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« CHINA'S ECONOMIC WAGER ON THE WTO REALITIES, MYTHS AND UNKNOWN FACTORS»

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China's Economic Wager on the WTO Realities, Myths and Unknown Factors[1]

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Few events have unleashed so much passion, generated so many analyses and publications, or given rise to so many hopes and anxieties among the Chinese population as China's accession to the World Trade Organisation (WTO). It is true that the stakes for China, at least theoretically, are high. Even leaving aside the feeling of national pride, at no longer being excluded from the « club » - which is less exclusive than is often said – which makes up the WTO, both the changes in the foreign trade system which China will have to make and the rights arising from its accession are potentially the bearers of enormous economic repercussions [2]. But it is also because the accession to the WTO is considered as a new stage, a new inspiration, a catalyser of internal economic reform, in short as an instrument of domestic policy. One can thus understand the extent and the fervour of the debates about the WTO, which could be compared with those which took place in Spanish, Portuguese and Greek society when they joined the European Community in the 1980s, or with those occurring at present in the countries of Central and Eastern Europe which are negotiating their entry to the European Union. A number of analyses have also compared China's accession to the WTO with the policy of liberalisation of December 1978, that is to say a generic economic policy decision which was to disrupt the structures and ways of functioning of the Chinese economy. As was the case in 1978, the leaders seem to be forced into reforming and producing strong economic growth, from which they derive their legitimacy, for fear being overtaken by the structural problems of the Chinese economy.

In this context, it is hardly surprising to find an extremely wide spectrum of analyses of the economic consequences of China's accession to the WTO. Between the pessimists who emphasise China's inability to meet challenges which are overstated the better to herald chaos, and the smug optimists who see in the WTO a booster capable of placing China in record time, and without mishap, on the orbit of the most economically developed countries, this article seeks to provide a more cautious and contrasted analysis. This analysis will emphasise in particular the factors which are likely to slow the liberalisation of the internal market, as well as the many unknown factors which have not been clarified by the econometric models, and which are likely to harbour many surprises as regards the influence of China's accession to the WTO on the country's economic development.

An external shock absorbed

At the forefront of the questions raised by a sizeable number of analyses of the risks run by China because of the modification of its foreign trade system, lies the fear that too extensive and too rapid an opening of the country's internal market might permanently destabilise domestic producers. Nevertheless, a more careful examination of the conditions of sale of imported products, of the long-term strategies chosen by foreign investors, as well as of the conditions of application of the WTO's rules make it possible to strongly counter this negative anticipation. In fact, the existence of a number of buffering effects[3] should soften the impact of liberalisation for domestic producers.

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[2] For a detailed summary of the commitments made by China for its accession to the WTO see annex 1, p. 749 of OECD, *China in the World Economy. The Domestic Policy Challenges*, Paris, OECD, 2002, 813 pp.

[3] Andrzej Kwiecinski, "Implications for the Rural Economy", OECD, *China in the World Economy. The Domestic Policy Challenges*, Paris, OECD, 2002, pp. 105-124

Negotiated opening and buffering effects : the example of agriculture

Chinese domestic prices, which are too remote from world prices, coupled with the lowering of customs tariffs contained in the WTO agreement could, according some analyses, produce a shift in domestic demand to imported products and a drastic fall in domestic producers' turnover, thus accelerating a massive rural exodus towards the coastal cities. This possibility has been very widely raised about basic agricultural products especially wheat, soya and rice, particularly for the producers in the poorest regions who have high production costs and are therefore at greater risk than producers in the coastal areas. Nevertheless, several factors encourage a relativisation of the scale of the impact to be expected in agriculture :

The agreements signed by China for its accession to the WTO allow for guarantees of protection of its internal agricultural market. Maximum import quotas have been negotiated on the basis of the general agreements allowed in the Uruguay Round for the liberalisation of agricultural products. These access quotas to the domestic market for imports are established in relation to domestic consumption. These quotas will be progressively increased on an annual basis until 2004 as is shown in Table 1[4].

Table 1 : Example of the evolution of import quotas and customs duties on agricultural products

Agricultural products	Imports 1998 (millions of tons)	Initial import quotas (2002) (millions of tons)	End of period quotas (2004) (millions of tons)	% of domestic consumption at the beginning and end of the period (2002-2004)	Customs duties on ıports below the quotas	Customs duties on imports above the quotas Beginning and end of period (2002-2004, except * 2006)
Wheat	1.55	7.30	9.30	6.1% - 7.8%	1%	80% - 43%
Maize	0.25	4.50	7.20	4.7% - 6.4%	1%	80% - 43%
Rice	0.26	2.66	5.32	1.4% - 2.7%	1%	80% - 43%
Soya oil	0.83	2.50	3.60	-	9%	85% - 9%*
Cotton	0.21	0.743	0.894	-	1%	76% - 40%

Sources : Nicholas Lardy, op. cit., 2002, p. 77 ; Agreement on market access between China and the United States (www.insidetrade.com)

Although, as Nicholas Lardy points out, China has agreed relatively larger import quotas than other WTO member countries, Table 1 shows that the maximum import quotas represent a relatively small part of domestic consumption even though, because of the size of the Chinese market, the imports are significant on a world scale[5]. Moreover, if the quotas are exceeded, China can impose customs duties capable of effectively protecting its domestic market (see the last column of Table 1), even though it has agreed to apply lower customs duties than those maintained by many other members of the WTO. These quotas should therefore limit the effect on local producers.

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[4] For a detailed review of the agreement see p. 77 –78 in Nicholas R. Lardy, *Integrating China into Global Economy*, Washington D.C., Brooking Institution Press, 2002, 244 p.

[5] N. Lardy, *op. cit.*, 2002, p . 78.

- Moreover, despite the variations observed between different categories of products, world and Chinese agricultural prices have already been converging for several years thanks to the productivity gains in Chinese agriculture. This trend should improve the competitivity of Chinese agriculture in relation to imports in the future.

- Lastly, the Chinese domestic market is far from being integrated. Transport costs of agricultural products are, on average, five times higher than in the United States. Producers in the interior regions who sell on local markets should not therefore face instant competition. In fact, transport costs for products imported to these markets raise the prices of these products considerably.[6] This phenomenon should, therefore, allow the poorest farmers in the most isolated regions to diversify their production or try to increase their productivity for several more years.

Exit costs for foreign investors : the example of the automotive industry

The impact on the development of the national industry has been widely mentioned as one of the main negatives factors in China's accession to the WTO. The econometric models, particularly those developed by Yang, by the World Bank, and by Li and Zhai at the Development Centre of the State Council, predict that some industries like automobiles and machine tools are likely to suffer from China's accession to the WTO, in terms of employment and production[7]. Will this really be the case ? China's ability to develop Chinese manufacturers without the majority control of foreign companies is now admittedly seriously jeopardized. But the effects in terms of employment and production are far from having been entirely anticipated by the various econometric models.

First of all, with the increase in consumption expected from the fall in prices, even if we imagine that a large part of the cars purchased are imported, service activities (distribution, repairs, and the second hand market) will grow quickly, producing growth in employment in these sectors. Moreover, major segments of the industry (utility vehicles, trucks and buses) are controlled by Chinese companies, and are very competitive in relation to foreign competition (the Dongfeng group, and the N°1 automobile group Yiqi). Finally, an analysis of the situation of foreign groups of automobile manufacturers, organised into joint ventures, and who currently dominate production in China, shows that they are not about to withdraw from the Chinese market. These joint Chinese-foreign companies have operated up to now behind customs barriers which allowed them to charge prices considerably above world prices, without being subjected to the technology race or having to introduce new models every year. Since China's accession to the WTO, all the indications are that these companies will adapt their strategies rather than give up their foothold in the market. The exit costs for foreign car producers who wanted to leave China would be all the higher for the fact that they have invested in gigantic production facilities. Citroën, for example, could produce 150,000 cars a year, whereas sales at present are around 50,000. Knowing that the Chinese market is going to grow progressively, these manufacturers will simply do the same as in other parts of the world which are open to international competition. This adaptation will include cutting the prices of their vehicles (which has already begun) and the more frequent introduction of new models, which implies the relocation of part of their R&D. Lastly, foreign producers will seek to integrate factories in China into an Asian regional production network (in some cases possibly making the Chinese

[6] A. Kwiecinski, op. cit., 2002

[7] See annex II, p. 761 in OECD, *China in the World Economy. The Domestic Policy Challenges*, Paris, OECD, 2002, 813 pp.

factory one of the centres of the Asian network)[8]. For all these reasons, even if the likelihood of the survival of an entirely Chinese manufacturer is small (as in England), in terms of employment and production, the Chinese auto industry as it exists today should not prove to be a loser because of China's accession to the WTO.

Special customs systems and smuggling

The concessions made by China are considerable in the light of its previous foreign trade system and of the advantages which other developing member countries of the WTO benefit from. Nonetheless many exceptions to the general system had been negotiated before China's accession to the WTO by various countries for several categories of products. The lowering of customs duties provided for in the accession protocol will therefore have a relatively limited impact for many firms in the industrial sector. Moreover, smuggling or grey trade had reached such proportions in the last few years for Chinese companies as well as for foreign companies established in China, especially in the coastal areas, that the customs duties were ineffective for a considerable part of imports, and even for some consumer goods. The numerous smuggling scandals over the last few years bear witness to this. The 1998 campaign against smuggling made it possible to obtain some figures which reveal the extent of the practice. The Chinese customs estimated that illegal imports worth close to 100 billion yuan, or 10% of total imports, had entered China in 1997[9]. In the case of certain products such as integrated circuits, special steels, cars, cigarettes, photographic film and petrol, the proportions are considerable. In the area of special steels, for example, illegal imports amounted in 1997 to 200% of national production[10]. In the sector of cathode ray tubes for televisions, the success of the campaign against illegal imports led to a tripling of legal imports [11]. In automobiles, a report by the Chinese institute for research on the development of the automobile industry estimated that illegal imports represented close to 17% of domestic demand[12]. All these factors lead one therefore to relativize the real impact of the concessions made by China concerning the lowering of customs duties.

Flexibilities of the application of the WTO rules and ways out

Another widely discussed theme on the risks run by China in the liberalisation of its domestic market is that of the strict application of the WTO's rules. It is said that not only has China negotiated more restrictive rules than those normally applied to other members of the WTO, but it has very little room for manœuvre in their application[13]. The protocol of China's accession to the WTO does provide, it is true, for surveillance systems aimed at verifying the application of the

[8] Interviews with the managers of Citroën-Dongfeng in Wuhan, August 2001.

[9] *South China Morning Post*, 22 November 1998.

[10] *South China Morning Post*, 22 November 1998.

[11] *Asian Wall Street Journal*, 5 March 1999.

[12] Quoted by the *South China Morning Post*, 11 November 1998.

[13] N. Lardy, *op. cit.*, 2002.

concessions that China conceded to its main trading partners[14]. Nonetheless, several factors may allow it to apply these rules in a more flexible manner, and even provide it with ways out.

The procedure for settling trading disputes in front of the Trade Dispute Settlements Body (DSB) of the WTO does not only come under the principles arising from WTO law, but depends also on diplomatic negotiations between States[15]. Imagine that a French company is the victim of a failure by China to apply one of the WTO rules which it had accepted. The company would have to go round what amounts to an assault course. First it has to assemble a dossier to show the losses incurred, and submit it to its embassy which transmits it to the relevant authorities in France. These then pass on the dossier to EU Commission in Brussels which alone is empowered to undertake proceedings before the DSB. At this stage comes a phase of bilateral consultations. If these consultations come to nothing, only then can the DSB set up a Special Group and begin the quasi-judicial phase of the procedure (with the possibility of appeal by the defendant). The phase of application of the recommendations of the Group or of the permanent appeal organ is the last stage. In the event of these recommendations not being carried out by the concerned party, the application of compensation or the suspension of trade concessions is provided for in the WTO agreement. Finally, if the the party concerned refuses the suspensions proposed, the last stage is reached : that of arbitration. Thus the procedure still remains relatively long and costly (in terms of human and financial resources), but above all it fits into a settlement of a political nature between States, which leaves the countries being attacked with a certain margin for manœuvre, especially if they have dossiers against the complainant country. The trade disputes which have been processed by the DSB in the last few years between the two major world trading partners, the US and the EU, particularly on the banana question or the (barely opened) question of the protection of US steelmakers, show that the disagreements very quickly take on a political character. Members of the WTO are thus often tempted to patiently assemble dossiers against their major trading partners, which they then opportunely produce when a dispute is being settled. Even if it is openly guilty of not respecting WTO clauses, an accused country can use other dossiers against the complainant country to negotiate an agreed settlement in the framework of the DSB.

In contrast with many developing countries, China has sufficient financial and human resources to play this political game. The many violations of the WTO's rules committed by developed countries particularly in agricultural subsidies and non-tariff barriers – which are the object of ongoing conflict between the industrialised countries and the developing economies – will undoubtedly be used by China in case of conflict over the application of the WTO's rules. Lastly, China will most likely, in the years to come, benefit from a relative leniency on the part of its major trading partners about the transformation of its legal system. They are aware of the immensity of the task to be accomplished. Thus the EU Trade Commissioner Pascal Lamy has stated that it would be preferable not to harass China during the first years of its accession to the WTO.

In any desire for reform, the cooperative or recalcitrant attitude of the (more or less well-organised) groups concerned by the reforms is essential to the success of the policy decided by the authorities[16]. The concessions granted by the Chinese government concerning the liberalisation of its domestic market are likely to disrupt certain excessively profitable positions, at both national and provincial level. It is precisely for this reason that the WTO is an effective means for the central

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[14] See in the first part of the China WTO report, the article by Leïla Choukroune « Rule of Law through Internalonalisation : The Objective of the Reforms ? » *China Perspectives*, N°69, January-February 2002, pp 7-20.

[15] Authority for the settling od trade disputes within the WTO.

[16] Andrei Shleifer and Daniel Treisman, *Without a map. Political Tactics and Economical Reform in Russia*, Cambridge, Massachusetts, MIT, 2001, 223 p.

authorities to circumvent certain established advantages and privileged situations which have been slowing the internal dynamic of reform. Beijing wants to move forward certain matters such as the improvement of the governance of State enterprises, the reform of the banking sector, regional protectionism which fragments the national market, and necessary elimination from the market of thousands of inefficient companies. The central government seems sufficiently powerful to impose painful reforms on rebellious groups within the national ministries. However, its ability to « control its troups » in the provinces is much weaker, as is shown by the complex relations between the centre and the provinces in such matters as taxation, industrial policy, regulation of the financial system and harmonisation of the distribution systems. It is to be feared that, despite as yet undefined compensations in terms of taxation and social security, those provinces likely to suffer from the liberalisation will continue to lag behind, and will show a certain creativity in setting up non-tariff barriers.

In the face of the criticisms which could emanate from abroad of the provincial governments' lack of respect for the concessions made by China when it acceded to the WTO, it is reasonable to think that the central authorities will adopt a double attitude. On one side will be displayed firm rhetoric aimed at foreign criticism of the attitude of the provinces and coupled with promises of change ; on the other there will be an inclination to a more or less conciliatory attitude towards the provinces which suffer from the opening up, an attitude which will probably vary according to the social consequences of the opening up on a local level. If the clauses in its accession protocol are blamed for an overly rapid restructuring of local economic fabric, and lead to social and political consequences deemed to be dangerous, one can reasonably expect the central government to look the other way and tacitly tolerate (while criticising them on an official rhetorical level) the discriminatory practices established by the provinces. However, if these social and political consequences are manageable, the central government will adopt a firmer attitude towards the provinces, arguing for the necessity of applying the WTO agreements, which will allow it to break down certain local protectionisms.

Generally speaking, the member countries of the WTO have proved highly imaginative in the establishment of non-tariff barriers or in the simple contravening of WTO rules which they themselves negotiated. China will do the same if it feels its economic or political interests to be threatened. The agricultural sector, for example, is certainly the one where the industrialised member countries have had the most difficulty accepting a negotiated end to a protectionism which has been the basis of the development of their national agriculture. Export subsidies and non-tariff barriers connected with health controls or environmental protection in the case of European agriculture, particularly in France, are still widely used to hinder the access of foreign agricultural products to the European market. Even the United States, whose administration favours the liberalisation of international trade and has fought against European practices, has nonetheless passed a law increasing subsidies to agricultural producers, followed by the raising of import duties on steel in order to protect its own ailing producers. These decisions will certainly push the developing countries also to use the weapons they deem necessary to protect their domestic markets. China, for example, has just decided to impose in its turn import duties on foreign steel as a protection measure and also on American soya oil as a measure of retaliation[17]. Still on the matter of agricultural products, China committed itself in its accession protocol to the WTO not to exceed the equivalent of 8.5% of agricultural production for the whole range of its subsidies to agricultural producers. Despite the difficulties of calculating all of the subsidies existing at present, and which would be situated at around 2% of agricultural production, China has margin for manœuvre which it

[17] On May 24, 2002 China decided to impose import duties for 180 days ranging from 7% to 26% according to the category of steel imported and could increase import duty on American soya oil up to around 24% ; South China Morning Post, May 23 2002.

will be able to use as needed. Beyond questions of agriculture, China also has a range of options to reduce the reach of the concessions made about the liberalisation of its domestic market. On the level of the financial sector, it can restrain the ability of foreign banks to refinance on the Chinese interbank market, thereby increasing their costs vis-à-vis the Chinese banks. On the industrial level, standards, health regulations, the maintaining of State control over some distribution or import networks, and other practises widely used by the member countries of the WTO, will allow it to cushion, if the need arises, the consequences of a clause included in its accession protocol. Generally speaking, China will be more inclined to use these practices if the industrialised countries, as is proving the case at present, do not give a good example.

All in all, without underestimating the short-term and medium-term consequences of China's accession to the WTO on the liberalisation of its domestic market, the phenomena described above show clearly that China has several tools at its dsiposal, with which to soften and control the impact of this liberalisation. Nonetheless, just as some analyses have overstated the potential negative consequences of the concessions agreed to by China in order to be able to join the WTO, some beneficial effects expected from this accession have sometimes been overestimated, while others are still difficult to define at present, so numerous and complex are the variables which influence them.

The unknown factors in China's accession to the WTO

The limits of the econometric models

Close to 20 econometric models have been made since 1997 in order to analyse the repercussions of China's accession to the WTO[18]. Although the authors of these models themselves point out clearly the limits of their mathematical constructs, once published, they nonetheless exercise a powerful influence on analyses, and sometimes even on negotiations. The predictions of the models are too often taken as given, when they should be envisaged at most as a framework for thought about the shape and the influence, in the very short term, of the few modelisable variables which come into play in China's accession to the WTO. Not only do these models suffer from numerous intrinsic limits but they are far from having integrated and picked up the influence of the multiple repercussions of a process of liberalisation such as China is embarking on through its accession to the WTO.

Almost all of these econometric models are based on the conventional theory of international trade known as comparative advantage. From a global point of view, these studies conclude almost unanimously on a positive gain of between 0% and 1.5% of growth in GDP per annum over the next decade (the results varying according to the extent of the lifting of barriers to Chinese textiles abroad). From a sectoral and regional point of view, these models therefore show unsurprisingly that China's accession to the WTO should translate into short-term and medium-term gains in those industries where China has a comparative advantage, that is to say industries with high work intensity located in the coastal provinces, such as textiles, clothing, or the assembly of products for the electronics sector. In contrast, those sectors which were highly protected and in which the capital factor (land, technology) plays a major role, such as agriculture, machine tools or automobiles, are likely to suffer in the short term as regards production and employment, from the arrival of foreign products on China's domestic market. Nonetheless, the theory of comparative advantage, which advocates the liberalisation of the foreign and domestic trade systems of

[18] See annex II p. 761 in OCDE, *op.cit.*, 2002.

countries, maintains that the short-term losses in these sectors will be compensated, on the one hand by gains in the sectors where China has comparative advantages, and on the other, in the medium and long term, by efficiency gains in the sectors which lose out in the short term. Those who were operating in these sectors under the shelter of protectionism will indeed have to react to the competition of imported products or of the foreign companies producing in China, by increasing their productivity, or by diversifying into other products where they can enjoy comparative advantages. In this way, some models such as that of Li Shantong and Zhai Fan predict the disappearance of 9.6 million jobs in agriculture during the transition phase[19]. But the authors indicate, in another model which evaluates the regional consequences of joining the WTO, that millions of jobs will be created in light industry and in the coastal cities[20]. In the longer term, in the face of more competitive American and European products, China's agricultutral producers will reduce overmanning and mechanise production (increasing productivity), while diversifying into other products. Medium and long term efficiency gains and the positive repercussions for consumers are one of the main reasons for advocating the liberalisation of economies (lowering of import duties and deregulation). According to free traders, these efficiency gains are possible not only in industry and agiculture, but also in services, which have been the object of negotiations since the Uruguay Round.

It is not the purpose of this article to point out the limits of the theory of comparative advantage and of the liberalisation of trade systems for developing contries in the framework of the WTO. It is interesting, however, in the case of China, to underline certain variables which are not taken into account in these models, and which underline the many unknown factors in the possible consequences of the liberalisation process.

With the lifting of quotas on Chinese textiles proposed by the United States and Europe and included in the WTO agreements, the models show that it is the textile sector which should gain the most where production and employment are concerned[21]. However, for a number of years Chinese manufacturers have been using indirect routes to bypass the quotas, by selling to third markets, particularly in Southeast Asia, and then re-exporting to the American and European markets. The gains in the textile industry are likely to be smaller than those anticipated in the econometric models which have taken the lowering of quotas into account. In this domain should also be pointed out, as Nicholas Lardy makes clear, all the uncertainty about the dynamism of international trade and the will of member countries to honour their decisions about the opening of their domestic markets to Chinese products[22]. Although international trade has grown continuously over the least forty years, periods of slowdown are not to be ruled out and would mean a loss of profits for Chinese exports. In the same way, the industrialised countries have in the past shown their reluctance to open their domestic markets despite the commitments made in the framework of the WTO. At the WTO meeting in Doha in November 2001, these barriers to entry provoked numerous criticisms from developing countries and nearly caused a breakdown in negotiations on the pursuit of trade liberalisation. The American government's decision to protect its domestic steel producers by imposing import duties is a good example of the infringement of the free trade which the

[19] Li Shantong and Zhai Fan, « The Implications of Acession to WTO on China's Economy », Third Annual Conference on Global Economic Analysis, Melbourne, Australia, 27–30 June, 2000.

[20] Li Shantong and Zhai Fan, « China's WTO Accession and Implications for National and Provincial Economies », Conference at the CEPII, Paris, 2001.

[21] See annex II p. 761 in OCDE, *op.cit*. 2002, for the differences between the models which take into account the lifting of textile quotas.

[22] N. Lardy, *op. cit.*, 2002, p . 78.

industrialised countries themselves demand. This decision, as well as that imposed by the EU, which is seeking to react by protecting its own producers, is costing Chinese steel producers dear, and China has officially requested the opening of negotiations so that its producers be exempted from the American import duties.

The transfer in the short term of manpower from the sectors losing out in the liberalisation to the sectors which are gaining does not happen automatically or without costs. If the gains connected with liberalisation are concentrated in light industry which is itself concentrated in the coastal provinces, the shedding of labour in agriculture and in the losing industrial sectors in the interior provinces will accentuate further the transfer of population to the coastal cities. The population pressures in the coastal zones necessitate the provision of more infrastructure (schools, housing, hospitals, roads). This infrastructure can indeed be financed by the tax income expected from growing activity in these zones, but its realization often takes considerable time. Moreover, mobility on the Chinese labour market is far from total because of the various administrative barriers (residence permit or hukou, local financing of social security), which means that only part of the population, often the youngest, will leave their region to find work. Part of the population affected by the lay-offs will therefore remain in the provinces of the interior and will need a minimum social security coverage which the authorities are already having great difficulty in providing. Only a revival of economic dynamism in the loser regions could guarantee smooth adjustments at low cost. The experience of liberalisation and of opening up in the developed countries shows that this is far from being the case. Restructuring is long and difficult on both the social and economic levels, to say nothing of the political repercussions which, in China's case, are an important element to be taken into account.

Moreover the efficiency gains in the medium and long terms expected from liberalisation are far from automatic. In many cases the « visible hand of the State » has to take over from the « invisible hand » of the market to allow the national economic players to react and establish strategies to increase productivity or to diversify into activities where they have a comparative advantage. In the case of agriculture, for example, despite the many effects which are likely to cushion the shock of liberalisation, the most exposed farmers will still need additional financing, and institutions which can teach new competencies and spread the new technological information necessary for the establishment of new activities. What of the expected adjustments in the national banking sector which are supposed to be introduced thanks to the opening of the Chinese market to foreign competition ? The Chinese banks will certainly benefit from a period longer than the transition period before facing direct competition from foreign banks. They wil also enjoy de facto advantages (as we have seen above). But before they become serious competitiors, they will have to set up enormous networks of branches, and hire and train staff experienced in banking techniques[23]. The adjustments which the Chinese banking sector faces in order to hoist itself up to the level of international competition therefore require an enormous programme of reforms which has only just been initiated. This effort is belated if one compares it with the efforts made since the 1997 Asian recession by other countries in the region like South Korea, Thailand, or Malaysia, states which, moreover, did not suffer from problems on a scale comparable to those faced by the Chinese banking sector today. According to the more or less optimistic estimates, the four major State banks are going to have to be recapitalised to the amount of between 30% and 58% of GDP (or between 327 and 632 billion US dollars)[24]. In order to avoid the accumulation of new non performing loans,

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[23] See John Thompson & Charles Pigott, "Developing the Financial System and Financial Regulatory Policies", OECD, *China in the World Economy. The Domestic Policy Challenges*, Paris, OECD, 2002, 813 p. See also John D. Langlois, JR., « The WTO and China's Financial System », *The China Quarterly*, September 2001, pp. 610-655.

[24] John Thompson & Charles Pigott, *op. cit.*, OECD, 2002.

the Chinese government is going to have to manage simultaneously the liberalisation of interest rates, the development of the interbank market, the establishment of more solid prudential rules, the likely privatisation of a good part of the State commercial banks, and a considerable improvement in enterprise governance systems. Given the the present state of the Chinese banking sector, and when one measures the work that has been done over the last ten years, there is reason to doubt the capacity of the Chinese State to successfully manage such wide-ranging reforms over a period as short as 5 to 10 years.

There are any number of examples which could be used to show that, in many sectors of the Chinese economy, the adjustments arising from liberalisation are not going to happen automatically. Consequently, they will require from the State major human and financial resources as well as reform of the institutions which manage the economy, in other words a whole range of measures which have not been taken into account by the econometric models, the outcome of which it is extremely difficult to predict at present.

Finally the question remains of what kind of economic system China is heading towards with liberalisation. If one is to believe in the theories of comparative advantage, China should specialise in the sectors in which it enjoys comparative advantages, which is to say essentially in the highly labour-intensive sectors. Now the entirely legitimate ambitions of the Chinese leaders go well beyond such a specialisation of their economic system. China aspires to climbing the value added ladder and to gradually emancipating itself from its present subordinate position on the international subcontracting pyramid which accounts for 55% of its foreign trade. China also aspires to developing world-class companies with strong technological capacities. The question is whether such aspirations are compatible with a liberalised trading system such as that accepted by China when it acceded to the WTO[25].

This question goes far beyond the case of China and concerns all the developing countries, particularly the big continental countries such as Russia, India or Brazil. An examination of the extensive literature on the catch-up strategies which have been the most successful over the last 50 years, shows that countries like Japan, South Korea or Taiwan, were far from resorting to the liberalisation of their trading systems at a stage of economic development comparable to that of present-day China[26]. These countries gave extensive priority to their domestic producers in their development strategy, by controlling foreign direct investment, regulating credit policy, protecting their domestic markets, favouring the accumulation of technological capacity in domestic companies or by forbidding majority control of their capital by foreign firms. By playing the WTO card, the Chinese leaders are, on the contrary, giving priority to consumers, leaving them the choice between domestic products and foreign ones (imports or the products of foreign firms established in China). The range of choices where development and catch-up strategies are concerned has, it is true, been somewhat narrowed under the impact of the globalisation of production and finance, as well as of the trade liberalisation produced by the multilateral negotiations in the framework of the WTO. Developing countries can no longer so easily play the protectionist card in order to assure their development. However, in the light of the Asian experiences mentioned above, as well as the experiences of developed countries, one is entitled to ask serious questions about the capacity for technological emancipation of the developing countries, including China, and their legitimate desire

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[25] Jean-François Huchet & Xavier Richet, « Between Bureaucracy and Market: Chinese Industrial Groups in Search of New Forms of Corporate Governance », *Journal of Post-Communist Economies*, vol. 14, n° 2, 2002, pp. 170-201.

[26] See the excellent article by K.S. Jomo, « Southeast Asia: From Miracle to Debacle », in Luigi Tomba ed., East Asian Capitalism: Conflicts, Growth and Crisis, Annali della Fondazione Giangiacomo Feltrinelli, n° XXXVI, Milan, Feltrinelli, 2002, pp. XLIII, 524 ; Peter Evans, Embedded Autonomy. States & Industrial Transformation, Princeton, Princeton University Press, 1995, 323 p. ; World Bank, « The East Asian Miracle : Economic Growth and Public Policy », World Bank & Oxford University Press, London, 1997.

to develop world-class companies in the present framework of globalisation. The economic nationalism expressed in the technological power of big national firms is far from having disappeared in China. Admittedly the Chaebol crisis in South Korea in 1997, and the economic stagnation of Japan since 1990 have considerably tarnished, among the Chinese leaders, the image of the development models which these two countries conveyed. But has China for all that abandoned the (so far unsuccessful) idea of having several of its national companies enter the Fortune 500 list of the biggest world companies ? The policies of creation of big Chinese groups and of mergers in several industrial sectors as well as the subsidisation of R&D show that such is not the case[27]. Has China definitively given up all thought of producing a Chinese automobile when the WTO seems to be directing it towards a situation close to that of the UK (an automobile industry without any national manufacturers) ? The protections negotiated in the framework of the WTO on engine production – a sector in which foreign firms do not have the right to exercise majority capital control – or the impossibility for foreign firms to increase their equity stake in order to take majority control of joint ventures in the automobile industry, show that the Chinese leaders still have not given up on this idea[28]. One could find a number of examples in aeronautics, telecommunications, machine tools, and integrated circuits (which despite increasing production remains a sector widely dominated by foreign firms). These aspirations of the Chinese leaders are nothing unusual, since they are at the heart of the legitimacy of the economic policies of the developed countries who find it easy to advocate the liberalisation of international trade, when they are in a position of overwhelming superiority in financial, technological and commercial terms. What will be the repercussions on all these apirations of the new strategy of liberalisation adopted by China in order to accede to the WTO, and how will these repercussions be managed politically ? These are questions which it is extremely difficult to answer at present, and which the econometric models are quite incapable of anticipating.

Acceleration and modification of the reform strategy

In a recent interview, Sir Leon Brittan, who in his capacity as former EU Trade Commissioner, took part in the negotiations on China's accession to the WTO, confided that during an interview with Prime Minister Zhu Rongji, the latter said to him that the concessions required of China were reforms which would, in any case, have been implemented even if China had not joined the WTO[29]. This statement by one of the principal architects of post-Deng Xiaoping economic policy was not only aimed at obtaining further concessions from China's major trading partners. It also reflected the decision, independent of the results of the WTO negotiations, to use the liberalisation and the deregulation of the domestic market as one of the favoured instruments of the vast project of future reforms.

Since the mid-1990s, the Chinese leaders have become fully aware of the fact that the problems faced by the Chinese economy feed on each other and are in danger, if nothing is done, of creating a systemic crisis of the kind experienced by the Asian countries in 1997 with, moreover, the spectre of political destabilisation such as in Indonesia. There is no better illustration of the interdependence of problems than the rapid growth of non performing loans in the banking sector.

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27 Jean-François Huchet, "Industry Reorganisation and Restructuring: Prospects, Problems, and Policy Priorities", OECD, *China in the World Economy. The Domestic Policy Challenges*, Paris, OECD, 2002, pp. 161-192

28 See the article by Eric Harwit, « The Impact of WTO Membership on the Automobile Industry in China », *The China Quarterly*, September 2001, pp. 655-670.

29 *Far Eastern Economic Review*, May 23 2002.

This phenomenon is the macroeconomic expression of bad governance on both company and State levels. The resolution of this problem is urgent, for on it depends future fiscal health (the State has to go into debt in order to recapitalise the banks) as well as the more efficient use of the country's financial resources in general. To solve this problem the State must nevertheless intervene on all fronts : that of the governance of companies by adressing tricky questions ranging from the transparency of the activities of boards of directors, to the possibility for minority stakeholders to sue imcompetent company managers, as well as the ubiquitous role of the Communist Party in the decision-making processes of public companies. The State must also reform the banking system by improving the prudential rules, depoliticising the decision-making processes, and developing better competencies in risk management. Similarly, the resolution of the problem of unproductive loans lies in restructuring, which implies the liquidation of a sizeable number of inefficient companies, which in turn demands an urgent improvement in the social security system. The Chinese leaders must therefore intervene simultaneously on all fronts, without fall-back positions, if they do not want to risk having the situation elude them.

In such a context, the question obviously arises of the domestic means and incentives of reform. An instrument had to be found which would galvanise domestic energies while creating irreversibility on the level of the timing and content of the reforms. Moreover some reforms demand sacrifices from particular groups of players in the provinces and in the ministries. In order to dismantle certain rent situations established during the reforms in the 1980s and the first half of the 1990s, an instrument had to be found which would by-pass any diversion or distortion by a coalition of interests opposed to reform. In such a context one understands better Zhu Rongji's remarks and his decisive action in the conclusion of the negotiations on China's accession to the WTO (his visit to the United States in April 1999, his interventions in the final phase). Liberalisation and deregulation were not only placed at the heart of the reforms, but they were negotiated in the framework of an international multilateral agreement, which gives them all the attributes and qualities necessary to become an essential catalyst for reform. China's accession to the WTO signals in a way a definitive break with the economic heritage of Deng Xiaoping, who had, rightly or wrongly, favoured an approach which was partial (in terms of the problems to be solved) and gradual (in terms of speed). China's accession to the WTO is above all an internal means of pursuing reform in a new mode and at a new rhythm, which represents a new challenge for the Chinese leadership, the outcome of which is difficult to predict. It will also be difficult from now on to perceive what comes under the pursuit of reform rather than the application of the concessions made by China for its accession to the WTO. The WTO is likely in this situation to crystallize expectations, criticisms and discontent if the pursuit of reforms were to lead to problems.

In conclusion, China's accession to the WTO provides an impetus to push through painful major reforms, which had become increasingly difficult to generate internally. Reforming by invoking external pressure while keeping open the option, in case of failure or of difficulty, of blaming foreign countries, is now standard procedure in the modernisation of an economy. With the exhaustion of the internal political dynamic of the Deng Xiaoping era, the present Chinese leaders badly needed this reason to by-pass the rent acquired by various categories affected by the reforms to come, without granting excessive compensation which would destabilise the balance of the country's finances.

If one adds the advantages expected from the accession in terms of exports, direct foreign investment, liberalisation of the domestic market and efficiency gains linked to liberalisation, one can be relatively optimistic about the economic wager made by the Chinese leaders when their country joined the WTO. Moreover, as we have shown, the Chinese authorities enjoy a number of buffering effects which protect them against too violent an impact linked to liberalisation and leave them considerable latitude as to the rate and extent of the adjusments to be made in order to best manage the liberalisation of their domestic market.

This optimism should, however, be tempered, for there also remain several major factors whose development is difficult to analyse at present, and which call for prudence and humility in understanding the repercussions of China's accession to the WTO. The stability of a favourable international environment capable of absorbing Chinese exports, the ability to manage the social costs of structural adjustment in employment in industry and especially in agriculture, the ability of Chinese companies to face foreign competition on their domestic market, as well as the difficulties of implementing simultaneous wide-ranging reform of the financial and public sectors. All these factors are difficult to « modelise ». The economic theory of comparative advantage, on which most econometric models which have sought to measure the economic consequences of China's accession to the WTO are based, is largely silent on these questions, and thereby quite incapable of measuring their power to do damage. In fact, what lies behind the positive development of these various unknown factors is simply the successful negotiation of the last stage, perhaps the most dangerous and difficult, that of the transition to a market economy, which China began what is now almost a quarter of a century ago.

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