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China: Developing Country and World Trade Giant

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Summary

China remains a developing country but is also a dominant force in world trade. This duality is the source of acute tensions in trade relations, and has culminated in a trade war between China and the United States. China is accused of taking advantage of trade rules that are too lenient: lack of reciprocity in market access, insufficient protection of intellectual property, and widespread and opaque subsidization. Responding to these criticisms, China is making progress on market access and intellectual property protection, but its progress in addressing subsidization appears to have stalled. There needs to be more awareness in China of the repercussions of its policies on world trade, and more recognition in the West of China's constraints and limitations as a developing country.

China is now the world's largest exporter of goods, yet it self-designates as a developing country in the World Trade Organization (WTO). This, and the fact that it is recognized as a developing country by the international financial institutions is, understandably, a source of friction between China and the United States and its allies. China, though evidently a world power, remains a developing country according to any plausible criterion. China exhibits features like those of other upper-middle income countries, including institutional weaknesses, corruption, and the vulnerability of its large poor population. For example, the share of agricultural employment in China is 25%, compared to 3% in high-income countries and 22% in upper-middle-income countries. Here, I discuss the implications of China's dual status—world power and developing country—for Chinese policy and for its trading partners.

I focus exclusively on the economic considerations associated with China's integration into the world trading system. Though the importance of security, geopolitics, and concerns about human rights in shaping China policy is evident, I leave those issues to others better equipped to deal with them. I take an outcome- and data-driven approach to evaluate China's trade relations and, where possible, I try to avoid the legalistic WTO-centered approach taken in many discussions of the subject. This is because what determines trade outcomes is not the fine print of trade agreements, but the general direction policymakers adopt and the actions of firms. Furthermore, with the WTO stalled, the big changes in policy are occurring outside that vital organization.

1. I thank Abdelaziz Ait Ali and Hinh Dinh for helpful comments.

Even though they are normally the subject of distinct jurisprudence, I treat international trade and foreign investment as two sides of the same coin, which in economic terms is what they typically are. For example, trade in services is carried out predominantly through foreign investment (Mode 3 Foreign Establishment). In the era of complex global value chains, it is difficult to promote trade—whether in manufacturing or services—without promoting foreign investment. Often, when I refer to 'trade' I convey messages that also apply to foreign investment. I refer to the United States and its main allies (the European Union, Japan, and the UK) as the 'West' or the 'Western powers'.

Trade Challenges Posed by China's Rise

China's income per capita remains low and China remains in many ways an economy in transition. According to various measures and surveys, China's institutions are less robust, and its market mechanisms are less prevalent and less developed than those of high-income countries. Implementation of laws and regulations is especially weak in China. I explored in a previous brief the implications of China's dual status for the main areas of the West's economic relationship with China: macroeconomics, development assistance, and climate. Perhaps surprising to some, I concluded that—while many differences remain—a considerable degree of convergence between China and the West on these crucial issues has already occurred, despite the enormous differences in income level and economic structure.

However, China's integration into the world trading system remains an important and exceedingly complex issue. International trade is the bedrock on which modern living standards and productivity rest, and China's size and diversity (both within China and between China and its trading partners) mean that the potential gains from trade are big, and so are the potential losses of decoupling from China. At the same time, China's unique state capitalist system makes achieving a level playing field in commercial relations especially difficult, requiring deep changes to the Chinese system. The failure to adequately address these challenges has led China and the United States into a destructive trade war. It is no exaggeration to say that the hostilities, which continue under the Biden administration, constitute a vital threat to the rules-based trading system and possibly to world peace.

China's integration into the world trading system is problematic in three main ways, each of which is the object of complaints against China by the Western powers:

- **Market access**. Reflecting its developing country status at the WTO, China's MFN (most-favored nation) applied tariffs are higher than those of advanced countries. China's foreign investment regime, which is largely not subject to WTO disciplines, is also more restrictive than those of advanced countries. Foreign firms operating in China must operate in joint ventures with Chinese firms in many sectors, and they are believed to be forced to share technology. China is not a party to the WTO Government Procurement Agreement.

- **Intellectual Property (IP)**. IP is not adequately protected in China, and, here too, WTO rules are insufficient.

- **Subsidies and state-owned enterprises (SOEs)**. China has a large state-owned enterprise sector which is viewed as subsidized in various ways. Many Chinese enterprises in the private sector are believed to be subsidized directly by the state or indirectly through SOE loan, price, and procurement practices. The subsidization is opaque. WTO disciplines on subsidies and SOEs are insufficient.

Based on Chinese unilateral reforms, bilateral and regional agreements recently concluded by China, and various outcome and policy indicators compiled by international organizations, I show that, on the first two issues, a large measure of convergence between China and Western powers has already occurred or is occurring. Even though it has not been possible to enshrine these changes in the WTO due to its extraordinarily cumbersome negotiations procedures (single undertaking/consensus rule), the progress is happening because Chinese policymakers (and many of China's trading partners) want it to happen. I conclude that on the issues of market access and intellectual property protection, the problems that remain are not fundamental or intractable. They are not about China's direction of travel (towards meeting the demands of the West) but the distance to be covered and how fast China is moving. Managing this transition requires not only better implementation by China but also improved understanding among the Western powers of China's objectives and constraints.

The third issue, subsidization and SOEs, is the most problematic because it goes to the heart of China's state-capitalist system. In this case, too, there has been considerable progress in Chinese thinking and practice but change on the ground remains insufficient. Accelerating the change requires, first and foremost, structural reforms in China and the willingness and capacity to deal with their social repercussions. But Western powers can also play a more constructive role to support of the reforms. Downplaying the rhetoric and developing an accurate assessment of the international distortions caused by the Chinese system would be a good starting point.

Before delving into these issues, it is worth noting that the long list of complaints against Chinese business practices—however valid—has not prevented China from becoming the leading destination for foreign direct investment. Nor has China's penetration of world markets, often driven by the exports of multinational firms, ceased, even amid a trade war. Multinational companies consistently rate China among their top strategic investment priorities. Whether as a huge and growing market, or as a competitive place to source, China retains its attraction.

Market Access

Access to China's markets remains more restricted than in advanced countries. However, China's market-access restrictions are in line with those of other large middle-income developing countries and policy is shifting in China to make markets more accessible. This change is unmistakable and takes many forms.

Tariffs are often mentioned as a hindrance to exports to China. Foreign investors in China operate complex supply chains which rely on many imported components or sell imported products directly to Chinese firms. China has unilaterally reduced its MFN applied import tariffs by about one percentage point over the last two years and they are now on average 7.6%. This level is higher than those of advanced countries, which are typically in the 2%-4% range, but is not prohibitive. In keeping with its developing country status, China's tariffs are now in line with those of a sample of large middle-income countries: Brazil, Indonesia, Mexico, Russia, Thailand, Turkey. Brazil's MFN tariffs are considerably higher than China's. Importantly, China (like Russia) bound 100% of its tariffs on its accession to the WTO. This feature means that trade in goods with China is predictable.

Market access depends on far more than tariffs on goods, of course. In trade costs (logistics, customs, etc.), China does relatively well compared to middle-income countries. China ranks 56 in "trading across borders", the World Bank's Doing Business (DB) assessment of the time and cost of exporting and importing (excluding tariffs), including processing merchandise through customs. China ranks well behind most advanced countries, but better than Brazil, Russia and Indonesia which rank near 100 or worse, and China is second only to Turkey in the sample of large middle-income countries. China ranks less well in the World Economic Forum's Global Competitiveness Report (GCR) "trade openness" indicator, which is more comprehensive than DB and includes non-tariff barriers, as assessed by replies to the executive survey, as well as tariffs. China is a far less open economy than Mexico, for example.

Viewed from the standpoint of foreign firms that want to operate in China, market access depends crucially on restrictions in the FDI regime. FDI restrictions are especially important in the service sector, since foreign establishment is the main way that services are provided internationally. In comparison to our sample of large middle-income countries, China ranks in the middle of the Organization for Economic Co-operation and Development's Foreign Direct Investment Restrictiveness Index (FDIRI). However, China's FDI regime is much more liberal than it was ten years ago. China has shown the best overall improvement in the FDIRI since 2010, with a 19% decrease in score. The financial sector has been largely closed in China but **significant steps** to loosen restrictions were taken in 2019, prompting a flurry of interest by major international banks and insurance companies. Importantly, China is far less restrictive in manufacturing, where most FDI in China is directed, than in services. China's manufacturing FDIRI score is 0.07 (1 being most restrictive and 0 being entirely free) which compares well with some OECD members, including Australia, Canada and Mexico, which have more restrictive regimes.

Even discounting the frequent declarations by Chinese leaders that they embrace globalization and intend to further open the economy, the numbers cited above show that this is in fact happening. Additionally, some

important new developments confirm this tendency:

- The 2019 Foreign Investment Law, which came into force on January 1, 2020, removes the joint venture requirements in many sectors, outlaws forced technology transfer, and places foreign firms broadly on the same legal footing as Chinese enterprises. This includes forbidding government entities at all levels from discriminating against foreign enterprises in government procurement. China has adopted this reform unilaterally, even though it has yet to formally join the WTO Government Procurement Agreement.

- China has concluded several bilateral trade agreements with smaller trading partners in recent years, often coinciding with the extension of its Belt and Road Initiative, and is engaged in negotiations of many more. Most significant is China's signing of the Regional Comprehensive Economic Partnership (RCEP) with other Asian nations, including Japan and South Korea, as well as ASEAN. The RCEP entails tariff elimination or reductions in goods sectors, and harmonization of rules of origin, designed to integrate value chains across the region. China is engaged in negotiations with Japan and Korea on a deeper trade deal. At the Asian Pacific Economic Cooperation (APEC) Summit in November 2020, Xi Jinping announced that China was considering joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). This remains an **unlikely prospect**, but China's interest, expressed at the highest level, gives an important signal about its intention to pursue economic integration in the Pacific basin.

- Although its ratification is in doubt because of a dispute over human rights, the Comprehensive Agreement on Investment (CAI) between China and the European Union concluded at the end of 2020 is of **considerable systemic importance**. On market access, through the CAI, China binds the liberalization of its manufacturing sector under the FIL in an international treaty, and commits for the first time since its WTO accession in 2001 to a substantial liberalization of its service sector. Even though the CAI is a bilateral treaty between China and the EU, under WTO rules the liberalization of services applies MFN to all other WTO members.

- It is important to note that, even as China has undertaken these varied steps towards a more liberal trade and investment regime, it has also become far less reliant on an export-driven growth model, and more reliant on domestic demand. As Ait Ali and I have shown, this tendency has been especially evident in trade in **manufactures**: in 2006 domestic consumption of China's manufactures was about 60% of exports of manufactures; by 2014, domestic consumption was 17% larger than exports.

Intellectual Property Protection

Based on recent surveys carried out by their respective chambers of commerce, many foreign firms remain uncomfortable with IP protection in China. About one fifth of U.S. survey respondents in China feel that their IP is not well protected, and this concern is also frequently expressed by Japanese firms[2]. Although most European business respondents assess positively the "effectiveness of China's written IP protections laws and regulations" (67%), fully 42% of respondents assess enforcement of the rules as **inadequate**.

According to the GCR, China ranks unimpressively, 53 out of 141 countries, on IP protection, slightly behind Indonesia but ahead of other large middle-income countries. China's IP ranking is far lower than the average of OECD countries which is in the mid-30s.

This finding reflects generally weak IP protection in developing countries. A recent European Commission report shows that EU firms report numerous violations of IP rights in all the countries in our sample, as well as in other large developing economies including India, Argentina and Malaysia.

China continues to take important steps to improve its IP protection regime and its enforcement. This stands to reason since Chinese firms have an increasing stake in protecting their own technology, and China must encourage innovation to reach high-income status. China is now a major investor in R&D and is rapidly moving up the value added/technology ladder in many sectors. In 2019, China passed the United States as the largest user of the patent system. According to the

2. An example of inadequate IP protection is reported by the European Commission to be the shortfall in payment of adequate royalties relating to the use of Standard Essential Patents (SEP) for the functioning of 4G technologies widely used by Chinese companies.

World Intellectual Property Organization (WIPO) in that year, Chinese entities **filed** nearly 59,000 applications for patents, about 1000 more than were filed from the United States. For the third year in a row, a Chinese company, Huawei, was the leading corporate filer of patent applications. A recent **GCR special report** developed composite indicators designed to measure countries' "transformation readiness", based on a survey of international executives. China's scores turned out to be in line with those of advanced countries, higher than Germany, for example, though lower than the United States. The GCR ranks China highly in innovation: tenth in innovation capability, second in the prominence of its research institutions, and eighteenth in ICT adoption.

China has enhanced the capacity of its courts to adjudicate on IP cases. This capacity varies greatly across Chinese provinces, with IP protection and recourse especially weak in the less-developed western provinces. In an important step, on January 1, 2019, a new IP Court of Appeal was established with national jurisdiction. Meanwhile, the Beijing IP court, whose capacity to deal with complex cases has come to be recognized by the legal and business community, resolved around 2500 cases in the first half of 2019. Among these **cases**, many were between Chinese parties and some involved foreigners. Of the cases involving foreigners, foreign firms accounted for 76% of the plaintiffs and 16% of the defendants. Foreign firms won 68% of the civil cases. However, the average award across all cases heard by the Beijing IP court, was just under $200,000. Foreign executives recognize that IP protection is **improving** in China, but they also often complain that, even in cases they win, awards are too low.

China has been willing to consolidate the improvements in its IP protection regime in international agreements, as shown in the Phase 1 trade deal it reached with the United States in 2020. Weak IP protection had been among the main complaints in the U.S. **Section 301 Report** that was the prelude to levying punitive tariffs on China. Most of China's new IP commitments in the Phase 1 deal consisted of procedural innovations that may lead to improved enforcement of China's obligations. Specifically, the agreement provides for publication of actions on IP protection enforcement, and for regular reporting on progress. Under the Phase 1 deal, China also agreed to bigger awards/penalties for IP theft.

Subsidies and State-Owned Enterprises

All countries have SOEs. According to a **recent IMF report** "*SOEs operate in virtually every country in the world. In some, they number in the thousands (China, Germany, Italy, Russia, Sweden, Ukraine) and are owned by national or subnational governments*". However, China's SOEs stand out for their scope and strategic importance. **A World Bank estimate** places their share of GDP at between 23% and 27%, much higher than in the OECD. SOEs in China are concentrated in capital-intensive sectors, such as utilities and mining, so their share of employment is far lower than their share of GDP. Because of a lack of data, the World Bank estimate of the share of SOE employment in total employment is very wide, ranging from 5% to 16%. Others place SOE employment at about 60 million, or 8% of total employment[3].

Several studies have shown that, as in many other countries, the SOE sector in China is inefficient, providing lower returns on assets and total factor productivity than the private sector. The SOE sector is also excessively indebted. The Chinese state has been engaged in a wide-ranging and profound effort to reform the SOE sector since the 1980s, when SOEs were prevalent throughout the Chinese economy, including in agriculture, accounting for 80% of GDP. Because of the crucial role SOEs play in the economy, both provincially and nationally, and as an instrument of Chinese Communist Party power, the reform has tended to be gradual, entailing a so-called 'dual-track' strategy: promoting the growth of the private sector while restructuring and improving the efficiency of the state sector. Even so, it is estimated that employment in SOEs has been cut in half since the beginning of the reform era. The reform effort has included corporatization of SOEs, partial or outright privatization, mergers and closures, and governance and management reforms. According to **Lardy**, the reform effort has slowed since the onset of the Great Financial Crisis in 2007, and is failing to yield adequate results. Still, as **Huang and Levy** have argued drawing on U.S. National Bureau of Statistics data, while the share of fixed asset investment by state-owned companies increased from 33% to 37% from 2015 to 2017, much of the increase was in infrastructure in poor western provinces, and privately-controlled companies now account for nearly half of total investment.

3. See Lixing Lin chapter in "China 2049".

The presence of a large and inefficient SOE sector is not only a dampener of China's growth but, given China's size, also a source of distortions in international trade and investment. Insofar as China's SOEs are subsidized through cheap loans, covered by implicit or explicit state guarantees, face soft budget constraints, benefit from regulations bestowing on them monopoly rights, or receive preferential treatment in public procurement, both Chinese and international competitors are put at a disadvantage. Moreover, politically influenced SOEs can themselves be a source of subsidies and various forms of preferential treatment for Chinese private firms.

While there is no doubt that a large and inefficient SOE sector is a big problem for China, there are reasons to believe that the international harm it causes is less than meets the eye. Chinese SOEs are under pressure to improve profitability and act according to commercial principles—to achieve 'competitive neutrality'. In many cases, SOEs in China operate in sectors outside the mainstream of international trade and investment (e.g. public utilities, domestic transport, infrastructure in remote regions), or in sectors affected by overcapacity, such as steel. As reported by **Huang and Levy**, SOE investment in manufacturing collapsed from 20% of total in 2008 to 8% in 2017.

China ranks quite high in terms of the contestability of its markets according to the GCR survey. When asked whether subsidy and tax distortions are a big problem, China again **ranks quite favorably**. EU and U.S. Chamber of Commerce surveys reveal that most European and U.S. firms do not feel they are discriminated against in comparison to Chinese companies. Although many firms still report discrimination, their share has declined over the last several years. Where Chinese SOEs have ventured overseas, for example by making acquisitions, they have met little success, which is unsurprising given their reputation for inefficiency. A combination of disappointing results, Chinese government pressure, and overseas resistance has deterred SOE overseas investment in the West. For example, in 2019, Chinese FDI in the EU was just €12 billion, of which only about 10% was by Chinese SOEs, representing a rounding error in EU total investment.

Most importantly, despite the slow progress on SOE reform recently, the private sector is clearly thriving in China. Even assuming that the SOE sector's share of GDP is no longer declining, as it has dramatically since reforms began, China's private sector has grown at a rate of around 6% a year over the last five years, in line with China's GDP. Accordingly, the private sector now accounts for the lion's share of new economic activity and employment in China. This is reflected in a large increase in the share of private companies in total stock market capitalization.

The government's efforts to improve the environment for business—whether Chinese or foreign—is perhaps best conveyed by the two most widely followed sets of comparative indicators. In 2019 the World Economic Forum GCR ranked China 28 in the world on competitiveness, while The World Bank's DB ranks China 30 in the world on ease of doing business, a huge improvement compared to five years previously, when China was ranked 90. On both measures, China ranks ahead of some high-income countries, including Italy, for example.

Also encouraging is China's willingness to commit for the first time under the CAI to a precise definition of SOEs and to a transparent procedure for identifying harmful subsidies and adopting remedies. However, the CAI does not go as far as subjecting subsides to dispute settlement through arbitration.

Conclusions and Recommendations

China, a developing country, and a former centrally planned economy still in transition, is the world's largest exporter of goods and the leading destination for foreign investment. China's continued integration into the trading system is the source of major concerns related to market access, protection of intellectual property, and subsidies associated with its large state sector. Both China and the Western powers need to become more aware of this reality and to adjust policies accordingly.

The Western powers should accept that China remains a developing country, and so should continue to benefit from the flexibilities accorded it under Special and Differential treatment in the WTO. This point is more about mindset than substance since WTO disciplines are not progressing and China has already taken on more commitments than other developing countries. Moreover, through both unilateral reforms and bilateral negotiations, China is clearly moving in the right direction on market access.

That said, in recognition of its special status as a world power, China should consider further small reductions in its MFN applied tariffs. This does not mean going down to the levels of high-income countries, however. China should retain bargaining chips as it pursues bilateral and regional trade agreements.

On intellectual property, it is imperative that China step up its implementation efforts along the lines promised in the Phase 1 agreement. The Western powers for their part must recognize the difficulties of implementation that China faces over its vast territory, and against the background of governance frailties.

On subsidization, the toughest challenge, the Western powers must recognize that China needs to undertake nothing less than a major restructuring of its economy. This process has been ongoing for the last 40 years, has made great progress, and will take many more years to be fully completed. China, on its side, should engage again the energy that drove its major reform efforts in the 1990s, when the SOE sector was scaled back dramatically. The SOEs that remain and are present in the commercial sector (as distinct from public goods) must be managed for financial results and according to the principle of competitive neutrality. Achieving competitive neutrality can include measures such as ensuring that the cost of capital (debt and equity) for SOEs is the same as for private firms, and even **compensation payments** for regulatory advantages.

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