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INTERNATIONAL TRADE

Challenges and Opportunities for U.S. Businesses in China

Statement of JayEtta Z. Hecker, Associate Director, International Relations and Trade Issues, National Security and International Affairs Division

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss some of the challenges and opportunities for U.S. businesses in China. My statement is based upon what we have observed as a result of completed and ongoing work addressing various issues regarding U.S.-China trade and economic relations. As you know, after 15 years of economic reform, the Chinese economy has become one of the fastest-growing in the world. However, while China has moved toward a quasi-market system, significant trade barriers still exist, according to U.S. businesses and the office of the U.S. Trade Representative (USTR). While managing to liberalize its economy and maintain rapid growth, the Chinese government has not yet fully implemented fundamental standards for international commerce. Despite gains that have been made in certain sectors, U.S. businesses still face a wide array of challenges in obtaining access to the China market. My statement today will cover

(1) China as a potential market for U.S. businesses, highlighting sectors where economic expansion will require foreign expertise and equipment;

(2) some of the challenges U.S. businesses face in gaining market access in China, as well as the concerns of some firms now operating there on issues such as China's accession to the World Trade Organization (WTO); and

(3) World Bank efforts to develop Chinese commercial standards to meet international norms, with a special focus on the importance of reforming China's banking and financial services sector.

The Expanding China Market

The size and growth rate of China's economy in recent years has made it a large export market for the United States. According to World Bank figures, on a purchasing power parity basis[1] China had the world's second largest economy in 1994, with a per capita gross national product (GNP) of $2,510 and a population of about 1.2 billion people. As China's economy has expanded, its demand for U.S. products has also grown. U.S. exports to China grew by 27 percent, to $11.7 billion in 1995. According to the Commerce Department, over the last 5 years U.S. exports to China have increased an average of 20 percent per year. In 1995, U.S. imports from

[1]The World Bank defines "purchasing power parity" as the number of units of a country's currency that is required to buy the same amounts of goods and services in the domestic market as one dollar would buy in the United States.

China grew by 17 percent, to $45.6 billion, with a resulting trade deficit of $33.9 billion.[2]

In 1995, the top five U.S. imports from China—which accounted for about 65 percent of total imports from China—were (1) miscellaneous manufactured articles such as toys and games, (2) clothing and apparel, (3) footwear, (4) telecommunications and sound recording and reproduction equipment, and (5) electrical machinery. According to a senior Commerce Department official, China acts as a provider of low-cost goods to the United States that largely compete with similar products from India and Indonesia. In 1995, the top five U.S. exports to China—which accounted for about 45 percent of total exports to China—were (1) fertilizers, (2) transport equipment (mainly aircraft and aircraft parts), (3) cereals and cereal preparations, (4) textile fibers, and (5) telecommunications and sound equipment. According to the U.S. Department of Agriculture, China is an increasingly important market for U.S. agriculture exports. In 1995, China purchased nearly 40 percent of all U.S. fertilizer exports and nearly 10 percent of all wheat and corn exports sold by U.S. farmers.

Within China, U.S. and foreign businesses continue to rapidly increase their operations and investments. Between 1992 and 1994, foreign direct investment (FDI) in China increased from $11.3 billion to $33.8 billion. The United States is China's third largest investor, behind Hong Kong and Macau (combined) and Taiwan, according to Chinese statistics. In 1995, total FDI in China was $37.5 billion, of which the U.S. share was $3.1 billion, or 8 percent of the total. According to World Bank figures for 1995,[3] China was the largest developing country recipient of net FDI, with 42 percent of all FDI going to developing countries.

Key Sectors for U.S. Exports to China

The World Bank estimates China's expected infrastructure development expenditures (e.g., transportation, power generation, and telecommunications) to be $750 billion over the next decade. According to the Commerce Department, between 1993 and the year 2000 China will expend $45 billion to $50 billion on transportation, including airport construction and air traffic safety and control capabilities. Between 1996

[2]However, as we reported in International Trade: U.S. Government Policy Issues Affecting U.S. Business Activities in China (GAO/GGD-94-94, May 4, 1994) the U.S. and Chinese governments disagree over how bilateral trade statistics should be calculated. The Chinese government records many goods that it ships through Hong Kong as Chinese exports to Hong Kong, while the United States records these goods as Chinese exports to the United States.

[3]Preliminary 1995 data from the World Bank.

and 2000, China is expected to purchase more than 300 large passenger aircraft, with a value of $13 billion. Furthermore, China may spend about $65 billion to expand its energy production. Over the next 10 years, China's plans for economic growth call for 168,000 megawatts of additional generating capacity — more than three times America's projected investment. With regard to telecommunications equipment and technology, the Commerce Department expects China to spend over $10 billion between the years 1993 and 2000. China is expected to add 100 million phone lines to the domestic network, equal to the entire number of phone lines already installed in the United States. Finally, China is expected to spend $35 billion on improving its environmental conditions.

In sectors where U.S. businesses hold a comparative advantage, China's plans to develop its infrastructure continue to present opportunities for U.S. exports. U.S. entry into these sectors remains important because initial purchases may set the standards for technology, equipment, and services procurements which, in turn, may encourage future exports.

Impediments to Accessing the Chinese Market

Since China initiated its series of market-oriented reforms, it has made progress in moving toward adopting international trading standards, including a series of memorandums of understanding (MOU) with the United States. However, the transition from a nonmarket economy to a more open, market-oriented economy has been a challenge for both China and its trading partners. In particular, increased market access, enforcement of intellectual property rights (IPR) protection, and the implementation of international trade standards in China have been the focus of both ongoing negotiations between the United States and China and of concern by the U.S. business community.

Market Access

In October 1992, the United States and China signed a groundbreaking MOU dealing with market access issues. The MOU commits China, among other things, to increase the transparency of its trade regime by openly publishing all trade-related laws, regulations, and decrees; removing a significant number of nontariff barriers and significantly reducing selected tariffs; and eliminating standards and testing requirements as barriers to trade, especially for agricultural products.

In January 1995, we reported on the implementation of the 1992 MOU[4] and found that while China had taken steps to comply with most of the provisions of the agreement, U.S. companies continued to experience market access problems. The most frequent concern reported by the 33 companies we interviewed was in the area of transparency, which refers to the extent to which laws and regulations are open, clear, measurable, and verifiable. A majority of those who cited transparency as a problem reported that China's trade and investment laws are unclear, inconsistent, or administered in a seemingly arbitrary manner. Companies also expressed significant concern over the high level of certain Chinese tariffs, which price U.S. goods out of the market. Some U.S. companies we interviewed also reported problems with Chinese nontariff barriers. The most frequently cited were import-licensing requirements, which in some cases resulted in increased technology transfer or increased local content and were perceived as time-consuming and arbitrary.

The 1996 USTR annual report on foreign trade barriers[5] shows that these issues continue to pose problems for U.S. businesses in China, despite some progress. The report indicates that the goal of achieving transparency and uniformity of trade rules throughout China remains elusive; that China still maintains a large number of nontariff measures such as quotas and licensing requirements; and that China's tariffs, in many cases, remain prohibitively high. The USTR report also highlights other areas of concern regarding market access. These include the following:

- China continues to use standards and certification practices that the United States and other trading partners regard as trade barriers. This has the effect of adding to the cost of manufactured goods and the outright banning of certain agricultural products.
- Despite China's commitment to publish all laws and regulations affecting imports and exports, some regulations and directives remain unpublished. Moreover, there is no published, publicly available, national procurement code in China.
- China's market for services remains severely restricted. China denies U.S. and other foreign companies national treatment,[6] and in many service

[4]See U.S.-China Trade: Implementation of Agreements on Market Access and Intellectual Property (GAO/GGD-95-61, Jan. 25, 1995).

[5]See 1996 National Trade Estimate Report on Foreign Trade Barriers, USTR (Washington, D.C.: 1996).

[6]National treatment is the act of treating a foreign product or supplier no less favorably than domestic suppliers.

sectors foreign firms are confined to providing services to other foreign firms or joint ventures.

Intellectual Property

In recent years, the United States and China have also struggled over an area of great importance to the United States: intellectual property. In January 1992, the United States and China signed the MOU on intellectual property, resolving USTR's Special 301 investigation[7] on China's inadequate protection of U.S. IPR. China committed to revising its patent law, providing administrative protection for certain U.S. pharmaceutical and agricultural chemical product inventions, enacting a law providing protection for trade secrets, and providing effective procedures and remedies to prevent or stop IPR infringement. However, as we said in our January 1995 report, U.S. companies experienced serious problems with enforcement of China's new intellectual property regime, particularly with the absence of a viable enforcement structure, inconsistent application of laws and regulations, a lack of resources dedicated to IPR enforcement, and a pervasive lack of transparency. In 1994, USTR again initiated a Special 301 investigation. This led to a new MOU on enforcement in February 1995, which was designed to address many of the problems found in our report, particularly the protection of copyrighted works, and trademarks, and increased market access for products based on intellectual property.

As with the 1992 MOU, problems occurred with the implementation of the enforcement MOU. The acting USTR recently testified that while China had taken action to improve intellectual property protection, particularly in the retail sector, it had not enforced key areas of the 1995 agreement, including halting IPR piracy at its source. As a result, the United States in May 1996 announced the publication of a retaliation list targeting Chinese exports to the United States, which would have matched the approximate value of damage inflicted on U.S. industries—estimated at $2 billion. In June 1996, China responded and took action to close over 15 factories producing pirated compact disks; announced a concentrated enforcement period targeted at areas where piracy is serious, such as Guangdong; and took steps to provide protection against the import and export of pirated intellectual property at China's borders, among other measures. In addition, according to USTR, China took steps to further open its market to U.S. software and audiovisual companies. USTR plans to continue

[7]Under what has been commonly called the "Special 301" process of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418, 19 U.S.C. 2242), USTR performs an annual review to identify countries that do not provide adequate or effective protection for U.S. intellectual property rights. If a country is designated a "priority foreign country," USTR must decide within 30 days whether to initiate an investigation into the country's IPR practices.

discussions with China on the need for further progress on IPR enforcement.

Implementing International Trade Standards

One important goal for both China and the United States, encompassing everything from tariffs to intellectual property rights and agriculture, is the issue of China's entry into WTO. The United States has consistently held that it supports the entry of China into WTO on the basis of a commercially viable package and on terms that are consistent with WTO provisions. To do so, U.S. officials have developed a "road map" that crystallizes the basic decisions China must make in each substantive area covered by WTO, according to recent USTR testimony. The United States and China have been holding discussions on China's WTO accession.

Many U.S. businesses operating in China report that, before China enters WTO, improvements in China's market access policies are necessary. Based on our meeting with the American Chamber of Commerce in Beijing and supported by a February 1996 Chamber survey of its members, U.S. businesses believe China's government must make fundamental improvements, including allowing foreign companies to engage in direct trade in China (i.e., buying and selling in their own names), reducing import restrictions, and protecting IPR. In addition, in the survey almost 60 percent of the respondents said they have not seen any significant liberalization of barriers in the services sector, and almost 75 percent said that they have had problems with the lack of clarity in investment regulations.

Finally, several academic China experts we met with described the need for improvements in the basic infrastructure of Chinese institutions regardless of entry into WTO, such as China's legal system and the rule of law in general; both its assemblies and its judiciary; and the central bank and the central revenue systems.

World Bank Efforts to Develop Chinese Commercial Standards

As China continues to reform its economy, the World Bank has provided loans and technical assistance intended to strengthen the domestic private sector and assist China in meeting international commercial standards. During the 1990s, China has been the largest recipient of World Bank loan commitments. Since 1981, the World Bank has committed about $23 billion in loans and loan guarantees for over 160 projects. According to the Chief of the World Bank's resident mission in Beijing, Chinese leader Deng Xiaoping made China's membership in the World Bank a priority after initiating economic reforms in 1978. The Chief of the mission told us that the Bank was the first foreign financial institution China asked to help reform its economy. He emphasized that China has directed its own economic reform agenda and has utilized the Bank's services as a vehicle for developing the reform process.

Lending Activities

The World Bank has provided funding for various sectors, including agriculture, transportation, energy, health, education, and the environment. The Bank's development efforts have included projects related to trade, such as port facilities and railways. Of the $23 billion in Bank funds committed for China, about $8.5 billion have been credits from the Bank's International Development Association (IDA). IDA efforts in China have recently begun to focus on poverty reduction and environmental activities. The International Finance Corporation, the arm of the Bank that provides loans and equity to the private sector in developing countries, has provided about $486 million in loans and equity for 18 projects in China. The Bank's Multilateral Investment and Guarantee Agency has provided investment insurance, valued at about $79 million, for about 20 projects in China

Bank Activities Intended to Strengthen Commercial Standards

Assisting China in implementing market-oriented reforms is a major thrust of the Bank. According to the Bank's resident mission Chief, Bank operations have recently begun to focus on building institutions necessary for private sector development. For example, the Bank is placing special emphasis on commercializing the operations of state-owned enterprises and reforming the financial sector. The Bank's framework for helping China reform its state enterprises involves (1) creating autonomous corporate enterprises; (2) separating the provision of social services (e.g., housing, social security, education, and health) from the enterprises; (3) subjecting the enterprises to market discipline; and (4) diversifying ownership, for example, by encouraging mergers, consolidations, sales, and leases. The Bank cites reforms of state-owned enterprises as key to improving efficiency in the Chinese economy and to facilitating reforms in the financial sector.

To address financial sector reforms, the Bank is currently financing a technical assistance loan to help China establish banking policies and commercial banking practices. Another technical assistance loan focuses on the preparation of economic legislation, legal training, and strengthening legal institutions responsible for legislation and implementation of economic laws. According to China's Ministry of Finance officials, the Bank has promoted tariff reform, the shareholding system, international competitive bidding, and has helped draft 54 laws that pertain to economic development.

As part of its efforts to promote market-oriented reforms, the Bank is emphasizing competition in a variety of sectors, such as transportation and energy. In transportation, the Bank is helping China reduce subsidies. According to officials in Shanghai's Municipal Finance Bureau, the transportation sector is moving from a monopoly to an oligopoly and is reducing subsidies so that consumers and enterprises share expenses. The Bank is also supporting China's efforts to ensure that enterprises in the power industry are run as efficient businesses and are attempting to reduce barriers to entry. China has already introduced competition in the power sector by holding competitive bidding for construction of most new power plants and allowing independent power producers to compete. Bank assistance will continue to emphasize the transition of regional or provincial power companies to autonomous, business-oriented entities.

Chinese government officials told us that benefits from World Bank financing go beyond lending and have helped improve the way institutions operate. For example, Chinese government officials told us that the Bank has helped improve the managerial expertise of government staff by introducing international competitive bidding practices, project appraisal, and project evaluation methods. Officials also told us that the Bank has helped introduce financial analysis techniques and methods for managing assets and liabilities. Additionally, officials from the Shanghai Municipal Electric Power Bureau said that under World Bank loans they have sent managers abroad to gain skills in evaluating the economic, technical, and financial elements of projects, as well as understanding international auditing standards and financial management.

Reforming the Banking and Financial Services Sector

The Bank is continuing to assist China in further reforms, which emphasize greater commercialization in banking activities. China is gradually opening up its financial market to foreign financial institutions, but still limits the scope of business activities.

World Bank Assessment of China's Reform Efforts

According to the World Bank, a primary objective of financial sector reform in China is to phase out direct controls by the government while relying increasingly on commercial criteria. Although China has implemented some reforms, the government's investment and credit plans continue to steer most financial resources to state enterprises, making it difficult to allocate resources efficiently (i.e., to uses that achieve the highest return within a sound regulatory environment). This situation, according to the Bank, has resulted in a large share of nonperforming loans extended by state banks and inefficient operations.

Based on information from the World Bank, China began changing its banking system as early as 1978. Since 1993, China has made the People's Bank of China responsible for monetary policy and supervision of the financial system, has created three policy banks to separate "policy" lending from commercial lending, and has granted increased autonomy in investment lending decisions to state commercial banks. To continue reforming the financial sector, the World Bank has recommended, among other things, that China (1) give further autonomy to state commercial banks by allowing them to design their entire lending program on their own, (2) facilitate the transformation of state commercial banks into genuine commercial banks, (3) reform interest rates to reduce the large number of officially-determined interest rates, and (4) strengthen regulatory oversight of nonbank financial institutions. Although legislation authorizes the People's Bank of China to set monetary policy, China's State Council must still approve its decisions, according to the U.S. Treasury Department.

Other Reforms

According to the U.S. Treasury Department, China has taken actions to increase the participation of foreign financial institutions. For example, China has gradually expanded the number of cities and special economic zones in which foreign financial institutions may apply for licenses. After consultations with the U.S. Treasury Department, China agreed in 1994 to accept applications for licenses in 12 additional cities, including Beijing. China has been slow to actually grant the licenses, however. Before 1996, foreign-invested firms doing business in China used "swap centers" to get foreign exchange for approved current account transactions. Effective February 1996, foreign-invested and domestic firms have the option of using swap centers or purchasing foreign exchange from designated Chinese banks, currently located in Shanghai, Shenzhen, Dalian, and Jiangsu. These locations account for about 70 percent of China's foreign exchange transactions, according to the U.S. Treasury Department.

Limitations in the Scope of Business for Foreign Financial Institutions

Although China has made some progress in reforming its banking and financial sectors, it continues to limit the scope of business for foreign financial institutions. Currently, foreign financial institutions may only conduct transactions in foreign currency and are not allowed to do business in local currency (or "renminbi"). This year, articles in the Chinese press have said that the State Council has decided to allow some foreign banks to engage in renminbi business in selected districts, such as the Shanghai-Pudong district. According to these articles, foreign banks would be limited to taking deposits and lending in local currency only to foreign-funded companies or foreign-related firms. However, no action has been taken on this announcement, according to the U.S. Treasury Department.

Further limitations in foreign participation in the financial sector extend to the stock market. China's two stock exchanges are located in Shanghai and Shenzhen. Both exchanges have introduced a variety of shares, but foreign investors are prohibited from investing in most shares, thus limiting the opportunity for foreigners' portfolio equity investment. The U.S. Treasury Department noted that at the end of 1994, shares available to foreign investors accounted for less than 3 percent of total market capitalization in the two stock exchanges. Additionally, foreign firms may only establish representative offices and may only broker shares purchased exclusively by foreign-invested companies or foreign residents. Foreign firms must also work with a domestic broker on the basis of a shared commission and may not underwrite local securities issues or act as dealers or brokers in renminbi-denominated securities in the primary or secondary market.

The Need for Further Reform

There is widespread agreement that further liberalization of the Chinese market is in the interest of U.S. businesses and will be necessary for China to maintain its high growth rates. U.S. businesses and USTR have argued that the United States should have access in China's markets equivalent to that which China receives in the United States. Currently, however, market access for U.S. and foreign businesses in China is inhibited by Chinese government measures to protect its state-run economy. According to a May 1996 World Bank country study on China, sustaining growth and maintaining economic stability will require further progress in the government's reliance upon market forces. While China has agreed to remove certain barriers to trade in response to ongoing negotiations with USTR, other trade barriers remain that limit exports and require continuous monitoring to protect and further U.S. interests.

Mr. Chairman and Members of the Committee, this concludes my prepared statement, which incorporates comments obtained from the U.S. Trade Representative, the Department of the Treasury and the Department of Commerce. I will be happy to answer any questions you or other Members of the Committee may have.

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