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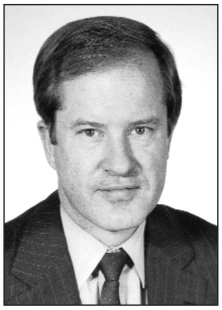
Permanent Normal Trade Relations for China

In what has been described as its most important vote this year, the U.S. Congress will soon decide whether to provide permanent normal trade relations to China. A vote is required because, after 14 years of negotiations, China is poised to enter the World Trade Organization (WTO). Assuming China concludes its bilateral negotiations with the European Union by June or July, entry is likely before the end of the year. The cornerstone principle of the World Trade Organization is that members provide each other unconditional Most Favored Nation trade status, now called Permanent Normal Trade Relations (PNTR) in U.S. trade law. Current U.S. law precludes granting PNTR to China; as a result President Clinton has asked Congress to amend the law.

A negative vote would have no bearing on China's entry into the World Trade Organization, but it would mean that U.S. companies would not benefit from the most important commitments China has made to become a member. Gaining the full range of benefits is particularly important in light of the large and growing deficit the United States faces in its trade with China (Figure 1). A positive vote would give U.S. companies the same advantages that would accrue to companies from Europe, Japan, and all other WTO member states when China enters the World Trade Organization. It would also provide an important boost to China's leadership, that is taking significant economic and political risks in order to meet the demands of the international community for substantial additional economic reforms as a condition for its WTO membership. A positive vote would strengthen bilateral economic relations more generally. That may help place a floor on the broader bilateral relationship, which continues to face critical challenges on security issues, stemming largely from tensions between China and Taiwan, and on human rights issues.

China's Domestic Economic Challenges

China faces a major challenge in sustaining the rapid economic growth that since 1978 has characterized its transition from a planned economy to a market economy. Economic growth, according to official data, was 7.1 percent in 1999, the seventh consecutive year in which growth was slower than in the previous year. The official Chinese government forecast



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In Our Interests

for 2000 is 7.0 percent, which would continue the growth slowdown yet one more year.

The challenge the leadership faces is actually much greater than these numbers suggest. The official data overstate the pace of economic expansion and the gains in real economic welfare, if for no other reason than the fact that there has been an extraordinary build up of unsold and unsaleable inventories over the past decade. While these inventories are counted as part of output and thus contribute to the growth of China's gross domestic product, they are not utilized for either consumption or fixed investment. The real resources that have gone into the production of these goods have been largely wasted. From 1990 through 1998, China's additions to inventories averaged 5.7 percent of gross domestic product. In the United States the comparable figure was 0.4 percent. While some increase in inventories is needed to support higher levels of output, the disproportionately large inventory build up in China reflects the continued production of low quality goods for which there is little or no demand. Chinese society would have been much better off if the goods had never been produced. China's Premier, Zhu Rongji, in his annual address to the National People's Congress in March, acknowledged that inventory build up was an ongoing problem and that China must "limit the production of non-marketable products." Of course, if China's banks were operating on a commercial basis, they would have cut off additional working capital loans to foundering companies, automatically limiting the build up of inventories.

Whatever the precise rate of real economic growth, there is little doubt that the Chinese economy has slowed significantly in recent years, despite a massive program of increased government expenditures and lending by state-owned banks through which the leadership has sought to prop up economic growth via increased outlays for investment.

In addition to the growth slowdown, there are several other indicators of the challenges China's leadership faces in the wake of the Asian financial crisis. Export growth has slowed dramatically since 1997. Between 1987 and 1997 Chinese exports surged from less than US$40 billion to $183 billion, an average annual rate of expansion of 16.5 percent. But in the past two years,

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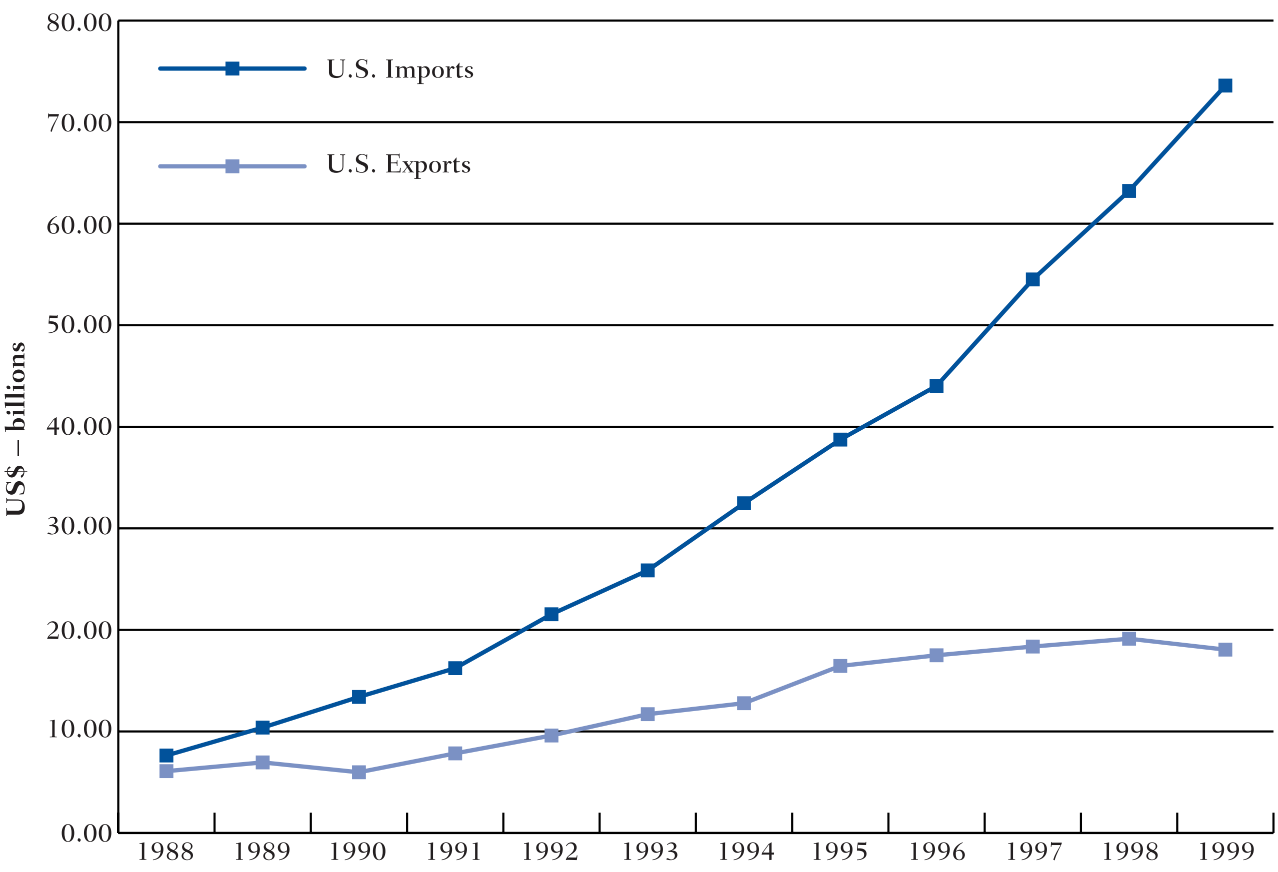
export growth has been far more modest, averaging only a little over 3 percent annually.

Similarly, after watching foreign direct investment inflows soar from US$3-4 billion annually in the late 1980s to $45 billion in 1997, the leadership saw foreign direct investment growth

Figure 1:

U.S. Trade with China 1988—1999



Note: U.S. Exports include U.S. goods re-exported to China through Hong Kong

in 1998 and then witnessed a significant decline to US$40 billion in 1999. This shrinkage in foreign direct investment is the first ever in the reform period.

Similarly, year after year foreign banks were willing to extend larger and larger amounts of foreign currency loans to China. But in 1998 foreign lending to China began to decline and after January 1999, when the Guangdong International Trust and Investment Company declared bankruptcy, loans declined sharply for the first time in more than a decade. By the end of the third quarter of 1999, total foreign currency lending to China by banks was down by US$20 billion, or about one-fourth, compared to year-end 1997.

Figure 2:
United States—China WTO Agreement, November 1999

- Agricultural tariffs fall to average of 17.5% by 2004, liberalizes imports of major agricultural commodities, import and distribution rights granted to foreigners
- Average tariff on industrial products falls to 9.4% by 2005; including elimination of all tariffs on high-technology products; auto tariffs fall from 80-100% to 25% by 2006
- Eliminates import quotas and licensing requirements by 2005
- Grants import and distribution rights to foreign corporations, allows them to set up wholly-owned distribution, sales (including retail), shipping, and service networks over a three year phase-in period
- Financial services - banking, insurance, and securities - increased access phased in over five years, culminating in full market access in all activities and regions, and national treatment for foreign banks; minority ownership in domestic securities firms and most insurance business
- Telecom - ends ban on foreign investment; allows 50% ownership in value added (internet) and paging services within two years after accession; 49% ownership in mobile telecom, domestic and international services phased in over five to six years
- Other services - increased market access for professional services, including accounting, consulting, engineering, medical, and information technology
- Commits China to implement and enforce international standards on protection of intellectual property; provides for increased access and distribution rights for motion pictures, music, and software
- United States agrees to extend China PNTR as a WTO member, phase out quotas on imports of Chinese textiles and apparel by 2004 (all other sectors already are fully open as a part of annual extension of NTR)

Safeguards and Protections

- Allows the United States to continue to treat China as a non-market economy in anti-dumping cases for 15 years after accession; this methodology generally results in the application of larger anti-dumping margins against Chinese imports
- Permits the United States to implement a product-specific safeguard to prevent large import surges from China; this safeguard, which allows the United States to impose restrictions on imports from China more easily than imports from other WTO members, would remain in effect for 12 years after China's WTO accession
- Allows the continuation of a safeguard mechanism to prevent textile import surges until the end of 2008; China will be the only WTO member subject to this mechanism

Source: USTR, Agreement on Market Access between the People's Republic of China and the United States of America

Finally, for the first time in three decades China's leadership is grappling with the problem of price deflation. The underlying problem has been over-investment in many sectors, leading to excess capacity and a tendency for manufacturers to cut prices in an effort to sell enough product to cover the cost of their labor and other variable inputs. Thus, price deflation in China for some critical products, such as steel, long predates the Asian financial crisis. But that crisis significantly deepened the deflationary trend since China's fixed exchange rate against the U.S. dollar meant that deflation elsewhere in the region was imported into China. While deflation is over in most of Asia because of a brisk recovery, deflation in China not only persists but accelerated in 1999.

The Search for a New Growth Paradigm

For the first time in three decades China's leadership is grappling with the problem of price deflation.

China's sweeping bilateral agreement with the United States on the terms of its membership in the World Trade Organization, concluded last fall, reflects the search by the Chinese leadership for a new growth paradigm (see Figure 2 for terms). There is widespread recognition that repeated short-term fiscal stimuli, which have been used to shore up growth since 1997, are no more than a temporary expedient. These short-term measures may prevent a complete collapse of economic growth, but they cannot generate sustained economic growth in the long run. The leadership has concluded that sustaining growth in the long run depends critically on allocating resources more efficiently rather than simply maintaining the highest rate of overall investment in the world. The leadership believes it can achieve increased efficiency by reducing the restrictions that have previously constrained the private sector of the economy and by bolstering competition, which will follow from opening up China more fully to the global economy.

To increase competition and stimulate productivity gains, the leadership has agreed to continue to reduce both tariff and nontariff barriers. More importantly, it has agreed to more fully open its service sector to increased foreign ownership. Financial services, telecommunications, and distribution (including wholesaling and retailing) are the most important areas where foreign firms will have significant new opportunities. All these steps will increase competition, thus placing significant additional pressure on domestic firms to lower their cost structures in order to survive. China's reformist leadership, in effect, is using the membership requirements of the World Trade Organization as a lever to achieve fundamental changes in state-owned enterprises and state-owned banks that they have long sought but which have been somewhat elusive.

There can be little doubt that the leadership fully appreciates the risks of the course on which they have embarked. Already tens of millions of urban workers have lost their jobs in state and collective factories as China accelerates domestic economic restructuring in preparation for increased international competition that inevitably will follow its membership in the World Trade Organization. Many of those who have been laid-off have found new jobs in the competitive portions of the economy–the rapidly growing private, foreign-funded, and export-oriented sectors. But those who lack the skills, or live in cities long dominated by state-owned factories, have little prospect for finding new jobs locally. Rising levels of urban unemployment, compounded by delays in the distribution of living allowances due laid-off workers and pensions due those already retired from failing state-owned companies, have led to widespread urban violence. In rural areas, too, the prospect is for substantial dislocation as China reduces its subsidies for basic staple commodities, such as wheat and corn, again in anticipation of increased inflows of lower-priced foreign products.

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The willingness of the leadership to incur these substantial short-term economic and political costs in the pursuit of long-term economic gains is a measure of the depth of their commitment to further reforms.

U.S. Interests

Granting PNTR to China is strongly in the U.S. national interest for several reasons. First, denying China PNTR would require the United States to invoke Article XIII of the Final Act of the Uruguay Round, meaning that we would not apply the World Trade Organization Agreement with respect to China, even after it became a member of the organization. The notice to non-apply would have to be delivered prior to the time the General Council of the World Trade Organization meets to approve the terms and conditions of China's membership, probably sometime in the second half of 2000.

China, in turn, would then almost certainly invoke Article XIII with respect to the United States, meaning that U.S. firms would not benefit from most of the sweeping market opening measures to which China agreed in the November 1999 bilateral agreement. Under the terms of an existing bilateral trade agreement, U.S. firms could expect their products to face lower import tariffs in China. But they would not be eligible to participate in the liberalization China has promised in financial services, telecommunications (including the internet), and distribution. And the United States would not be able to utilize the World Trade Organization's multilateral process to resolve trade disputes with China. Although the United States could subsequently reverse its non-application, during the intervening period firms from Europe, Japan, Canada, Australia, and elsewhere would gain a decisive advantage over U.S. firms, particularly in the service sectors that China has agreed to open more fully.

Second, and even more importantly, the failure of the U.S. Congress to grant PNTR to China would undermine the position of reformers in China. They have overcome intense domestic opposition to membership in the World Trade Organization, in part by arguing that such membership is the only means of avoiding the process of annual renewal of normal trade relations in their largest export market–the United States.

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The United States should embrace the commitment of the Chinese leadership to integrate China more fully in the world economy, rely more heavily on market forces to allocate resources within China, liberalize further the flow of information on which the market depends, expand the role of the private sector, and provide greater protection to intellectual property.

Over a period of time these commitments will have profoundly transforming effects within China as well as expanding trade and investment relations with the rest of the world. The most effective way for the U.S. Congress to signal support for these developments is to pass legislation authorizing the president to extend PNTR status to China when it enters the World Trade Organization. Failure to do so plays into the hands of conservative elements in China that seek to constrain the role of the private sector, limit the role of the market, restrict the development of the internet, and generally control more tightly the flow of information.

Finally, the failure of the U.S. Congress to grant permanent normal trade relations to China would significantly undermine the position of our negotiators in the final stage of China's entry to the World Trade Organization–the drafting of the protocol of accession and the report of the working party. These two documents, which will be negotiated in a multilateral setting in Geneva after China has concluded all of its bilateral negotiations, will spell out in detail China's commitments on all WTO rules. While some of these already have been specified in the November 1999 bilateral agreement between China and the United States, several critical commitments remain to be set forth and clarified at the multilateral stage.

While not all of these remaining issues have been publicly identified, at a minimum they include the details of China's commitment to eliminate agricultural export subsidies, which are not set forth in the bilateral agreement between China and the United States; China's commitment to comply with both the Uruguay Round Agreement on Technical Barriers to Trade and the Understanding on the Interpretation of Article XVII of GATT 1994, which covers the activities of state trading enterprises; and the details of the trade

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policy review process that will track China's compliance with its terms of accession once it has become a WTO member.

Given the importance of the issues that remain to be addressed, it is strongly in our interest that the voice of U.S. negotiators be just as strong in the multilateral negotiations as it was in the bilateral negotiations that led to the November 1999 agreement. The best way to assure this is for the U.S. Congress to provide the President with the authority to extend permanent normal trade relations to China.

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