

An Economic Analysis of China's Recent Entry into the WTO

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On September 17th, 2001, the World Trade Organization (WTO) Working Party on China's Accession successfully completed a fifteen year long endeavor to negotiate China's entry into the World Trading Organization. Hailed as a "watershed in the evolution of the global economic system"¹ by the WTO, and a "hard-won triumph [and] a milestone in the march of globalization"² by economists, this event will impact China, her trading partners, the global economy, and the global multilateral trading system on multiple levels. While much has been written about the process and implications of China's WTO accession with respect to the domestic and international politics and economics of individual countries, what may interest trade economist more is how this change affects economic efficiency and welfare, and what implication this has for the system as a whole. More specifically, we are interested in the following questions: How can we explain and justify, from an economic point of view, why and on what terms China's accession took place? Will it bring welfare benefits to China and to the rest of the world? Finally, is it good for the multilateral trading system endeavor?

This paper will first give a brief overview of the accession agreements – from the tariff and non-tariff barrier reductions, to the various agreements over China's position in the enforcement structure. Then we will analyze the entry itself with respect to the theoretical explanations on how the multilateral trading system works. We will attempt to explain China's entry into the WTO in terms of these theoretical models, and then gauge whether this event supports or contradicts these theoretical models. Next, we will examine the implications of accession for China and its welfare, and then for the world in general. Finally, we will analyze how China's accession to the WTO on the given terms affects the strength of the multilateral system as a trading regime.

The Agreement

The central purpose of the WTO is the improvement of welfare of member countries through trade liberalization. However, entry into the organization is far more involved than through simple tariff reductions.

¹ China and the world trading system" WTO Director-General's Speech at Beijing University, http://www.wto.org/english/news_e/pres97_e/chipress.htm

² Frost, Ellen L. "China, the WTO, and Globalization: What Happens Next", Institute for International Economics, 7/19/2001. <http://www.iie.com/publications/papers/frost0801.htm>

Trade Liberalization³

Overall, China, in the various bilateral agreements and the final agreements negotiated leading up to accession, has agreed to cut average import duties from 15% to 9% over 5 years. The chart below summarizes changes to tariff levels on certain traded goods:

Category	Agreement
Agricultural Products	<ul style="list-style-type: none"> • Decrease average bound tariff level to 15% (ranging from 0%-60%) • Limit subsidies to 8.5% of the value of the product • Institute a Tariff-Rate-Quota (TRQ) system on products other than barley, peanut oil, sunflower-seed oil, cottonseed oil, and a phase-out for soybean oil, to be gradually phased out
Industrial Products	<ul style="list-style-type: none"> • Decrease average bound tariff level to 8.9% (ranging from 0%-47%) • Eliminate all tariffs on information technology products as per the Information Technology Agreement (ITA)

Besides cutting tariff levels, China will remove virtually all non-tariff barriers within five years:

Category	Agreement
Telecoms	Joint-Ventures will be allowed starting with 25% limit for foreign investment gradually reducing that limit over five years
Banking	Foreign financial institutions will be phased in, eventually being permitted to provide all services to all Chinese clients within five years
Insurance	Foreign insurers will be phased in over five years
Agricultural Products	Eliminate middlemen and state-trading enterprise restrictions. Use of international scientific standards for certification of agricultural goods

In return for import liberalization, China's exporters will gain the same market access to WTO member economies as they grant to other WTO members, on the principal of non-discrimination. It should be noted, however, that as part of the US-China bilateral agreement, China will, in effect, extend the voluntary export restraints

³ Details about tariff and NTB liberalization are from "WTO successfully concludes negotiations on China's entry," The World Trade Organization, 17 Sept 2001 (http://www.wto.org/english/news_e/pres01_e/pr243_e.htm), Prof. Botellier's "China's Economic Reforms" lecture on 24 Feb 2003, and from "Summary of U.S. – China Bilateral WTO Agreement", The White House Office of Public Liason, 17 Nov 2001, as many of the final accession terms were based on the US-China bilateral agreement.

(VERs) placed on textiles according to the Multi-Fiber Agreement (MFA), until 2009, even though the MFA expired on December 31, 2000.

Enforcement Related Agreements

Two rather large points of contention during the accession negotiations were the classifications of China with respect to the multilateral trading regime – whether it was a developing or a developed country, and if it was a market or a non-market economy. The question as to the classification of China in terms of level of development had implications for the timeframe in which she was allowed to implement tariff changes. While being a non-trivial question, this was resolved relatively smoothly with a compromise, allowing China to phase in reforms over 1-6 years.

The more contentious question was the classification of China as a market or a non-market economy, as it has implications for anti-dumping and dispute settlement. As agreed in the US-China bilateral WTO agreement, China is to be treated as a non-market economy for 15 years after accession (until 2017). As long as China is treated as a non-market economy, foreign firms will be permitted to use third-party countries in order to construct “fair market value” when filing an anti-dumping case allowing them to, “ignore local Chinese prices and use surrogate or constructed prices, a practice which allows large-scale manipulation of data, as the U.S. Commerce Department has ably demonstrated over the years.”⁴ As explained by Weiss⁵, this will bias the anti-dumping process even farther in the direction of findings of dumping behavior. Additionally, this will allow foreign firms to increase the dumping margin, allowing them to apply even greater counter-veiling duties.⁶

In addition to agreeing to a liberal interpretation of her economy, China also agreed in the US-China bilateral WTO agreement to special safeguard measures. Normal WTO safeguard measures are non-discriminatory and only allow broadly (non-discriminatory) applied protection for industries faced with a “flood” of damaging imports. However, the agreed to “Product-Specific Safeguard” provision in the US-China bilateral agreement will allow the US to unilaterally apply safeguard measures on a discriminatory basis specifically on Chinese goods, “based on legal standards that differ from those in the WTO Safeguards Agreement”. As the US themselves have described it, “This could permit action in more cases.”⁷ These provisions will also apply for fifteen years after accession.

⁴ Claude E. Barfield and Mark A. Groombridge, “Two Sides to China's WTO Membership,” Center for Trade Policy Studies, <http://www.free-trade.org/pubs/articles/mg-11-22-99.html>

⁵ Prof. Weiss in during a class lecture in the “International Trade System”, 10 Feb 2003

⁶ Hoekman and Kostecki, “the Political Economy of the World Trading System: The WTO and Beyond,” Oxford University Press, NY, 2001.

⁷ “Summary of U.S. – China Bilateral WTO Agreement”, The White House Office of Public Liason, 17 Nov 2001, <http://www.uschina.org/public/wto/ustr/generalfacts.html>

China WTO membership in the Context of Theories of the International Trading System

According to basic theory of trade economics, a small economy can be better off by simply declaring unilateral free trade – the consumer surplus (CS) welfare gains derived from lower prices more than offsets the producer surplus (PS) loss and the tariff revenue (TR) loss (in the so called Harberger triangle representing pure efficiency gain). In a large economy that can affect world prices, however, increased export demand from free trade (i.e. lower domestic prices) may be large enough to increase world prices. Therefore, the consumer surplus gain is partially mitigated by a rise in world prices, and consequently fails to offset the producer surplus loss plus the tariff revenue loss. This leads us to the concept of an optimal tariff – the tariff at which welfare, as measured by the sum of CS, PS, and TR, is maximized.

In this context, should China be considered a large or a small economy? Being the sixth largest economy in the world (second largest when measured using PPP)⁸ and being the seventh largest trader in the world⁹, one may expect China to clearly be a large country in this case. However, in their recent book Measuring the Costs of Protection in China, Shugang Yansheng and Zhongxin, in estimating import price elasticity determined it to be low enough to assume a flat (infinitely elastic) import supply curve¹⁰ indicating the treatment China as a “small economy” with respect to analyzing welfare effects of trade protection. This leads them to conclude empirically that China would experience net welfare gains by declaring universal free trade.

This leads to the question – if China’s optimal tariff is to have no tariff, why are they spending so much energy and political capital in order to join the WTO instead of simply declaring universal free trade? This remains a valid question even despite the fact that China indeed had been promoting trade liberalization in the few years leading up to their WTO accession. Two observations can be made in order to answer this question. First, Chinese policymakers not only maximize aggregate national welfare, but seek to maximize a basket of concerns which includes – other than national welfare – equality and employment. Indeed, the unemployment effects on the reforming industrial state sector and the implications of this unemployment on stability of the reform process and the country as a whole had been, and continues to be a major concern of WTO entry. Therefore, it can be justified that the Chinese policymakers have an optimal tariff that is above zero. The second observation Chinese policy makers perceive a welfare gain in increasing access to foreign markets. Again, with regards to the reform process they see the export sector and its growth as the key to sustaining economic growth.

With these two observations, it is possible to apply the model described by Bagwell and Staiger as economic reasoning behind China’s entry into the WTO¹¹: With an assumption of a certain Chinese optimal tariff, we can assume some Nash equilibrium point that not free trade. Then China and her trading partners, utilizing the reciprocal and

⁸ World Bank rankings in 2001: <http://www.worldbank.org/data/databytopic/GDP.pdf> and http://www.worldbank.org/data/databytopic/GDP_PPP.pdf

⁹ World Trade Organization rankings in 2000, http://www.wto.org/english/news_e/pres01_e/pr249_e.htm

¹⁰ Shugang, Yansheng, Zhongxin, Measuring the Costs of Protection in China. Institute of International Economics, Nov 1998. p. 56. The authors estimate price elasticity empirically using the Customs Statistics published by the General Administration of Customs

¹¹ Bagwell and Staiger, The Economics of the World Trading System. The MIT Press: Cambridge, MA., 2002. p.17.

multilateral nature provided by the WTO framework, will be able to successfully negotiate mutually beneficial (i.e. Pareto-optimal) trade liberalization. In this way, Bagwell and Staiger's model can be used to make a viable economic argument for China needing to join the WTO.

However, the fact remains that China could still gain net economic welfare benefits from unilateral declaration of free trade. Indeed, China's pursuit of WTO membership seems to stem more from political-economy considerations than to pure economic ones. Therefore, it is probably more appropriate to use Either's model of the world trading system, in order to explain China's efforts for accession as well as its future role in the system.

In the context of Either's model, China could be considered an "outside country (Autarky)" in transition to becoming an "inside country (trade but high tariffs)". In Either's model, the incentive for "outside countries" to become "inside countries", is the increased level of FDI, and the associated benefits that FDI brings (technology transfer and growth). Attracting foreign investment has been a cornerstone of China's reform strategy, and the increased foreign attractiveness that the WTO brings is one of the main advantages that Chinese policymakers perceive in their recent accession. Indeed, in 2002 – her first year of WTO membership – China surpassed the U.S. to be the world's largest recipient of FDI¹². In becoming one of the "inside countries" China also hopes to benefit from the technology externality of trade, and while it may be unrealistic to expect China to be one of Either's "leaders (innovators)", they still stand to benefit from being a "follower (holds comparative advantage)" through this technology transfer. Perhaps, then, it is in Either's model that we find the most likely way in which the Chinese view the world trading system, and that gives the best explanation to the Chinese impressive pursuit of membership into the WTO.

The effect on China

In this section, we will attempt describe the economic costs and benefits of WTO accession for China. Besides the FDI and technology transfer as explained immediately above, China stands to gain from trade liberalization by addressing the deadweight loss problems associated with trade protectionism, as hinted earlier. In their book, Shugang, Yansheng, and Zhongxin's conclude that if China were to drop trade restrictions on the 25 most protected industries, Chinese consumers would gross \$35bn in consumer surplus (1.1% of GDP), and the Chinese economy would net \$5bn in efficiency gains. If China went further to declare unilateral free trade, the Chinese CS gain would be \$78bn, or 14% of GDP¹³. It can be definitively concluded that by joining the WTO and lowering import restrictions while enjoying lowered export restrictions to other WTO member countries, China would be able to experience both a consumer surplus and net efficiency gain from increased imports at a lower price and would also experience net producer surplus gains from increased exports.

¹² "China to Draw US\$50bn FDI, to be World's No. 1 Recipient". People's Daily, December 5, 2002.

¹³ Shugang, Yansheng, Zhongxin, Measuring the Costs of Protection in China., Institute of International Economics, Nov 1998. p 14.

The amount by which China would gain can be hinted to by various predictions of the level of trade creation that WTO accession will bring. For example, the economist Fred Hu estimates that China's total trade would double from its 1998 level by 2005¹⁴, and various estimates place an increase of US-China bilateral trade by 9% to 13%.¹⁵

Perhaps more important than the static effects of trade creation are the dynamic efficiency effects that will be brought to the Chinese economy. Frasier, in his article, "Coming to Terms with the 'WTO Effect' on US-China Trade and China's Economic Growth" emphasizes this point that the most important effect of WTO membership for China, was its ability to transform her economy. He notes that a Goldman Sachs study estimates a benefit of 0.5% in growth rates by 2005 from WTO membership¹⁶. Indeed, doing a domestic political analysis one sees that this indeed was a primary concern for Chinese policymakers – the ability of WTO membership to promote efficiency and follow-through on other reforms.¹⁷

It should be recognized, however, that there will also be costs for China, as it joins the world trading system. As with all trade liberalization, there are structural adjustment costs associated with changing the composition of consumption of domestic and international goods, unemployment being the primary manifestation of these costs. For example, in Shugang, Yangsheng and Zhongxin's estimates of complete trade liberalization in 25 highly protected sectors, they estimate that the short-term costs would be "substantial both in terms of lost domestic output (a drop of about \$40 billion, or 32 percent of preliberalization output in the protected sectors) and lost jobs (about 11.2 million workers in the protected sectors)."¹⁸ It is this job loss that Chinese policymakers are particularly worried about, as the instability threat from unemployment continues to rise.

One final risk of WTO membership for China are the potential terms of trade loss that could be experienced, should the US or other foreign countries use anti-dumping measures liberally, especially given the environment biased toward dumping findings under which China has entered. As Weiss has mentioned¹⁹, the safeguard and anti-dumping (particularly if they are discriminatory) part of the world trading regime, is reminiscent of the unilateralism of strategic trade policy, where one country tries to lock-in welfare gains at the expense of the other country. Similarly, the extension of the VERs associated with the MFA have net welfare loss implications for China.

¹⁴ Mark Frasier, "Coming to Terms with the 'WTO Effect' on US-China Trade and China's Economic Growth", The National Bureau of Asian Research, Sept 1999, <http://www.nbr.org/publications/briefing/frazier99/index.html>

¹⁵ *ibid*, Rosen, Daniel, "China and the World Trade Organization: An Economic Balance Sheet," Institute for International Economics, June 1999, <http://www.iie.com/publications/pb/pb99-6.htm>

¹⁶ Mark Frasier, "Coming to Terms with the 'WTO Effect' on US-China Trade and China's Economic Growth", The National Bureau of Asian Research, Sept 1999, <http://www.nbr.org/publications/briefing/frazier99/index.html>

¹⁷ Daniel Hui, "China's WTO Accession: A Domestic Political Analysis", December 2002, for prof. Lampton.

¹⁸ Shugang, Yansheng, Zhongxin, Measuring the Costs of Protection in China, Institute of International Economics, Nov 1998.

¹⁹ Prof. Weiss in during a class lecture in the "International Trade System", 10 Feb 2003

Overall, it could be safely argued that WTO membership will greatly benefit China from an economic standpoint in the long run, while the short-run risks and adjustment costs are substantial yet not completely offsetting, such that gains can theoretically be redistributed to the losers.

The effect on Global Welfare

While we can make a positive assessment of the economic effect of the WTO accession agreement on China, a separate distinct, and equally important question is - what are the global welfare implications of China's entry into the WTO?

As can be seen with the analysis above, China's membership into the WTO promises a substantial amount of trade creation, which is generally unambiguously welfare enhancing since production shifts from a higher cost producer to a lower cost producer and consumption shifts from higher-cost domestic products to lower cost imported products.

However, it is more ambiguous when considering that additional Chinese exports into foreign countries will replace the exports of a third country. Such movements in trade flows are suspect because they have the possibility of trade diversion, which implies negative welfare effects. This occurs if imports from a non-member country are replaced by imports from a less efficient, new member of the trading system. To help understand the nature of this kind of trade flow in this particular case, consider the following chart showing changes to the US's bilateral trade flows as a result of China's accession agreements²⁰:

Impact of April 1999 tariff offer on the direction of change in U.S. bilateral trade balance

Partner	Static effects	Static plus growth effects ¹
	— \$U.S. millions —	
Canada	24	27
Mexico	89	83
EU	74	39
Japan	63	115
Other OECD	-21	-18
Korea	129	133
Taiwan	300	329
Hong Kong	-172	477
China	-149	-586
ASEAN	126	47
South Asia	194	113
Rest of World	7	-83
World	664	674

¹ Growth effects include productivity growth and capital accumulation associated with China's trade liberalization. Source: USITC staff estimates for base year 1998, reflecting fixed exchange rates.

As can be seen, as a result of the accession agreements, increased imports from China to the US will replace a certain level of imports from practically all other countries, with an exception of the Hong Kong and the "Other OCED" category, as the US's

²⁰ Chart is from "Assessment of the Economic Effects on the United States China's Accession to the WTO," U.S. International Trade Commission, Publication 3228, August 1999, <http://www.fas.org/news/china/1999/ES3228.PDF>

bilateral trade balance broadly improves across these regions. However, since the majorities of these countries are also part of the WTO, and therefore face the same US import tariffs that China faces, under the principle of MFN, these changes in trade flows could not be considered trade-diversion. Instead, they can be interpreted as the replacing of imports by the lowest-cost producer, which is welfare enhancing.²¹ If one can assume that the US cases is representative of other nations, then it could be concluded that welfare reducing trade diversion effects of China's entry into the WTO is minimal.

Therefore, a rather strong case can be made that China's membership to the WTO has a positive net welfare effect on the world economy.

The effect on the multilateral trading system

It is generally agreed that the entry of China into the WTO has been a very positive milestone for the future of the multilateral trading system, primarily because of the huge size of her economy and her growing share of world trade. As former WTO Director-General, Renato Ruggiero noted, "WTO increasingly needs China as a full and active member to be a truly universal system," and additionally that,

China's economic relations with the world are simply too large and too pervasive to manage effectively through a maze of arbitrary, shifting and unstable bilateral deals. China's best guarantee of coherent and consistent international trade policies is to be found inside the rules-based multilateral system²²

Indeed, that China chose to pursue the multi-lateral approach to trade liberalization rather than a unilateral or regional one will strengthen the WTO as a system and trade regime.

However, there are some concerns that certain aspects of China's accession agreements may have negative implications on the overall functioning of the system. First, over the course of the fifteen years of accession negotiation, the WTO and its member countries managed to set an unusually high bar for China, requiring considerable trade liberalization as well as system reform. This may create a precedent for future countries that may either decide that the cost of membership is too high, or may attempt to enter, but fail to make the necessary concessions. However at the same time, China's entry is proof to other nations that a successful negotiation even with such a high bar is not only possible, but also desirable.

Another concern is the nature and level of the enforcement agreements that invite a wide range of future anti-dumping actions against China. With the recent general increase of the use of anti-dumping, the increased opportunity for anti-dumping against China, as well as the unorthodox discriminatory safeguards allowed, are we about to see a new era of unilateralism and protectionism? The passage of time will allow us to observe what effects China's enforcement agreements have on the level of anti-dumping, and what the WTO's response may be to an increased level of activity of anti-dumping.

²¹ The only possible exception to this is the possible trade diversion from Vietnam, listed as part of the ASEAN category. While several of the members of ASEAN are not part of the WTO (Vietnam, Brunei, Laos, Cambodia), Vietnam is the only country in this group whose export composition and labor costs are competitive with China.

²² in a speech delivered at Beijing University on 21 April 1999, http://www.wto.org/english/news_e/spr_e/china_e.htm

Conclusion

Mike Moore, WTO Director-General, at the conclusion of the meeting of the Working Party on China's Accession stated,

With China's membership, the WTO will take a major step towards becoming a truly world organization. The near-universal acceptance of its rules-based system will serve a pivotal role in underpinning global economic cooperation.”²³

Considered from an economic standpoint, China's accession to the WTO can be considered a positive development on a multitude of levels – for the Chinese domestic aggregate welfare, for global welfare, and for the multilateral trading system as a whole. While, as with any large economic “shock”, there will need to be a period of potentially costly adjustment, the short term gains should make such an adjustment highly feasible, given proper management, and the long term gains for the Chinese, the world, and the multilateral trading system should be seen as the real dividend from China's accession into the World Trade Organization.

²³ “WTO successfully concludes negotiations on China's entry”, The World Trade Organization. 17 September 2001, http://www.wto.org/english/news_e/pres01_e/pr243_e.htm

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