Program Brief

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"China's Entry into the WTO: Implications for China and the World Economy"

A Discussion with Dr. Nicholas Lardy
Senior Fellow at the Brookings Institution

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At a recent luncheon at The Nixon Center, Dr. Nicholas Lardy, Senior Foreign Policy Fellow at the Brookings Institution and author of the new book *Integrating China into the Global Economy*, argued that China's membership in the World Trade Organization will have a large impact on the country's domestic economy and international trade. Lardy explained that China's entry may also cause a 'displacement effect,' whereby manufacturing currently located in Asia or Mexico moves to China. David M. Lampton, Director of Chinese Studies at the Nixon Center, moderated the discussion.

Why Did China Join the WTO?

Lardy began his remarks by discussing why China agreed to such strict disciplines and restrictions to join the World Trade Organization. China did not need the WTO to be a force in global trade. Lardy explained that since World War II, China has increased its share of world trade more rapidly than any other country, that it is the seventh largest trading nation, and that it was the biggest trading economy outside the WTO. However, despite that rapid trade expansion, economic growth has been slowing and China still faces substantial structural challenges. Lardy asserted that China's leaders "came to the view that globalization was basically an inevitable trend, that the challenge for the leadership was how to position China to take advantage of it." Zhu Rongji and other leaders believed that WTO commitments and increased foreign competition could be a 'lever' or stimulus for further reforms within China. According to that strategy, Lardy said WTO entry provided an "external discipline for the reform process within China."

Is China Ready?

As for China's ability to comply with its WTO commitments, Lardy asserted that China's goods market is already fairly open and offered three sets of evidence:

- Nominal Tariffs on Commodities have declined steadily since the 1980s, from an average of 55 percent in the early 1980s to 12 percent today. They are required to fall to 9 percent. Approximately 60 percent of

imports enjoy tariff exemption programs, lowering the effective tariff rate.

- Non-Tariff Barriers, such as quotas and licensing requirements, covered 50 percent of goods in the late 1980s but now apply to less than 5 percent.
- State Trading Companies, which previously controlled trade in 90 percent of goods, now handle only about ten percent of traded goods.

With the exception of grain, automobile, and fertilizer industries that remain heavily taxed, Lardy argued that reductions in tariffs, non-tariff barriers, and the diminishing role of state trading companies have liberalized China's goods market. Given this existing openness, WTO commitments will have a larger impact on China's service sector, particularly in the telecommunications and transport industries.

China's openness to the world can also be seen in the amount of foreign direct investment (FDI) it receives. Since 1982, China has gone from having virtually no FDI to amassing a total of approximately $400 billion, and as Lardy noted, this suggests that China is increasingly open to foreign investment.

What Are the Implications for the U.S.?

In 2001, China replaced Japan as the source of America's biggest bilateral trade deficit. Although the Clinton Administration argued that giving China Permanent Normal Trade Relations status would significantly reduce the U.S.-China trade deficit, Lardy suggested that "it's not in the cards." He argued that there may be a 'displacement effect,' whereby China replaces other countries as the supplier of important U.S. imports. Although America will not lose many jobs, other countries that compete directly with China in labor-intensive industries (such as Mexico, Taiwan, South Korea, and Hong Kong) will suffer, and the U.S. trade deficit with China will likely increase. He said that this pattern is already visible with respect to U.S. imports of games, toys, and footwear.

Lardy said that similar displacement might soon happen to the information technology industry. With Japan's share of IT goods declining from 70 percent to 40 percent and China's portion rising to 10 percent, he argued that we may be seeing the beginning of the displacement of the IT industry from current East Asian producers to China. The migration of Taiwanese production facilities to the mainland supports this trend. Taiwan is a global leader in IT production, and currently manufactures 60 percent of the world's notebook computers. Notably, last year, a Taiwanese company opened the first notebook computer factory on the mainland and Lardy suggested that this signals a shift. "Once one of them moves, the rest will follow relatively quickly, for competitive reasons," he said. As a result, China's increasing market share in global IT production may cause the U.S. bilateral trade deficit to expand.

Will China Meet Its WTO Commitments?

Lardy examined China's WTO compliance in three areas. First, Lardy said that for access to the goods market, given China's progress reducing tariff and non-tariff barriers and the relative ease of measuring compliance, "the trajectory is reasonably good." Second, he said that market access in services (such as financial services, telecommunication, and distribution) would be more difficult. This is a result of the "disconnect between trade officials who negotiate for market access and domestic regulators who are responsible for overseeing the development of a domestic industry," according to Lardy. Often, Chinese regulators were not involved in the negotiation process and only learned about specific commitments after the deal was signed. Also, he noted that service sector compliance is difficult to measure. Third, with respect to rules based issues, he said that China has agreed to higher compliance standards than many recent WTO entrants. For example, China has agreed to cease all agricultural export subsidies- something no other country has agreed to.

Lardy concluded his remarks by arguing that the extent of China's ability to sell their products in foreign markets may ultimately be decisive for its role in the WTO. According to China's WTO agreement, "China has agreed to a provision that will make it extraordinarily easy [for foreign countries] to limit the import of Chinese goods." For example, the injury standard necessary to invoke transitional safeguards against Chinese goods is extremely low. Furthermore, unlike typical safeguards, this mechanism does not have to be gradually phased out, (although it must end after 12 years when the entire provision expires). According to Lardy, "transitional safeguards, textile safeguards, and anti-dumping methodology, the non-market-economy provisions of anti-dumping, could be used fairly substantially to restrict the increase in China's exports into the international market." However, as the trade row between China and Japan shows, China is willing to defend itself, he said.

Responding to a question from the audience, Lardy touched on the capacity of China's economy to absorb domestic production if its exports stall. Although the situation varies by product, he said that generally China "is not going to be able to absorb domestically all the output of the huge amount of production capacity that is being moved there." Clearly, many foreign investors see China as an export platform. However, some large multi-national companies like Carrafour, Kodak, and Volkswagen are profiting by selling to the local market. Unlike its export dependent neighbors, China's economic growth is driven by domestic demand. As long as the domestic economy keeps growing, the ability to absorb imports will increase.

WTO accession will also impact unemployment in China, as economic changes both create and destroy jobs. Unfortunately, Lardy says these processes will not happen in the same locations. China may lose half a million jobs in the auto industry and up to 10 million farm jobs. However, new jobs in the apparel and IT industries are likely to be in southeast China. Problems like this will test Beijing for years as it adjusts to WTO membership.

This **Program Brief** *was prepared by Nixon Center staff member Kelani C. Chan.*

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RICHARD NIXON LIBRARY & BIRTHPLACE FOUNDATION
George L. Argyros, Chairman
John H. Taylor, Executive Director

THE NIXON CENTER
Maurice R. Greenberg, Chairman
Dimitri K. Simes, President
1615 L Street, NW, Suite 1250
Washington, DC 20036
202-887-1000 Fax 202-887-5222