) limitations on the legal form of market entry — e.g. joint ventures are generally a preferred form of market entry over wholly foreign-owned companies in many service sectors;

4) quantitative restrictions on market access in terms of, for instance, the number of service suppliers, the number of service operations, the maximum share of foreign equity participation; and

5) geographical restrictions — only selected "zones" and cities are open to foreign investment.

With the information available in the public domain, it is very difficult to gauge how restrictive these measures are in practice. A case in point is market access to the telecom sector. As noted above, foreign firms are forbidden from taking a direct equity stake in Chinese telecommunication ventures or from operating telecom services. However, they have found an ingenious way to circumvent the legal ban by setting up three-way management contracts between the operator (Chinese), joint ventures (Chinese) and investors (Foreign) — what is known as "CCF financing" — through which China's second telecom operator, China Unicom, has raised $1.4 billion or 72 per cent of its funding (Zita, 1998). Therefore, despite such an extensive list of protective measures, the country has experienced rapid expansion of imports in commercial services during the 1990s (see Table 3).

Table 5 indicates that among major service sectors, tourism has become the most important in terms of net foreign exchange earnings. Another major development is a strong rise in imports of communication, insurance and other business services. Such a pattern of service trade reflects not only differences in the level of economic development and relative resource endowment but also the prominent role the government has played in regulating access to the service markets. In a more liberal policy environment, China could realise its large potential in expanding international transactions in services on both export and import sides. At the same time, further market opening and greater foreign participation will promote overall industrial restructuring and allow a substantial change in the ownership structure of state-owned enterprises (SOEs). Given the scope and scale of its potential impact, liberalisation of services has become a major policy challenge for a reforming China.

Table 5. **Breakdown of Commercial Services in China**

	Value (Million dollars)				Percentage Shares			
	1988		1995		1988		1995	
	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
Commercial Services [a]	4686	3326	18430	24635	100	100	100	100
Transportation	2062	2276	3352	9526	44	68	18	39
Freight	1308	1387	2478	8727	28	42	13	35
Other Transportation	754	889	874	799	16	27	5	3
Travel	1797	633	8730	3688	38	19	47	15
Other services	827	417	6348	11421	18	13	34	46
Communications	24	11	756	217	1	0	4	1
Insurance	345	213	1852	4273	7	6	10	17
Other business services [b]	458	193	3740	6930	10	6	20	28

a) Commercial services are total services minus government services, n.i.e., as defined by WTO (1997 *a*).
b) Construction, financial, computer and information, and other business services.

Source: The authors' own calculation based on IMF, *Balance of Payments Statistics Yearbook* 1996 and 1997.

Domestic Resistance to Liberalisation

Why is China so unwilling to open up its domestic service markets to foreign competition? There seem to be three main arguments against liberalisation of services, namely, infant-industry protection, costs of adjustment and national security considerations, though the first two are intricately linked to the last one in a transition economy such as China's.

Infant-Industry Protection

The first argument is a variant of the traditional infant-industry protection, which is applied to services. By restricting foreign access to the domestic market for a certain period of time, the Chinese authorities want to nurture those domestic producers — national champions — that may have potential competitive edges before they face up to full competition from foreign suppliers. They also welcome foreign equity participation to the extent that this helps domestic producers to acquire capital, management skills and technologies needed for modernisation and industrial development. This is why in many sectors 50-50 joint ventures or minority share holdings are given clear preference as a form of foreign equity participation.

It is well-known in the trade literature that there are serious pitfalls in designing and implementing the policies for infant industry protection[28]. For example, the main rationale for infant industry protection is derived from the temporary use of protective measures behind which domestic "infant" firms are nurtured until they become strong and competitive "adults". There are, however, innumerable cases in which the targeted industries remain in a state of perpetual infancy in spite of protection granted to them. In addition, once protection is granted, it becomes more difficult politically to remove that protection later. In such cases, the measures applied for infant-industry protection outlive the original rationale and become a costly drag on the economy as a whole. This danger of self-propelling infant-industry protection should not be underestimated in the present Chinese context, given large investment needs for modernising the country's under-developed service sectors. The opportunity cost of such policy would be socially unbearable, as rapid technological advances and regulatory changes have been "revolutionising" many segments of services worldwide.

Furthermore, restrictions on market entry have an important distributional impact, benefiting domestic producers at the expense of consumers. If foreign producers are allowed in the domestic markets but this does not enhance competition, then foreign direct investment is likely to reduce national welfare due to the transfer of rents from domestic to foreign producers. This potentially harmful effect of foreign direct investment should be properly weighed against any benefits that foreign suppliers may bring in the host country. The question of who appropriates rents accruing from protection is of crucial importance for understanding the "snail" pace of liberalisation of services in China.

The Costs of Adjustment

Secondly, those in favour of shielding the service sectors from foreign competition often argue that liberalisation of services will exacerbate the country's unemployment problem. A substantial change in the ownership structure of SOEs which is caused by foreign capital participation may increase the number of laid-off workers. As the economy

is slowing down markedly in the aftermath of the 1997 Asian crises, Chinese leaders are concerned that the disgruntled unemployed in the SOE sector would undermine social stability, especially at the local level.

While the official rate of overall unemployment and urban unemployment in 1996 was 3.0 per cent and 5.5 per cent respectively, it is widely believed that the extent of "redundant workers" or "underemployment" in the SOE sector is substantial (Fan, Lunati and O'Connor, 1998). A recent study conducted by Wu (1998) estimated the extent of underemployment — defined as the difference between the actual employment and minimum labour input required for given output — to be in the order of 30 per cent of total workforce; in other words, about 15 million workers are excess in China's state industrial sector[29]. His study also suggests that the redundancy rate varies widely across industries and from one region to another, but the general picture is such that redundancy is worse for old firms in relatively capital-intensive industries located in the poor regions. A key message emerging from these studies is: shedding surplus labour from SOEs is an inevitable outcome of SOE restructuring irrespective of opening up the service market.

Under normal circumstances the costs of adjustment to trade liberalisation can be seen as a short-term, sector-specific problem and should be weighed against long-term economic gains that it brings to society at large. In the present Chinese context, however, the adjustment problem arising from liberalisation of services may have much bigger political and social ramifications, because liberalisation has direct bearing on the reform of the SOE sector. In this respect, the following point deserves special attention.

The necessity of reforming the SOE sector has been prompted by a significant deterioration in the country's government finances during the post-1978 period. Total government revenues fell from more than 34 per cent of GNP in 1978 to roughly 11 per cent in 1996. The bulk of this decline can be attributed to reduced fiscal contributions of SOEs. At the same time, the financial subsidies to loss-making SOEs, which constitute no less than 40 per cent of all industrial SOEs, have become a heavy fiscal burden for the government at both central and local levels. In addition, insolvent domestic banks will have to be recapitalised and restructured so as to function as "truly commercial banks" in a more competitive market environment. In other words, developing more viable and dynamic service sectors, particularly in the areas of financial, legal, accounting, telecommunication and other business services, is a key to the success of these reforms, and the orderly opening-up of the service markets to foreign competition ought to be seen as an essential part of the government's reform strategy (see below).

National Security Considerations

Thirdly, the national security argument is often used to justify protection of strategically important industries from unfair competition with foreign companies. As we observed in the previous section, this is reflected in the fact of the total ban of foreign capital participation in many "politically sensitive" segments of the service sector. As seen in other policy areas, the Chinese authorities have been taking a strategy called the "experimental, step-by-step approach" to market opening with the view of striking a political balance between national security considerations on the one hand and public needs for better and cheaper services on the other. However, a multitude of restrictive measures currently applied to the service sector run direct counter to the public interests. The government has made various policy "experiments" in some sectors and/or designated regions, which may have

been successful from the political point of view. In the eyes of foreign investors, however, the experimental approach implies that China might halt or even reverse its policies any time in future. The government's abrupt shift in telecommunication policy during 1998 without any clear statement about the possibility of allowing in foreign equity participation has left a sense of policy confusion with foreign firms.

A first point to be stressed in this context is that liberalisation and deregulation of services do not endanger national security. This does not mean, however, that privatisation and the *laissez-faire* policy can produce a socially desirable outcome. Privatisation can help to improve internal efficiency (cost-minimisation) stimulated by the profit-seeking behaviour of privatised firms, but the gains from privatisation in terms of allocative efficiency ("pricing according to marginal costs") depend crucially on the incentive structure and the degree of competition facing privatised firms. Competition policy may be required to prevent them from abusing their strong market power as incumbents. For most network services, such as telecommunications or energy supply, privatisation by itself is not sufficient to realise a competitive market. If a newly privatised company enjoys a monopoly position, privatisation will result in a mere transfer of market rents from public to private hands. In order to avoid the adverse effects of monopolisation, it is imperative to put an appropriate regulatory framework in place and subject it to international competition.

The experience of OECD countries during the 1990s indicates a major shift in regulatory policy towards deregulation with an increasing emphasis on competition in the service sector. There are a number of developments underlying this shift in policy (Hoj, Kato and Pilat, 1995):

— traditional regulatory instruments that tend to stifle competition by restricting market entry and fixing prices or quantities result in serious efficiency losses and disincentives to innovation;

— technological changes have brought down entry costs and created both a demand for and supply of new information services, thereby opening the way for re-assessing traditional policy instruments with respect to regulation of natural monopolies, such as telecommunication services; and

— globalisation and integration of goods and financial markets across countries on the one hand and a surge in foreign direct investment on the other have increased the degree of international competition in many service industries.

The Role of GATS

In this context, the *General Agreements on Trade in Services* (GATS) provides a useful instrument for Chinese policy makers to increase competition in an orderly manner by defining and legally binding future liberalisation schedules. In a nutshell, the GATS can play a critical role in two respects:

— the GATS can provide an identifiable (legally bound) measure of market access in the eyes of foreign investors; and

— the GATS can send a clear signal to domestic firms regarding how much foreign competition will be invited into the domestic market in the coming years.

The Chinese government may wish to commit itself to binding at the *status quo*, signalling that existing market conditions are guaranteed. Commitments of this nature are probably the most common ones that have been made by many developing countries in Asia with respect to financial services (Mattoo, 1998) and basic telecommunication services (Low and Mattoo, 1998).

In addition, it should be stressed that the GATS (Article XIX) explicitly recognises the idea of "progressive liberalisation" as a means of securing effective market access through successive rounds of negotiations of specific commitments[30]. It is also recognised that due respect should be paid to "national policy objectives and the level of development of individual Members, both overall and in individual sectors". Therefore, developing countries are granted "appropriate flexibility" in specifying terms, limitations and conditions on market access with respect to sectors where such commitments are undertaken (Article XIX:2). Therefore, bringing China under the GATS/WTO framework will help facilitate this process, as it enhances transparency and predictability in national policy making. At the same time, greater foreign participation will promote overall industrial restructuring by allowing a substantial change in the ownership structure of state-owned enterprises (SOEs).

IV. CONCLUDING REMARKS

Trade liberalisation allows a country to pursue its comparative advantage through specialisation and creates a positive net welfare impact[31]. This concept of comparative advantage can also apply to international trade in services, since a country can always benefit by specialising in those service activities which it provides more efficiently. While the Chinese authorities have opened up some segments of the service sector to foreign investors, access to several key markets, such as financial and telecommunications services, has been highly regulated or prohibited. Domestic resistance to liberalisation stems from three main factors, namely, infant-industry protection, costs of adjustment, and national security considerations. This paper examined the significance of these factors in the context of China's liberalisation of services.

We argue that while the pace of external liberalisation should be in harmony with that of domestic reform, a further liberalisation of services is imperative if China wishes to develop a more viable and dynamic service sector and seeks to gain the full benefits of globalisation. A plethora of protective measures currently in place for short-term, political considerations will do more harm than good. One way out of this "time inconsistency" problem is to make firm a commitment to the principle and *modus operandi* of "progressive liberalisation" which is explicitly recognised under the GATS. Quite contrary to the often proclaimed but self-imposed "experimental, step-by-step approach", this multilaterally-sanctioned approach serves to secure effective market access and to promote liberalisation in a predictable manner, while guaranteeing flexibility needed for domestic producers to adjust to a new competitive environment.

A wide gap between China and some WTO member countries over the issue of market access in services has become a major obstacle to the progress of current negotiations on the country's accession to WTO membership. The very nature of international transactions in services implies that government regulations on foreign investment have an important influence over the scope and degree of market access in services[32]. Given the government's highly restrictive attitude, liberalisation of services can be seen as a litmus test for sustainability of China's open-economy reforms in the coming decade.

Lardy (1998) points out that China has already enjoyed the major benefits of WTO membership, i.e. permanent most-favoured-nation (MFN) treatment, from every major country except the United States, even though it is not a member of the WTO. While this situation tends to reduce the relative benefits of joining the WTO in China's calculation, he argues that membership in the WTO would lock in the liberalisation measures that the country has already undertaken. In the area of services, this "binding" function is particularly important to prevent "backtracking" policy developments, since foreign participation often takes the form of long-term investment.

Finally, the complementary relationship between liberalisation of goods and liberalisation of services deserves more attention in the current discussion on China's open-economy reforms. By the mid-1990s, China had become the largest merchandise exporter from the non-OECD economies to the OECD market. Between 1990 and 1995, the country's share of total OECD imports in goods more than doubled from 1.8 to 3.7 per cent. Although its aggregate import share is still small in the overall OECD market, China

has become a (if not the) major exporter in a narrow range of unskilled/semi-skilled products (Annex Table 2). In the medium term, the country will have to diversify and upgrade its export profile towards more human capital- and technology- intensive products in order to sustain its open-door policy. To this end, the development of a more viable and dynamic service sector is of crucial importance. Shielding domestic service industries from international competition is not a policy prescription for stimulating growth and creating new productive jobs.

ANNEX. OPEN-ECONOMY REFORMS SINCE 1994

Trade Policy

China's trade policy reform since 1994 touches upon the following areas: restructuring the state-owned foreign trade companies (FTCs), lowering industrial tariffs, reducing non-tariff barriers, and opening up agricultural and service markets.

Restructuring State-Owned FTCs

China's state-owned FTCs have played a major role in stimulating and promoting foreign trade. Since the onset of trade policy reform in 1978, the number of FTCs has grown from a handful of 12 state monopolies to over 8 000 by the end of 1997[33]. Over the years, FTCs have been granted more financial and operational independence and been subject to less plan responsibilities. In 1994, they became no more responsible for fulfilling targeted foreign exchange earnings[34]. Since October 1997, the People's Bank of China has allowed all FTCs to retain part of their foreign exchange earnings as a means to encourage exports[35].

China's Foreign Trade Law was promulgated in July 1994 with the aim of enhancing transparency of the legal framework of foreign trade. In the same year the export quota bidding system[36] was introduced for a selected number of products that are subject to export quotas. The export rights are sold to winning FTCs based on competition, reversing the old system of free-of-charge distribution by administrative decree. This bidding system is expected to apply to most of export quotas in the future.

Since 1991, small FTCs have been encouraged by the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) to consolidate and form groups through amalgamations and mergers — the Chinese version of Korea's *chaebols,* that is, big alliances and company groups that combine production and trade activities. The emerging alliance between FTCs and manufacturers in these conglomerates is perceived by the government as a pre-condition for Chinese enterprises to compete in international markets[37]. There are now about 100 such foreign trade conglomerates in China which are often classified either by administration or by region, and they are supported by their corresponding founding administrations.

Restructuring FTCs is by no means an easy task, since all FTCs are still state-owned and they are not effectively independent from government control and protection. Many FTCs can make profits simply because of their "monopoly rights" granted by the government. Reforms are thus necessary to reduce government control in foreign trade activities by, first, converting them to share-holding companies and diversifying the ownership structure, and second, extending trading rights to all enterprises. The question of trading rights continues to be a key issue to China's trade policy reform.

Lowering Industrial Tariffs

WTO member governments have been requesting China to lower tariff rates for industrial products through its accession negotiations. In 1993, for example, the country's average tariff rate (unweighted) was about 36 per cent, one of the highest among the developing countries[38]. After a series of tariff reductions, it was lowered to 17 per cent as from October 1997.

China's tariff structure has also been criticised for being unbalanced across regions and products. First, SEZs are entitled to an average tariff rate lower than that in the rest of the nation. Border trade, processing trade with imported materials, and barter trade enjoy a lower tariff rate than other forms of trade. Second, tariff rates tend to escalate from basic foodstuffs and priority raw materials (under 15 per cent) to intermediate inputs and capital goods (20-40 per cent) and to finished consumer goods and products classified as non-essential (60 per cent and above). Such wide dispersion of tariff rates implies that the level of effective tariff protection for domestic industries producing finished goods, such as textiles and clothing and machinery and equipment, is particularly high[39].

In this regard it is important to note that although China's nominal tariff rate has been high, its tariff collection rate — a ratio of tariff revenues relative to total imports — has always been considerably lower due to duty exemptions and reductions. The collection rate was a mere 6 per cent in 1994[40], a level comparable to developed countries. This low rate of tariff collection is often referred to as evidence supporting the country's trade openness. However, this merely shows that tariff exemptions and rebates have been extensively used as important instruments in China's export push, since much of these measures are indeed granted to export-processing industries.

China has pledged to reduce its average level of tariffs to 15 per cent by 2000 and further to 10 per cent by 2005 for industrial products, but the government has yet to reduce the wide dispersion of tariff rates and cut some very high rates ("tariff peaks") such as those on imported cars, which will require reforming those SOEs protected by high tariffs. Moreover, the government has not been committed to binding its tariff schedules.

Reducing Non-tariff Measures

Besides tariffs, the Chinese authorities regulate imports through the use of quotas and licensing. Currently, 15 machinery and electrical appliances (such as automobiles and refrigerators) and 13 ordinary commodities are subject to import quota[41], and imports of 49 commodities come under the licensing system. At the beginning of 1996, around 40 per cent of import volume was under government control. The government plans to lower this figure to 20 per cent by the end of the century. Further reforms should see an introduction of transitional measures including non-quota licence management and competitive bidding for quota allocation.

In 1994, an import registration system was applied to machinery and electrical products. The government has promised to abolish the import inspection and approval system by the end of century.

Another reform area is to increase transparency in the country's import rules and regulations. The import control system is most dubious in all areas of foreign trade. Disputes often arise because of lack of co-ordination between various governmental agencies in charge of import control and between central and local governments. Even within provinces

and municipalities, regulations are not transparent. Enhancing transparency and reducing discrimination in the licensing system, particularly at the level of local authorities, continues to be an important area of concern.

Opening Up Agricultural Markets

Agriculture is one of China's priority sectors for attracting foreign investment. Foreign companies are allowed to produce and process bulk agricultural products (such as grain, cotton, vegetable oil, sugar, vegetables, fruit), animal products (such as meat, poultry egg, dairy products) and aquatic products[42]. Currently, the majority of foreign direct investment is involved in the processing, rather than production, of agricultural and animal products. China's land policy requires the approval of the State Council for any investment that utilises more than 62.5 hectares of arable land or 125 hectares of other land. However, this process usually takes a notoriously long time, thereby discouraging foreign firms from producing agricultural and animal products since these investments usually require large amounts of land.

Trade in grain products can be conducted only through specialised state trading companies. In 1994, state grain procurement once again became compulsory and regional self-sufficiency policy was reintroduced. In June 1998, the Chinese government issued a new policy on grain trade; the pre-reform state monopoly for purchasing and marketing was reinstated. Only the state grain companies are now allowed to purchase grains, and grain prices are set by the government in such as way as to compensate for their accumulated losses. However, this new policy has led to a huge stock, as the state grain companies must purchase whatever amounts farmers want to sell[43]. Moreover, due to inefficiency of marketing and distribution, the wholesale price has become substantially higher than international prices (1000-1200 yuan/ton versus 800-900 yuan/ton).

In 1995, China became a major importer of agricultural products, with net imports of more than 19 million tons of grain. Scarcity in agricultural land, instability in the supply of grain and an inefficient distribution system means that China's agricultural product market will remain unstable in the foreseeable future. It is unlikely that China will place much reliance on foreign supply for staple foods simply because this is considered dangerous for the stability and security of the country. WTO Members have requested the Chinese government to publish its planned volume of agriculture imports on a yearly basis, but China insists on "importing according to market demand".

Foreign Exchange Management

The foreign exchange regime is perhaps one of the reform areas where China has made most progress over the past decade. First, the official exchange rate was unified with the prevailing swap market rate in January 1994, and soon afterwards the inter-bank foreign exchange market was established. Second, the current account was made convertible in July 1996. Foreign companies in China are now allowed to convert the yuan into foreign currencies for current-account transactions, such as importing materials, paying royalties and license fees and repatriating dividends[44]. Furthermore, with current account convertibility, foreign firms do not need to balance their foreign exchange positions as before. Third, at the beginning of December 1996, China formally accepted the terms and

conditions specified under the IMF's Article VIII Agreement so that the government can no longer impose trade restrictions for balance of payments reasons nor engage in a discriminatory currency arrangements or multiple currency practices without IMF approval.

Before the Asian financial crisis unfolded in summer 1997, the Chinese government had stated the possibility of achieving the capital-account convertibility by the year 2000. Although this is no longer applicable under the present economic situation, it is nevertheless important that China continues to restructure and recapitalise its weak banking system (see below).

Foreign Investment Policy

Foreign investment flows into China since 1979 have been dramatic. By the end of 1997, the total number of approved foreign-invested projects had reached 304 821 (among which 145 000 were already in operation), and the total accumulated amount of foreign direct investment actually used was $221.9 billion. In 1997, foreign-funded enterprises (FFEs) employed 17.5 million workers[45], which was about 12 per cent of China's non-agriculture labour force, and their exports and imports accounted for 47 per cent of the national total.

In the 1980s, foreign companies were allowed to invest in hotels and restaurants, light-industry manufacturing, chemical engineering, electronics, and food processing. In June 1995, the *Guiding Catalogue of Industries for Foreign Investment*[46] was issued (see Annex Table 1). For the first time, foreign investors in China were given a clearly defined list of projects that are encouraged, restricted, and prohibited. The "encouraged" projects included agriculture, infrastructure, power generation, mining, high-technology project, energy, and environment conservation.

The second national foreign investment conference[47] held in December 1997, revised the 1995 version of the *Guiding Catalogue of Industries for Foreign Investment*. In the new guiding catalogue the number of encouraged projects for foreign investment has been raised. Some industries have been elevated from the "restricted" to "encouraged" category, but, overall, no significant changes in market liberalisation have occurred.

About 80 per cent of China's foreign investment in 1997 came from ASEAN, Hong Kong China, Japan, Korea and Chinese Taipei[48], and the vast majority of this investment went to coastal regions[49]. To promote the development of economies in the relatively backward regions, the government has expressed the necessity of granting the central and western regions preferential treatment, but no clearly defined rules have been put into practice. Currently the coastal provinces list both capital- and technology-intensive industries and export-oriented projects as priorities for foreign investment, and the central and western provinces hope to attract more foreign investment to agriculture, water conservation, transportation, energy, raw materials and environment projects so as to accelerate the exploitation of resources and the construction of essential infrastructure[50].

Recently China has unified the tax regime for foreign and domestic enterprises (except income tax) and restricted the use of tax incentives at provincial and municipal levels. FFEs in China are entitled to a complete income tax exemption for two years and then a reduced (50 per cent) tax exemption for three years[51]. Afterwards, FFEs' income tax rates

vary depending on their locations, for example, 15 per cent in SEZs, 24 per cent in Open Cities, and 33 per cent in the rest of nation, while domestic enterprises (except those in SEZs) are required to pay a 33 per cent income tax.

As a move towards "national treatment", from April 1996, imports of equipment and raw material by newly-approved and established FFEs were required to pay import duties (ranging from 23 to 36 per cent). This practice, however, was reversed at the start of January 1998, as the amount of foreign investment contracts declined sharply in 1997[52].

Policy measures, such as tax breaks, duty-free imports, flexible labour practices for hiring and firing and other preferential treatment granted to FFEs, have artificially raised the rate of return on capital invested in particular types of industrial activity and regions. The recent initiative by the central government to rationalise incentive measures, especially those provided by local governments, and enhance transparency in tax and foreign exchange rules, is considered as a step forward in the right direction. It is thus unfortunate that some of these measures had to be reversed at a time of economic difficulties following the Asian financial crisis in 1997.

The Role of Special Economic Zones (SEZs)

At early stages of China's reform process, SEZs played a crucial role in serving as "economic laboratories" in trade liberalisation. They successfully created job opportunities locally and attracted labour-intensive foreign investment projects, but failed to attract technology- and capital-intensive investment and to accumulate the expected amount of foreign exchange for the country as a whole. Moreover, the discriminatory policies in favour of investment in SEZs and other zones have been criticised as China has made efforts to join (or re-join) the GATT/WTO. In response to these criticisms, the Chinese government has recently undertaken steps to re-define the role of SEZs in national economy.

First, starting in 1994, SEZs have exercised tight controls on approval of foreign investment in labour-intensive and real estate projects and encouraged (or ordered) labour-intensive enterprises to be relocated to outside SEZs. Capital- and technology-intensive projects have become the main "catch" of SEZs' governments.

Second, as of January 1997, FFEs were granted "national treatment" in Shenzhen, including selling to domestic markets, establishing insurance business and travel agents, and conducting wholesale and retail businesses. This "Shenzhen Experiment" is designed to adjust gradually or withdraw special and preferential treatment granted to SEZs. By 2000, this policy will be applied to all SEZs. For the time being, the SEZ income tax rate remains at 15 per cent as noted above.

The removal of preferential polices in SEZs is a necessary step towards integrating the Chinese economy fully into the world economy and to achieving balanced regional development. SEZs will, however, continue to serve as "economic laboratories" in the reform and opening-up process. The areas for experimentation will include the above-mentioned "national treatment" for foreign-funded enterprises, reducing the role of government in economic activity, and opening up commerce, trade, finance and insurance services. Nevertheless, SEZs no longer have a monopoly over these experiments as they had before. Other development zones have also been granted permission to join the role

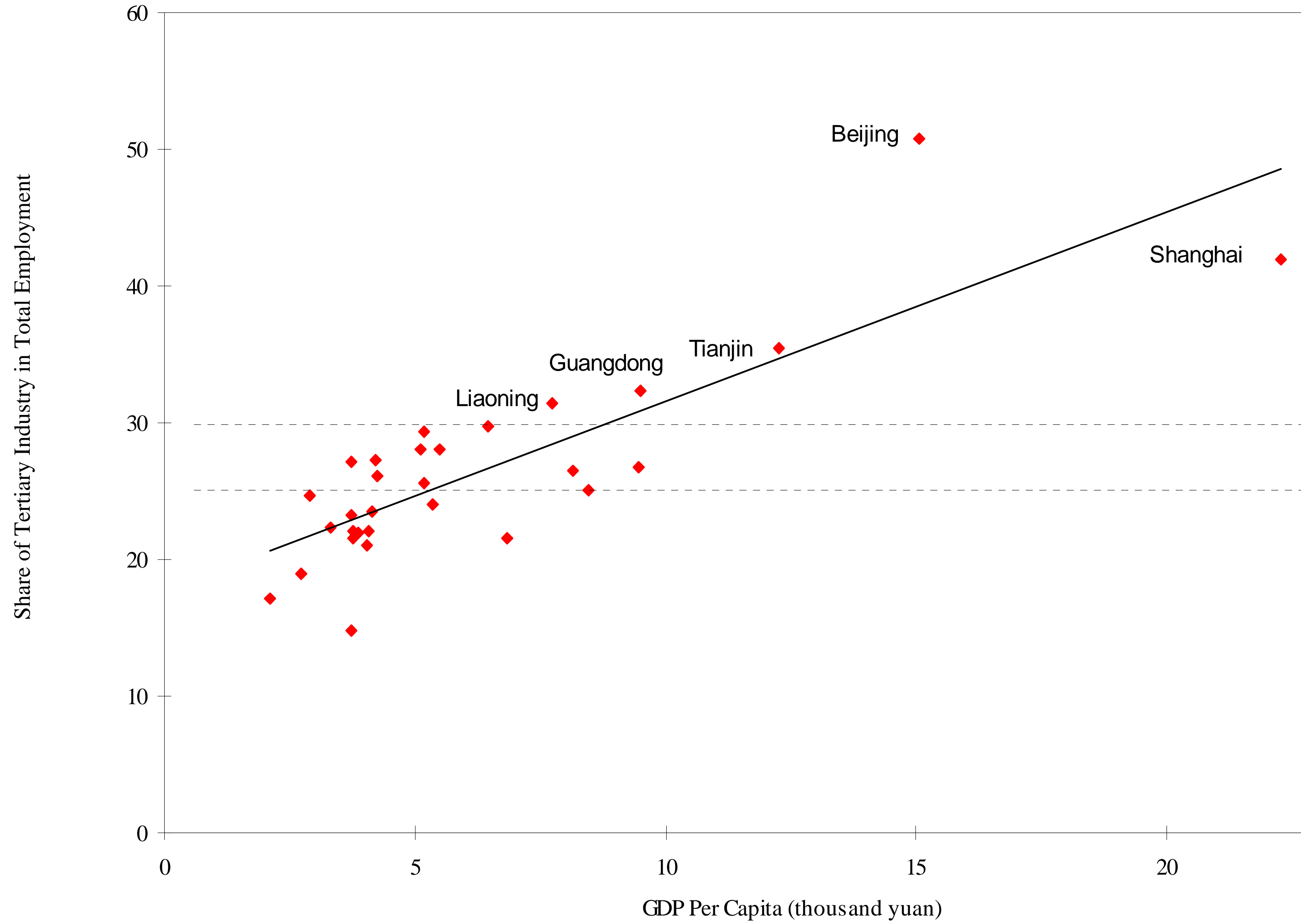
of experiment laboratory. For example, foreign banks are allowed to conduct local currency businesses in Pudong and only later in SEZs, and foreign insurance companies were first allowed to sell policies in Shanghai and Guangzhou.

China's current practice of imposing restrictions on market access by geographical area without making any clear commitment as to when they are phased out requires more scrutiny. As discussed in the Introduction, the level of development in the services sector is closely associated with that of per capita income. More developed regions tend to have greater demand for commercial services than less developed regions. It is thus natural that foreign investment in services flows into more developed provinces and cities. A high concentration of foreign banking and insurance services in Shanghai and other major coastal cities is a case in point.

Regional employment patterns in services highlight this point (Figure 1). Those regions where services employed over 30 per cent of total workers in 1996 include Beijing, Shanghai, Tianjin, Guangdong and Liaoning provinces. Beijing, Shanghai and Tianjin are the cities directly under the supervision of the central government and, in general, have more developed service sectors than the rest of the cities in China. Liaoning, one of the most important industrial bases in China, is complemented by strong service sectors (such as banking and transportation to support industrial development). Guangdong, one of the pioneer provinces in China's opening up, has seen services growing faster than most of the other provinces in the country. Note that Shanghai, Beijing, Tianjin and Guangdong are also the top four regions in terms of per capita GDP.

Those provinces that had a 25 to 30 per cent share of services in total employment include Zhejiang, Jiangsu, Fujian, and other relatively developed regions in China. In terms of per capita GDP, Zhejiang, Jiangsu and Fujian provinces achieved a higher level than Liaoning in 1996. The other provinces with less than 25 per cent of total workers in services are made up mainly by the less developed regions. In contrast to the first two groups, the industrial sector of these regions is less developed and has more resources in agriculture or small businesses such as retail trade. Such regional patterns in industry development presents a strong positive relationship between the level of services industry and the level of economic development in general. Apart from political considerations, it makes little economic sense to maintain restrictions on market access by geography.

Figure 1. Regional Pattern in China (1996):
Per Capita GDP and Share of Tertiary Industry in Total Employment



NOTES AND REFERENCES

1. In 1997, China ranked as the world's 6th largest trading economy after the EU (excluding intra-EU trade and counted as one economy), the United States, Japan, Hong Kong China, and Canada (WTO, 1998, Vol. II, Table I.6). Note, however, that about 80 per cent of Hong Kong's trade is re-exports of goods, much of which comes from and goes to China. According to UNCTAD's 1997 *World Investment Report* (Annex Table B.1), China ranked 2nd in 1996 as the recipient of foreign direct investment after the United States. It should also be noted that in the 1990s China has emerged as a leading exporter of capital among the developing economies (Wall, 1997).
2. See, for example, Lardy (1992).
3. China's attempt to join the WTO began in 1986 when it sought to resume its original General Agreement of Tariffs and Trade (GATT) membership. While a detailed discussion on China's WTO accession is beyond the scope of this paper, it is worth noting that this negotiation has become highly political, given the complexities of the negotiating agenda, including, *inter alia,* "developing country" status, state trading, intellectual property rights and the special safeguard provision. See, for example, Anderson, 1997; Eglin, 1997; and Wall, 1996, for further discussion.
4. In September 1997, China-Japan bilateral negotiations on market access in goods came to a *de facto* agreement, which has shifted the negotiation's focus even more to services.
5. For example, Greenfield (1966) and Katouzian (1970) argue that the demand for producer services grows with development. The interdependent relationship between services and manufacturing has also been widely studied. Francois and Reinert (1995) argue that the expansion of services is related to the expansion of private sector intermediate services and to the increased demand in manufacturing for service inputs. Park (1989), and Uno (1989) also investigated empirically the issue of rising producer service inputs into manufacturing.
6. Sachs and Schatz (1994), Francois (1990), and Dighe, Francois and Reinert (1995).
7. More precisely, the WTO trade statistics define services as "commercial services", excluding "government services, n.i.e." from the balance of payments statistics.
8. The general provisions of the GATS apply to all member countries, while the extent and conditions of specific commitments to liberalisation are decided by individual member countries. See, for example, UNCTAD/World Bank (1994), OECD (1994), and Bourgeois, Berrod and Fournier (1995) for a concise account of the GATS and sector-specific agreements.
9. Under the *Financial Services Agreement,* 70 WTO member governments have agreed to further liberalise their banking, securities, insurance as well as financial information markets by allowing commercial presence of foreign financial services and eliminating or relaxing limitations on foreign ownership of local financial institutions.
10. Under the *Basic Telecommunication Services Agreement,* 72 WTO member governments have agreed to liberalise their basic telecommunication service markets by dismantling public-sector monopolies and introducing competition over networks.
11. Shenzhen, Xiamen, Zhuhai, Shantou and Hainan Island.
12. The "construction of high technology and products development centres" is added as an "encouraged project", and "land exploration, construction of large-scale tourism, culture, recreation parks and state tourist areas" is added as "projects restricted (B)".
13. "The Current Opening-up and The Future Prospects of China's Trade in Services", speech by Mr. Jianguo Huo, China State Economic and Trade Commission, APEC Training Program on Trade in Services, May 4-8, 1998, Qingdao, China.
14. See, for example, J.P. Morgan's "Asian Financial Market", April 24, 1998, pp. 13-18.
15. Guangzhou, Fuzhou, Tianjin, Nanjing, Qingdao, Dalian and Ningbo.

16. As specified in *Regulations Governing Foreign Financial Institutions of the People's Republic of China.* See Xie (1995, p. 20) for further details.
17. Among these eight foreign banks are Citibank, Hong Kong and Shanghai Banking Co-operation, the Industrial Bank of Japan, and Bank of Tokyo-Mitsubishi.
18. *International Herald Tribune*, August 12, 1998.
19. United Nations, 1991, Vol. 2, p. 246.
20. American International Group.
21. *China Economic Review*, February 1996, p. 6.
22. *Financial Times*, March 24, 1998.
23. See Ma and Zhou (1998).
24. Hainan Air Co-operation is the only joint-venture stock company in air cargo. See Zhang (1997).
25. International call back and telephone card services are also prohibited in China; a policy issued in July 1995.
26. Recently MPT and Ministry of Electronics have been merged to become Ministry of Information Technology.
27. *China Economic Review*, May 1996, p. 13.
28. A classic treatment of this subject can be found in Corden (1974, Chapter 9).
29. His study is based on the firm-level survey data which covers 747 SOEs in four provinces (Jiangsu, Sichuan, Shanxi and Jilin) for the period of 1990-94.
30. Article XIX:1 stipulates that WTO Member countries will have to begin a new round of negotiations within five years after the WTO Agreement is put in force, that is, before 2000.
31. Haaland and Tollefsen (1994) argue that the overall welfare effect of liberalisation of services may be significant.
32. As specified in subparagraph 2(c) of Article I, the GATS cover in its domain foreign direct investment in relation to the supply of a service by a supplier of one Member through commercial presence in any other Member.
33. Three types of companies are allowed to conduct foreign trade activities in China: state-owned foreign trade companies (over 8 000), producing companies with trading rights (several thousands), and foreign-funded enterprises (about 145 000).
34. Before 1994, all Chinese FTCs were requested to hand over to the government a pre-determined amount of foreign exchange earnings. At the unification of two exchange rates, official and swap market rates in 1994, renminbi was devalued, and this made it easier for FTCs to fulfil their foreign exchange targets. Then the government has decided to relieve FTCs of their foreign exchange obligations. However, if producing enterprises (with trading rights) cannot accomplish their production plans continuously for several years, they will be deprived of their trading rights.
35. The amount of foreign exchange earnings FTCs are allowed to retain is no higher than 15 per cent of their total exports in the previous year. Under the foreign exchange retention system before 1995, FTCs could purchase back part of their foreign exchange earnings from the government at the official exchange rate. After 1995 FTCs were allowed to purchase foreign exchanges at the swap market rate.
36. Currently the Chinese government controls exports through authorising trading rights, allocating quotas, and licensing permits to trading companies.
37. As noted above, decentralisation of trading rights led to the birth of thousands FTCs. To gain a share in international markets, small FTCs often compete among themselves by lowering the price of exports to foreign markets.

38. See, for example, Fukasaku and Solignac-Lecomte (1996) and World Bank (1997) for a cross-country comparison among developing countries.

39. See Fukasaku and Solignac-Lecomte (1996) for a cross-sectoral comparison of nominal and effective tariff rates.

40. See Zhao (1997).

41. See World Bank (1997, p. 87).

42. For details, see China's *Guiding Catalogue on the Industries for Foreign Investment* issued in 1995.

43. In Heilongjiang province, the state grain companies purchased 15 million tons of grains in 1998, but they managed to sell only one fifth of it.

44. However, according to *China Economic Review* (March 1997, p. 14), there are still uncertainties. First, how will the government handle the export quotas written into the earlier contracts of joint ventures? Second, under the new foreign exchange regime, export commitments are still referred to "in the formula used to calculate the permitted ceiling on the amount of fund allowed to be held in the current account".

45. The total number of workers employed by FFEs would have reached 25 million if one included those engaged in processing and trading companies serving FFEs.

46. See *Almanac of China's Foreign Economic Relations and Trade* (1996/97, pp. 166-179) for further details.

47. The first national foreign investment conference was held in 1984.

48. This means that the recent Asian financial crisis will have a negative impact on the inflows of foreign investment to China

49. The nine coastal provinces and three municipalities have consistently attracted more than 85 per cent of the total (World Bank, 1997, p. 90).

50. "The centre and west will enjoy improved export quotas for local products and other, unspecified, preferential treatment." *Economist Intelligence Unit's Country Report,* China, 1996, 2nd Quarter, p. 42.

51. After the year when FFEs record profits from their investment.

52. The total amount of contracted foreign capital declined by 29 per cent in 1997, but the total amount of foreign capital actually utilised increased by 8 per cent.

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ANNEX TABLE 1.
REGULATIONS ON THE OPENING-UP OF THE SERVICES SECTOR IN CHINA

(Provisional Regulations Guiding Foreign Investment, June 1995)

Projects Encouraged

Transportation, Post and Communications Industry

- Railway transport technology and equipment;
- Construction and management of local railways and associated bridges, tunnels and ferries;
- Road and port machinery and its design and manufacture technology;
- Construction and management of urban subway and light-duty rail system;
- Construction and management of roads, bridges, tunnels and ports;
- Construction and management of civil airports;
- Manufacture of 900-MHz digital mobile communication equipment;
- Synchronous optic-fiber of more than five time-groups, microwave communication systems and measurement equipment manufacturing;
- Manufacture of asynchronous transfer mode (ATM) exchange equipment.

Service Industry

- International economic and scientific and technological information consultation services;
- Repairing and after-sale services of precision instrument and equipment.

Projects Restricted (A*)

Service Industry

- Taxi (cars can only be purchased domestically);
- Gas stations (restricted to the construction and management of related projects).

Projects Restricted (B*)

Transportation, Post and Communications Industries

- Construction and management of arterial railways (the State shall command the majority of shares);
- Over-water transportation (off limits to solely foreign-funded enterprises);
- Cross-border car transportation (off limits to solely foreign-funded enterprises);
- Aerial transportation (the State shall command the majority of shares);
- Interchangeable aviation;
- Manufacture of digital program-controlled exchanges.

Domestic and foreign trade, tourism, real estate and service industries (off limits to solely foreign-funded enterprises)

- Retail and wholesale business;
- Goods supply and sales;
- Foreign trade;
- Construction and management of state-level tourist zones;
- High grade hotels, villas and office buildings;
- Golf course;
- Travel agencies;
- Accounting, auditing and legal consultant and broker services;
- Representative services (shipping, freight, futures, sales and advertisements);
- Education and translation services.

Financial and Related Services

- Banks, financial companies, trust investment companies;
- Insurance companies, insurance brokerage and representative companies;
- Securities companies, investment banks, merchant banks, fund-management companies;
- Financial leasing;
- Foreign currency dealings;
- Financial, insurance, and foreign currency constant;
- Production, processing, wholesale and retail sale of gold and silver, jewelry and ornaments.

Projects Prohibited

Post, Telecommunication and Transportation Industries

- Management and administration of postal and telecommunication services;
- Aviation traffic control.

Trade

- Futures trade.

Broadcast, Television and Film-making

- Broadcasting and television stations (including cable television networks and transmission and relay) at any level;
- Production, publication and circulation of broadcast and television programmes;
- Shooting, circulation, and screening of movies;
- Video projection.

* *Notes:* The industries that fall into "restriction A" category are considered "saturated" in domestic markets. Those projects with an investment under $30 million can seek the approval from local governments. However, those projects that belong to "restriction B" category, regardless of the amount of its investment, have to seek the approval from the central government.

Annex Table 2. **Profile of OECD Countries' Manufactured Imports from World Total and China by Product, 1995**

(Million dollars and percentages)

		OECD Total			NAFTA			OECD Asia & Pacific			OECD Europe		
SITC	Rev. 3	Total	China	Share	Total	China	Share	Total	China	Share	Total	China	Share
Chemicals and Related Products, n.e.s.	5	337575	4609	1.4	62595	1092	1.7	31652	1398	4.4	243327	2119	0.9
Organic Chemicals	51	85772	1354	1.6	18354	301	1.6	8996	332	3.7	58421	719	1.2
Inorganic Chemicals	52	25387	1237	4.9	6404	254	4.0	3887	606	15.6	15095	376	2.5
Dyeing, Tanning and Colouring Materials	53	19940	194	1.0	3510	66	1.9	1301	33	2.5	15128	94	0.6
Medical and Pharmaceutical Products	54	55489	771	1.4	7997	210	2.6	6541	145	2.2	40950	415	1.0
Essential Oils and Perfume Materials	55	23944	222	0.9	3900	66	1.7	2106	73	3.5	17937	82	0.5
Ferilizers other than group 272	56	9445	21	0.2	1898	1	0.1	1103	20	1.8	6444	1	0.0
Plastics in Primary Forms	57	53937	124	0.2	8294	26	0.3	2375	22	0.9	43267	75	0.2
Plastics in Non-Primary Forms	58	25733	66	0.3	5209	18	0.3	1511	14	0.9	19011	32	0.2
Chemical Materials and Products, n.e.s.	59	37924	616	1.6	7025	145	2.1	3829	149	3.9	27070	321	1.2
Manufactured Goods Classified Chiefly by Material	6	541545	15744	2.9	127151	5123	4.0	49298	5718	11.6	365094	4901	1.3
Leather, Leather Manufactures and Dressed Furskins	61	8546	164	1.9	1768	38	2.1	431	23	5.3	6347	102	1.6
Rubber Manufactures, n.e.s.	62	29504	272	0.9	8223	142	1.7	1984	48	2.4	19297	82	0.4
Cork and Wood Manufactures (excluding furniture)	63	22016	838	3.8	4748	263	5.5	3864	324	8.4	13403	250	1.9
Paper and Paper Manufactures	64	73023	582	0.8	17550	286	1.6	3877	114	2.9	51595	181	0.4
Textile Yarn, Fabrics and Related Products	65	81045	5179	6.4	15414	1401	9.1	8229	2118	25.7	57401	1659	2.9
Non-metallic Mineral Manufactures, n.e.s.	66	72201	2262	3.1	17826	1006	5.6	7205	741	10.3	47169	514	1.1
Iron and Steel	67	99008	1844	1.9	20715	310	1.5	7178	1189	16.6	71114	344	0.5
Non-ferrous Metals	68	79141	1044	1.3	18344	196	1.1	11406	570	5.0	49391	276	0.6
Manufactures of Metal, n.e.s.	69	77062	3555	4.6	22561	1477	6.5	5122	587	11.5	49379	1490	3.0

Annex Table 2. **Profile of OECD Countries' Manufactured Imports from World Total and China by Product, 1995** (cont.)
(Million dollars and percentages)

SITC	Rev. 3	OECD Total			NAFTA			OECD Asia & Pacific			OECD Europe		
		Total	China	Share	Total	China	Share	Total	China	Share	Total	China	Share
Machinery and Transport Equipment	7	1302544	27516	2.1	474963	13428	2.8	108451	5297	4.9	719129	8790	1.2
Power Generating Machinery and Equipment	71	81935	1055	1.3	31631	314	1.0	5195	438	8.4	45108	302	0.7
Sepcialized Machinery	72	87843	324	0.4	27853	128	0.5	7012	103	1.5	52977	91	0.2
Metal Working Machinery	73	22542	210	0.9	8161	76	0.9	1468	49	3.3	12911	85	0.7
Other Industrial Machinery and Parts	74	126173	1913	1.5	37755	980	2.6	9110	323	3.5	79307	609	0.8
Office Machines and ADP Equipment	75	201703	6194	3.1	74576	3135	4.2	21461	828	3.9	105664	2229	2.1
Telecommunication and Sound Recording Apparatus	76	110891	9079	8.2	43119	4753	11.0	12464	1526	12.2	55307	2799	5.1
Electrical Machinery, Apparatus and Appliances, n.e.s	77	265565	7705	2.9	104362	3522	3.4	25968	1740	6.7	135234	2442	1.8
Road Vehicles	78	354445	866	0.2	136130	480	0.4	20471	225	1.1	197842	160	0.1
Other Transport Equipment	79	51464	167	0.3	11371	36	0.3	5297	62	1.2	34795	69	0.2
Miscellaneous Manufactures Articles	8	487834	67243	13.8	157463	30550	19.4	60060	18256	30.4	270310	18436	6.8
Prefabricated Buidings, Sanitary, Heating and Lighting fixtures	81	13483	1643	12.2	3253	975	30.0	891	153	17.2	9338	513	5.5
Furniture and Parts Thereof	82	36892	2164	5.9	11203	1067	9.5	3449	676	19.6	22239	420	1.9
Travel Goods, Handbags, etc.	83	12032	4906	40.8	3958	1893	47.8	3253	1117	34.3	4820	1895	39.3
Articles of Apparel and Clothing Accessories	84	141747	24469	17.3	45968	6666	14.5	20327	11451	56.3	75451	6351	8.4
Footwear	85	35027	9353	26.7	13692	6450	47.1	3501	1633	46.6	17833	1268	7.1
Professional and Scientific Instruments, n.e.s.	87	58904	883	1.5	16765	438	2.6	7291	120	1.6	34847	325	0.9
Photo Apparatus, Optical Goods, Watches and Clocks	88	40840	2573	6.3	12385	1027	8.3	5169	490	9.5	23285	1056	4.5
Miscellaneous Manufactured Articles, n.e.s.	89	148907	21249	14.3	50236	12031	23.9	16176	2613	16.2	82495	6605	8.0
Total of the above	5 - 8	1895367	100160	5.3	651740	45445	7.0	178846	25744	14.4	991180	27229.35	2.7

Notes:

1. OECD - 25 OECD Member countries as of end 1995. Germany includes Eastern Germany since January 1991. Mexico and Czech Republic joined the Organisation in 1994 and 1995, respectively, so that both countries are included in OECD-Total, starting in 1990 and 1993. Hungary, Poland and Korea joined the OECD in 1996, but this table does not include these countries as OECD Members.
2. NAFTA - Canada, Mexico and the United States.
3. OECD Asia & Pacific - Australia, Japan and New Zealand.
4. OECD Europe - EU 15 plus Czech Republic, Iceland, Norway, Switzerland and Turkey.

Source: OECD, Foreign Trade by commodities, 1995, Volume 5.

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