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**The Global and Domestic Impact of China Joining  
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# The Global and Domestic Impact of China Joining the World Trade Organization

## **Heads of Research Team:**

- Li Shantong      Director, Department of Development Strategy and Regional Economy,  
Development Research Center, the State Council, PRC
- Wang Zhi         Economist, Department of Agricultural Economics, Purdue University stationed at  
Economic Research Services, United States Department of Agriculture

## **Advisor of Research Team:**

- Wang Huijiong    Deputy Director, Academic Committee, Development Research Center,  
the State Council, PRC

## **Researchers:**

- Xu Lin             Division Chief, Bureau of Development Planning, State Planning and Development  
Committee, PRC
- Zhai Fan          Research Fellow, Deputy Division Chief, Department of Development Strategy and  
Regional Economy, Development Research Center, the State Council, PRC
- Guo Xiangjun     Division Chief, Bureau of Macro Adjustment and Control Systems, Economic  
Restructuring Office of the State Council, PRC
- He Jianming      Bureau of Macro Adjustment and Control Systems, Economic Restructuring Office  
of the State Council, PRC

## **Executive Summary**

It has been 12 years since China applied to resume its original membership of General Agreement on Tariffs and Trade (GATT) in 1986. Twenty-six multilateral working party meetings and hundreds of bilateral negotiations on China's accession have been held during this period. Not only the international economic and political situation, but also the performance of China's economic development, trade and economic system has tremendously changed during this period. All these variables fundamentally changed the incentives of the dominant members of World Trade Organization (WTO) and their position toward China's accession. Even though the negotiations have been lasting for 12 years, however, China has only concluded the negotiation with 10 partners among 36 member countries who have held bilateral negotiations with China.

Since earlier 90s, China has made great efforts to make concessions and commitments in the area of market accession in terms of reduction of tariff and non-tariff barriers, reforming trade system and regulations, and trade related investment measures. As a developing country with more than 1.2 billion of population and about only 750 US dollars per capita GDP, China is still in the process of industrialization, too sharp concession in market opening may lose its domestic economic and political basis. Therefore, the political risks that Chinese government and US government are facing in negotiating on conditions for China's membership in the WTO are equivalent.

According to the practice and procedure for WTO to accept a new member, the year of 1999 will be critical for China's accession to WTO if China wants to be a member and the major parties of WTO also want China to be a member. If China can not finish the negotiation with its major partners before the end of 1999, it is almost impossible for China to be a member of WTO prior to 2005, because a new round of multilateral negotiation among WTO member will start in 2000. It usually lasts for a couple of years, and within the negotiation period the issue of accepting new members usually will not be considered by WTO. That means if the coming round of negotiation takes as long as the Uruguay round had took, China's entry to the WTO may be the fact after the year of 2005.

There is no question in the international community that China should become a member of the WTO. The problem is how and under what conditions to integrate China into the world trading system in a manner that best serves the interests of both China and the exiting members of the WTO. Therefore, evaluating the commitments and offers that China has already made to date in the negotiation is of practical interest for both policy makers in China and China's major trading partner countries. This research aims at providing a relative comprehensive analysis of the impact of China's accession to the WTO on patterns of world trade, as well as the structure adjustment and income distribution of Chinese economy, based on the market access commitments that China has made to date. It quantitatively estimates the relevant

benefit and cost of those commitments from both domestic and international perspective, thus may help relevant parties to make rational compromise in the ongoing negotiations.

Two models are used in the analysis. The first one is a 41-sector, 10-representative household (5 rural and 5 urban) recursive dynamic single country China model with special treatment of China's foreign trade regime. This model incorporates a stylized version of China's two different trade regimes: ordinary trade and processing trade, and differentiates production by ordinary production and export processing. It also incorporates scale economy and market structure as well as some other features of China's current hybrid economy. It has been used to evaluate different trade reform packages and assess their impact on domestic economy of China's WTO accession. The second model is a 17-region, 19-sector recursive dynamic model for world trade and production. It has been applied on the analysis of the impact of integrating China into the world trading system on production and trade patterns across major countries in the world as well as the trade relationships between China and its major trade partners. Because world prices are endogenous in this model, its solution will be used as world price shock in the experiments conducted by the single country China model. Both models cover the period from 1995 to 2010.

Four policy aspects of WTO entry commitment is simulated by the two models based on the offer made by China in its accession negotiation, including:

- Reduction of customs tariff
- Abolish of non-tariff barriers to industrial products in steps
- Accelerate the growth of import quota of agricultural products and abolish all import quotas finally
- Phase out the MFA quota on China's export of textile and clothing in developed countries' markets

Seven different scenarios were simulated by the two models. Major results are summarized as follows:

1) China would gain significantly in economic efficiency when China becomes a member of WTO. The simulation results show that if China enters the WTO and fully implements its commitment on market access at 2005, its real GDP and welfare measured in Hicks equivalent variations (EV) would increase by 195.5 billion yuan and 159.5 billion yuan (1995 price, or 1.5% and 1.2% of real GDP of 2005) respectively. The large gains in real GDP mainly results from the enhanced efficiency of resource allocation through increased specialization according to China's comparative advantage, but elimination of the MFA increases competitiveness of China's textile and apparel, leading to export expansion of these products, also contributes to the real GDP growth. If the gains to total factor productivity (TFP) improvement and economic growth from trade liberalization are taken into account, China's efficiency gain will be even large. Its average growth rate of real GDP from 1997 to 2010 will 1 percentage point higher than the case that China stays outside the WTO, resulting a more than 30 percent accumulated real GDP growth by 2010.

2) Due to the scarcity of arable land in per capita terms, the comparative advantage of agricultural sector will deteriorate over time in China. Agricultural protection will have a high social cost in the long run. Trade liberalization in agriculture play critical role in China's accession to the WTO and constitutes about two third of China's total efficiency gains from WTO entry. While the impact from reduction of tariff and elimination of non-tariff barriers in industrial products are relative moderate due to the low tariff collection rate and duty exemptions for processing trade.

3) The efficiency gains are not evenly distributed among sectors, therefore, access to the WTO also implies a relatively dramatic economic structural adjustment. Output of highly protected agricultural and some of the capital intensive industrial sectors such as automobile, instruments, cotton, wheat, etc., would contract significantly, while the labor intensive sectors such as textile and clothing would be the main beneficiaries.

4) Structural adjustment involves adjustment cost. Displacement of labor force across sectors would be one of the major components of adjustment cost. The huge size of labor force in China's agriculture needs massive transformation of agricultural labor force to manufacturing and service sectors. Our simulation results indicate that the amount of labor force need to be transferred out of agriculture would amount to about 9.6 million due to China's WTO accession.

5) The elimination of MFA quota and expansion of world textile and clothing market will have important implications to the transformation of Chinese agricultural labor force. The expansion of textile and clothing industries, which are typical labor intensive, will reduce the unemployment pressure that China face today. Our simulation results indicate there would be an increase of migration from agriculture to manufacturing activities by about 5.4 million because of China's WTO entry.

6) Agriculture and Automobile will be two major negative affected domestic sectors by China's WTO entry. However, Agricultural trade liberalization will not cause problems in China's "Food Security". Even if China totally eliminates the import quota of agricultural products, its grain self-sufficiency ratio will still remain above 92 percent. If scale economy and monopoly competition are taken into account in automobile sector, the negative production and employment impact will be smaller than most people expected (about 12 percent). While the pro-competitive effect of trade liberation will reduce the number of firms that currently operate in China's auto industry by 27 percent. This will enhance its efficiency and international competitiveness.

7) The cost of agricultural protection will grow during China's industrialization. Therefore trade liberalization in agriculture may reduce rural household's income. The later the reform, the more serious the problem. Our simulation results show that the real income of rural households declines by 2.1%, while the real income of urban households increases 4.6%

by 2005 because of China's WTO accession.

8) Major gains from China's WTO accession would accrue to China itself. However, rest of the world, especially developed countries and Asian newly industrialized economies, also benefits. Developing countries with a similar endowment structure as China, like those in South and Southeast Asia, would experience keener competition in labor-intensive exports and lower prices for their products. More production factor will remain in food and agricultural sectors in those countries and increase their net agricultural exports.

9) China's WTO accession imposes profound impact on world labor-intensive export and primary agricultural import market. Its world market share of apparel extends by 10 percentage point, reduce other countries' market share across the world. China also increases its land-intensive primary agricultural imports dramatically, and will exceed Japan, becoming an important world agricultural product importer by 2010 if it is admitted into the WTO. US market share in China's primary agriculture and automobile import market will increase by 2.4 and 1.5 percentage point respectively after admitting China into the WTO. However, US market share on China's machinery and equipment market will lose slightly (0.3 percentage point).

10) It will benefit both sides if industrial countries are willing to lift quantitative restrictions on labor-intensive imports from China in exchange for concessions from China on opening its markets to land and capital intensive products from developed countries. Both sides have their own bargaining chips in bilateral trade negotiations. Industrial countries may alternatively grant other low-income countries preferable treatment, thereby restricting China's export growth of labor-intensive goods to OECD markets. This would not adversely affect consumers in developed countries significantly at the long run (but will hurt them in short and medium run) because labor-intensive exports from China and other developing countries are highly substitutable. China could choose to keep its current food self-sufficiency policy and restrict agricultural imports from world exporting countries. However, this will increase the difficulty in solving its increasingly serious unemployment problem and impose a higher and higher protection cost for its economy.

In all, shortage of arable land and capital and existence of large amount of unskilled labor force are the basic national condition of China. This situation can not be changed fundamentally within the near future. This basic national condition will be the major decisive factor in the identification and choice of China's future economic and social development strategy. Participation of the international division of labor, sharing the efficiency gains from economic globalization is a basic trend of China's future economic development. In the next 10-20 years, China will face the dual challenge of industrialization and globalization. Accession to the WTO is one of these challenges. But it also means a great opportunity. China should seize this opportunity and make active adjustment of its domestic policies to adopt this basic trend of economic development in order to reduce or minimize its associated adjustment cost. The role of government would be crucial in this process. Therefore, we recommend the

Chinese government to adopt following policies and actively pursue WTO entry in 1999:

- 1) Supporting capital and technology intensive industries through means of industrial policy to minimize the negative impact of trade liberalization to these sectors. However, these industrial policies should be functional rather than targeting, i.e. to give assistance to the weaker through appropriate means of financing, technological development, distribution of R&D results and encourage firm to merge in sectors exist scale economy. It should not be a simple means of subsidy or protection.
- 2) To prevent the social instability and uneven distribution of welfare gains from trade liberalization, the domestic tax policy should play a stronger function on redistribution to reduce the impact of income inequality problems may associate with China's WTO accession.
- 3) Create necessary condition for transferring labor force out of agriculture. Transferring the rural labor force out of agriculture is one of the major challenges during China's industrialization and modernization. This is a more difficult task than relocation workers currently working in state own enterprise the government face in the long run. Joining the WTO to secure the access to the international market is one of the most effective means to solve this problem. An earlier entry to the WTO will secure the benefits of phasing out MFA and avoid discrimination against China in world labor-intensive export market.
- 4) Sustaining a high saving rate and foreign capital inflow. Strong supply of capital is a necessary condition for China's industrial structure upgrade and the transformation of agricultural labor force. Due to the huge amount of labor force and low capital/labor ratio, rapid accumulation of capital will be a major source of economic growth in coming years. China has run trade surplus for a quite long time and this contributes to its large foreign exchange reserve. It increases China's international credibility and help China stabilize its exchange rate. However, it also means a constant capital outflow and may slow down China's capital accumulation in the long run. In this regard, keeping a balanced trade even run a temporary deficit, and rely on attracting long term foreign direct investment to keep balance of payment will be favorable for China's capital accumulation. Because the industrial structure may be biased to labor intensive sectors due to China's WTO accession, it is necessary to have a higher accumulation rate of capital in this process in favor of the transformation of China's comparative advantage and upgrading its industrial structure.
- 5) It is very important for China to join the WTO before the beginning of a new round of multilateral negotiation, because the standard of entry may continue to rise in the new round and as China's economic growth. Therefore, China should actively pursue negotiation with major WTO contracting parties in 1999 and try to bring its long match to WTO accession to a closure. A best strategy for China in the negotiation is to use the opening of its markets as a bargaining chip to ask developed countries lift their limits on labor-intensive products imported from China.

There are several limitations of our study need to be mentioned. First, it does not take into account other major aspects of WTO membership, such as reduction of barriers in service trade and foreign investment, protection of intellectual property rights, securing market access, enforcement of commitment, and cooperation in dispute settlement. It at best captures only one aspect of the issue at hand. Second, China has not finalized the terms of its WTO entry when this analysis has finished. The size of its trade concessions, the time schedule of implementation for each of the liberalization measures, and the length of the phase-in period, are all uncertain. We used a relatively stylized representation of future trade liberalization measures will likely be adopted by China based on the most recent offer from China in its accession negotiation. Third, the two CGE models used in this report are a highly stylized simplification of the Chinese and world economy, and is far from perfect (Wang, 1997). Finally, there are uncertainties about the size of parameters, such as elasticities of substitution of products from different sources and elasticities between capital goods imports and TFP growth, while the actual size of the impact is very sensitive to those key parameters. Therefore, the results reported in this report need to be interpreted with caution: they can be viewed as indicative but not as precise real outcomes.