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Unraveling the Mysteries of China's Foreign Trade Regime

A View from Jiangsu Province

Arvind Panagariya

Proposed reform targets for China's foreign trade.

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This paper — a product of the Trade Policy Division, Country Economics Department — is part of a larger effort in the Bank to understand the international trade regimes of centrally planned economies. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Dawn Ballantyne, room N10-025, extension 37947 (27 pages). November 1991.

Panagariya describes briefly the evolution of China's complex foreign trade regime, paying special attention to the implementation of national trade policies at provincial and city levels. This is important for understanding developments in China's external sector because provinces came to enjoy a high degree of autonomy in the 1980s. Jiangsu, one of the fastest growing provinces in China, experienced rapid growth in exports.

Assuming that China will move toward a market economy only gradually, Panagariya proposes piecemeal reform of trade policy as most desirable for improving efficiency and fostering competition. Among reforms he proposes:

• At the national level, liberalizing trade, expanding direct export rights, further rationalizing the foreign exchange retention system, extending the agency system to exports, and eliminating the discrepancy between domestic and export prices.

• More selective targeting of sectors for export and greater willingness to exit when a target sector appears to be the wrong one.

• Allowing town and village enterprises to operate as freely as possible, removing barriers to interprovincial trade and mobility of labor, and encouraging the formation of industry groups only up to the point that they do not acquire monopoly power.

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*The findings, interpretations, and conclusions in the paper are entirely mine. They do not necessarily represent the views of the World bank, its Executive Directors or the countries they represent. I am indebted to Christine Wallich for many helpful discussions and to Jaime de Melo, Peter Harrold, Donald Keesing, Fernando Montes-Negret and Wendy Takacs for comments on an earlier draft.

Unraveling the Mystries of China's Foreign Trade Regime:

A View From Jiangsu Province

This paper provides an analytic discussion of China's complex foreign trade regime and suggests policy reforms. The paper pays special attention to the implementation of national trade policies at provincial and city levels. This is important for understanding developments in China's external sector because, during 1980s, provinces have come to enjoy a high degree of autonomy. I draw specific examples at provincial and city levels from Jiangsu province and Wuxi city. Jiangsu is one of the fastest growing provinces in China; it has also experienced a rapid growth in exports during the past 10 years.[1]

The paper is divided into five sections. In Section 1, a brief history of the developments in China's foreign trade regime is provided. In Section 2, I discuss the major institutions responsible for China's foreign trade. In Section 3 and 4, I outline trade policies other policies affecting foreign trade, respectively. In Section 5, some policy reforms are suggested.

1. Evolution of China's Foreign Trade Regime[2]

During the three decades following the founding of the People's Republic of China (PRC) in 1949, a guiding principle of China's economic strategy was self reliance. Trade was relatively unimportant and grew rather slowly. Trade flows were controlled through a centralized planning system under the Ministry of Foreign Trade (MFT). All trade was conducted by 12 centralized Foreign Trade Corporations (FTCs) organized along product lines and having branch offices in the main provinces producing or utilizing their products.

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[1]The paper is based partially on a mission to Jiangsu during the month of September 1990.

[2]This section is based inter alia on the following sources: the World Bank, China: External Trade and Capital, 1988; World Bank, China: Between Plan and Market, 1990, Denny, David L., "Provincial Trade Patterns," China Business Review, September-October 1987, pp. 18-22; Ross, Madelyn C., "Foreign Trade Offensive," China Business Review, July-August 1987; pp. 30-35, Ross, Madelyn C., "Changing the Foreign Trade System," China Business Review, May-June 1988, pp. 34-36; and Leung, Wayne, "Consolidating Decentralization," China Trade Report, pp. 6-7.

Starting in 1978, China began to open its economy to foreign trade. Three major turning points can be identified. First, in December 1978, China launched its open-door policy as a part of the overall economic reform program. Second, in September 1984, the report on the Reform of the Trade System was adopted. Finally, in 1988, China adopted the Plan for Restructuring the Foreign Trade System. These changes led to an increase in China's exports-to-GDP ratio from 4.6% in 1978 to 12.7% in 1989. The country's share in world exports grew from 0.8% to 1.7% over the same period.

In the following, I describe these reforms in some detail.

Developments During 1979-1984. In July 1979, China enacted the "Law of the PRC on Joint Ventures Using Chinese and Foreign Investment". This law permitted foreign investment in China for the first time since 1949. In order to attract foreign investment and boost exports, four Special Economic Zones (SEZs) (Shenzhen, Zhuhai, Shantou and Xiamen) were established in 1980-81. This was followed by the opening of 14 coastal cities and the island of Hainan in 1984.[3]

Several developments took place during the period 1979-84. Branch offices of FTCs became relatively independent, provinces created their own FTCs to deal with specific foreign trade needs, and line ministries established their own FTCs to engage in trade in their products. In 1979, a system of foreign exchange retention rights at the provincial and enterprise level was instituted. Import licensing, accompanied by decentralization of licensing-authority, was also introduced. These changes led to a decline in the volume of trade controlled by the Ministry of Foreign Economic Relations and Trade

[3] The SEZs and open coastal cities are aimed at attracting skills, technology and foreign capital into China. They operate under the so-called "open policy" which gives them greater autonomy in managing foreign investment than the rest of China. This paper does not focus on issues of foreign investment. For details on incentives to foreign investment in the SEZs and open coastal cities the reader should consult the World Bank, China: External Trade and Capital, pp. 264-267.

(MOFERT) through the FTCs and their branches from 89% in 1981 to 72% in 1984.[4] The share of FTCs controlled by provinces and line ministries increased correspondingly.

Developments During 1985-87. In September 1984, the State Council approved the report submitted by MOFERT on Reform of the Foreign Trade System. The general thrust of this report was towards a transfer of power from the center to lower levels of administration. The report recommended that FTCs be made independent of their administrative departments and be given full authority to carry out all day-to-day functions related to trade. Subject to the approval by MOFERT, large production enterprises could be allowed to handle foreign trade themselves. The report also recommended the adoption of agency system under which FTCs were to become passive agents of enterprises and handle exports and imports for a service charge leaving enterprises responsible for profits and losses.

The September 1984 report formed the basis of subsequent trade reforms in China. Various changes recommended by the report were not implemented immediately, however. Indeed along the way there were reversals involving recentralization, followed by further attempts at decentralization, and recentralization once again.

Changes made as result of the 1984 report loosened considerably MOFERT's control over imports and led to a sharp increase in trade deficit. Alarmed by this, foreign trade officials reimposed many central controls. For example, types of activities in which FTCs could engage and their ability to compete against one another came under a more strict control of MOFERT. The system of licensing became more elaborate than before. A large number of export and import items were placed under direct control of MOFERT.[5]

In spite of these reversals, the general direction of China's foreign trade policy towards export expansion did not change. In particular, China targeted certain sectors for lateral economic cooperation

[4]MOFERT was created in March 1982 by combining the Ministry of Foreign Trade, Ministry of Economic Relations with Foreign countries, Import Export Commission and Foreign Investment Control Commission.

[5]For further details, see the article by David L. Denny mentioned earlier.

among enterprises to boost exports. This cooperation, discussed later in greater detail, took the form of Production Networks for Export (PNEs) and export associations.

Developments During 1988-to-date. In 1988, China adopted the Plan for Restructuring the Foreign Trade System. This round of reforms stressed the implementation of contract responsibility system, increased regional autonomy, and further integration of production and trade activities. The plan enhanced further the role of enterprises, trading companies, and provincial and local governments in foreign trade decisions.

A detailed discussion of the 1988 trade reform with special reference to Jiangsu is provided later in the paper. Before we move to the next section, however, it is useful to note some additional developments during 1978-89. First, since 1980, the Chinese currency, renminbi, has been devalued several times with the result that the exchange rate has changed from 1.5 renminbi per U.S. dollar in 1980 to 5.22 renminbi per U.S. dollar in 1990. Second, the foreign exchange retention system, introduced in 1979, has evolved considerably. Third, starting in 1988, China started opening swap centers where retained foreign exchange can be bought and sold at market clearing prices. By August 1990, a total of 90 such centers were already in operation. Fourth, in recent years, China has encouraged the formation of enterprise groups along the lines of Japanese zaibatsu which combine the functions of production, trading and finance. Finally, there has been an expansion of the system of direct export rights to firms.

Let us now turn to a discussion of institutions and trade policies as they exist currently.

2. Institutions

From the viewpoint of trade, three institutions are important: MOFERT which makes the major trade policy decisions, FTCs which carry out most of the business functions in the area of trade, and the State Administration of Exchange Control (SAEC) which regulates the sources and uses of foreign exchange. We discuss below each of these in greater detail.

2.1 Ministry of Foreign Economic Relations and Trade (MOFERT).

MOFERT makes all the major policy decisions with respect to foreign trade. It decides the country's overall trade policy, formulates national export and import plans, issues licenses for exports and imports of commodities under central jurisdiction, initiates trade reforms, formulates policies with respect to imports of foreign technology and investment, and so on.

In each province, MOFERT has a branch office. Formally, this office is called the Provincial Commission of Foreign Economic Relations and Trade although for convenience it is often referred to as the provincial commission of MOFERT. A provincial commission is responsible for management and planning of provincial imports and exports, issuing licenses for exports and imports of commodities under provincial jurisdiction, and approval of the range of commodities to be covered by different FTCs under its jurisdiction. The provincial commission also confers the rights to trade directly on individual firms or enterprise groups within the province.

At the city level, there are Municipal Commissions of Foreign Economic Relations and Trade. Generally, these commissions are under the supervision of the relevant Provincial MOFERT.

2.2 Foreign trade Corporations (FTCs) and Other Trading Entities.

FTCs, also referred to as Import & Export Corporations, constitute the business arm of MOFERT. Leaving aside minor exceptions to be noted below, all of China's exports and imports are handled by FTCs.

FTCs are organized along product lines and exist at national, provincial, municipal and county levels. At the national level, they are under MOFERT's administrative supervision while at the provincial level they are under the relevant Commission of MOFERT. National FTCs procure goods for export both directly and through provincial FTCs. It is estimated that there are 5000 FTCs in operation in China currently.[6]

[6]See Leung, Wayne, "Consolidating Decentralization," China Trade Report, June 1990, p 7. Madelyn C. Ross in "Foreign Trade Offensive," China Business Review, July-August 1987, p.34, put this number in 1987 at 1,200.

There are three major functions of a provincial FTC. First, it procures goods for its correspondent central FTC. Second, it exports directly commodities that are not central monopolies. For these commodities, the FTC seeks potential buyers abroad, signs contracts with them, procures goods in the home market and exports them. Finally, the FTC imports raw materials required by enterprises.

At the city and county levels, FTCs are under the administrative supervision of Municipal Commission of Foreign economic Relations and Trade and under business supervision of corresponding provincial FTCs. In Wuxi Municipality, there are 9 FTCs. In addition, the three counties under the municipality has one FTC each. Municipal FTCs procure goods for provincial FTCs and can also export directly. County FTCs procure goods for the municipality but sometimes (as in the case of Jiang Yin county in Wuxi) they can also procure goods for provincial FTCs. Any goods beyond municipal and provincial quotas procured by county FTCs can be sold for a profit to FTCs in the same or other provinces or to national FTCs.

Besides above FTCs, there are a few other types of FTCs. Sometimes enterprises from different localities band together into an FTC on the basis of certain common interest, e.g., China Bearing Export Corporation and China Cable and Wire Export Corporation. There are also FTCs comprised of regional general trading corporations in Guangdong, Fujian, Shanghai, Tianjin and Beijing.

A handful of enterprises and business groups also enjoy the <u>rights to trade directly</u>. These enterprises and business groups can export their output and import raw materials necessary for production directly. The rights to trade directly are conferred upon these enterprises by the relevant provincial commission of MOFERT based on guidelines issued by the State. In Jiangsu, there are 27 such enterprises and business groups at present. In 1989, they exported $80 million worth of goods amounting to 3.28% of total provincial exports. Exchange retention rights of these enterprises and groups are the same as of other enterprises in the industry.

Finally, there are also reports of <u>exports through illegal channels</u>. It appears that a large proportion of illegal trade takes place with Hong Kong. According to one account, "In the past, many exporters sidestepped the designated foreign trade channels and sold their goods to Hong Kong agents who paid them in foreign exchange. The resulting 'export at any price' mentality drove down the international price of many Chinese goods. MOFERT estimates that in 1985, parallel trade through Hong Kong decreased the value of China's exports by Y2 billion."[7] A prominent commodity subject to illegal exports is silk. It is reported that as much as 37% of silk exported to Hong Kong in 1986 went through illegal channels.[8]

On the import side, a large number of cases involving seizure of goods by customs officials is reported each year. In 1984 alone, there were 26,000 such cases. The value of goods involved in these cases was $25 million and items confiscated included watches, radios, cassette recorders, televisions, video recorders, cars, motorcycles, and chemical fiber products. The magnitude of undetected illegal trade is only a matter of speculation.[9]

2.3 State Administration of Foreign Exchange Control (SAEC) and Foreign Exchange Adjustment Centers (FEACs)

SAEC was created in 1984 to regulate the sources and uses of foreign exchange. It maintains branch offices in provinces as well as many municipalities. In addition to controlling the province's sources and uses of foreign exchange, a provincial branch is responsible for ensuring that the province's foreign exchange contract with the center is fulfilled. Between May 1986 to March 1988, branch offices of the SAEC in most provinces also administered foreign exchange adjustment involving a transfer of retained foreign exchange of one enterprise to another. Municipal branches of SAEC perform the same functions at the city level as provincial branches at the provincial level.

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[7]Ross, Madelyn C., "Changing the Foreign Trade System," China Business Review, May-June 1988, pp. 35.

[8]In 1986, official exports of silk from China to Hong Kong amounted to $376 million. For more details on smuggling of silk, see LoPinto, B.M., "Fashioning a Successful Silk Industry," China Business Review, March-April 1988, pp. 54-56.

[9]For further details see, Chan, Yvonne and Levy, Mimi, "The New Customs Law," China Business Review, November-December, 1987, pp 45-46.

In 1988, a major development took place in China in the area of foreign exchange. The central government decided to establish Foreign Exchange Adjustment Centers (FEACs) under SAEC in 57 cities.[10] Progress on establishing these centers was swift and by August 1989, there were as many as 90 of them in operation. The main function of FEACs, or swap centers as they are called popularly, is to facilitate purchase and sale of retained foreign exchange at more or less a market clearing rate albeit for specific purposes within the rules laid down by the center. In 1988, $6.26 billion, accounting for 33.85% of foreign exchange retained by enterprises, was traded at these centers.[11] By the end of 1990, there were 12 FEACs in Jiangsu province alone.

3. Trade Policies[12]

In order to understand the trade policy framework in China, it is useful to divide the discussion into three broad areas: (i) export licensing, (ii) imports licensing, and (iii) tariffs and export taxes. In the following, we describe each of these policy instruments in detail.

3.1 Export Licensing.

Export licenses are divided into three categories. MOFERT decides which commodities are included in which category. Classification of commodities into the three categories is adjusted frequently.

Category one goods are under direct control of MOFERT. In this category, all aspects of exports including conclusion of contracts, issuing of export licenses, and financing are handled by MOFERT. National FTCs have a monopoly over these exports. According to the latest list available, dated June 1988, there are 27 commodities including rice, pork, raw silk, raw cotton, cotton yarn, grey cotton fabrics, diamonds, crude oil, coal, and tungsten on this list.[13]

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[10]FEACs have existed in China since 1985. To our knowledge, the first FEAC was established in Shenszhen. See Yowell, Diane, "Swap Center System to Expand," China Business review, 1988, September-October 1988, 10-12.

[11]See Brahm, L.J., "The Swap Service," China Trade Report, November 1989, pp. 8-9.

[12]For a more detailed account, see the World Bank, China: Between Plan and Market, 1990.

[13]See Almanac of China's Foreign Economic Relations and Trade, 1989, pp. 107-118, for a complete list of items under different categories of exports.

Category two goods are also subject to MOFERT's mandatory export plan. The main difference between this category and the previous one is that trade in this category is divided into two parts. Export contracts are concluded at the national level while export licensing, financing and other functions are handled at local levels. According to the June 1988 list, in this category, export licenses are issued for 41 commodities by Special Commissioners' Offices of MOFERT and for 91 commodities by commissions of provinces, autonomous regions, municipalities directly under the central government and cities and regions with separate plans. Commodities in category two include items such as frozen pork, wool, toilet paper, live cattle, beef, mutton, ham, edible sugar, timber, groundnut oil, edible salt, carpet, cement, steel products, knitted grey fabrics, and bed sheets.

Category three goods include all goods not included in categories one and two. Here no export licenses are required and central government involvement is minimal. Trade in commodities in this category is handled at provincial or local levels. A sizable proportion of exports falls under this category.

Several justifications are provided for restrictions on exports of the products in categories 1one and two. For certain commodities such as rice and crude oil, it is argued that they are staple resources and that national livelihood depends on them. For some other commodities including raw silk and raw cotton, it is felt that China has monopoly power in the world market for them. In the case of some raw material exports, the restrictions are intended to encourage exports of higher value added goods. A final possible reason is that certain goods are subject voluntary export restraints in the world market and have to be allocated by the central government among provinces.

3.2 Import Licensing.

Like export licenses, import licenses are also divided into three categories. In the first category, we have goods for which licenses are issued directly by MOFERT. Some materials in this category are considered essential for economic development while others are believed to be price sensitive requiring centralized purchasing. In December 1987, there were 14 items in this category including steel products, timber, civil aircraft, petroleum, sugar, and wool. This list has grown longer since then and includes automobiles.

For goods in the second category, licenses are issued by MOFERT's commissions in provinces, autonomous regions, municipalities directly under the central government, and cities and regions with separate plans. This category of goods is considered important for provinces and includes items such as washing machines, tape recorders, motorcycles, cameras, watches, synthetic cloth, garments made of chemical fabrics, and electronic microscopes. In December 1987, the list contained 53 items.

Finally, there are goods for which licenses are issued by MOFERT's Special Commissioners' Offices at major ports. Items in this list are a subset of the previous two lists. The Special Commissioners issue licenses for the coastal cities and for enterprises with foreign investments in regions of their responsibility for several of the commodities in the first category. They also issue licenses for commodities in the second category to enterprises under direct control of central departments in regions of their responsibility.

3.3 Export Taxes and Import Tariffs.

Export taxes and tariffs in China are governed by "Regulations on Import and Export Duties" promulgated in March 1985 and amended in September 1987 by the State Council.[14] The trade taxes are administered by the General Administration of Customs (GAC) which has branches in each provincial-level administrative region. Tax schedules are revised frequently.[15]

Export duties are levied on relatively few items. In 1985, export duties were assessed on 35 commodities with rates ranging from 10 to 60 percent. In January 1987, the number of items subject to this tax fell to 8.

[14]The text of this law can be found in Almanac of Foreign Economic Relations and Trade, 1988, pp. 163-166.

[15]For a detailed discussion of trade taxes in China, see World Bank, China: External Trade and Capital, 1988.

The system of import tariffs is very elaborate. More than 2000 items categorized into approximately 100 types of goods are subject import duties. Tariff rates on imports fall into two categories: general tariff rates and minimum tariff rates. The former apply to imports from countries with which China does not have trade treaties giving reciprocal favorable treatment. The minimum tariff applies to countries with which China does have such treaties. Countries in this group include United States, Japan, Australia, Eastern Bloc countries, etc.

In 1987, minimum rates ranged from 3 to 150% while general rates varied from 8 to 180%. It appears that import duties were reduced in 1988. But during 1990, they were raised again.

In addition to minimum and general tariffs, China also levies a "regulatory tariff." This tariff works like a temporary import surcharge. For example, in January 1990, regulatory tariffs of 50% were imposed on sweeteners, perfume, soap and dust catchers. These items already carried rather high minimum and general tariffs. For example, the minimum and general tariffs on perfume are 120% and 150%.

Imported inputs used in the production of exportables are not subject to import duties. China has a system of export-duty drawback in place under which duties paid on imports used in exportables are refunded to enterprises. Materials entering the country for processing and assembly and eventual reexport are also exempt from duty. This provision helps reduce the anti-trade bias of the trade regime.

4. Other Policies Affecting Exports

There are several additional policies which influence exports. We classify them into six broad categories: (i) Export targeting policies, (ii) Direct export and import rights, (iii) Foreign exchange retention rights, (iv) Foreign trade contracting system and export targets, (v) Export pricing policies, and (vi) Local policies affecting exports. We discuss each of these policies in turn.

4.1 Export Targeting: Production Networks for Exports

The Seventh Five Year Plan provided for the creation of what are called Production Networks for Exports (PNEs). The idea behind these networks is to stimulate the exports of advanced enterprises within target industries. Participating factories are selected by the national authorities. The networks' objectives are to move into higher value added exports, improve quality, multiply categories and raise competitiveness.

The first industry group to benefit from this scheme was machinery and electrical goods. Plans for a PNE in this industry group were approved by the State Council in October 1985. Several hundred factories producing rather diverse products were selected to participate in the network. It was envisaged that the government will invest $108 million each year for five years on technical upgrading of the chosen factories. In addition, factories in the network were to be given guaranteed supplies of raw materials, power and packaging materials, preferential access to transportation, tax reductions or exemptions on imported equipment and materials, attractive purchase prices for their goods, and higher foreign exchange retention rights than other enterprises in the same industry. By the end of 1987, exports of ten products in the network had reached the level of $100 million or more. These products included watches, radio-cassette recorders, radios, hand tools, architectural hardware, telephones, television sets and ships.

Production Networks for Exports have also been created in light industrial products and textiles, and farm and sideline products. Recently, there has been a move to bring the export-oriented rural enterprises within the fold of PNEs.[16] Thus, in May 1990, 193 township enterprises were chosen by the national government to participate in PNEs. Of these 193 enterprises the largest number, 41, came from Jiangsu. As a part of the network, these enterprises will enjoy the same favorable pay and conditions as State enterprises in the network.

4.2 Direct Export and Import Rights.

In recent years, China has encouraged the policy of giving direct export and import rights to qualified enterprises and enterprise groups. There are two types of groups with these rights in Jiangsu. Presently, these groups together presumably account for less than 5% of Jiangsu's total exports. But in future, they may emerge as important instruments of growth in foreign trade.

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[16]For more details on PNEs, see Almanac for China's Foreign Economic Relations and Trade, 1988, pp. 83-85 and Madelyn C. Ross, op. cit.

The first group consists of enterprises that receive rights to trade directly from the Jiangsu Commission based on criteria laid down by the center. There are 27 such enterprises and business groups in the province at present. In 1989, they exported $80 million worth of goods amounting to 3.28% of total provincial exports.

Direct-export rights can be granted by a provincial Commission for only those goods not subject to export licensing (i.e., goods in category three in Section 2.1). The main criterion for obtaining these rights is that the annual value of goods exported by the enterprise through FTCs at the time of application be Y10 million or more. In addition, the Commission must be satisfied with the personnel's qualifications in the area of direct trading.

Within three years of granting of export rights, direct exports of the enterprise must reach at least Y3 million (revised recently from Y5 million). Otherwise, the right to trade directly can be withdrawn. Exchange retention rights of these enterprises and groups are the same as of other enterprises in the industry.

The second group with direct export rights consists of some center designated enterprises or enterprise groups. Two examples in this category in Jiangsu are Nanjing Radio Import-Export Corporation and Nanjing Automobile Import-Export Corporation. These corporations are allowed to retain 100% of their foreign exchange. We were not provided enough information about these groups but as far as we are able to judge, they are a part of the PNEs described above.

4.3 Exchange Retention Rights.

In order to encourage exports, China has put in place a rather elaborate system of foreign exchange retention rights. Retained foreign exchange can be either used for imports permitted by the

State or sold for specific purposes in a FEAC.[17] In effect, the system offsets partially the negative effect of the overvalued exchange rate and/or the low renminbi prices paid by FTCs on exports.

Rights to foreign exchange generated by exports are shared among the central, provincial and municipal governments, FTCs, and the enterprise responsible for exports. Shares of these recipients may differ by commodities and have been revised several times during the last 12 years. According to current shares, established at the beginning of 1991, for most of the commodities, 20% of retention rights are allocated to the central government, 10% to provincial and local governments, 10% to enterprises, and 60% to FTCs. This allocation is modified by a second round of transactions according to which the central government can buy up to 10 and 20 percentage points of retention rights from enterprises and FTCs, respectively, at the exchange rate prevailing in FEACs. Thus, ultimately, the central government can acquire up to 50% of the foreign exchange generated by exports. Further details on the current sharing system are unavailable but it appears that for priority sectors such as machinery and electrical goods, retention rights are more favorable to enterprises and FTCs.

We have more detailed information on pre-1991 retention ratios. these ratios differed by commodities and occasionally by provinces. They also depended on whether or not exports in question were in excess of the mandatory quota and whether or not the enterprise in question belonged to a

[17]The central government sets priorities for purchase and sales of foreign exchange. According to the priorities prevailing in 1989, 5 items were given preference, another 3 were permitted if foreign exchange was plentiful, and 6 items were prohibited. The priority items were: (i) materials for agriculture (e.g., fertilizer and pesticides); (ii) necessities (e.g., rice, sugar and grain); (iii) raw materials for light industry such as textiles; (iv) key projects which can generate foreign exchange for the country (e.g., central government supported projects for technical updating and renovation); and (v) joint ventures. The three items allowed subject to the availability of foreign exchange were: (i) science, technology, cultural exchange, medical equipment, education and sanitation; (ii) parts needed by electronic enterprises approved by the central government; and (iii) raw materials for other industrial enterprises. The prohibited items consisted of (i) general consumption items (e.g., cigarettes, cosmetics, soft drinks, and clothes); (ii) luxury goods (e.g., cars, refrigerators and gold); (iii) products made domestically (e.g., machinery, electronic goods); (iv) foreign debt; (v) leasing fees to be paid abroad; and (vi) investment abroad.

Production Network for Exports (PNE). For instance, the retention rights were divided between the center and provinces in 75:25 ratio for within quota exports but in 20:80 ratio for above quota exports.[18]

These rules did not apply uniformly to all industries and enterprises. For example, in light industry, arts & craft, and knitwear, the 20:80 sharing rule applied to all exports. Similarly, in machinery and electrical goods sector, for within quota exports, the split between the center and provinces was 35:65. Moreover, enterprises received 21 percentage points out of the province's share rather than the 12.5 percentage points under the other two rules. Incidentally, machinery and electrical goods sector has also been the one where the center has promoted most vigorously the Production Network for Exports through a variety of incentives.[19]

A point which deserves noting is that retention rights within a sector are generally uniform across enterprises. Thus, collectives, TVEs and enterprises with direct export rights have the same retention rights as state owned enterprises who export their goods through FTCs.

Under the system prevailing prior to 1991, buyers and sellers within the jurisdiction of a given FEAC were normally required to buy and sell retained foreign exchange in that FEAC. This meant that exchange rates could vary across FEACs. The reform introduced in January 1991 appears to have relaxed this restriction. This change is in the right direction since it will equalize the marginal value of foreign exchange across various users.

4.4 Contracting System and Export Targets

China has an elaborate system of contracts to achieve its export and foreign exchange targets. Thus, all provinces are required to sign annual contracts with MOFERT specifying their export quotas, the basic amount ot renminbi subsidy to be received for earning foreign exchange through exports, and

[18]Under the 75:25 division, the province's share was subdivided as follows: 12.5% went to the enterprise, 7.5% to the municipal commission of MOFERT, and 5% to the provincial commission of MOFERT. The corresponding subdivision under 20:80 rule was: 55% to the FTC, 12.5% to the enterprise, 7.5% to the municipal commission of MOFERT and 5% to the provincial commission of MOFERT.

[19] For above-quota exports, foreign exchange rights in this sector were divided according to the same 20:80 rule applicable to other industries.

foreign exchange earnings to be turned over to the center. For three years starting January 1988, Jiangsu was to provide foreign exchange worth $700 million annually to the center. Any foreign exchange generated by Jiangsu in excess of this amount was to be shared in the 20:80 ratio between the center and the province.

In order to fulfill their contractual obligations to the center, provincial commissions sign contracts with their subordinate bodies. For example, Jiangsu Commission of MOFERT signs contracts with provincial FTCs, municipal commissions under its jurisdiction and some city and county FTCs specifying their export and foreign exchange quotas.[20] Municipal commissions sign similar contracts with FTCs both in the city and counties under their jurisdiction. All FTCs, in turn, sign contracts with enterprises, collectives and TVEs.

Contracts in Jiangsu between FTCs on the one hand and enterprises, collectives or TVEs on the other may contain three types of export targets: instructive, indicative, and market adjustable.[21] These targets are generally negotiated between the FTC and the enterprise. Instructive and indicative targets must be met commodity-by-commodity as stated in the contract whereas market adjustable targets allow a change in the mix goods. For exports subject to instructive targets, raw material supplies as well as purchase of the product are guaranteed. For the other two types of targets, neither of these guarantees exists. Sometimes if an enterprise is having difficulty in meeting its exports under an indicative target, however, the relevant FTC may provide assistance with respect to raw material procurement. Any exports in excess of targets in contracts can be sold through FTCs in other provinces.

As far as I have been able to ascertain, instructive targets correspond to the previously-mentioned export quotas in the province's and municipalities' contracts. They also seem to correspond to

[20]Nanjing municipality which has a provincial level status receives its export and foreign exchange quotas directly from the center.

[21]As far as one can ascertain, these contracts differ across provinces and what hold true for Jiangsu may not hold true for other provinces.

MOFERT's command plan for exports. In the same vein, indicative and market adjustable targets seem to correspond to MOFERT's guidance plan.

It is perhaps important to note that usually mandatory targets apply only to state owned enterprises. Collectives and TVEs are subject to these targets only rarely. Furthermore, not all TVEs that export are subject to export targets. For example, in Wuxi, there are approximately 700 exporting TVEs. Only 400 of these TVEs are subject to any export targets and those that are subject to mandatory targets are much fewer.

4.5 Export Pricing policies

Depending on the good, procurement prices for exports in terms of renminbi are set by the center, province or city. For goods in category one which are central monopoly, prices are set by the relevant central FTC. Procurement prices of goods in category three are set at provincial or city levels. For category two goods, it appears that some prices are set by the center and some by provinces. The mission was told that these prices are based on the FTC's estimate of production costs. But it is not entirely clear how the FTC estimates production costs of enterprises.

Recently, China has also encouraged the formation of export associations which are authorized, inter alia, to "advise" FTCs on prices. The aim of these associations is to give order to export marketing by bringing competitive entities together but in practice they are likely to have effects similar to those of a cartel. Currently, five such associations exist. They cover electrical goods, electronics and machinery; cereals, oils, foodstuffs and native produce; metals and chemicals; textiles and garments; and light industrial products, arts and crafts. FTCs and any other enterprises with the right to engage in direct foreign trade are supposed to join the relevant association. An enterprise or FTC which refuses to follow the association's advice can be expelled from it following which MOFERT can withdraw the enterprise's or FTC's right to export.[22]

[22]See Leung, Wayne, "Consolidating Decentralization," China Trade Report, June 1990, pp. 6-7.

Available evidence suggests that on the average domestic sales prices exceed the prices paid by FTCs to enterprises for exports. In two specific cases in which we were able to obtain information, the export price was substantially below the corresponding domestic price. In one of these cases, an enterprise with direct export rights received the highest price on domestic sales, followed by direct-export price and the price on exports through the FTC, in that order. According to the estimates provided to the mission, on the average, in Jiangsu, export prices received by enterprises are 10% below the corresponding domestic prices. This difference in prices exerts a negative effect on exports and efficiency.

In all likelihood, on the average, enterprises incur losses on exports which are covered partially through higher prices on domestic sales. Put differently, domestic consumers provide a cross-subsidy on exports. In addition, it appears that in setting procurement prices, FTCs subsidize high cost exports at the expense of low cost exports. Under the contract responsibility system, any losses incurred on purchases of high-cost exports must be offset by profits on low-cost exports. Thus, FTCs seem to use their monopsony power over enterprises and sectors exhibiting low costs of production. The implication is that low-cost goods are exported in below-optimal quantities while the opposite is true of high-cost exports.

Adoption of the agency system under which FTCs work as pure intermediaries and ship goods abroad for a commission has not made much headway. For example, in Jiangsu, no more than 5% of export are shipped under the agency system. The same is not true on the import side, however. At least in Jiangsu, FTCs bring almost all imports on a commission basis. This means that any time the domestic currency is devalued, as for example in November 1990, its impact on the import price is felt immediately in Jiangsu. The export price can, by contrast, be almost completely immune to a devaluation.[23]

[23]To the extent of retention rights which can be sold in FEACs at a market clearing price, exporters will experience a price increase. But retention rights of enterprises are limited.

4.6 Local Policies Influencing Exports

Our discussion up to this point may suggest that provinces' exports are more or less governed by the rules laid down by the center and that provinces has no policy levers to influence trade flows. This is, however, very far from the reality.

At a general level, it must be remembered that the Chinese economic system is highly decentralized now and implementation of policy is largely under the control of provinces. For example, the center gives mandatory targets or export quotas for only a limited items and /or in limited volumes. But in Jiangsu, contracts between FTCs and enterprises for indicative and market adjustable targets are also binding. Similarly, in spite of the existence of trade associations, FTCs seem to continue to have a great deal of power in setting export prices. As noted before, taking advantage of their monopsony power, FTCs often set these prices below the corresponding domestic prices.

Jiangsu has other policy instruments at its disposal as well. For example, within the State's guidelines, provincial and city governments decide how the raw materials imported by using locally retained foreign exchange earnings are allocated among enterprises, collectives and TVEs and across different sectors. Provinces and cities also provide indirect export subsidies through the provision of critical inputs such as power to export oriented enterprises. Further incentives are provided in the form of higher bonuses for managers and employees on the basis of export performance. Within the guidelines laid down by the State, provinces can confer rights to trade directly upon enterprises and enterprise groups.

A further important instrument at the local level is the establishment of joint ventures between FTCs and enterprises. During the Seventh Plan, Wuxi City alone established 160 of these ventures. During the Eighth Plan the city will establish another 200 such ventures. As Wuxi's plan is to expand TVEs in a big way, 85% of these ventures will be with TVEs. Thus, Wuxi will be able to influence not only the structure of output by choosing joint ventures in priority sectors but will also enhance the role of TVEs in its economy. Capital for these ventures will come largely from bank loans and partly from retained profits of FTCs and Foreign Trade Development Fund which is in turn funded from profits on sales of retained foreign exchange and from local taxes.

5. Suggestions for Further Reforms

China has come a long way towards achieving an outward orientation of the economy during the 1980s. The country's exports have expanded rapidly during the last decade. This expansion has in turn helped accelerate the growth of per capita incomes. In order to continue on this path, reforms in the area of international trade regime must continue. Some of the reforms will have to be carried out at the national level while others can be carried out at the local level.[24] In the following, we discuss reforms at each of the two levels.

An important qualification must be kept in mind in evaluating any policy reforms in centrally planned economies. The prices prevailing in these economies do not normally reflect, even approximately, the true opportunity costs. Therefore, strictly speaking, one cannot simply compare the observed costs with world prices to decide whether a particular sector should expand or contract. The view taken below is that an encouragement of procompetitive and pro free trade reforms is desirable.

5.1 Reforms at the National Level

(i) The Licensing Regime and Tariffs. Despite major reforms, there is much room for further liberalization of exports and imports. China's foreign trade is still very tightly controlled. Imports of most consumer goods are virtually prohibited. Often imports of raw materials also requires licenses. Even on the export side, a very large number of goods is centrally controlled. In commodities for which China has market power this control may be justified, although even there excessive restrictions lead to smuggling and a loss of foreign exchange as happened in the case of silk.[25] In the commodities where

[24]The following suggestions assume that at least for a while, the basic economic structure will not change. In particular, it is assumed that the planned economy will not be replaced by a market economy.

[25]See LoPinto, Beverly M., "Fashioning a Successful Silk Industry," China Business Review, March-April 1988 for a fascinating account of smuggling in silk industry.

China does not have market power, export restrictions make even less sense, especially when the country has a shortage of foreign exchange.

China should also consider rationalization of its tariff structure. Some tariff rate are excessively high and encourage smuggling. There is a substantial room for efficiency gains from lowering the tariffs.

(ii) Expansion of Direct Export Rights. The policy of conferring direct export and import rights upon firms is an extremely important development. Currently, this instrument is under-exploited in two respects. First, the rights are being conferred very selectively. It is true that the failure to fulfill export contracts by unreliable firms which manage to get direct trade rights may undermine the reputation of more reliable exporters. Yet it seems that the current approach is too conservative and a more rapid expansion will enable more firms to establish direct contacts with their customers. Much can be learned from direct dealings with buyers. Often learning effects and technology acquisition are the result of direct contact with buyers. Second, firms which do have the rights to trade directly can only export their own products and import raw materials for themselves. It will be desirable to relax this constraint and allow direct traders to export other firms' products and import raw materials for them. Reputation-conscious firms will export only high quality products of smaller firms, especially TVEs, who cannot afford their own marketing network. Thus, reputation of the exporting firm in the world markets will most likely be enhanced. At the same time, FTCs will be subject to a greater competitive pressure to search foreign markets more thoroughly in order to get higher prices for exports and lower prices of imports for their clients. The long term objective should be to develop direct trading firms into a serious alternative to FTCs.

(iii) Rationalization of the Foreign Exchange Retention System. Although the long term goal of Chinese authorities is to move to a freely convertible currency, until that happens the system of exchange retention rights will continue to play an important role. Therefore, further reform of this system makes sense.

The reform introduced in January 1991 seems to have corrected some of the distortions in retention rates existing previously. In particular, for a given commodity, retention rates do not seem to vary across provinces or between within and above quota exports. The rates do seem to still vary across commodities, however. Whether or not these variations are efficient is a complex issue.[26] But on grounds of transparency and administrative simplicity, a strong case can be made in favor of one or two retention rates.

A further issue concerns the sharing of locally retained foreign exchange. If the agency system is introduced aggressively for exports as recommended below, almost all of locally retained foreign exchange should be given to exporting enterprises. The current practice of giving as much as 60% of the foreign exchange generated by above quota exports to FTCs leaves relatively little foreign exchange for enterprises. The 60% retention makes specially no sense when goods have been exported by an enterprise with rights to trade directly. Moreover, FTCs presumably use the foreign exchange less efficiently than enterprises.

A final point is that under the newly introduced system, the center is allowed to buy back 30% of the retained foreign exchange from FTCs and enterprises. This gives the center a considerable amount of monopsony power over the exchange rate determined in FEACs. Moreover, even though enterprises make some profit on the sale of retained foreign exchange to the center, they lose the flexibility provided previously by the retention rights. Purely from the viewpoint of enterprises, the recent reform has taken a step backwards.

<u>(iv) FTCs: Expansion of the Agency System</u>. The most important change required in the operation of FTCs is the expansion of the agency system in exports. Under the current system, FTCs do not make an effort to ensure that exports of each individual commodity are profitable. Instead, since they are required only to ensure no losses in the aggregate under the contract responsibility system, they

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[26]If the central government's objective is to raise a certain amount of foreign exchange or to target certain industries for exports, the optimal structure of retention rates across commodities will not be uniform. At the same time the determination of the optimal structure will require the kind of information that is difficult to obtain for even advanced industrial countries.

engage in a complex exercise of cross subsidization of various activities. This cross subsidization is economically inefficient. Once the agency system is introduced, the cross subsidization will be controlled automatically.

A second area which deserves some attention is the existence of monopsony power over enterprises on the part of FTCs. This appears to be particularly true for within quota exports. Even if enterprises are required to export a certain quantity of goods, there is no reason to require that those exports go through a particular FTC. If enterprises are given the option to choose among FTCs engaged in exporting the given commodity at least within the province, the latter will be under a greater competitive pressure. For example, after the export quota has been determined, enterprises under Nanjing municipality could be allowed to export textiles through Jiangsu's provincial textiles FTC or textiles FTCs in other cities of the province.

5. Export Targeting. One of the policies China has followed during the latter half of the 1980s is that of export targeting. So far, targeting seems to have worked well. For the future, two things must be remembered. First, experience in countries such as South Korea suggests that targeting succeeds only so long as it is selective. Second and more importantly, as soon as it appears that the country has targeted an industry in which it does not have a comparative advantage, the country should exit out of that industry. In a large number of countries, targeting has failed principally because governments refused to exit out of the targeted industry even after it was clear that they were promoting wrong industries.

6. Export Pricing Policies. The long term objective of reforms policies should to encourage the determination of prices via market forces. Until this becomes a reality, however, gains can be made by reforming the existing system. A simple change which will go a long way towards promoting efficiency is to bring the domestic and exports prices of the same commodity as close to each other as possible. If the domestic price of a commodity is higher than the export price, the marginal benefit from domestic consumption is higher than that from exporting. The opposite is true when the domestic price is lower

than the export price. In both cases, welfare can be improved by bringing the two prices closer to each other.

5.2 Reforms at Local Levels with Special Reference to Jiangsu

Some of the reforms mentioned above can also be pursued partially at the provincial level. For example, Jiangsu can be more aggressive in conferring the rights to trade directly. The province can also start implementing the agency system more rapidly than it has done so far. Finally, to the extent that Jiangsu has some freedom in setting prices, it can reduce the differences between the export and domestic prices.

Some additional changes which Jiangsu can make to improve efficiency are as follows.

(i) Promotion and Decentralization of TVEs. Jiangsu has been a leader in the development of TVEs. Growth of these enterprises should continue to be encouraged. Lately, there appears to be a trend in Jiangsu to bring TVEs under a tighter control of the city administration. This trend should be resisted. In large part, TVEs are more dynamic than state owned enterprises due to the fact that they operate in a market environment. If this feature is undermined, their efficiency and attractiveness will suffer seriously.

(ii) Interprovincial Trade. In published sources, reports appear frequently that provinces restrict the flow of goods from other provinces. Although we came across only a few cases of this nature in Jiangsu, the practice may be wider. Provinces can gain from trade with other provinces in the same way that they gain from trading with other countries. Restrictions on inter provincial trade may confer short term gains on certain enterprises but in the long run they will hurt Jiangsu's economy. If certain goods and raw materials are available at lower prices in other provinces, Jiangsu should take advantage of them. Likewise, if certain goods fetch higher prices in other provinces, Jiangsu should profit from selling those goods there.

(iii) Formation of Industry Groups. Recently, China has adopted the policy of encouraging the formation of big industry groups along the lines of the Japanese zaibatsu which combine the functions production, trading and finance. This a development in the right direction and Jiangsu should take full advantage of it. Industry groups generate important economies of scale and scope. Moreover, they will also facilitate the process of reputation- building in the world market.

(iv) Labor versus Capital Intensive Development. Broadly speaking, China's comparative advantage lies in labor intensive goods. Jiangsu is perhaps no exception in this regard. Therefore, the general direction of the economy should be towards labor intensive goods. This objective is consistent with the objective of the development of TVEs.

In this context, an interesting issue arises with respect to machinery and electrical goods sector. Given the incentives provided by the national government, Jiangsu has rightly chosen to expand this sector during the Eighth and Ninth Plans. However, some of the goods in this sector are very capital intensive. In choosing among the goods within this sector, Jiangsu will need to be careful. Otherwise, the objective of promoting the machinery sector could come in conflict with that of promoting TVEs and labor intensive industries.

(v) Establishment of a Rules Based Regime. Currently Jiangsu has a variety of incentive schemes for exports at the provincial as well as city level. These schemes take the form of preferential access to and/or lower prices of raw materials, better access to power, higher bonuses for managers who are successful in exporting, etc. These incentives are implemented by negotiations on an enterprise-by-enterprise basis. This process is likely to be distortionary and inefficient. Efficiency can be increased considerably by devising a rules based regime. For example, access to raw materials and power can be made uniform and the available resources can be used to give higher export prices.

6. Summary

In this paper, I have made two broad contributions. First, I have laid out cleary various aspects of China's foreign trade system at the central, provincial, and city levels. This should be useful for followers of Chinese economy because China's trading system is very complex and, to my knowledge, an upto date, conveniently accessible, comprehensive source describing it is not available. Second, I have discussed trade policy reforms which can help improve the efficiency of the existing system. In doing so, I have assumed that China is likely to move to a market economy only gradually. Therefore, piecemeal reforms which improve efficiency and toster competition are desirable.

Reforms have been sugested both at the national and local levels. Among the reforms suggested at the national level are liberalization of trade, expansion of direct export rights, further rationalization of foreign exchange retention system, extension of the agency system to exports and eliminate divergence between the domestic and export prices. In targeting sectors for exports, China should be selective and willing to exit when targeted sector appears to be the wrong one. At local levels, town and village enterprises should be allowed to operate as freely as possible, barriers to interprovincial trade and labor mobility should be removed, and industry groups should be encouraged upto the point that they are unable to exert any monopoly power.

In concluding the paper, it must be noted that an important factor responsible for the phenomenal growth of exports in China which has not been discussed in this paper is direct foreign investment. China has made special efforts to attract foreign investors particularly in the four Special Economic Zones. The general policy environment in these zones is very liberal not merely with respect to foreign investment but trade as well. Foreign investors have contributed not merely capital but critically needed technical know how, management skills, and access to overseas markets. Future work which quantifies the effects of these factors on export and GDP growth and suggests policy reforms in the area of direct foreign nvestment will be useful.

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