**Shi Yutian**

# Changes of foreign trade and economic policies in China

International Journal of Management and Economics 20, 160-177

2006

**Shi Yutian**
*International Economics Department*
*Changchun Institute of Taxation, China*

# Changes of Foreign Trade and Economic Policies in China

China started its market oriented economic reform in December 1978. Though the full status of a market economy is still not accepted by the EU and the United States, but the market system in China is, evaluated by some Chinese academic institutions, functioning as well as in those market economy developing countries. China is now still taking all possible measures to improve the performance of the market. My presentation will focus on the policy changes in the foreign trade and economic sector, which has improved and/or will further improve the performance of the market system in China. My presentation will cover the following three parts: Part One, Historical Data and Main Policy Changes behind Them. Part Two, Main Problems of the Market Performance at Present and Part Three, Expected Policy Changes to Improve the Market System.

## Historical Data and Policy Changes behind Them

To have a better understanding of what is happening in China, the following data might be helpful.

**Value of Trade.** Before the start of the market oriented economic reform, China's domestic market was relatively isolated from the world market. In 1978, China's total trade was only USD20.64 billion, with an export of a tiny USD9.75 billion, which was less than 1% of the world total and ranked as the 32$^{nd}$ among the exporting countries in the world. As shown in **table 1**, in the last 27 years, China's foreign trade sector expanded unbelievably fast. In 2005, total trade value was USD1422.12 billion, increased by 69 times compared with 1978, with export increased by 78 times, and import increased by 60 times. China has become one of the largest trading countries in the world. In 2005, China's total GDP was USD2225.7 billion. The value of export, USD762.00 billion, was about 34% of total GDP. No other countries as large as China have ever had such a high rate. This means China's domestic market is now highly related to the world market.

**Growth Rate of Trade. Table 2** shows the growth rate of China's foreign trade. For most of the years after 1991, the growth rates were higher than 10 percentage point, or even as high as 20 or 30 percent.

**Table 1. Value of Trade 1978-2005 (billion USD)**

| Year | EX+IM | Export | Import | Year | EX+IM | Export | Import |
|---|---|---|---|---|---|---|---|
| 1978 | 20.64 | 9.75 | 10.89 | 1992 | 165.53 | 84.94 | 80.59 |
| 1979 | 29.33 | 13.66 | 15.68 | 1993 | 195.70 | 91.74 | 103.96 |
| 1980 | 37.82 | 18.27 | 19.55 | 1994 | 236.62 | 121.01 | 115.62 |
| 1981 | 44.03 | 22.01 | 22.02 | 1995 | 280.86 | 148.78 | 132.08 |
| 1982 | 41.61 | 22.32 | 19.29 | 1996 | 289.88 | 151.05 | 138.83 |
| 1983 | 43.62 | 22.23 | 21.39 | 1997 | 325.16 | 182.79 | 142.37 |
| 1984 | 53.55 | 26.14 | 27.41 | 1998 | 323.95 | 183.71 | 140.24 |
| 1985 | 69.60 | 27.35 | 42.25 | 1999 | 360.63 | 194.93 | 165.70 |
| 1986 | 73.85 | 30.94 | 42.90 | 2000 | 474.30 | 249.20 | 225.09 |
| 1987 | 82.65 | 39.44 | 43.22 | 2001 | 509.65 | 266.10 | 243.55 |
| 1988 | 102.78 | 47.52 | 55.27 | 2002 | 620.77 | 325.57 | 295.20 |
| 1989 | 111.68 | 52.54 | 59.14 | 2003 | 851.21 | 438.37 | 412.84 |
| 1990 | 115.44 | 62.09 | 53.35 | 2004 | 1154.79 | 593.37 | 561.42 |
| 1991 | 135.70 | 71.91 | 63.79 | 2005 | 1422.12 | 762.00 | 660.12 |

Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn
China Customs Statistics: www.customs.gov.cn

**Table 2. Growth Rate of Trade 1978-2005 (%)**

| Year | EX+IM | Export | Import | Year | EX+IM | Export | Import |
|---|---|---|---|---|---|---|---|
| 1978 | 39.4 | 28.4 | 51.0 | 1992 | 22.0 | 18.1 | 26.3 |
| 1979 | 42.0 | 40.2 | 43.9 | 1993 | 18.2 | 8.0 | 29.0 |
| 1980 | 28.9 | 33.8 | 24.7 | 1994 | 20.9 | 31.9 | 11.2 |
| 1981 | 16.4 | 20.4 | 12.6 | 1995 | 18.7 | 23.0 | 14.2 |
| 1982 | -5.5 | 1.4 | -12.4 | 1996 | 3.2 | 1.5 | 5.1 |
| 1983 | 4.8 | -0.4 | 10.9 | 1997 | 12.2 | 21.0 | 2.5 |
| 1984 | 22.8 | 17.6 | 28.1 | 1998 | -0.4 | 0.5 | -1.5 |
| 1985 | 30.0 | 4.6 | 54.1 | 1999 | 11.3 | 6.1 | 18.2 |
| 1986 | 6.1 | 13.1 | 1.5 | 2000 | 31.5 | 27.8 | 35.8 |
| 1987 | 11.9 | 27.5 | 0.7 | 2001 | 7.5 | 6.8 | 8.2 |
| 1988 | 24.4 | 20.5 | 27.9 | 2002 | 21.8 | 22.3 | 21.2 |
| 1989 | 8.7 | 10.6 | 7.0 | 2003 | 37.1 | 34.6 | 39.9 |
| 1990 | 3.4 | 18.2 | -9.8 | 2004 | 35.7 | 35.4 | 36.0 |
| 1991 | 17.6 | 15.8 | 19.6 | 2005 | 23.2 | 28.4 | 17.6 |

Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn
China Customs Statistics: www.customs.gov.cn

**Table 3. Changes of Foreign Exchange Reserves (value in billion USD)**

| Year | Value | Net Change | Year | Value | Net Change |
|---|---|---|---|---|---|
| 1980 | -1.30 | -2.14 | 1993 | 21.20 | 1.76 |
| 1981 | 2.71 | 4.00 | 1994 | 51.62 | 30.42 |
| 1982 | 6.99 | 4.28 | 1995 | 73.60 | 21.98 |
| 1983 | 8.90 | 1.92 | 1996 | 105.03 | 31.43 |
| 1984 | 8.22 | -0.68 | 1997 | 139.89 | 34.86 |
| 1985 | 2.64 | -5.58 | 1998 | 144.96 | 5.07 |
| 1986 | 2.07 | -0.57 | 1999 | 154.68 | 9.72 |
| 1987 | 2.92 | 0.85 | 2000 | 165.57 | 10.90 |
| 1988 | 3.37 | 0.45 | 2001 | 212.16 | 46.59 |
| 1989 | 5.55 | 2.18 | 2002 | 286.41 | 74.25 |
| 1990 | 11.09 | 5.54 | 2003 | 448.25 | 162.84 |
| 1991 | 21.71 | 10.62 | 2004 | 609.93 | 161.68 |
| 1992 | 19.44 | -2.27 | 2005 | 818.90 | 208.90 |

Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn
China Customs Statistics: www.customs.gov.cn

**Changes of Foreign Exchange Reserves.** From **Table 3** we can see that in 1980s and early 1990s, there was obviously a shortage of foreign exchange in China. After decades of isolation under the belief of „self-reliance and hard struggle", China was in great needs to import advanced technology from the developed countries to restructuring its backward industrial sector once it was opened to the outside world, but its export was not competitive enough. This led to trade deficits in most of years in 1980s. Besides, the foreign trade sector and even the whole economy were still centralized in nature before the 1994 reform. So „exporting goods to earn foreign currency" became the most important task of its foreign trade sector and was the priority of nearly all of its economic policies.

In order to enter WTO in 1995 when the organization was formally established, China had taken a great step in economic reform toward international practice in 1994. Though China was not accepted as a WTO member in 1995 as hoped, its trade balance was significantly improved thereafter, and had accumulated a large reserve of foreign exchange. By the end of 2005, China's foreign exchange reserves were as high as USD818.90 billion.

**Actual FDI Inflow.** In the last 20 years, China was the most successful country in the developing world to attract FDI. By the end of 2005, accumulated number of foreign invested enterprises in China was 552942, with USD662.75 billion of foreign capital actually invested. **Table 4** shows that the value of FDI to China each year is increasing steadily year after year except in 1999 and 2005.

**Table 4. Actual FDI Inflow (in billion USD)**

| Year | Value | % | Year | Value | % |
|---|---|---|---|---|---|
| 1979-1982 | 1.77 | – | 1994 | 33.77 | 22.7 |
| 1983 | 0.92 | – | 1995 | 37.52 | 11.1 |
| 1984 | 1.42 | 54.9 | 1996 | 41.73 | 11.2 |
| 1985 | 1.96 | 37.8 | 1997 | 45.26 | 8.5 |
| 1986 | 2.24 | 14.7 | 1998 | 45.46 | 0.5 |
| 1987 | 2.31 | 3.1 | 1999 | 40.32 | –11.3 |
| 1988 | 3.19 | 38.0 | 2000 | 40.72 | 1.0 |
| 1989 | 3.39 | 6.2 | 2001 | 46.88 | 15.1 |
| 1990 | 3.49 | 2.8 | 2002 | 52.74 | 12.5 |
| 1991 | 4.37 | 25.2 | 2003 | 53.51 | 1.5 |
| 1992 | 11.01 | 152.1 | 2004 | 60.63 | 13.3 |
| 1993 | 27.52 | 150.0 | 2005 | 60.30 | -0.5 |

Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn
China Customs Statistics: www.customs.gov.cn

## Main Policy Changes behind Those Data

The data shown above are reflections of policy changes. The most important changes of policies I would like to mention are as follows:

**Extension of the Right of Foreign Trade Operation.** Foreign Trade in China had been monopolized by 8 state import and export corporations before 1979. The right of dealing with foreign trade was extended to local state owned import and export corporations and all foreign invested companies in the 1980s, to private manufacturers (subject to approval)in 1990s, and to all companies under a registration system from 2004.

**Reduction of Trade Obstacles and Elimination of Subsidies.** China has made a great effort to reduce trade obstacles since the start of its economic reform, both tariff and non-tariff. And the process speeded up in 1990s.

The average tariff rate was around 42% in early 1990s, and was reduced to 14% in 2001, to 12% in 2002, and to 11% in 2003.

In 1980s, more than 200 categories of commodities were subject to import or export licenses. Now, only 3 categories of commodities for imports and 47 categories for exports are subject to licenses or export quotas, as promised before China's entry to WTO.

Under the centralized economic system, all losses of the state owned import and export corporations were subsidized by the government. In 1991, the subsidies from the budget to state owned import and export corporations were totally eliminated. They began to assume sole responsibilities for their profits or losses.

**Exchange Rate Changes.** China's import and export performance in the past two decades showed a very close relationship with exchange rate changes.

Though we can see a clear tendency of depreciation in **Table 5** before 1994, in fact, the Chinese currency RMB *Yuan* was highly over-valued in that period of time because of the even faster increase of the price level. The current account was tightly controlled, with a higher paralleled market rate remained until the end of 1993. In January 1, 1994, China relaxed its current account control and adopted a managed floating single rate system based on the supply and demand of the market with an over-depreciation of the currency from about 5.7000/USD to about 8.7000/USD. The appreciation from 1994 to 1997 can be seen as an adjustment back to its real value. The Asian Financial Crisis came suddenly in 1997. To help the Asian neighbors to get rid of the crisis, the Chinese government promised not to depreciate RMB *Yuan*, but the process of appreciation also stopped. RMB *Yuan* remained fixed to US dollar for more than 7 years from 1998 to mid 2005. The under-valued RMB *Yuan* had greatly improved China's export position, and led to the ever-increasing trade surplus since then.

**Table 5. Changes of Exchange Rate at Year Average (*Yuan* per USD)**

| Year | Year Average | Year | Year Average |
|---|---|---|---|
| 1979 | 1.5549 | 1992 | 5.5146 |
| 1980 | 1.4984 | 1993 | 5.7620 |
| 1981 | 1.7050 | 1994 | 8.6187 |
| 1982 | 1.8925 | 1995 | 8.3510 |
| 1983 | 1.9759 | 1996 | 8.3142 |
| 1984 | 2.3270 | 1997 | 8.2898 |
| 1985 | 2.9366 | 1998 | 8.2791 |
| 1986 | 3.4528 | 1999 | 8.2783 |
| 1987 | 3.7221 | 2000 | 8.2784 |
| 1988 | 3.7221 | 2001 | 8.2770 |
| 1989 | 3.7651 | 2002 | 8.2770 |
| 1990 | 4.7832 | 2003 | 8.2770 |
| 1991 | 5.3233 | 2004 | 8.2765 |

Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

The People's Bank of China: www.pbc.gov.cn

With the entry of WTO in December 2001, China's trade policies became more and more transparent and to the requirement of the organization.

## Main Problems of the Market Performance

**1) Permanent Imbalance of Trade.** If the market functions perfectly, theoretically, any imbalance would be automatically cleared. Unfortunately, this does not happen in China's international trade performance. 1993 saw the last trade deficit of -12.22 billion US dollars in China. Since 1994, China has experienced an ever-increasing trade surplus continuously for 12 years. In 2005, China's trade surplus was as high as 101.88 billion US dollars, which is nearly 5% of its total GDP. This is obviously one of the most important problems in China's trade and economic relations with the other countries. It can easily lead to trade wars and is also the main source of some other problems. At the same time, it is a clear sign of market imperfection.

**2) Problems of the Exchange Rate Determination System.** A distortion of exchange rate is the main source of the distortion of the market system. As mentioned above, the exchange rate of RMB *Yuan* was over-valued before the end of 1993. In January 1, 1994, China adopted a unitary managed floating exchange rate determination system which is based on the market demand and supply. Though the first market rate set in January 1, 1994 was obviously undervalued, it should have been a good start of a more flexible and market oriented exchange rate system. It worked well from 1994 to 1997, RMB *Yuan* appreciated by 5% in this period of time to correct the undervaluation. But after the Asian Financial Crisis in 1997, in fact, RMB was pegged to US dollar, the exchange rate to USD remain relatively unchanged for about 7 years when it should have continued to appreciate. In fact, the purchasing power of RMB *Yuan* is much higher than its face value. For example, according to the market rate, 1 Poland zloty equals about 2.5 RMB *Yuan*. But if you have a chance to go to China, you will find that, most of the necessity goods sold in the two countries have about the same price in each domestic market denominated in each local currency, rather than in one currency as stated by „the law of one price. The Chinese would be reluctant to buy from Poland because everything seems more expensive when converted into RMB *Yuan*. This can explain why Poland (and also some other countries) experienced large trade deficit in the trade with China. This permanent undervaluation of RMB *Yuan* is one of the reasons of China's trade surplus which led to an over supply of foreign currencies and a fast accumulation of China's foreign exchange reserves.

**3) Ownership Structure of Importing and Exporting Enterprises.** Along with the rapid increase of FDI inflow, foreign investors became the main exporter and importer in China. Because of those favorable policies provided to foreign investors, domestic private enterprises are at an inferior position in the competition. China is one of the largest exporting countries in the world, but famous Chinese brands are very few. Foreign invested enterprises take too large a share in China's imports and exports.

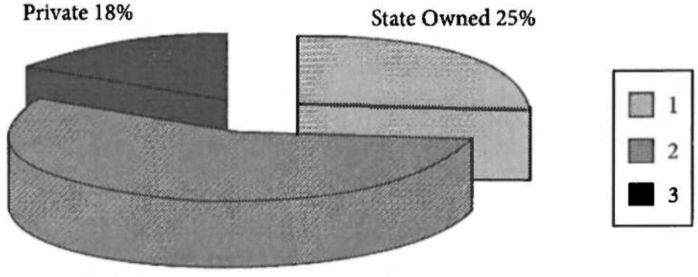


**Figure 1. Share of Export by Ownership of Enterprises in 2004**
Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

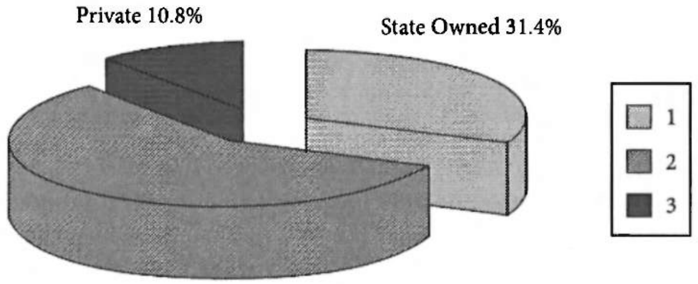


**Figure 2. Share of Import by Ownership of Enterprises in 2004**
Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

Figure 1 and 2 shows the share of import and export by ownership of enterprises in 2004. In both cases, foreign direct investment (FDI) took about 57% of the share, leaving domestic private enterprises with only 18% in export and 10.8% in import. In 2005, the situation was quite similar. Based on statistics from the Customs of China, in 2005, the share in exports was 58.30% for FDI, 22.15% for state owned enterprises, and 19.55% for private ones. For imports, the figure was 58.70%, 29.88% and 11.42% respectively. It is obvious that more than half of China's import and export are dominated by foreign investors. An investigation shows that in all the sectors that are involved in international trade, the largest five enterprises are foreign invested. In 28 manufacturing sectors, 21 are dominated by foreign investors (Yang Yonghua, 2005). Since export has already taken more than 1/3 of China's GDP, some people worry that the dominated share of FDI in export may make the economy of China highly dependent on foreign demand and vulnerable to changes in world market. Some even worry about the safety of national economy.

**4) Large Share of Processing Trade.** Processing trade refers to the business activity of importing all or part of the raw and auxiliary materials, parts and components, accessories, and packaging materials from abroad, and re-exporting the finished products after processing or assembly by domestic enterprises. It includes processing with import materials and processing with materials supplied by clients. Processing trade takes a dominant share in China's exports and also a large share in imports. In 2005, China's total export value was USD762.00 billion, in which, USD416.48 billion was processing export, 54.66% of total exports. Processing import was USD274.03 billion, 41.51% of total imports.

The policy to processing trade is among the most debatable ones in China. Theoretically, processing trade is one of the best options to bring into play China's comparative advantage, because China has the largest and probably one of the cheapest labor forces in the world, and most of the processed products are labor intensive in nature. With China becoming the „processing workshop of the world", consumers in other countries can enjoy cheaper consumer goods. In the first stage of the economic reform in China, processing trade had been an important source to provide the foreign exchange needed to import advanced technology and equipments. Processing trade also provides more job opportunities. It is estimated that there are more than 20 million people involved in processing trade in China.

But with the rapid increase of processing trade, it attracts more and more blames. It is summarized by some discommenders that foreign investors bring to China 30% of capital, get 50% of stocks and take away 70% of profit. The value of export is large, but with little value added. And it is also believed that processing trade is responsible for the damage of environment in China. Because processing trade is mainly dominated by foreign investors, with the rapid increase of processing trade, many domestic enterprises have been annexed and some famous national brands disappeared. China is one of the largest exporters of the world, but with very few self-developed property rights and Chinese brands. Policies favorable to processing trade may not be favorable for the development of domestic enterprises.

**5) Anti-Dumping Measures from the Other Countries.** A word appears most frequently in Chinese media is „anti-dumping". China has ranked the first of anti-dumping targets for 10 years continuously. Since 1995, the year WTO was formally established, there have been 707 anti-dumping cases against China's exports, which is 1/7 of the world total.

This can be seen as the direct result of a trade war caused by the ever-increasing trade surplus of China. Domestically, it is a sign of market failure. Anti-dumping means products produced in China are too cheap! Since the establishment of WTO in 1995, trade obstacles of China's main trading partners have been eliminated gradually. At the same time, the competitiveness of Chinese enterprises has been greatly improved. The exchange rate of RMB *Yuan* has been more and more undervalued following the depreciating US dollar. All these factors made China's exports very much price-competitive and led to an increasing export quantity at a decreasing price. For example, in 2003, the export quantity of TV sets increased by 70%, but the value of export increased by only 47%. The export quantity of cars and motorcar chassis increased by 206.7% but with only 56.3% increase in export value.

Externally, China is not considered to be a market economy by its main trading partners including EU and the United States. For example, the EU has rejected petitions of 13 Chinese shoemakers for grants of market economy status on account of not in compliance with the international accounting standards, ignoring the fact that 98 percent of Chinese shoemakers are private or joint ventures. Then the importing countries can use the price of third countries as a reference price in anti-dumping investigations against China.

**6) Over-Dependence on Several Main Trading Partners.** Trade between China and the largest 10 trading partners takes about 80% of China's total trade. This makes China easily affected by changes in any of them. Figures 3 to 5 show the share of the largest trading partners of China in 2004.

This should not be a very big problem because within the 10 trading partners, EU consists of 25 countries and ASEAN of 10 countries. The 10 trading partners include nearly all the main trading countries in the world. I put it here mainly to show the main trading partners of China. But with the rapid development of China's economy, its dependence on foreign raw materials will increase. It is important for China to develop its trade relations with the other developing countries. China's trade with EU is also not evenly distributed among EU members. Based on the statistics from the Customs of China, in 2004, China's total trade with Poland is USD2.33 billion. China's export to Poland is USD 1.84 billion, which is about 0.3% of China's total export, 1.7% of China's export

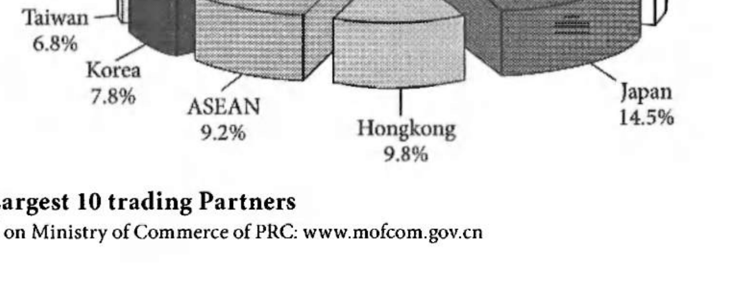


**Figure 3. Largest 10 trading Partners**
Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

to EU; and import USD 0.49 billion from Poland, about 0.09% of China's total import, and 0.7% of China's import from EU. In 2005, bilateral trade between the two countries increased by 35.3%, in which China's export to Poland increased by 40.8% with 14.4% increase in import from Poland. The figure might be larger from the statistics of Poland, because some transit trade to Poland was categorized into China's export to Hongkong. Anyhow, the potential is very large.

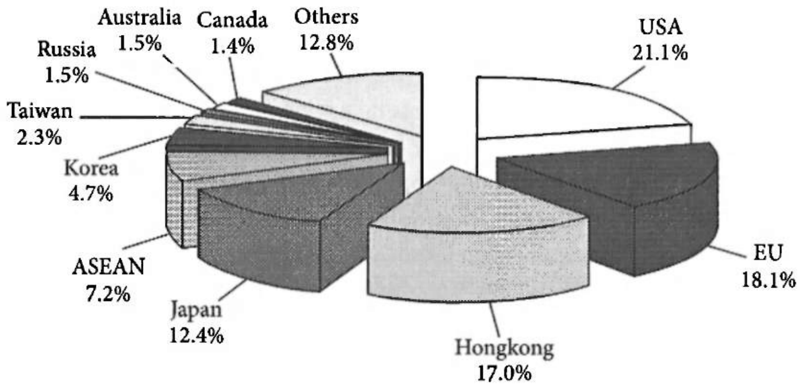


**Figure 4. The Largest Ten Export Markets**
Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

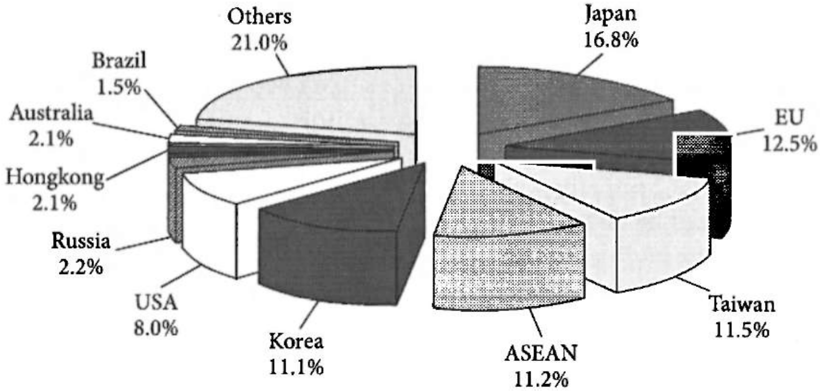


**Figure 5. The Largest Ten Import Markets**
Source: Based on Ministry of Commerce of PRC: www.mofcom.gov.cn

## Expected Policy Changes to Improve the Market System

Fortunately, the problems mentioned above have attracted great attention from the policy makers and are also under discussion of the scholars. Hopefully, they will be solved gradually by the improvement of the market mechanism and better adjusted macroeconomic policies.

**Reform of the Exchange Rate System toward a Convertible RMB *Yuan*.** The Chinese currency RMB *Yuan* became convertible under current account in 1994 under certain conditions and became fully convertible under current account in 1996. But the capital account is still strictly controlled. To improve the market performance and make China a perfect market economy, China is on the way to relax its control over capital account to make Chinese *Yuan* fully convertible and become an international currency in the future.

With the authorization of the State Council, on July 21, 2005, China moved into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The RMB will no longer be pegged to the US dollar. Instead, the RMB exchange rate will be determined based on a basket of certain major currencies with assigned weights selected in line with the real situation of China's external sector development. At the same time, proper measures could be taken to manage and adjust the RMB exchange rate based on market supply and demand while considering the changes of the basket of currencies, so as to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level. This is an important change of China's exchange rate policy from pegging the US dollar to a more flexible system. According to Zhou Xiaochuan, the governor of the People's Bank of China, in comparison with an exchange rate regime of pegging to the US dollar solely, a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies can better reflect the competitiveness of RMB against major currencies, better absorb the impact generated by an unstable US dollar and moderate the fluctuations of RMB exchange rates at the multilateral level, safeguard the overall stability of China's foreign economic and trade environment and consequently promote the basic equilibrium of balance of payments as well as the sustained, coordinated and healthy growth of the Chinese economy.

This might be seen as a further step toward a fully convertible Chinese *Yuan*, and Chinese *Yuan* began to appreciate steadily since then.

**Table 6** shows a clear tendency of appreciation of RMB in the second half of 2005. The year end rate of 2005 was 8.0702, which means a 2.56% appreciation compared with the year end rate of 2004. It is most likely that the appreciation will continue for a certain period of time, though there are quite different opinions about the question of „by how much".

**Table 6. Changes of Exchange Rate after July 2005 (end of month; Yuan/USD)**

| 2005.06 | 2005.07 | 2005.08 | 2005.09 | 2005.10 | 2005.11 | 2005.12 |
|---|---|---|---|---|---|---|
| 8.2765 | 8.1080 | 8.0973 | 8.0930 | 8.0840 | 8.0796 | 8.0702 |

At present, the appreciation of RMB will help to reduce the trade surplus and improve the external imbalance of the economy, stimulate the development of service sector domestically so to reduce its dependence on the world market by increased domestic demand. Some economists consider appreciation of RMB as a substitute of raising interest rate in case of possible inflation. They suggest that the appreciation should be even greater than market expectation.

Some others insist that it is not a wise choice to reduce export too sharply. China is still not ready to depend on domestic demand as the engine of economic development. A sharp appreciation will cause an imbalanced development of economy, which is harmful to China as well as to the world economy as a whole. They suggest that the appreciation should not be greater than 3%.

This debate is, to some extent, a temporary issue. What is important is a more flexible exchange rate determination system. Daily floating range is now 0.3%, and it is expected that it will be enlarged at a proper time in the near future.

The target of the People's Bank of China (PBC) is to speed up the relative reforms to make RMB more ready for the general adoption of the market principle. To improve the market mechanism, enhance the market-based exchange rate determination system and allow the market to better allocate resources, the PBC will further strengthen the development of the inter-bank foreign exchange market by providing more risk management instruments for banks and enterprises, expand designated banks' forward sale and purchase of foreign exchange to customers and launch RMB swaps against foreign currencies. The tight control over capital account will be gradually relaxed.

Until now, there is still no official schedule about the implement of capital account convertibility. Hu Xiaolian, Deputy Governor of the People's Bank of China, recently pointed out that full convertibility of RMB is an unalterable goal of the reform of China's foreign exchange system. But there is no fix schedule for it. Convertibility of RMB under capital account is a complicated systems engineering. The course of its fulfillment must match up to the level of China's economic development, to the ability of macroeconomic adjustment and control, to the development of the financial market, and to the risk management ability of market participants. It must also keep pace with the other reforms. The situation of international economy and financial environment must be considered as well. The capital account should be relaxed step by step. There was no given schedule. But the academic community is much more optimistic. Some economists suggest that RMB should become convertible before Beijing 2008 Olympic Games.

**Possible Policy Changes Relating to FDI Inflow.** Utilizing foreign capital to speed up the development of domestic economy has been one of the most important policies since the start of the market oriented economic reform. China has provided all kinds of preferential treatments to foreign investors in the past 27 years. Foreign investors have enjoyed „super national treatment" as termed by domestic investors. From Table 4 we can see that FDI flowed into China kept increasing every year except in 1999 and 2005. The slight drop of FDI in 2005 has caused some worries about possible competition from India and other developing countries, but it also led to a discussion about the necessities and possibilities of keeping FDI increasing year by year. Some analysts expected that FDI inflow to China will enter a relatively stable period. The net value of FDI to China each year will be around USD60 billion allowed for certain fluctuations (Wang Naishui, 2006). I am not sure if this expectation will come true, but what is certain is that with the improvement of China's investment environment and the side effects brought by FDI, the government, especially the local governments at different levels in China will become more rational in FDI attractions. This will lead to some policy adjustment.

First, China's FDI policy will become more and more neutral with less discrimination and also with less preferential treatment.

Since the entry of WTO, China has already reduced its limitation on foreign invested enterprises, e.g. no more requirement of self-balance of foreign exchange, local component in their products and export performance.

There are still some limitations, such as limitations on the percentage of stock ownership in some areas (e.g. telecommunication and finance). These limitations will be further reduced.

But China will also reduce some preferential treatment. The most important change will be the unification of the company income tax rates for foreign and domestic firms.

At present, income tax rates for domestic enterprises are: 33%, 27% and 18% (for small and low profit firms only). For foreign investors the rates are 30%, 24% (in new and hi-tech industrial development zones) and 15% (in special economic zones). But the real rate for many FDI companies is only 7.5%, because some local governments provide their own even preferential rates. It is estimated that the average tax burden of foreign-funded enterprises is about 11% at present, but 22% for domestic enterprises. The tax burden for China's large and medium-sized state-owned enterprises is usually as high as 30%. In addition, foreign-funded enterprises are allowed to list all wages as cost, while domestic companies are not.

The „super national treatment" to FDI may find its rationality for the last 27 years, but it shows more and more negative effects:

(1) First of all, it falls short of the principle of „fair play" in a market economy. It is unfavorable and unfair for the development of domestic private enterprises. The difference in tax burden put domestic enterprises in an inferior position when competing with foreign competitors. Foreign investors choose China as the production base mainly for the cheap factors of production in China. With the development of China's

economy, the wage rate will increase gradually. The advantage of cheap labor can not be kept for a long period of time. Once foreign investors decide to transfer their production to other countries, China's export and the whole economy would be greatly influenced. For a market economy to function healthily, the development of domestic private enterprises is crucial.

(2) It leads to a distortion of firm behavior—some domestic firms try to transfer their funds out of the country, and then come back as foreign capital to chase the benefit of FDI. It is said that about 1/3 of FDI in China is in fact domestic capital.

(3) Another possible negative influence is on the national confidence, because foreign capital firm means high salary, domestic firm means low salary. The average level of salary in foreign funded enterprises is about 30% higher than domestic firms. This also makes domestic enterprises inferior in attracting qualified technicians and skilled workers.

Utilizing foreign capital is not the ultimate goal. We should not attract foreign capital only for more foreign capital, even at the expense of domestic private capital. A new law relating to company income tax is under consideration to unify the tax rates to around 25%, with preferential rates not based on ownerships but on industrial policies. Lou Jiwei, vice minister of Finance, stated at a recent briefing on China's economic situation that „the conditions are ripe" to unify the corporate income tax for domestic and foreign-funded enterprises. Though he said that he expected the process to be completed in one or two years, there may be a transitional period lasting 10 years. The coming step would be to remove or simplify various corporate income tax incentives, which would also help expand the tax bases. Then corporate income tax incentives would be granted by industrial sector and geological location. For example, a 15% rate will be applied on all new and hi-tech businesses, no matter it is inside or outside a new and hi-tech industrial development zone. A 15% rate will applied in China's western regions no matter the business is a domestic company or a foreign-funded company".

This will improve the market mechanism, stimulate the development of domestic private enterprises, and balance the supply and demand of foreign exchange.

Secondly, the structure of foreign capital needs to be gradually adjusted. From the very beginning of the economic reform, the government of China emphasized greatly on using foreign direct investment (FDI), and indirect capital or portfolio investment was tightly controlled. From 1979 to 2003, FDI accounted for 73% of foreign capital to China, the share of bank loans and other types of foreign capital was less than 27%. In 2005, the value of foreign direct investment was USD60.30 billion compared with USD3.48 billion of other types of foreign capital. The deference is that, FDI is controlled by foreign investors, the indirect investment may not. With the gradually relaxed capital account, the government should encourage some qualified domestic enterprises, including private enterprises to borrow from the international capital market, properly and gradually reduce the share of FDI in foreign capital utilization.

Finally, the „Anti-Trust Law" should come into effect as soon as possible. With more and more multinationals come to invest in China, some sectors tend to be monopolized by foreign investors. At present, nearly 450 of the 500 largest multinationals have their investment in China. As mentioned above, in 28 manufacturing sectors, 21 are dominated by foreign investors. To protect the economic safety, an „Anti-Trust Law" is urgently needed.

**The „Going-out" Strategy.** In 2003, the government of China clearly announced a „going out" strategy, i.e. to promote domestic enterprises to invest in other countries. As stated by Hu Jintao in his report at the 16$^{th}$ National Congress of CPC, „Implementation of the strategy of „going out" is an important measure taken in the new stage of opening up. We should encourage and help relatively competitive enterprises with various forms of ownership to invest abroad in order to increase export of goods and labor services and bring about a number of strong multinational enterprises and brand names." Though the scale of overseas investment is still very small, but the „going out" strategy will become an important part of „the 11$^{th}$ Five Year Program" (from 2006 to 2010).

In 2003, China had approved 510 overseas investment projects, with a total investment of USD 2.09 billion. The figure was USD 3.62 billion in 2004 and USD 6.92 billion in 2005. Geographically, in 2005, 60.3% of China's overseas investment was in Asia, 16.2% to Latin America, 6.9% to Africa, 6.7% to North America, 6.3% to Europe and 3.6% to Oceania, mainly to Australia and New Zealand. It is expected that in the next five years, overseas investment will reach 8 billion to 10 billion USD every year.

The main purposes of the „going out" strategy include:

(1) Develop China's own multinational corporations and famous brand names. A very typical feature of Chinese enterprises is „empty at the two ends", i.e. lack of technological innovation and lack of sale and service network abroad. The main job is to process or deal with assembly line works. This makes the Chinese enterprises not only lose the large share of profit, but also lose the chance of long term development. To up-grade the level of opening up to the outside world, to make China a real great power in the world trade and economy, China must foster its own multinationals and develop its own famous brands with its self-developed technology. The „going out" strategy is an important way toward this direction.

(2) Improve the efficiency of domestic enterprises by larger scale resource allocation. The main purpose of the „going out" strategy is not to export large amount of capital. China is not so strong to export capital in large scales. The main purpose is to improve the efficiency of domestic enterprises by larger scale resource allocation. By investing abroad, Chinese enterprises can face the foreign market more directly, utilize local persons with ability, learn their more advanced technology, and make use of the favorable R & D environment to set up their own R & D center. They can also learn the advanced experience of management from foreign multinationals

to establish their own sales and service network so to develop and utilize the international market more efficiently, and increase export of goods and labor services.

(3) Stable supply of natural resources. By investing abroad, Chinese enterprises can develop some important natural resources together with their foreign partners on the basis of the principle of „reciprocal and mutual benefit". The latest statistics indicate that the rate of growth in oil and gas production in China continued to slow in 2003. At the same time, domestic consumption and consequent imports of crude oil increased significantly. In 2003, China produced some 169 million tons of crude oil (up 1.5 percent year-on-year) and 34 billion cubic meters of natural gas (up 6.8 percent). Meanwhile in that same year, crude oil imports were 91 million tons (up 31.3 percent). Imports accounted for 36.1 percent of national consumption that reached 252 million tons (up 10.2 percent).

Faced with substantial growth in the demand for oil, Chinese firms have not only been tapping more domestic oil sources but have also been energetically pursuing a „go-out" strategy, looking for new and stable sources of oil in the international market.

**Possible policy changes include:**

1) Relax the control of overseas investment;
2) Establish the legal system to guarantee the benefit of the investors and safety of the foreign exchange, the property right and overseas assets.
3) Simplify the procedure of examination and approval.
4) Allow the overseas enterprises to buy foreign exchange as circulating funds.
5) Provide more credit support and information services.

## Proposed Changes in the Foreign Trade System

The foreign trade system of China will be further reformed to make it even closer to WTO requirements and international practice.

(1) Reform of the Export Promotion System – switch from direct supports to a more active industrial policy for export promotion. The foreign trade system can be subdivided into management system, operation system and promotion system. With the market oriented economic reform in the past two decades, the foreign trade management system and operation system of China have become much closer to international practice, but the improvement of the promotion system still has a long way to go. For many years, the government of China tends to lay particular stress on direct support, i.e. to provide preferential policies to support the export activities of the enterprises directly. This is not in accordance with WTO principles. Depreciation or undervaluation of RMB has also played an important role in the promotion of China's exports, but with the reform of the foreign exchange system and changes of international economic environment, it can not be used very often any more.

The new export promotion system should be based on the market mechanism. Export promotion policies are to provide a better market environment for exports. Market forces will play a more important role in the promotion of exports. Besides, export promotion policies should be in line with domestic industrial policies, and provide more preferential policies and services for the export of hi-tech products with self-developed property rights. As mentioned above, the share of domestic private enterprises in export is still very small compared with foreign funded and state-owned enterprises. To help domestic private enterprises to export will become another central target of export promotion policies in the next stage of reform.

(2) Transformation of the Function of Government – from management to services, especially the local government. All foreign trade activities should be more and more market oriented. In the next five year of the 11th Five Year Program, the role of the government in administrative instructions and examinations should be further reduced. The Ministry of Commerce will focus on macroeconomic management and adjustment. The role of local government in foreign trade administration will be gradually abolished, and the local foreign trade administrative department will become a service provider. The central government will implement direct management and adjustment of market by tax rate, interest rate adjustments and other macroeconomic instruments, and the enterprises would follow the market signals not government instructions. Administrative instruments can be used only in case of market failure.

(3) Reduce the Tariff to the Level of Medium Developed Countries. The average tariff rate was 14% in 2001, reduced to 12% in 2002, 11% in 2003, 10.4% in 2004 and 9.9% in 2005. In January 1, 2006, China further reduced the tariff of more than 100 tariff items, but the influence on average level of tariff is relatively small. The average tariff rate remains to be 9.9%, 15.2% for agricultural products and 9.0% for manufactured goods. It is expected that China will further reduce its level of tariff to the level of medium developed countries.

(4) Relax Current Account Management. With the over supply of foreign exchange, the People's Bank of China will relax or even eliminate the compulsory settlement of foreign exchange under current account, which is the main reason of over supply of foreign exchange in China. Private use of foreign exchange will also be relaxed.

## Propelling of Regional Economic Integration

In 1990s, China was still very cautious to be involved in regional economic integration, and was among the few WTO members that had no free trade agreements with any other countries or districts. But now, China is becoming an active participant and propellant of regional economic integration of the new century.

On November 18, 2005, China signed a Free Trade Agreement with Chile, which was the first bilateral FTA of China with another single country. At the same time, China is now actively negotiating with other countries or groups of countries who are willing to establish FTA with China. Negotiations under way include FTA negotiations with Australia, New Zealand, Pakistan, India, ASEAN (10 + 1), Customs Union of South Africa and MERCOSUR etc., just to mention a few. Some new FTAs will be signed in the next few years. China will also play a leading role in the promotion of the Asian Free Trade Area. Since all countries negotiating FTAs with China must first accept the full status of China as a market economy, regional economic integration will provide China an even better environment of foreign trade, which will in turn, speed up the perfection of the market mechanism in China.

## Conclusion

China's market oriented economic reform is relatively successful. The market is functioning as well as most of the market economy developing countries. With its remarkable performance in foreign trade and economic sector, China is in a good condition to continue its market oriented economic reform. Those problems that still exist can be solved gradually by proper policy changes, which will further improve its market mechanism and make China an acceptable market economy to all the developed countries in the future.

## References

Ministry of Commerce of PRC: www.mofcom.gov.cn

China Customs Statistics: www.customs.gov.cn

The People's Bank of China: www.pbc.gov.cn

Speech of Governor Zhou Xiaochuan at the Inauguration Ceremony of The People's Bank of China Shanghai Head Office, August 10, 2005, www.pbc.gov.cn

Yang Yonghua, Processing Trade: Merits and Faults, Southern China Daily, 2005-07-27

Wang Naishui, USD60 Billion FDI Expected Each Year, China Information Paper, 2006-01-10

Xu Qiang, Global Development of FTAs and the Strategy of China, International Economic Co-operation, 2004-12

Cai Wei, Directions of Reform of Company Income Tax in China, China Foreign Capital, 2005-03

Shen Danyang, Reform of the Foreign Trade System in the 11th Five Year Program, www.mofcom.gov.cn

Zhao Jinping, Prospects of Foreign Capital Utilization in 2006, China Economic Times, 2006-01