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**DIRECTORATE OF INTELLIGENCE**

26 March 1987

**Comments on China's Submission to GATT on Trade**





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**Background**

In the wake of the political uncertainty following the ouster of General Secretary Hu Yaobang in January, China's economic reform leaders appear to be focusing on the defense of core policies of economic reform and the opening to the outside world. As a result, we expect no bold new reform initiatives over the short term, and look for little progress to be made on those issues important to China's accession to GATT. Moreover, because we believe China is facing a serious foreign exchange crunch, we doubt Beijing will regain the momentum of reform in the trade system. In this uncertain environment, US and foreign officials must be able to differentiate between the reforms Beijing has put in place and the reforms pending implementation. The "Memorandum on China's Foreign Trade Regime" China submitted to the GATT Secretariat earlier this year appears to broadly emphasize the direction of economic reform without reference to what has been accomplished and what remains to be done. The following comments provide some balance to Beijing's sweeping generalizations presented in the memorandum, providing clarification on some points and raising questions on others.



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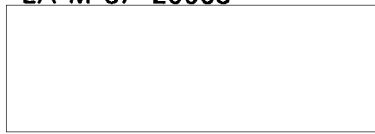
This memorandum was prepared by  Office of East Asian Analysis. Information available as of 26 March 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Chief, China Division, OEA, 



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### **Agricultural Reform**

**"Considerable progress has been made in the development of township enterprises, the great majority of which being collective and individual. The price control over agricultural and sideline products has been largely liberalized." (p. 5)**

- Local government agencies have been separated from economic units in most cases, but peasants are still largely dependent on the state agencies for the provision of production inputs--such as fertilizer and fuel--and to market most of their products.
- To say price control has been "largely liberalized" is an exaggeration. The state makes sure prices stay within a certain range and sets the range of allowable prices. Additionally, commodities procured from peasants under contracts are purchased at prices "negotiated" with the state. 

### **Ownership**

**"Currently there are not only state-owned and collective enterprises, but also individual economy, private enterprises, Chinese-foreign equity joint ventures, Chinese-foreign contractual joint ventures and wholly foreign-owned enterprises in China." (p. 4)**

- According to the State Statistical Bureau, state-owned enterprises accounted for one-fifth of all industrial enterprises in 1985, with the balance under collective ownership. State-owned enterprises, however, account for 70 percent of China's total production. Nearly 22 percent of collectively owned enterprises are township enterprises. We have no data on the the size of the other ownership forms, although private ownership and wholly foreign-owned ventures represent a very minor share of the whole. The output of individual-owned, joint venture, and foreign-owned enterprises account for less than 1 percent of China's gross industrial output value. 



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**"Many medium and small-sized state enterprises are allowed to be contracted or leased out." (p. 5)**

- In large measure, the enterprises selected for leasing arrangements are small and deficit-ridden. According to the State Statistical Bureau, 2,900 small, state-owned enterprises have been leased or contracted out. This leasing, however, appears regionalized; Liaoning Province alone accounts for more than 20 percent of leased enterprises. [REDACTED]

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**"Shareholder-enterprises have been set up on an experimental basis." (p. 5)**

- In mid-1986, Beijing authorized the sale of enterprise shares on an individual basis to factory workers in collective enterprises. The sale of such instruments is restricted and they cannot be publicly sold or traded. Beijing has also appears to have limited experiments with stock issues in urban factories to those that are collectively owned.
- Shareholder enterprises bear little resemblance to the Western concept of stock ownership, and the state remains the major shareholder. There is no secondary market to sell shares and no system for determining the value of shares. The Chinese version of stocks bears more resemblance to Western bonds in that they are an important method for raising funds for capital expenditures. [REDACTED]

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### **Enterprise Autonomy**

**"Governments at all levels have had their functions separated from those of the enterprises, streamlined their administration work and delegated more power to lower levels." (p. 5)**

- There is still considerable debate in China over the definition of the roles of all of the power groups surrounding state enterprises. Last week the National Party Congress (NPC) Standing Committee again failed to agree on a draft--which is now in its seventh version--of the state sector industrial enterprise law to present to the full NPC session currently in session. The law is intended to codify the relations between enterprise managers, the party committee, and other enterprise power centers and to define relations between enterprises and their ministries. Under the law, enterprise managers would become legally responsible for the performance and operations of their enterprises.
- Failure to pass an enterprise law has also delayed implementation of the state sector bankruptcy law passed last fall. The bankruptcy law is slated to go into effect three months after the passage of the enterprise law.
- The decentralization of power has often halted at the provincial or municipal level, with the locality taking up the role forfeited by the central government. In addition, in many instances local officials have proven unwilling to follow Beijing's

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lead--or even direction--to surrender their own roles in production and have set up administrative "corporations" to maintain a degree of control. These corporations have prevented the devolution of power from reaching the enterprises and continue to interfere in production decisions and operations. One People's Daily article reported that most of the state's large and medium-sized enterprises are under the control of such administrative and semiadministrative companies. [Redacted]

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**"The excessive and rigid control of enterprises by the state has been greatly changed. The enterprises are moving towards the direction of full authority for their own management and full responsibility for their own profits and losses." (p. 5)**

- In practice, the degree of autonomy accorded enterprises varies by industry, size of firm, and whether it is state or collectively owned. In general, the greatest autonomy is found in small, collective industries producing items not directly related to the national interest. Industries that are major foreign exchange earners tend to have less autonomy.
- The factory management responsibility system--which is designed to give the factory director key decisionmaking authority--is operating in one-third of state-owned industrial enterprises, according to a Chinese survey. [Redacted] implementation is spotty, however, as evidenced by a 1986 survey of 10 provinces, which found that only 20 percent of those enterprises practicing the manager responsibility system had fully implemented it.
- Enterprises' assumption of full responsibility over profits and losses will be slow in coming. In the absence of bankruptcy regulations, factories with deficits can continue to rely on state bailouts to cover their losses. Factory managers also remain unenthusiastic about accepting the responsibility for profits and losses under a price system that remains irrational.
- Party secretaries in factories continue to exert great influence over managerial decisions. At best, managers must consult with party committees on personnel decisions; the authority promised to managers for firing workers has not been granted. [Redacted]

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**"Some large and medium-sized enterprises or syndicates are approved to engage in exporting their own products and importing raw materials for their own use." (p. 11)**

- The right to export directly is still granted to relatively few enterprises as the entrenched state trading system protects its own interests. According to the US Consulate in Hong Kong, between 1981 and 1984 only six factories--all in Guangzhou--were granted export authority. Following a period of reconsolidation in 1985, last year more than 100 additional factories were given direct export authority. 

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**"The system of retaining a proportion of foreign exchange earned is practised so as to expand the right of local governments, departments and enterprises concerned to dispose of foreign exchange at their own discretion." (p. 11)**

- Almost all export factories  are allowed to retain a portion of their foreign exchange earnings. Although Beijing has dictated that exporters would retain at least 12.5 percent of their foreign exchange earnings, some factories receive less than this standard.
- Despite the retention of foreign exchange, these enterprises have no direct control over the foreign exchange they earn. All retained foreign exchange must be deposited with the Bank of China where the enterprise is given access to a foreign exchange quota. Following a multilayered approval process for use of the foreign exchange--which must support exports--factory managers still must buy their foreign exchange back from the bank at the official exchange rate plus a small surcharge. 

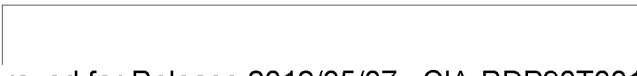
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**"The establishment of conglomerates and groups of enterprises is encouraged." (p. 5)**

- In the past year, Beijing has promoted horizontal linkages among enterprises as a means of increasing production. To date, we have seen much of this "encouragement" occur in the form of state-directed recentralization. For example, "export syndicates" have been formed in the textile sector to improve the production management of thousands of state and collectively-run enterprises. Through the syndicates, the planning and production of individual fabric and apparel manufacturers will be coordinated to produce a particular type of finished product. Management groups, composed of managers from the constituent enterprises, will direct the syndicates under the guidance of the local Ministry of Textile Industry bureaus. 

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### Foreign Exchange Reform

**"Since 1979, China has gradually carried out reforms of its foreign exchange system." (p. 20)**

- Beijing has established foreign exchange trading centers in the special economic zones and Shanghai, and in late 1986 lifted some of the controls on the trading of foreign currencies for renminbi in three of the special economic zones--Shenzhen, Zhuhai, and Xiamen. Although this free trading of foreign exchange is a significant step in the reform process, US Consulate officials in Hong Kong report that, at least in Shenzhen, officials remain unwilling to let the foreign currencies float in response to market demand.
- Last November, State Planning Commission Chairman Song Ping announced that foreign exchange allocation reforms would go ahead in 1987, a theme that was reiterated in mid-February by MOFERT official Wu Jiahuang during discussions with US Embassy officials on China's GATT application. But in late February, a senior MOFERT official claimed that Beijing has decided to postpone this reform. With reform of the foreign trade sector based on changes in the foreign exchange allocation system, this postponement will significantly slow trade decentralization.

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### Mandatory vs. Guidance Planning

**"Totally mandatory foreign trade planning practiced in the past has been replaced correspondingly by mandatory planning, guidance planning and adjustment through market forces." (p. 12)**

- The proportion of mandatory plan to guidance plan varies from factory to factory, industry to industry, and province to province, with seemingly no clear national program to guide this presumably essential aspect of economic reform, according to the US Consulate in Chengdu. The range of mandatory planning for industrial enterprises varies from 18 percent in Shanghai to 80 percent in Sichuan (excluding Chongqing). The share of total production under mandatory planning in Zhejiang and Jiangsu provinces is 23 and 40 percent respectively. One factor that naturally influences the proportion of mandatory to guidance planning is the type of product manufactured and the raw materials used.
- While the number of mandatory plans is decreasing, the state still has a very direct hand in controlling production through the ministries and state enterprises. In addition, guidance plans tend to be treated as mandatory. We do not know what the consequences are for an enterprise that does not fulfill its guidance quota as opposed to not fulfilling its mandatory quota.
- The movement toward adjustment through market forces is overstated. Enterprises are permitted to sell over-quota production at prices negotiated within state-set parameters. Currently, about 50 percent of steel, 60 percent of coal, and 84 percent of cement are sold outside of the state plan.

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**Price Reform**

**"Price control is being gradually relaxed." (p. 5)**

- Beijing eased controls on the prices of vegetables and meat in 1985, and freed prices of major consumer goods--such as bicycles and televisions--last fall. But plans for the continued freeing of consumer items from price controls announced in December were reversed in mid-January as the State Council called for the rigid maintenance of the existing price structure. Beijing's plans to decontrol prices of key industrial commodity prices this year have also been scrapped because of concerns about the potential inflationary impact. Beijing realizes that the country's distorted price system needs reforming, but conservatives generally favor centrally regulated price adjustments rather than relaxation of state price controls.
- Beijing is committed to intervening in the market to keep price fluctuations within acceptable limits. For instance, when China loosened controls on vegetable prices in May 1985, prices on free markets in Beijing soared and municipal authorities ordered state supply units to increase purchases from surrounding areas and sell them at lower prices to bring free market prices down.
- Beijing often points to rising average prices of key commodities as evidence of less price control. In most instances, these higher prices do not reflect an increase in state prices, but a higher proportion of the commodity being sold over-quota at above state-set prices. Even these over-quota prices usually are strictly controlled within set boundaries. [redacted]

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**Import Pricing**

**"Under (the agency pricing system), the domestic price of an import commodity is composed of the cif value, import duty, internal taxes, banking charges, commissions, etc." (p. 19)**

- In many instances, we believe Beijing manipulates the variables in this pricing equation to control "demand". US businessmen complain of the unknowns in the equation, including the rate of exchange used to convert US dollars into renminbi equivalents, which leaves them little room for recourse. According to the US Embassy in Beijing, even when policies regarding import valuation are published, there is a gap between policy and enforcement. Foreign businessmen complain of capricious and uneven treatment by customs officials at the various entry points, including outright harassment and the imposition of duties where policy would indicate otherwise. [redacted]

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### Export Pricing

**"(Export) prices are determined on the basis of domestic costs and international market conditions...supply and demand conditions on international markets are also taken into account in determining export prices." (p. 19)**

- We do not know what role, if any, domestic costs play in determining export prices. We believe export prices are generally based on international price levels without reference to costs of production since, under China's irrational price system, true costs are not known. In the past, provincial and municipal exporters have often sold exports below cost with the losses covered by the state. During the first eight months of 1986, nearly 18 percent of all state enterprises were operating at a loss, up from 11 percent the previous two years.



### Wages, Bonuses and Labor Reform

**"The restoration of the bonus system and the trial implementation of linking the total amount of wage and bonus with productivity have greatly enhanced the productivity of the enterprise and the enthusiasm of the workers and staff." (p. 6)**

- Last year Beijing continued to urge factory managers to set wages and bonuses according to productivity and allowed some enterprises to base their total wage bill on factory productivity. While Beijing would like to move away from the egalitarian system under which wages are unrelated to productivity, there are concerns that material rewards could create excessively wide income disparities. For the most part, both wages and bonuses continue to be paid without regard to individual productivity.
- On 1 October 1986, China inaugurated a labor reform package that promotes contract labor agreements in place of the lifetime tenure system and guarantees greater labor mobility. But labor reforms have been unevenly implemented, and labor officials have told US Embassy officials that these reforms will be phased in slowly over a two-year period. Even where the labor contract system has been implemented, the real test of success will come in three to five years when contracts for the first group of workers hired under the new system come up for renewal. Although factory managers will have the right to dismiss workers, few are expected to be fired.








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**National Trade Policy**

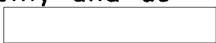
**"China's foreign trade policy has been brought into effect throughout the country." (p. 11)**

- The lack of transparency in China's trading system is compounded by the uneven application of trade policies and procedures nationwide. Although not condoning discretionary application of its policies, Beijing has been ineffective in maintaining a single, uniform customs and trade policy. This is further complicated by the various secret internal guidelines. These regulations, out of the purview of foreigners, are often implemented as trial policies which foreigners must accept as if they were binding legislation. According to the US Consulate in Shanghai, some foreign firms spend considerable amounts of time and money trying to gain information on unpublished new laws or policies. 

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**Central Intervention**


**When an unexpected development of production or market changes occurs, the state may make appropriate readjustment of the planned import and export targets, including mandatory ones." (p. 13)**

- In the past, Beijing has demonstrated a proclivity toward central intervention to remedy economic disruptions. This is evidenced by the cyclical nature of trade reform since 1979 as Beijing tightened control as problems arose and slowly reinstated more autonomy as conditions normalized. China's reform will retain much of this on-again, off-again nature as Chinese leaders remain divided over whether market forces are reliable tools for regulating the economy and as periodic efforts at decentralization will spark increased trade deficits. 

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**Tariffs**

**"As for parts or components of machinery, equipment, instruments and meters which cannot be produced domestically, or the quality of which is not up to standard, the duty shall be levied at lower rates than those on complete products." (p. 13)**

- In early February, People's Bank of China President Chen Muhua told a visiting US diplomat that foreign exchange controls would be tightened and import substitution policies followed more strictly--even to the extent of banning foreign products of higher quality than those produced domestically. 

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**Import Licensing**

**"MOFERT readjusts the items of restricted import commodities in the light of the availability of foreign exchange and the changes of domestic production and market situation, and duly makes them public." (p. 17)**

- Beijing's track record for publicizing regulation changes is a poor one. Often new regulations are discovered after the change is foisted on the foreign businessman. 

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**"MOFERT is the department exclusively responsible for administering the licensing system. It may authorize the departments of foreign economic relations and trade at the provincial level or the special commissioner offices located at the main ports, to issue licenses for some import or export commodities within their respective administrative areas." (p. 16)..."The interim regulations (on import licensing) are uniformly implemented throughout China, without country or regional restrictions." (p. 17)**

- With few exceptions, MOFERT has delegated licensing authority to the local levels. This authority is not uniformly delegated, however, and these local jurisdictions have differing lists of goods for which they can issue licenses. Theoretically, it is possible to obtain from MOFERT a list of entities authorized to issue licenses for a particular product or line of products. Whether a foreign firm would be able to get such a list is uncertain, however, according to the US Embassy in Beijing. 

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**Transparency**

**"Orders for (licenses) should be placed through the corporations approved by the State to engage in the business of importing such commodities...MOFERT readjusts the items of restricted import commodities...and duly makes them public." (p. 17)**

- One principal obstacle affecting China's trading partners is the lack of transparency in the country's trading regime. Information concerning the availability of the various Chinese entities to engage in trade--provincial, municipal, and local level enterprises and trading organizations--is scarce, as is information on the availability of import licenses, the access to foreign exchange, and the authority to import under regional and state economic plans. The criteria used in foreign purchasing decisions for government procurement also remains a prime area of opacity in China's trading system. The inability of Beijing to offer consistent and high-caliber economic and trade data also adds to the confusion.



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