

**One Country, Two Systems:
Implications of WTO Entry for China**

by

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1. Introduction

The reunification of Hong Kong and China on July 1, 1997, was aptly described by the phrase “one country, two systems,” but in fact, China already had extensive experience with this concept. Beginning with the establishment of Special Economic Zones early in 1979, and extended to the Open Cities and Economic and Technology Development Zones in 1984, China has managed export- and market-oriented enclaves within its economy. This was reinforced by inflows of foreign direct investment, which have greatly accelerated during the 1990s. The so-called “foreign invested enterprises” (FIE) operate under rules completely different than those governing the rest of the economy: besides having duty-free access to imports provided that these are embodied in exports, the FIE also enjoy lower rates of taxation than domestic firms. The contribution of FIEs to domestic output was still modest (less than 2%) up to 1990, but then took off with the huge inflows of foreign investment into China. By 1994, the FIEs share in industrial output had grown to 8.6%, and it is much higher in specific sectors such as film, passenger cars, certain chemicals, and carbonated beverages.¹ The presence of the FIEs is much more apparent in trade, and they accounted for nearly one-half of China’s imports and one-third of China’s exports in 1994.

Besides the foreign invested enterprises, most of the remainder of industrial output and trade is contributed by the state-owned enterprises and the urban and rural collectives; private and household enterprises contributed 15% of industrial output in 1994, but a negligible portion of either imports or exports. Thus, the fundamental distinction in the economy is between the

¹ Barry Naughton, “China’s Emergence and Prospects as a Trading Nation,” *Brooking Paper on Economic Activity*, 1996:2, p. 288; data originally taken from the Chinese Statistical Yearbook, 1995, State Statistical Bureau.

FIEs on the one hand, and the state-owned and collective enterprises on the other. This creates a *dual structure* in production and trade that is essential to understanding the Chinese economy.

In my talk today, I would like to argue that the maintenance of this dual structure leads to a wide array of policies in China that are in conflict with the principles of the World Trade Organization (WTO). Thus, as China moves toward entry into the WTO, it will be necessarily have to dismantle some of the barriers that are preserving this dual structure. This is probably a good thing in the long-run, because as economists, we are aware that any dual structure must have within it some distortions that lead to inefficient production and exchange. Nevertheless, dismantling this dual structure leads to questions of the best *timing* of policy changes – which policies to discard first, and which to retain until the end – that have important consequences for dislocation in the short-run. So what I am arguing is that the entry of China to the WTO is not just about meeting the various requirements for open trade. Rather, the entry of China to the WTO has the potential to transform the structure of the Chinese economy by creating *one system* under which both foreign and domestic firms compete equally.

In my talk I would like to first describe the dual structure of international trade as it exists in China today, and point out the ways in which this structure is inconsistent with the principles of the WTO. The recent proposals from China to enter the WTO brings it partway towards meeting these principles, but retain many of the dual features of the trade regime. Then, I would like to discuss the ways in which the FIEs contribute both positively and negatively to the Chinese economy. I will conclude by making a few remarks on the special role of Hong Kong in Chinese trade, and by comparing the challenge faced by China in joining the WTO with the recent experience of other developing countries.

2. Structure of Trade

Table 1 – China’s Imports and Exports by Customs Regime, 1994

From Table 1, only 31% of imports into China in 1994 are classified as “ordinary trade,” i.e. products that are sold to domestic firms or consumers. Another 41% comes in as “processing trade,” which is later exported, and a further 20% of imports is initial investment of joint ventures. Both the processing trade and the initial investments of joint ventures enjoy duty-free status. This duty-free status was rescinded for imported capital equipment from mid-April, 1996 to December 31, 1997. However, there was a fall in the imports of capital equipment during that time, and in response to this, the Chinese have reinstated the duty-free status (and exemption from the VAT, which is normally 17%) of many categories of imported capital equipment.

Thus, only the 31% of trade that is “ordinary” is subject to the published tariffs schedules. This means that there is a huge difference between the published tariffs, and the duties actually collected, expressed as a percentage of the total value of imports. This can be seen from Table 2, which compares the tariff structure for China to that of other large developing countries.

Table 2 – Tariff Systems of China and other Large Developing Countries

The unweighted average of the tariffs for China have already fallen from 43% to 23%, and will fall even further to 16% under China’s current WTO accession proposal. This will be as low as all of the other developing countries shown in Table 2, except Hungary. It is noteworthy that all of the countries shown there *except* China are members of the WTO, and those with effective date listed 1/1/95 actually were members of the GATT prior to the creation of the WTO on that date; only Columbia and Egypt are recent entrants to the WTO.

The duties collected by China, expressed as a percentage of total import values, were only 5.6% in 1992 and 7.4% in 1996. This is an exceptionally low rate of collection, and is similar only to Brazil, or to industrial countries. This low rate is due to the very large portions of import that enter duty free: the intermediate inputs for inward processing, and the capital inputs for joint ventures. The low rate of duties collected might make it appear that China is already an very open economy. But I think this is *not* true: for several reasons, China is still a highly restricted market for foreign firms that wish to sell here.

Dispersion of Tariffs Across Sectors

First, China still has a rather large dispersion of tariff rates across specific commodities. In Table 2, the standard deviation of tariffs rates across sectors in 1992 is higher than many other developing countries (with the exception of India and Pakistan). For example, in textiles the 1992 tariff rate was 66% and in motor vehicles it was 79%. These two sectors accounted for about 11% and 4% of the gross value of industrial output, respectively, so that both of these are protecting a very large domestic industry. Textiles trade has been the subject of a recent trade negotiations with the United States, and both the U.S. and E.U. have called for a reduction in tariffs in sectors such as chemicals and motor vehicles.

Some idea of the economic impact of the differing rates of protection can be seen by simulating the effects of *removing* this protection. Models created by the World Bank to examine the effects of WTO entry on China's industrial output show that the net impact of trade liberalization (under China's second offer to the WTO) would positively affect all but two sectors of the Chinese economy – see Table 3, second column. The only sectors that experience a decline in output due to trade liberalization are Other Food Products and Textiles. The increased outputs of all other sectors is due to the preferential tariffs China would receive, thus

increasing foreign demand for Chinese goods, in addition to increased domestic demand as resources shift to more productive sectors and raise income overall.

Non-tariff Barriers

A second reason that the Chinese market still appears quite closed to foreign firms is the extensive use of non-tariff barriers. This can be seen in part by considering the types of enterprise that import.

Table 3 – China’s Imports and Exports by Type of Enterprise, 1994

State-owned companies and collectives must import and export through the foreign trade companies (FTCs). The FTC are an carry-over from the regime of central planning in China, and when trade reform began in 1978 there between 10 and 16 foreign trade companies.² According to various estimates this number grew to between 3,600 and 8,700 in 1994,³ and is even larger today. Virtually all of the FTC are state-owned, though as part of the WTO negotiations China has agreed to permit the establishment of foreign-invested trade companies.⁴ Each FTC is given the rights to deal in a selected number of commodities (in a procedure is called “canalization”), and this creates a very substantial *non-tariff barrier to trade*, that is of particular concern to the United States. A recent report from the U.S. International Trade Commission (*International Economic Review*, July 1997, p. 6) states that:

“China’s 1994 Foreign Trade Law specifies that foreigners may not engage directly in international trade. Foreign companies must use a government-approved Chinese company that

² Nicholas Lardy, 1992, *Foreign Trade and Economic Reform in China, 1978-1990*. Cambridge: Cambridge University Press. The World Bank, *China: Foreign Trade Reform*, p. 12, puts the number of FTC as twelve in 1978.

³ International Trade Centre, *Survey of China’s International Trade*, UNCTAD/WTO, 1995, Table 8, p. 22.

⁴ In 1996, three foreign companies (from Japan, South Korea and Germany) were granted permission to establish joint venture trading companies in Pudong economic zone, in Shanghai (Naughton, 1996, note 42).

has trading rights in order to trade with China. In addition, they must use a Chinese distributor to distribute imports in the domestic market.” Clearly, eliminating the need to use government-approving trade companies is a prerequisite for successful WTO entry by China. The ITC report goes on to note the progress of recent negotiations on this issue: “At the March 1997 meeting of the Working Party, China said it would grant trading rights to foreign and domestic firms in China. Unlike an earlier proposal, this trading rights offer does not reportedly allow foreign firms to distribute their own goods in China”.

Another 46% of product are imported by foreign invested enterprises (FIEs), and much of this is duty-free. However, the FIEs are *not* permitted to sell freely in the domestic market. Rather, there are incentives for them to export a considerable portion of their output. These incentives come as part of the “Twenty-two Regulations” established in 1986 that defines an “export oriented” firm as one that exports at least 50% of its production value. This type of export performance requirement has the same economic impact as an export subsidy, which are not permitted under the WTO. This is another way that the trade regime potentially runs afoul of the WTO. But I will also argue below that these “export requirements” might not be in China’s best interests.

In addition to the non-tariff barriers that come from the use of FTCs, other barriers stem from import licenses, quotas, import controls, product certification requirements, and a general lack of transparency in Chinese customs law/regulation. This is the area in which China, and most other nations, suffers the most from impediments to trade. These non-tariff barriers cover a wide range of China’s imports, as estimated by the World Bank in Figure 1. They are highest in Rice and Wheat, where non-tariff barriers affect 100% of the imports, following by other agricultural goods. In manufactured goods, non-tariff barriers cover 60% of the imports in

Natural Resources, and about 40% of the imports in Other Food Products, Transport Industries, and Heavy Manufactures.

The impact of reducing tariffs in China and *also* phasing out its non-tariff barriers is shown in Table 3, column 3. It is important to note here that in China's negotiations with the WTO, provisions are made for the protection of certain infant industries through China's retaining limited rights to State Trading even after WTO membership. This protection will primarily extend to Rice and Wheat production, so that they do not experience a decline due to the elimination of non-tariff barriers. Other Food Products will experience a greater decline than with the reduction of tariffs alone, as also the Machinery sector. However, Textiles will experience an *increase* in output due to the reduction of both tariffs and non-trade barriers, since this includes the elimination of the Multifibre Arrangement (MFA) that currently restricts Chinese exports of textiles to the industrial countries.

Intellectual Property Rights

The inability of foreign firms to market their goods directly in China is a particularly severe non-tariff barrier for goods such as CDs and software. Most of the costs of these goods comes from product development, and the actual costs of mass-producing them are very minor relative to their value and selling price. Music CDs produced in America could easily be cost-competitive in China, because the cost of reproducing the CDs is less than one dollar. But with the difficulty of marketing these items in China, there is a strong incentive created for local firms to copy the products and sell them locally. This, of course, was the basis for the U.S. intellectual property complaints against China in 1995 and 1996, under the "Super 301" provisions of U.S. trade law. As a result of these negotiations with the U.S., the United States Trade Representative reports that China has closed some 62 factories producing illegal CDs, and trained a great many

judges in China on intellectual property rights laws. These are positive developments from the point of view of Sino-U.S. relations, but I think it is overlooked that the *reason* the copying of foreign CDs comes up in the first place is that these products do not have free access to the Chinese market. The best way to reduce the *incentive* for Chinese firms to pirate copyrighted material is to allow foreign companies to market these goods freely in China, and this would strongly reinforce the efforts that China is now making through its legal system to comply with intellectual property rights.

3. Foreign Invested Enterprises

The trade figures we have looked at emphasize the *dual* nature of China's trade regime. Many the provisions of this regime are contradictory to the principles of GATT and the WTO, and would need to be modified for successful entry. In addition, many of the provisions are contradictory with each other. For example, the import of duty-free capital equipment by foreign firms give then an inherent advantage over the state-owned companies. This in one reason why there are limits to the sale of goods by the FIEs to the domestic market, so to protect the SOEs, and thereby creating an export-promotion and an import-substitution regime at the same time. Another example comes from the fact that the SOEs and FTCs handle the majority of exports, including some of the contractual processing trade, where goods are produced under contract with a foreign supplier. The FTCs charge a markup on exports handled, which raises the costs of the goods overseas, and the firms producing the goods do not have any choice but to use the trading company. This is another way in which the regime favors the foreign-invested firms.

Given the special incentives that are being provided to foreign firms, it is worth asking whether they are definitely in the interest of the Chinese economy, or not. There are both benefits and costs from their presence. One benefit is through foreign firms importing *capital*

equipment, which is believed to be a key factor in fostering growth. This has been shown to hold to regressions explaining the growth performance of countries. On the other hand, this benefit would presumably come whether the capital equipment was being imported by foreign or domestic firms. The current duty-free status for imported capital equipment does extend to domestic firms producing in industries that China has prioritized for development.

A second benefit is in terms of higher *wages paid* by foreign firms. Wages paid to workers in FIEs are much higher than those paid by State Owned Enterprises (SOEs) and Urban Cooperatives. This can be seen from Figure 2, which uses data from the Chinese Statistical Yearbook.⁵ The wage differentials shown in Figure 2 reflects the ability of the FIEs to offer wages contracts where up to 30% is in response to worker productivity, and another 20% can be bonuses. Thus, up to one-half of the wage contract is in response to productivity differences across workers, whereas the SOEs operate under a more rigid wage formula. It is no wonder then, that the FIEs are able to operate at a higher level of productivity as compared to the state-owned and urban collectives, and there is a clear gain to the Chinese economy from the presence of the foreign firms.

However, there also be some costs the large presence of foreign-invested firms in China, and these point to the importance of having a single system of rules under which both domestic and foreign firms operate. The first cost comes from the “export performance” requirements of the FIEs. This is an area of some controversy in the current negotiations over Chinese entry to the WTO. China claims that direct financial subsidies on all exports including agricultural goods ended on January 1, 1991.⁶ However, both the U.S. Trade Representative and the World Bank believe that incentives to *over-export* still exist in several forms. One is through requirements

⁵ The data shown for the foreign-invested enterprises also includes wages paid by certain enterprises owned by joint share-holding; of these two, the foreign enterprises pay even higher wages on average.

given to the FTCs to achieve certain export targets, or foreign exchange earnings. These targets are allocated to the provinces, and in turn to the regional FTCs.⁷ It is believed that these targets lead to excessive imports, at below market prices, which amounts to a terms of trade loss for China. These export requirements are criticized in the latest report on *Foreign Trade Barriers, 1998*, by the U.S. Trade Representative, which gives the following example (pp. 52-53):

“China’s recent corn exports (6.6 million metric tons in 1997) demonstrate clearly the continued willingness of parts of the Chinese government to subsidize exports. Most of China’s 1997 corn exports were sold at prices \$20 to \$30 below domestic wholesale corn prices. Chinese officials argue that there is no subsidy involved since the corn was purchased domestically in 1995 and 1996 when domestic prices were much lower than they were when exported. The Chinese government incurred a loss of as much as \$50 million in 1997 through exportation when compared to what the government might have realized by selling the corn in the domestic market.” The report goes on to say: “In the context of negotiations on its accession to the WTO, China has agreed not to use export subsidies for agricultural products. Thus, reaching an understanding on what practices constitute subsidization is an important task.”

This example refers to exporting by the FTCs in China, and it is worth asking whether the same incentive to over-export applies to the foreign invested enterprises. I believe that this type of incentive does exist, because of rules governing FIEs access to the domestic market. Specifically, under the “Twenty-two Regulations” established in 1986 governing foreign investment, an “export oriented” firm is one that exports at least 50% of its production value. Such a firm receives a range of tax exemptions, including: exemption from having to pay the state housing and welfare subsidies to employees; exemption from the 10% tax on profits

⁶ United States Trade Representative, *Foreign Trade Barriers*, 1998, p. 52.

⁷ See *China: Foreign Trade Reform*, The World Bank, 1994, pp. 24-27.

remitted abroad; and extended reduction period on paying the corporate income tax; priority access to Bank of China loans; additional tax benefits for reinvested profits; and reduced land use fees.⁸ Since 50% of output must be exported to receive this incentive, this could quite plausibly lead to situations where the exports would reduce the market prices, which is again a terms of trade loss for China.

Besides the impact on the terms of trade, there is a second potential cost to the presence of the FIEs in the Chinese economy, which is related to the idea of “trade diversion.” A foreign-invested firm selling some its output on the domestic market would do so at the tariff-protected, domestic prices. This exceeds the free-trade price at which the good could be purchased from abroad. Even if the good is purchased from abroad subject to the tariff, then the government would collect the tariff revenue, so the *social cost* of the goods is still essentially the free-trade price. But when the FIE is permitted to sell the good domestically, then the *social cost* of the good is the higher, tariff-protected price. Under these circumstances, it is quite possible that the Chinese economy loses rather than gains from the local production and sale by the FIE.

This is analogous to the sort of “trade diversion” that occurs within a customs union or free trade area. For example, when the United States buys a product duty-free from Mexico, under the North American Free Trade Area, then it is quite possible that the same product could be purchased more cheaply from Asia, except that Asia faces tariffs for sale in the United States. From the consumers point of view, the good is purchased more cheaply from Mexico; but from the *social* point of view, it would be better to purchase the good from Asia and collect the associated tariff revenue. This would be called “trade diversion” from Asia to Mexico, and it means the U.S. is worse off by purchasing the good from Mexico. In the same way, I am

⁸ Phillip Donald Grub and Jian Hai Lin, *Foreign Direct Investment in China*, New York: Quorum Books, p. 57.

suggesting that there are circumstances under which China is worse off by purchasing goods from the FIEs, as compared to importing them.⁹

This possibility of “trade diversion” and social losses due to foreign direct investment is well-established in the theoretical literature.¹⁰ It has been noted in that literature that one way to avoid any social losses is to tax the foreign enterprises at a higher rate than applies to domestic enterprises: by appropriate choice of the foreign tax rate, any possibility of losses would be eliminated. However, China does just the reverse: it taxes FIEs at one-half the rate of corporate income tax that applies to domestic firms (15% versus 30%). Therefore, social losses due to the diversion of trade away from imports, and towards the FIEs, remains a possibility.

The fact that there are separate corporate tax rates for the domestic versus foreign enterprises is symptomatic of the conflicting incentives for the two types of firms. The SOEs are given preferential access to imports for the domestic market, through the FTCs, which are themselves restricted to deal in specific commodities. To ensure the foreign firms are still attracted to China, they are given a reduced corporate tax rate. But this makes them more profitable than the domestic firms, and so a barrier is erected, restricting the access of foreign firms to the domestic market, and so on. The policies are piled on top of each other, each one counter-balancing the other, in an effort to maintain the dualistic trade and production regime. Ultimately, economic efficiency would call for a unified set of policies that apply equally well to foreign and domestic firms. Given the recent history of China as a centrally planned economy, it is understandable that it will take some time to get there. But I think that this would be the most lasting contribution of the policy changes being proposed for WTO entry.

⁹ This possibility has been noted by Barry Naughton, “China’s Emergence and Prospects as a Trading Nation,” *Brookings Paper on Economic Activity*, 1996:2, p. 309, note 53.

¹⁰ Richard A. Brecher and Carlos Diaz Alejandro, “Tariffs, Foreign Capital, and Immiserizing Growth,” *Journal of International Economics*, 7, 1977, pp. 317-322.

4. The Role of Hong Kong

Even if China moves towards a more unified system for domestic and foreign firms, Hong Kong will remain a separate system for the foreseeable future. I would like to digress from my main theme to comment on the special role of Hong Kong. Clearly, its presence greatly expands the trade opportunities for all the rest of China. Since Hong Kong is a distinct customs area, its trade accounts should be kept separate from those of China. But this is an area where there has been considerable confusion, especially on the American side. As part of the negotiations for WTO entry, I would like to suggest that China insist that the United States revise its trade accounting procedures to more accurately reflect trade that in coming from China versus trade with Hong Kong. A revision of this type would have a dramatic effect on the bilateral trade deficit that is recorded between the United States and China. Since this bilateral deficit is itself mistakenly used as an indicator of protectionist policies, getting the bilateral deficit right would be a useful step towards resolving economic tensions between the countries.

The entrepôt trade of Hong Kong has caused the bilateral US-China trade deficit estimated by the U.S. Dept of Commerce to be very different from that estimated by China's Customs authorities. In Table 5, I contrast the values of eastbound and westbound trade between the U.S. and China, as reported by these two countries. Part A gives eastbound trade (i.e. China's exports and U.S. imports), and Part B gives westbound trade (U.S. exports and China's imports), while Part C computes the difference between westbound and eastbound trade to arrive at the U.S.-China trade balance. The information in the first column is obtained from the U.S. Department of Commerce, while that in the second to fourth columns is obtained from the Customs General Administration, PRC. I supplement this with information on Hong Kong re-exports in the last column, as reported by the Hong Kong Census and Statistics Office.

From Part C of Table 1, we can see that U.S.-China trade balance differs not only in the magnitude reported by the two countries, but even in its sign! The United States reports a trade *deficit* with China, which has increased about tenfold over the years 1988-1996, from about \$3.5 billion to \$39.5 billion. In contrast, China reports that the United States was running a trade *surplus* in the years 1988-1992, which turned into a deficit beginning in 1993. In 1996, the U.S. reported deficit with China of \$39.5 billion compares to the Chinese reported value of the U.S. deficit of \$10.5 billion, so that these two figures differ by \$29 billion or a factor of three times.

The most important source of the different values for the trade deficit is the entrepôt trade of Hong Kong. The U.S. Department of Commerce calculates total Chinese exports to the US by *including* the full value of Hong Kong re-exports of goods from Chinese origin. In contrast, the Chinese customs authorities calculate exports to the United States as consisting of all goods whose final destination (the U.S.) is known at the time the product leaves China. The problem is that often the Chinese exporter does not know the final destination of the good, so that many of the goods bound for the United States are instead treated as exports to Hong Kong.

Since 1993, the Chinese customs authorities have attempted to determine the final destination for goods exported to Hong Kong with greater accuracy, so as to improve its reported trade statistics. This can be seen by breaking up the Chinese exports to the U.S. into those goods that are directly exported (in the third column of Table 1, Part A), and those goods that are exported via Hong Kong (in the fourth column). The latter can be compared to the value reported by the Hong Kong census authorities, in the last column, on the value of re-exports from China to the U.S. Thus, in 1988, China reported \$705 million in exports to Hong Kong bound for the U.S., while Hong Kong reported \$5.6 billion in re-exports to the U.S. that originated in China. These differ by a factor of eight times. In 1995, China reported \$14.3 billion in exports

to Hong Kong bound for the U.S., while Hong Kong reported \$27.5 billion in re-exports to the U.S. that originated in China. These now differ by only a factor of two, though the difference in dollar values is still very large.

There are at least two reasons why the value of Chinese goods sent to Hong Kong, and destined for the U.S., differs from the reported value of Hong Kong re-exports from China to the U.S. The first, which I have already mentioned, is that an exporter in China may not know the ultimate destination of a good when it is sent to Hong Kong. But even if this discrepancy did not occur, there is still a second reason. The value of Chinese exports to Hong Kong, which are destined for the U.S., represent the value of these goods *when they leave China*. In contrast, the Hong Kong re-exports from China to the United States represent the value of these goods *when they leave Hong Kong*. In other words, these two values differ by the *markup or value-added in Hong Kong*. Since traders in Hong Kong are providing various services to these goods, such as arranging for transportation and insurance, as well as identifying customers, the value-added in Hong Kong may be substantial.

Given that there is some value-added in Hong Kong, that activity should properly be recorded as an export from Hong Kong – not from China. The U.S. Department of Commerce does not follow this practice, but includes the Hong Kong value-added as an export from China. For this reason, the trade deficit with China reported by the U.S. is *overstated*. On the other hand, China is unable to count all of the goods leaving its country, and destined for the U.S. via Hong Kong, as an export to the United States. For this reason, the value of the U.S. trade deficit as reported by China is *understated*. In order to estimate the “true” value of the deficit, it is necessary to compute the value-added in Hong Kong on goods shipped from China to the U.S., and also in the reverse direction. Attributing this value-added as an export from Hong Kong, the

discrepancy between the U.S. and Chinese magnitudes of the bilateral trade deficit can be substantially reduced.

Markup on Hong Kong Re-exports from China to the U.S.

In joint work with Wen Hai and several other co-authors, we have estimated the markup in Hong Kong with somewhat greater precision than has been done by any previous studies.¹¹ The difficulty is that one needs to compare, at a disaggregate level, the value of a good when it enters Hong Kong from China, to the value of the same goods when it leaves. In order to do this, it is essential to work with both the disaggregate Chinese and Hong Kong Statistics, since neither one of them alone is enough to make this measurement. We have done exactly that, and find estimates of the markup on China goods re-exported through Hong Kong to the U.S. ranging between 22% and 29%, depending on the year. These markups are expressed as a percentage of the Hong Kong re-export value, so that about *one-quarter* of this value should be counted as Hong Kong export rather than a Chinese export. Our estimates of the markup lie *in-between* those obtained by several others studies, mainly because we were able to work with a more comprehensive dataset than had ever been used before.

Revised Values for U.S.-China Trade Deficit

The estimated markups for goods shipped through Hong Kong can be used to revise and reconcile the differing values for U.S.-China trade. The key principle is that the value-added on goods as they pass through Hong Kong should be attributed to Hong Kong, rather than treated as an export of China. For eastbound trade in part A of Table 6, the first column shows the value-added on Hong Kong re-exports of Chinese goods to the United States. This is deducted from

the value that the United States reports as imports from China (Table 5A, column 1), to obtain the *revised* value of U.S. imports (Table 6A, column 2). The value for Chinese exports to the U.S. also needs to be adjusted, to reflect the fact that many of these exports are simply not recorded. Instead of using the Chinese value for the exports to the United States via Hong Kong (Table 1A, column 4), we instead use the value reported by Hong Kong for Chinese re-exports to the U.S. Kong (Table 1A, column 5), *less* the value-added onto these goods in Hong Kong.

The discrepancy between the revised U.S. imports from China and the Chinese exports to the U.S. is now \$7.5 billion in 1995. While the discrepancy is still sizable, it is much less than the original discrepancy of \$20.3 in the reported value from each country. Thus, by properly attributed the value-added to Hong Kong, we have reduced to discrepancy in the U.S. and Chinese values for eastbound trade to about one-third of its original magnitude. The values for westbound trade also need to be revised, though in this case the estimated value-added on the goods as they pass through Hong Kong is much smaller, so the revisions are less important.

Taking the difference between the revised value of imports and exports, we obtain the revised estimate of the U.S.-China trade deficit shown in Table 6, part C: the revised US figures give a deficit of \$21.6 billion in 1995, as compared to \$15.6 billion from the revised Chinese numbers. These differ by \$5 billion, while the original data had a difference of \$25.2 billion for 1995 (from Table 1, part C). Thus, proper attribution of trade flows through Hong Kong has tremendously reduced the discrepancy in the U.S. and Chinese values of the trade deficit, to *one-fifth* of its original size. This is illustrated graphically in Figure 3, where we show the original deficits according the U.S. and Chinese official data, and the revised estimates according to our calculations.

¹¹ Robert C. Feenstra, Wen Hai, Wing T. Woo, and Shunli Yao, "The U.S.-China Bilateral Trade Balance: Its Size and Determinants," Pacific Rim Business and Development Program, UC Davis, Working paper no. 30, May 1998;

Figure 3 originally appeared in the *Wall Street Journal*, shortly after we completed our work in January. An official from the U.S. Department of Commerce was quoted in that article as saying: “We don’t disagree with their methodology, but as a matter of policy we have to report these numbers as we always have, which is in keeping with the United Nations guidelines.”¹² In other words, there seems to be no effort at all to change in the methodology used within the United States, despite the fact the China is attempting to improve its own trade accounting, and is also consulting with South Korea, Germany, the U.K. and other countries on resolving their bilateral trade figures. So perhaps the current negotiations over China’s entry into the WTO would be a time to get high-level support and push for improved trade accounting within the United States, too.

5. The Challenge Ahead

Let me conclude my talk by comparing China’s situation with another developing country that has close links to the United States through trade and investment, and that is Mexico. There are two features of Mexico that I think are particularly instructive to China. First, when Mexico joined the North American Free Trade Agreement in 1994, and therefore agreed to phase out trade barriers with the United States, this was actually just an *extension* of domestic policies that it had already undertaken. Mexico had already lowered its tariffs, loosened the policies governing foreign direct investment, and had embarked on an extensive program of privatization and deregulation prior to joining NAFTA. So the opening of its market to the United States and Canada was a natural extension of the policies it had already undertaken, and gave a sort of international “seal of approval” to these policies.

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¹² David Wessell, “Big Discrepancy Exists Between Data From U.S. and China on Trade Deficit,” *The Wall Street Journal*, January 22, 1998, p. A2.

In the same way, I would hope that China would take the opportunity of its accession to the WTO to embark on a program of policy reform that break down the walls between the foreign and domestic sectors, and move towards a single, unified system. Give foreign firms greater access to the domestic market, but at the same time, tax them at the same rate applied to domestic firms. Give domestic firms the opportunity to export without having to go through a FTC, and at the same time, encourage greater competition between the FTC. In this way, the FTC can act as true intermediaries in providing trade information and services, much like their counterparts in Hong Kong.

The second lesson from Mexico is that eliminating the *dual* nature of the production and trade regime is not that easy, and poses risks. In 1970, Mexico had a larger consumer electronics industry than either South Korea or Taiwan, and it would have been easy to conclude that it would be the most successful in the years ahead. This has not happened, and despite NAFTA, the electronics industry in Mexico today retains many of its dual features: there are some firms producing in the areas around Mexico City, and other foreign-owned *maquiladora* firms that are located on the border with the United States, and are engaged in assembly for the U.S. market.¹³ Unfortunately, the foreign-owned *maquiladora* have not been a source of long-term growth and innovation in the economy, and instead, their presence led to a reduction in the capacity of supporting industries within electronics. Thus, the *maquiladora* led to a kind of “hollowing out” of the industry within Mexico. There is debate over why this has happened, but whatever the reason, I think that China has certain advantages that will enable it to *avoid* the problem.

In particular, China has the great advantage of *size!* It is clear that foreign firms are

¹³ Nichola J. Lowe and Martin Kenney, “Too Far from Asia, Too Close to the United States: Consumer Electronics Production in Mexico, 1965-1985,” April 1998, Pacific Rim Business and Development Working Paper no. 29, Institute of Governmental Affairs, UC Davis.

extremely ready and willing to come into China and produce for the huge domestic market. Much of the foreign activity to date has been in the form of processing for export, but when the rules requiring this are relaxed, we expect to see more local production for the domestic market. There is every reason to expect that the large size of the Chinese market will support local supplying industries, as are essential to the long-term productivity and innovation within the industry. In addition, China has the great advantage of the skilled international traders in Hong Kong, and in the overseas Chinese located throughout the world. By using these networks and also fostering greater competition among the FTCs, it can be expected that information about global markets opportunities can be as great in China as anywhere in the world. I think the growth in exports that we have already seen from China will be small in comparison with what can be achieved through the market-oriented reforms that are being contemplated now under China's entry to the WTO.

Table 1 – China’s Imports and Exports by Customs Regime, 1994

Customs Regime	Share in National Imports	Share in National Exports
Ordinary trade	30.7	51
Processing trade	41.2	47
<i>Of which:</i>		
Contractual inward processing	13.1	15
Other inward processing	28.1	32
Joint ventures	19.9	n.a.
<i>Of which:</i>		
Initial investment of joint ventures	17.5	n.a.
Inputs of joint ventures for the domestic market	2.4	n.a.
Barter trade	2.1	1
Compensation trade	0.3	0
Border trade	0.2	0
Equipment for inward processing	1.1	n.a.
Leasing	2.6	n.a.
Outward processing	0.0	1
Foreign currency shops	1.0	n.a.
Other	1.0	0

Notes:

n.a. = not applicable

Source:

Survey of China’s International Trade, International Trade Centre, UNCTAD/WTO, 1995, Tables 12,13.

Table 2 – Tariff Systems of China and other Large Developing Countries

Country	Year	Unweighted Average Tariff	Weighted Average Tariff	Standard Deviation	Duties Collected (% Imports)	WTO Member since
Argentina	1987	21.8	17.1	24.3	16.1	1/1/95 ^b
Brazil	1987	47.8	31.9	17.1	6.9	1/1/95
China	1992	42.8	31.9	30.0	5.6	
	1996	23.0	19.8	na	7.4 ^a	
	2005	16.2	na	na	na	
Columbia	1990	26.4	15.1	20.3	16.7	4/30/95
Egypt	1991	31.0	na	31.0	17.0	6/30/95
Hungary	1989	15.1	na	13.7	9.6	1/1/95
India	1986	99.6	54.8	50.1	51.2	1/1/95
Kenya	1987	40.0	na	21.5	15.6	1/1/95
Pakistan	1990	64.8	35.9	41.4	30.8	1/1/95

Sources:

China: Foreign Trade Reform, The World Bank, 1994, Table 3.3, p. 56. More recent figures for China are from *China 2020: China Engaged*, The World Bank, 1997, pp. 13-14.

Data on WTO membership is taken from ww.wto.org.

Notes:

- a. This includes collection of customs duties and the VAT on imports; the VAT is normally 17% on imports and domestically produced good (but 13% on selected commodities).
- b. Those countries shown as WTO members since 1/1/95 belonged to the GATT before that date.

Table 3: Changes in Industrial Output Under Different Trade Simulations

	Baseline (1997-2005)	WTO Effect	WTO Effect And NTB
Rice	39	1	1
Wheat	20	3	1
Coarse Grains	47	4	6
Nongrain Crops	74	2	4
Livestock	113	11	20
Meat and Milk	80	19	20
Other Food Products	88	-22	-32
Natural Resources	248	8	-8
Textiles	134	-17	37
Wearing Apparel	142	103	494
Light Manufactures	177	22	16
Transport Industries	773	482	292
Machinery and Equipment	354	5	-44
Basic Heavy Manufactures	279	9	1
Services	224	6	8
Capital Goods	217	2	3

Note: These data were compiled prior to the Asian financial crisis.

Source: World Bank, *China 2020: China Engaged*, Table 2.4, p. 16.

Table 4 – China’s Imports and Exports by Type of Enterprise, 1994

Type of Enterprise	Share in National Imports	Share in National Exports
State-owned enterprises and FTCs	52.1	70.2
<i>Of which:</i>		
Regional FTCs	17	40
National FTCs	27	12
State-owned enterprises	8	17
Foreign invested enterprises	45.8	28.6
<i>Of which:</i>		
Non-equity joint ventures	8.0	4.4
Equity joint ventures	25.8	14.9
Fully foreign funded firms	12.0	9.3
Collective enterprises	0.8	0.9
Private enterprises	0.0	0.0
Other enterprises	1.2	0.2

Notes:

a Estimates based on a survey of regional and national trading companies and other SOEs in 22 regions (i.e. all of China’s regions excluding Fujian, Guangdong, Nei Monggol, Qinghai, Xizang, Xinjiang, and Yunnan) in 1993.

Source:

Survey of China’s International Trade, International Trade Centre, UNCTAD/WTO, 1995, Tables 7,8.

Table 5 – U.S.-China Bilateral Trade Deficit (1988-1996)

(A) Eastbound trade (China Exports and US Imports), in Million US\$					
Year	(1) US Imports	(2) China Published Exports to US Total	(3) Direct Exports	(4) via Hong Kong	(5) Hong Kong Re-exports
1988	8511	3382	2676	705	5589
1989	11988	4410	3369	1041	8517
1990	15237	5179	3813	1367	10534
1991	18969	6159	4372	1786	13413
1992	25728	8594	5555	3039	18058
1993	31540	16965	6212	10753	21716
1994	38787	21461	7986	13476	25258
1995	45543	24713	10455	14259	27548
1996	51513	26683	14230	12453	Na
(B) Westbound trade (US Exports and China Imports), in Million US\$					
Year	(1) US Exports	(2) China Published Imports from the US Total	(3) Direct Imports	(4) via Hong Kong	(5) Hong Kong Re-exports
1988	5010	6668	4130	2538	1237
1989	5755	7863	5329	2534	1324
1990	4806	6588	4229	2359	1327
1991	6278	8008	5279	2729	1716
1992	7418	8901	5699	3202	2346
1993	8763	10687	6401	4287	3174
1994	9282	13894	9690	4204	3697
1995	11754	16118	11245	4873	4972
1996	11993	16155	11602	4553	Na
(C) Trade Balance Between US and China, in Million US\$					
<i>Year</i>	US Data	China Data			
1988	-3501	3286			
1989	-6233	3453			
1990	-10431	1409			
1991	-12691	1849			
1992	-18310	307			
1993	-22777	-6278			
1994	-29505	-7567			
1995	-33789	-8595			
1996	-39520	-10528			

Notes to Table 5:

na = not available.

Direct exports from China and direct imports from China also includes a small amount of goods traveling via countries other than Hong Kong.

Sources:

U.S. imports and exports from *U.S. Foreign Trade Highlights, 1996*, U.S. Department of Commerce, International Trade Administration, Office of Trade and Economic Analysis, August 1997, Tables 6 and 7.

China imports and exports computed from disaggregate electronic data provided by the Customs General Administration, People's Republic of China.

Hong Kong re-exports computed from disaggregate electronic data provided by the Hong Kong Census and Statistics Office.

Table 6 – Revised US-China Bilateral Trade Deficit (1988-1996)

(A) Eastbound trade (China Exports and US Imports), in Million US\$					
Year	(1) HK Value Added	(2) U.S. Imports	(3) China Exports	(4) Discrepancy (revised)	(5) Discrepancy (original)
1988	1562	6949	6703	246	5129
1989	2442	9546	9444	102	7578
1990	2961	12276	11386	890	10058
1991	3366	15603	14419	1184	12810
1992	4367	21361	19245	2115	17134
1993	5063	26477	22865	3612	14575
1994	5556	33231	27688	5543	17326
1995	7202	38341	30800	7540	20830
(B) Westbound trade (US Exports and China Imports), in Million US\$					
Year	(1) HK Value Added	(2) U.S. Exports	(3) China Imports	(4) Discrepancy (revised)	(5) Discrepancy (original)
1988	42	6205	6226	63	1658
1989	83	6996	7308	395	2108
1990	142	5991	6051	202	1782
1991	50	7944	7478	-417	1730
1992	103	9660	8264	-1293	1483
1993	116	11821	9930	-1775	1924
1994	0	12979	13060	81	4612
1995	0	16726	15151	-1575	4364
(C) Trade Balance Between US and China, in Million US\$					
<i>Year</i>	US Data	China Data			
1988	-744	-477			
1989	-2550	-2136			
1990	-6285	-5335			
1991	-7659	-6941			
1992	-11700	-10982			
1993	-14657	-12935			
1994	-20252	-14628			
1995	-21615	-15649			

Notes to Table 6:**Part A:**

Column (1) is the estimated value-added on Hong Kong re-exports of Chinese goods to the US.

Column (2) equals Table 5A, column (1) minus Table 6A, column (1).

Column (3) equals Table 5A, column (3)+(5) minus Table 6A, column (1).

Column (4) equals Table 6A, column (2) minus column (3).

Column (5) equals Table 5A, column (1) minus column (2).

Part B:

Column (1) is the estimated value-added on Hong Kong re-exports of US goods to China.

Column (2) equals Table 5B, column (1)+(5) minus Table 6B, column (1).

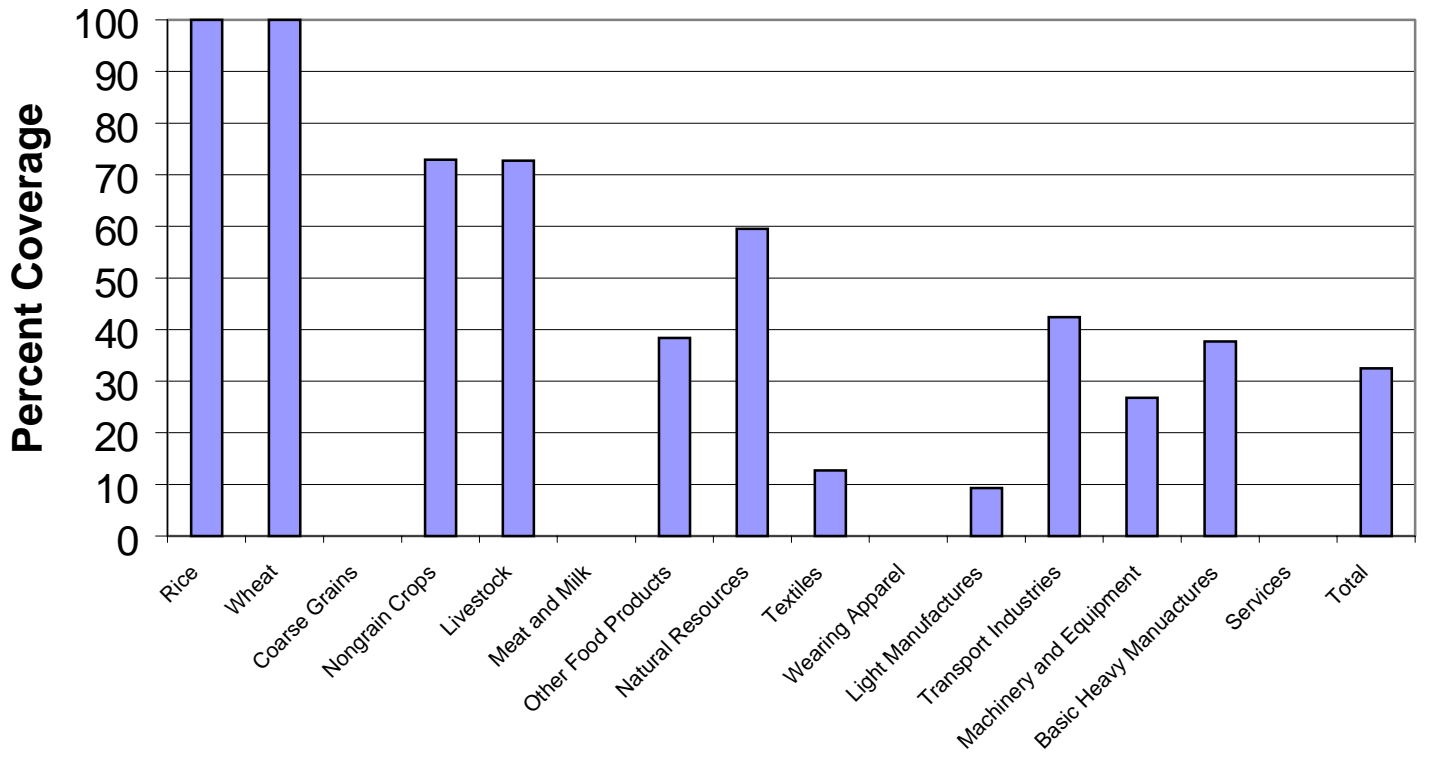
Column (3) equals Table 5B, column (2) multiplied by 0.94, minus Table 6B, column (1).

Column (4) equals Table 6B, column (3) minus column (2).

Column (5) equals Table 5B, column (2) minus column (1).

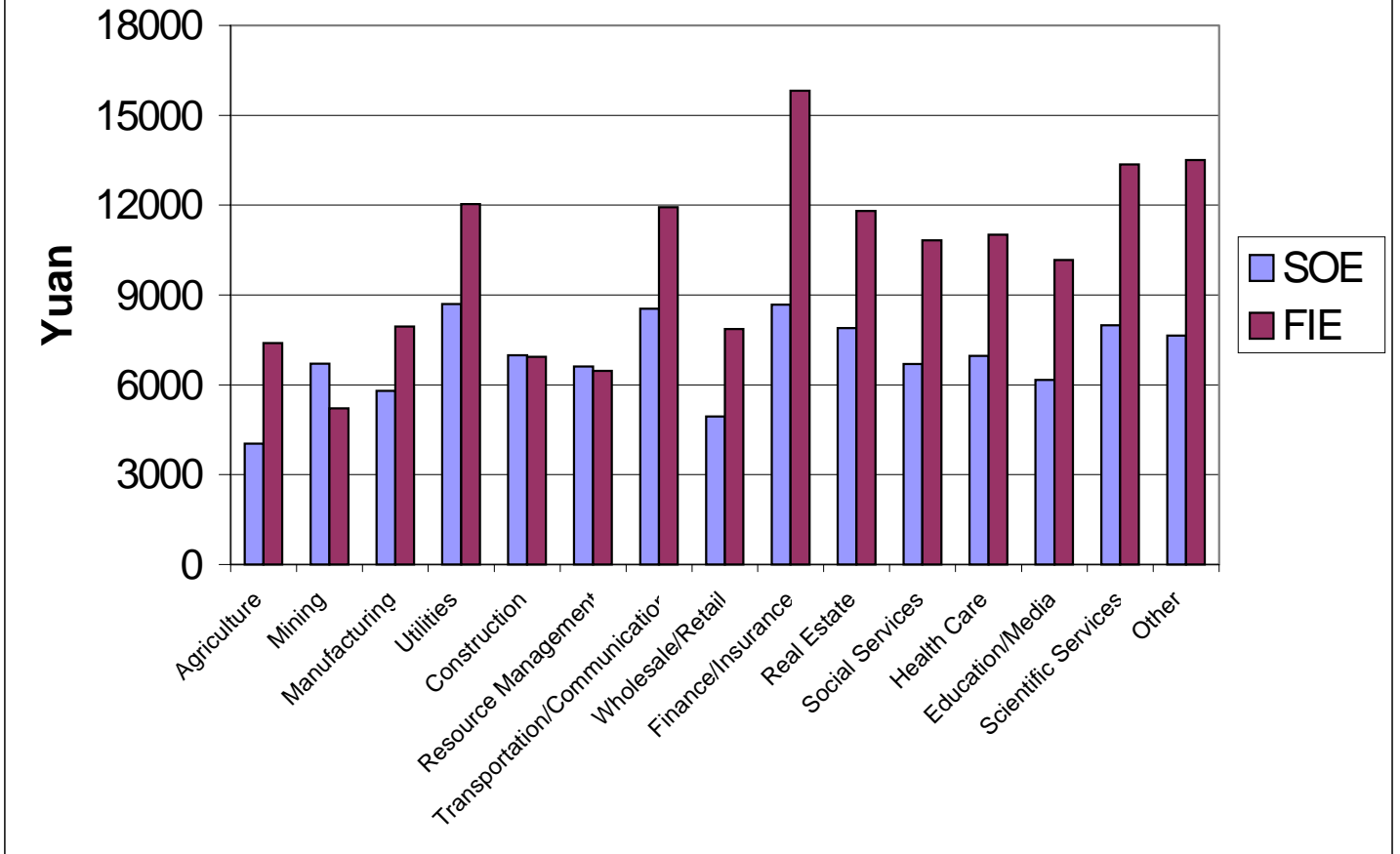
Source: Robert C. Feenstra, Wen Hai, Wing T. Woo, and Shunli Yao, "The U.S.-China Bilateral Trade Balance: Its Size and Determinants," Pacific Rim Business and Development Program, UC Davis, Working paper no. 30, May 1998; NBER Working Paper. No. 6598, June 1998.

Figure 1: Nontariff Measures Affecting China's Imports (1996)



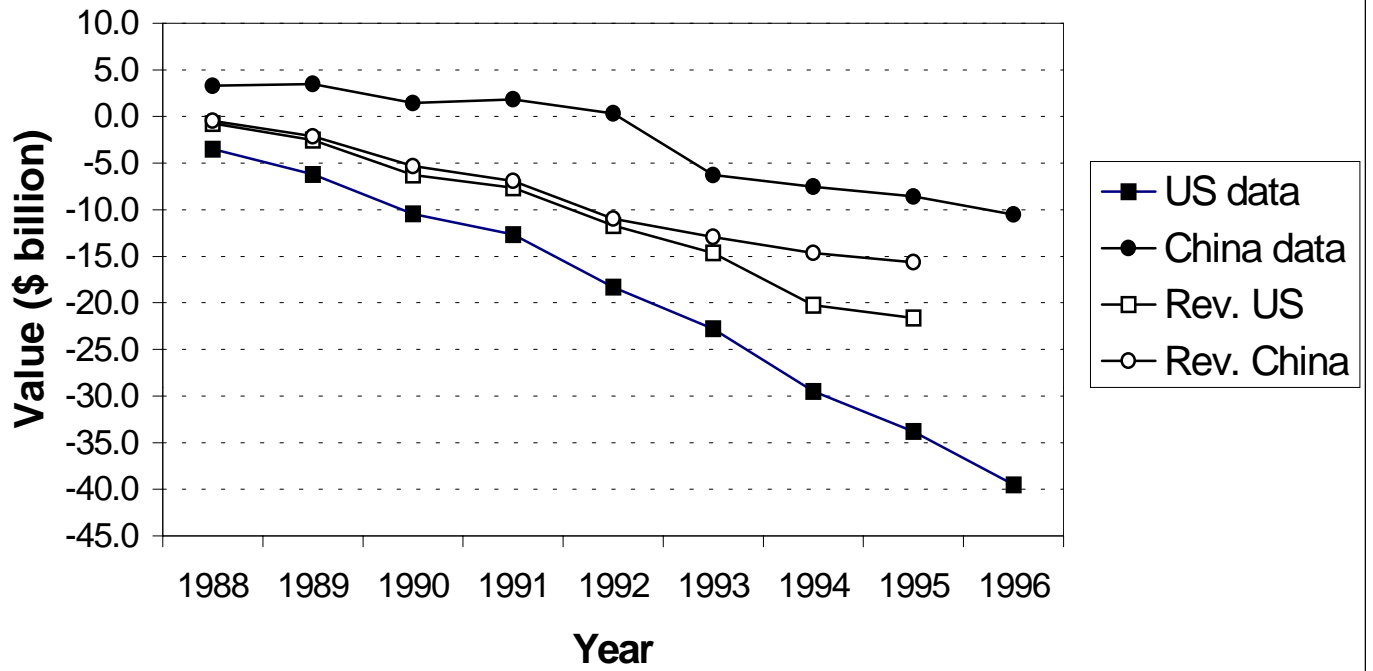
Source: World Bank, *China 2020: China Engaged*.

Figure 2: Average Wage of Staff and Workers by Sector (1996)



Source: *China Statistical Yearbook*, State Statistical Bureau, 1997.

Figure 3: U.S.-China Bilateral Trade Deficit



Source: Tables 5 and 6.