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Introduction to China's Financial Markets and Business Basics

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An Overview of China's Powerful and Growing Economy

China is a magnet for business interests worldwide. It is one of the largest trading nations with annual imports and exports exceeding $1 trillion. It is the world's largest producer of many product categories. China's fast-rising foreign exchange reserves are having major impacts on international commodities prices and interest rates. China's foreign exchange policy is the center of attention for the global financial markets. The 1.3 billion population and the burgeoning economic growth have resulted in exploding domestic markets. Economic reforms, inflow of foreign direct investment, and membership in the World Trade Organization (WTO) are all major contributors to China's growth. In addition, China plans to gradually sell shares of stock of more than 1,300 largely state-owned companies to further the country's transition toward capitalism. This chapter provides an overview of China's economy, international trade, foreign exchange reserves, special economic zones, and effects of the accession into the WTO.

THE GLOBAL POWERHOUSE

From the initiation of the economic reforms in 1979 through 2006, China's gross domestic product (GDP) grew at an average rate of more than 9 percent. Many economists speculate that if China sustains this level of growth, it could become the world's largest economy by 2050. International trade has been a major part of China's booming economy. The large monetary flows of foreign direct investment and foreign-invested firms accounts for a significant portion of China's trade. The resulting surge in foreign exchange reserves has given rise to debates on China's currency policy and how the policy affects its economy and that of its trading partners.

China's Economic Development

Before the initiation of the economic reforms starting in 1979, China was an isolated, centrally planned economy. The economy was made up of predominantly Beijing-controlled, state-owned enterprises. Foreign-invested firms or private enterprises were virtually nonexistent. The Communist philosophy was "take what you need" not "what you deserve." There were no incentives to work hard. The economy was inefficient and stagnant.

Starting in 1979, China launched several economic reforms. The government permitted (and thus encouraged) price and ownership incentives for farmers by allowing them to sell a portion of their crops in the free market. Beijing also sought to decentralize economic policy making in several economic sectors. In addition, the government established special economic zones and development zones that offered tax and trade incentives to attract foreign investment (discussed in detail in a later section). The economy grew faster, from 5.3 percent pre-reform (1960–1978) to more than 9 percent post-reform (1979–2006).

The economic output of $2.26 trillion in 2005 sent China past France, Britain, and Italy to become the fourth largest economy in the world.[1] China's rapid growth and trade expansion could be sustained into the future, provided China is able to keep the economic reforms going, prevent the economy from over heating, and develop the tens of thousands of new managers crucial to continue the economic miracle.

China has emerged as an economic powerhouse with tremendous opportunities for all those who want to unleash this market's vast potential. Since 1980, China has grown faster for longer than any country in history. China now accounts for 13 percent of global outputs based on purchasing power parity (PPP) exchange rates. China's accession to the WTO and events like the awarding of the 2008 Olympics to Beijing attest to China's growing importance on the world economic stage. Key to China's economic growth is its entry into global markets, not only through foreign direct investment, but also through its impressive growth of exports and imports. Economic reforms also led to higher efficiency and enhanced productivity in the economy, boosting output and increasing resources for additional investments. Reform of the financial sector has moved up the policy agenda, especially after joining the WTO, to better support China's economic expansion.

This exceptional economic performance is leading to huge wealth creation. A growing number of Chinese people now have a net worth of more than $1 million. Chinese purchasing power now represents 12 percent of the global sales of luxury handbags, shoes, jewelry, and the like. Bentley Beijing is one of Rolls-Royce's top-selling dealerships. Shanghai hosted the Formula One Grand Prix in October 2005. Shanghai's Maglev, one of the world's fastest trains, began full operation in March 2004, covering the 20 miles from Shanghai to Pudong International Airport in a blistering 7 minutes and 20 seconds. With such economic power and rising visibility on the global stage, China attracts foreign investments of $60 billion a year. In addition, China's international trade (imports and exports) has exceeded $1 trillion per year since 2004 and its foreign exchange reserves crossed over the $1 trillion mark to $1.066 trillion at the end of 2006.

The 1.3 billion Chinese customers present tremendous market opportunities for all kinds of products and services. Multinationals use China not only as a manufacturing base to compete regionally or globally but also to compete in its burgeoning domestic market. The enormous workforce and the low wages give China huge cost advantages. Thus, China has been able to import materials and export products at very competitive terms. This results in trade surpluses year after year. The investment power of the foreign exchange reserves has significant impact on global interest rates. For example, the *Chicago Tribune* reported on January 14, 2006, that mortgage industry watchers were concerned about China's recent signal to diversify its foreign investments.[2] Market watchers were concerned that if China purchased fewer U.S. Treasury securities or agency securities (such as those issued by Freddie Mac and Fannie Mae), it might drive interest rates higher and substantially cool the real estate market.

Adding to those advantages are the high expectations of China that most people have. Such high expectations motivate investors and companies all over the world to allocate resources to China. Those investments are creating more opportunities, which in turn lead to higher expectations. To realize those expectations, investors and companies needed to have access to China. When China joined the WTO in 2001, it provided foreign institutions that access.

Profit from China's Burgeoning Growth

China's development has been a good thing for the West. Companies from all over the world buy, sell, and invest in China. They are profiting from China's competitive production costs, huge domestic markets, and direct investments in growing sectors.

Many domestic-focused companies in the West and Japan cannot compete with China in the production of computers, clothes, toys, and electronics. Thus, they established facilities in China to take advantage of low production costs. About half of the exports coming out of China are from big foreign multinationals that use the mainland as a production base. Multinationals hope to be able to compete with Chinese companies to sell their products and services in the Chinese domestic market.

The high-tech sector is highly penetrated by foreign firms. Many of the U.S. and European big names have established operations in China. For example, Motorola and Nokia see China as their biggest market. Microsoft, Yahoo, and Google are all big players. Automobile companies such as Volkswagen, General Motors, Toyota, Nissan, and Honda grab the majority of the market share. Although Volkswagen has represented the largest car sales for many years, other manufacturers are beginning to make inroads. For example, Cadillac plans to have 40 showrooms in China by year-end 2007.

In the rapidly growing banking and financial services markets, global financial institutions such as HSBC, Bank of America, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Citigroup are expanding operations and buying stakes at large state-owned banks. Investments in other sectors, by way of venture capital or private equity, are booming as well.

Road Map to the Book

This book describes the super growth in China, presents what the opportunities are and how to profit from them, and discusses the potential risks. Part I introduces opportunities in China and business basics. We start by describing China's growing economy and financial markets. We then discuss the opportunities that come with the opening of China, how to position and profit from them, the business culture, and the risks. This part also covers business and financial regulations and how to enter the Chinese market.

Part II focuses on investment banking. Major activities include private equity, mergers and acquisitions, underwriting, derivatives, and asset management. Those operations are expected to bring in billions of dollars of income for financial companies from the United States, Europe, and Japan. Many large financial houses have already established a presence or formed strategic partnerships with Chinese institutions.

Large institutions can invest directly in China. Retail investors have other ways to get into the game as well. Part III describes the major vehicles investors use to "indirectly" invest in China by way of investing in Chinese stocks and funds traded outside China. Many Chinese companies list their shares in Hong Kong, London, and New York. Mutual fund companies have also established funds to specifically invest in China. Furthermore, exchange-traded funds representing the Chinese stock market or sector indexes provide foreign investors an efficient and liquid means to access the Chinese stock markets.

RAPIDLY EXPANDING INTERNATIONAL TRADE AND FOREIGN EXCHANGE RESERVES

Economic reforms have made China a major trading power. China's exports grew from $14 billion at the start of the economic reforms in 1979 to $762 billion in 2005 while imports increased from $16 billion to $660 billion. In 2005, the trade surplus was $102 billion. Much of the surplus came from exports to the United States and Europe. Excluding the United States, China actually had a deficit of $12 billion. As is clear from the Table 1.1, China's international trade surpassed $1 trillion in 2004 and continued to increase in subsequent years. China's foreign trade of $1.4 trillion in 2005 made it the third largest foreign trader behind the United States and Germany. If this pace of growth continues, it is likely to overtake the United States as the largest exporter by the end of the decade.

The expansion process has been facilitated by trade reforms and the general opening of the economy that have attracted surging foreign direct investment (see Table 1.2) and increased integration with the global trading system. Given China's size and substantial development potential, it will continue to have a large impact on the global economy. China's top-10 export destinations are the United States, Hong Kong, Japan, South Korea, Germany, the Netherlands, United Kingdom, Taiwan, Singapore, and Italy. Key import suppliers are mostly from Asia. The top import sup-

TABLE 1.1 China's International Trade

	Exports ($ Billions)	*Imports ($ Billions)*
1979	13.7	15.7
1980	18.1	19.5
1981	21.5	21.6
1982	21.9	18.9
1983	22.1	21.3
1984	24.8	26.0
1985	27.3	42.5
1986	31.4	43.2
1987	39.4	43.2
1988	47.6	55.3
1989	52.9	59.1
1990	62.9	53.9
1991	71.9	63.9
1992	85.5	81.8
1993	91.6	103.6
1994	120.8	115.6
1995	148.8	132.1
1996	151.1	138.8
1997	182.7	142.2
1998	183.8	140.2
1999	194.9	165.8
2000	249.2	225.1
2001	266.2	243.6
2002	325.6	295.2
2003	438.4	412.8
2004	593.4	561.4
2005	762.0	660.1
2006	961.1	791.7

Source: (1) International Monetary Fund, "Directions of Trade Statistics"; (2) *New York Times,* January 11, 2006; (3) News release, Embassy of the People's Republic of China in the United States, January 10, 2007.

pliers are Japan, South Korea, Taiwan, the United States, Germany, Malaysia, Singapore, Australia, Russia, and Thailand.

International Trade

China has emerged as a trade giant for imports and exports. On the export side, China has long claimed success as the world's factory for light industrial goods for export, such as textiles and toys, and continues to enjoy success in this area. At the same

TABLE 1.2 Foreign Direct Investments in China

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
No. of Contracts	7,273	37,011	24,556	21,001	19,799	16,918	22,347	26,139	34,171	41,081	43,664	44,000
Amt. Contracted ($ Billion)	6.60	91.28	73.28	51.00	52.10	41.22	62.38	69.19	82.77	115.07	153.47	na
Amt. Utilized ($ Billion)	3.41	37.52	41.73	45.26	45.46	40.32	40.72	46.85	52.74	53.51	60.63	60.33
U.S. No. of Contracts	357	3,474	2,517	2,188	2,238	2,028	2,609	2,594	3,363	4,060	3,925	na
U.S. Amt. Contracted ($ Billion)	0.36	7.47	6.92	4.94	6.48	6.02	8.00	7.51	8.20	10.16	12.17	na
U.S. Amt. Utilized ($ Billion)	0.46	3.08	3.44	3.24	3.90	4.22	4.38	4.86	5.40	4.20	3.94	3.06
U.S. Share of Contracted Investment	5.40%	8.20%	9.44%	9.68%	12.44%	14.59%	12.83%	10.85%	9.91%	8.83%	7.93%	na

Source: The U.S.-China Business Council.

time, China has also focused on production of high value-added exports. This transformation is reflected in the significant shift in China's exports away from basic manufactured items and textiles into electronics and high-tech products, which now account for an increasing share of China's exports. For example, the customs figures showed that in 2005 China's high-tech exports rose 32 percent year-on-year to $218.3 billion. Exports of electronics products also rose 32 percent to $426.8 billion, accounting for 56 percent of total export value for the year. This move is further strengthened by the fact that Taiwanese manufacturers are making use of China's low-cost production as a base for high-tech manufacturing, more for re-importing into Taiwan than for China domestic sales. Table 1.3 lists China's market shares in Japan, the United States, and the European Union.

China has experienced a tremendous increase in infrastructure-related imports as it modernizes across the transportation, power, shipping, and telecom industries to foster the development of industry and sustain economic growth. Projects to develop infrastructure go hand-in-hand with China's efforts to support the surge in foreign direct investment. China has proven its ability to meet promised timeframes for order fulfillment and to satisfy the requirements of U.S. and European importers. High quality goods consistently delivered on time, along with access to markets and competitive pricing, have all contributed to China's success story. This success is reflected in an impressive real gross domestic product growth of 10 percent in the most recent three years, and a continued steady growth in trade, which reached $851 billion in 2003 and over $1 trillion in 2004.

As China broadens its production base to include higher-value products, the country's requirement for raw materials has grown in parallel with increased global demand. For example, oil demand is rising rapidly as the government works to diversify energy sources and move away from a reliance on coal. China accounts for about one third of the growth in global oil demand. There is also a rapid rise in demand for natural gas and hydropower. Companies in China, both multinational and state-owned enterprises (SOEs), need raw materials and semifinished goods for conversion to larger-ticket goods for sale in the domestic market and for re-export overseas. This, in turn, is driving an increased inflow of commodities.

TABLE 1.3 China's Export Market Shares (Percent)

	1970	*1980*	*1990*	*1995*	*2000*	*2003*	*2005*
Japan	1.4	3.1	5.1	10.7	14.5	18.5	11.03
United States	0.0	0.5	3.2	6.3	8.6	12.5	21.42
European Union	0.6	0.7	2.9	3.8	6.2	8.9	18.87

Source: International Monetary Fund, "Direction of Trade Statistics."

Note: Figures are imports from China divided by total imports, in percentage.

The immediate challenge is to keep up with China's voracious commodities appetite and the growing world demand for Chinese goods. These two demands are putting an upward pressure on pricing. For example, as the world's largest producer of steel, China requires a large inflow of iron ore and other ingredients for steel production. Commodity flows to China such as iron ore, copper, and oil have all seen price increases. With world pressure to keep the supply of raw materials apace with demand, the related challenge is to maintain competitive pricing for commodity imports. Upward pricing pressure must be kept in check to facilitate China's processing of raw materials to finished goods at competitive prices. This impacts China's ability to compete on big-ticket exports destined for large U.S. and European importers and importers in developing countries where China has made considerable inroads.

There has been a significant shift in share of total Asian exports into China. The fact that China has become increasingly prominent as an export destination for Asia as a whole underscores China's growing role as the Asian production hub. In addition, more intermediate products are being shipped to China for assembly before being shipped on to their ultimate markets. China's role in Asian regional trade has also become increasingly important. Imports from the region are growing rapidly, and China now is among the most important export destinations for other Asian countries (Table 1.4).

China's trade expansion in part reflects greater specialization in production within the Asian region. China now serves as the final processing and assembly platform for a large quantity of imports coming in from other Asian countries and then going out to the West. These changes have resulted in a shift in China's bilateral trade balances, with a significant portion of the surpluses with the West offset by the deficit with the neighboring countries, as evidenced by the trade statistics mentioned earlier that China ran a trade deficit with its trading partners excluding the United States. Reflecting this growing prominence and rising imports, China has been an important source of growth for the world economy. China's imports are growing rapidly from all trading partners and it is now the third largest importer of

TABLE 1.4 Imports to China (Percent)

	1980	*1990*	*1995*	*2000*	*2003*	*2005*
Asian	15.0	41.0	47.1	53.5	52.8	38.00
ASEAN	3.4	5.6	7.4	9.3	11.3	na
Japan	26.5	14.2	21.9	17.8	18.0	15.22
Korea	na	0.4	7.8	10.0	10.4	11.64
Taiwan	na	na	11.2	11.3	12.9	na
European Union	15.8	17.0	16.1	13.3	12.9	11.14
United States	19.6	12.2	12.2	9.6	8.2	7.42

Source: International Monetary Fund, Direction of Trade Statistics.

developing countries' exports after the United States and the European Union. It is the largest importer of copper and steel, and among the largest importer of other raw materials.

Foreign Exchange Reserves

China has accumulated more than $1 trillion in foreign exchange reserves. The allocation of those funds for investment purposes has huge implications on global financial asset prices and interest rates.

At the start of the economic reform in the late 1970s, China's foreign exchange reserves were minimal. In the early 1980s, export growth contributed to an initial increase in reserves that grew to $8.9 billion by 1983. Trade deficits in 1985 and 1986 eroded the reserves in those years (declined to $2.1 billion in 1986). In 1987, the surplus on trade in services slightly exceeded the merchandise trade deficit, producing a small current-account surplus, and a net capital inflow helped push reserves back up to $2.9 billion. The reserves were held above this level for another two years. The economic slowdown of 1989 to 1991 produced a sharp fall in imports in 1990, while exports continued to rise, producing a merchandise trade surplus for that year of $11.1 billion. The level of foreign exchange reserves crossed over the $100 billion mark in 1996 to $105.0 billion.

Joining the WTO in 2001 contributed to a rapid growth in China's imports and exports. Foreign direct investment inflows exceeded $50 billion a year in 2002 to 2003 and topped $60 billion a year in 2004 to 2006. Foreign exchange reserves reached a record $819 billion at the end of 2005 (see Table 1.5). By the end of 2006, the amount exceeded $1 trillion.

There has been much talk recently about stimulating private consumption in China, which is seen by a growing chorus of policy makers and analysts worldwide to be an important means of reducing China's growing external surplus. It is important for China to rebalance the economy away from heavy dependence on exports to lead growth toward self-sustaining domestic demand.

As companies have improved their performance, corporate savings have risen and now account for almost half of national savings. Corporations have an incentive to retain their earnings in order to finance their investment with internal funds. This is particularly true for private sector companies, which have limited access to bank financing and few domestic alternatives for raising money. State-owned enterprises that do make profits are generally not required to pay dividends to the government, and these companies naturally prefer to retain their earnings and plow them back into new investments.

By some measures, Chinese households have in recent years saved almost a third of their disposable income. One would expect a lower saving rate in an economy that still has a relatively low per capita income and, more importantly, good prospects for continued high income growth. So why do Chinese households save so much of their current income? Most observers believe the precautionary motive for saving is very strong among Chinese households because of the lack of an adequate pension system

TABLE 1.5 China's Foreign Exchange Reserves

Year	*$ Billions*
1977	1.0
1978	0.2
1979	0.8
1980	−1.3
1981	2.7
1982	7.0
1983	8.9
1984	8.2
1985	2.6
1986	2.1
1987	2.9
1988	3.4
1989	5.6
1990	11.1
1991	21.7
1992	19.4
1993	21.2
1994	51.6
1995	73.6
1996	105.0
1997	140.0
1998	145.0
1999	154.7
2000	165.6
2001	212.2
2002	286.4
2003	403.3
2004	609.9
2005	818.9
2006	1,066.0

Source: State Administration of Foreign Exchange, China.

and the sharply rising costs of health care. Demographic factors add to this saving motive. The one-child policy instituted in the 1970s to control population growth has led to a declining young working class to support the old generation. The need to finance education expenses has also bolstered saving.

The slow development of financial markets in China has meant limited availability of credit, so that households generally have to save in order to purchase big-ticket items, like houses and cars, rather than being able to borrow against future income. It also has meant that there are low returns on households' financial assets and limited opportunities for portfolio diversification, since there are few alternatives to depositing savings in state-owned banks.

All of this suggests that financial market reform and development is a key priority, which the Chinese authorities recognize. The pace of the reform has picked up since China joined the WTO in 2001. Enterprises might be less compelled to rely on internally generated funds if they have access to financial markets to raise capital. Increased access to credit for households, the availability of a wider range of saving instruments that would help them to diversify risk, and higher returns on their assets also could contribute to a reduction in household savings. Thus, building a broader-based, well-functioning financial market would help to rebalance China's economy by tilting domestic demand growth away from heavy reliance on investment toward consumption. Exchange-rate flexibility could have a role by providing more scope for monetary policy independence and helping cushion the economy from economic shocks. It could contribute to rebalancing the economy by improving investment decisions, and the appreciation of its currency raises consumption by bolstering households' real incomes. The government also has a major part to play in influencing saving and consumption, particularly through provision of education, health care, and pensions. Reducing uncertainties in these areas could substantially diminish the strong precautionary saving motive among Chinese households and give them the confidence to raise their consumption.

SPECIAL ECONOMIC ZONES

China's special economic zones (SEZs) are a unique approach to economic development. Chinese policy makers realized that international trade and commerce had the potential for improving China's overall economic situation. They also recognized that by inviting foreign investors into the country, they could learn about foreign technologies and business practices. The establishment of the SEZs allowed Beijing to try out unconventional market-oriented techniques to promote economic development in designated geographic areas. If the experiments were successful, they could be applied to other parts of the country. If the specific measures were not beneficial, the effect was minimized. This gradual approach has enabled the country to become more open and efficient while avoiding unwanted economic or social instability. As such, the objectives are to use innovative market techniques to develop the coastal areas, to attract foreign investment to modernize China's industries, and to serve as a window to the outside world. The establishment of the SEZs has unambiguously contributed to the super economy of China today.

The main SEZs are Shenzhen, Zhuhai, Shantou, Xiamen cities, and Hainan Province. The Hainan Province SEZ was established in 1988 although the other four zones were established in 1980. Jiang Zemin, former president, stated that "The development of SEZs is an important part of building socialism with Chinese characteristics" at a grand gathering in Guangdong Province in 2000 to mark the twentieth anniversary of the establishment of the Shenzhen SEZ.[3] However, SEZs open China to the world and are heavily influenced by capitalism. As a result, those zones probably will not contribute to "building socialism" but instead to transforming China into a capitalist market.

In addition to the five SEZs, the concept also includes open coastal cities, coastal economic open zones, high-tech industrial development zones, export-processing zones, bonded areas, and Shanghai Pudong New Area. Since 1984, China has opened coastal cities, including Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Pudong Area of Shanghai, Ningbo, Fuzhou, Guangzhou, Zhanjiang, Beihai, and others. Connected by railways with inland, the open coastal cities serve as important trade ports. From 1984 to 2002, the State Council ratified 49 economic and technological development zones (including Dalian, Tianjin, Ningbo, Beijing, and Harbin) to attract foreign investment and speed up economic development. Likewise, coastal economic zones act as the bridge and window for foreign trade and the base for earning foreign exchange through exports. Furthermore, high-tech industrial development zones promote the development of science and technology that are key to international competition. The State Council has approved 53 state-level high-tech development zones. Another related area is export-processing zones. Those aim at more efficient processing and management of trade. The bonded area in Pudong New Area was established to promote the development of export-oriented services. In addition, the Shanghai Pudong New Area aims to develop Pudong as an export-oriented, multifunctional, and modern area for pushing China's economy into the future.

Development of the Special Economic Zones

The SEZs were initially established after the model of export-processing zones in Taiwan and Korea.[4] The first Asian export-processing zone was in Kaoshiung, Taiwan, as a key strategy for outward industrialization policy that was the foundation of Taiwan's economic achievement. The role of SEZs in China's development is similar to that of export-processing zones in high-performing East Asian countries. However, China's industrial development may not follow a pattern similar to the East Asian model because of China's socialism, its vast size of land, and enormous regional diversity.

Before the establishment of the SEZs in Guangdong Province, a small area in Shekou was marked out in Shenzhen as an export-processing zone. The SEZs were originally intended to serve as a place for testing new reforms of enterprise management, finance, and labor matters. This was a significant development because Beijing sought, for the first time, to link foreign investment with trade in those zones. By providing preferential treatment and facilities for foreign investment and trade, the SEZs turned the inward-looking strategy to an open-door policy. The five SEZs together with 14 other coastal cities constituted the front line of the open-door policy. The locations of four of the SEZs were selected because of their proximity to Hong Kong and Taiwan with easy access to information, technology, management know-how, and capital. In addition to economic factors, political considerations were also involved in selecting SEZs in Guangdong and Fujian Provinces. Selecting SEZs far away from the major centers of population confined the possible disruptions of the SEZs within the existing order.

Consequently, in August 1980, the People's Congress passed Regulations for the Special Economy Zone of Guangdong Province. The word "Special" refers to the special policies and flexible measures granted by the central government, allowing SEZs to utilize a special economic management system to:

- Experiment with and acquire of modern high-tech and management expertise
- Create employment
- Earn foreign exchange reserves through promotion of exports
- Promote economic development and regional development
- Create links with Hong Kong, Macao, Taiwan, and overseas Chinese communities
- Experiment with new economic reform with market forces

World Trade Organization Impact

The SEZs showed a great degree of flexibility in attracting businesses and allowing different types of arrangements for foreign investors. The zones provided investors with specific benefits that were not available elsewhere in the country. Those incentives along with infrastructure improvements and a legal and administrative system favoring the establishment of private and joint-venture enterprises led to a flood of foreign investments.

China's membership in the WTO presents challenges. With WTO membership, Beijing is trying to unify income tax rates for domestic and foreign corporations. Foreign enterprises enjoyed a 15 percent income tax rate versus the standard 33 percent national rate. Tax holidays of two or three years were common in the 1980s and 1990s. With the new policy, this dual tax scheme may no longer exist. How does the dismantling of these preferential treatments affect China's SEZs? Some argue that the loss of various incentives will cause foreign companies to locate in other parts of the country or in other parts of Asia. Others believe that membership in the WTO will not be the end of the SEZs but will require Beijing to reposition its policies to attract foreign investors.

MEMBERSHIP IN THE WORLD TRADE ORGANIZATION

China joined the WTO on December 11, 2001, as part of an ongoing process of integration into the global economy that started with the open door policies in the late 1970s. Membership in the WTO signified another stage of China's economic restructuring. It is also a political statement that the economic reforms and open-door strategies will continue. Membership indicates a broadening of international trade reform from a policy that had been focused on SEZs to a more comprehensive approach under which China agreed to change its laws, institutions, and policies so that they conform to the norms of international trade.

Process Leading to Membership

China applied to become a member of the General Agreement on Tariff and Trade (GATT) on July 11, 1986. From 1986 to 1989, GATT conducted meetings to settle problems with regard to China's application. During this period, GATT's contracting parties, including Japan, the European Community (EC), Australia, New Zealand, and Canada supported China's accession. The process was going smoothly without China agreeing to any major changes in its trade policy to meet GATT requirements.

However, all the goodwill GATT members showed toward China was lost after the Tiananmen Square incident on June 4, 1989. China's suppression of the democratic movement derailed the accession process, and most contracting parties withdrew their support. The United States made greater demands for economic reform as a condition for China's membership. As a result, China began to align its policy with GATT requirements.

By 1991, China's relationship with the United States had soured over disputes on China's handling of intellectual property rights (IPR), China's most-favored-nation (MFN) status in the United States, human rights violations on the mainland, and Beijing's military technology transfers to third-world countries. These issues created difficulties for China as it sought renewal of its MFN status by the United States. As a result, China changed its tactics and started to negotiate with smaller countries. China won the support of Belgium, Brazil, and Argentina, and soon had won over other, more important, contracting parties, such as Germany, Australia, and Great Britain. Bolstered by this new momentum of support, China was able to gain the support of still other countries.

The period from 1989 to 1992 marked two important themes: building a coalition of support outside the United States and internal policy changes to conform to GATT principles. During this period, China offered several significant concessions, including: (1) amendment of Sino-foreign investment law in December 1989, (2) publication of trade policies in December 1991, and (3) the establishment of a research institute to study international trade rules and to help the country rejoin GATT.

As GATT evolved into the WTO, China had the opportunity to gain a founding member status. Yet, China's contentious relationship and trade imbalance with the United States continued to hamper its quest for membership. After more than a year and a half of inactivity on China's part, it resumed negotiations with GATT in February 1992. Negotiations continued until December 1994 because both United States and other member countries demanded concessions from China in many areas. The primary focus of negotiations during 1992 to 1993 was on tariff reduction. In 1994, the emphasis shifted to other areas, such as intellectual property rights and market access by service sectors. China's desire to become a founding member led to many concessions on its part including: (1) concessions on human rights issues, (2) concessions covering sensitive areas, such as the automobile industry, and (3) extension of copyright protection.

With many major concessions addressed, the EU, Japan, and Australia supported China's admission into the GATT by the first half of 1994. To win the support of the United States, China offered concessions on a list of products that no longer needed import licensing and named 50 import categories whose tariffs were to be reduced.

After its bid for founding member status failed, China suspended formal negotiations. Both the United States and China came to loggerheads as neither was ready to back down from its position. The United States was upset over China's lack of action on U.S. copyright infringement issues and the growing trade deficit with China. The beginning of 1995 was the breaking point, when talks on copyright issues fell through, a trade war broke out between the countries.

Other areas of dispute soon erupted, including China's aggression toward Taiwan and continued disputes over developing country status, which drew opposition from the U.S. commercial and agricultural sectors. With regard to developing country status, the United States considered China to be a developed country due to its vast economic size and fast economic growth. Yet, China viewed this designation negatively and believed it would result in economic instability. Formal bilateral negotiations were stalled. The EU attempted to restart negotiations on China's behalf; it recognized China's developing country status and pushed for a transition period that would gradually change China's status to a full member. This approach received a lukewarm reception from the United States.

In 1996, the WTO's larger contracting parties, such as the EU, Canada, and Japan, resumed formal negotiations with China and sought to accelerate China's accession. The EU "transition period" approach for China received widespread support among WTO members and China. The EU now focused its negotiations on addressing which areas would be phased in, how long would the phases last, and which areas were to be immediately opened. The EU sought better terms on market access, subsidies, and tariffs. Access to the automobile sector was the most significant issue because the EU demanded drastic cuts in Chinese automobile tariffs and greater transparency of China's long-term policies in the automobile industry. During 1996, the relations between the United States and China soured even further as a result of the intellectual property rights disputes. In March, the United States called for $3 million dollars in preliminary sanctions against Chinese exports due to China's failure to protect U.S. intellectual property rights. In June, China and the United States reached an agreement over intellectual property rights. Yet, other areas of American concerns needed to be addressed, such as agricultural issues and the trade deficit. This led the United States to push for increased access to China's markets.

In 1997, China made a series of offers to WTO members and carried out many negotiations with member countries. The new offers covered tariff reduction in which China reduced the average tariff rate from 23 percent to 17 percent by October 1997. Regulations on distribution and production for foreign companies in China also were addressed. China promised to open the wholesale and retail sectors to foreign investment and to grant rights to all enterprises in China to import or export after a short transition period.

During 1997, the U.S. Congress took a tough stance on a variety of issues with China and proposed several stringent sanctions, including: (1) a ban on prison-labor products, (2) a ban on travel to the United States by Chinese officials who engaged in religious persecution or who forced women to have abortions as a means of population control, (3) inclusion of American human rights monitors in Beijing, (4) a ban on American trade with companies controlled by the Chinese military, and (5) denial of below-market-rate international loans to China.

In 1998, negotiations centered on China's liberalization of the agricultural and services sectors. Adding to WTO members' arguments was the fact that China had increased its share of exports over its Asian neighbors as a result of the 1997 Asian financial crisis. Members maintained that China's increased fortunes allowed it to increase its share of Western countries' imports drastically. As a result, China offered to reduce tariffs to 10.8 percent by 2005 and to eliminate import restrictions on 385 types of commodities over the next 10 years. Additionally, China provided concessions concerning the telecommunications and services sectors, including banking and insurance markets.

In 1999, China focused its attention on negotiations with the United States. China offered tariff cuts on beef and wheat. The United States had several additional concerns, including accusations that the Chinese were stealing nuclear secrets from the United States, a rising trade deficit with China, and apprehensions raised by both U.S. steel and information technology industries.

To further complicate issues, a NATO bomb hit China's embassy in Belgrade during the conflict in Bosnia. To curb internal dissent over the incident, China suspended negotiations with the United States. As this issue faded, China resumed negotiations with the United States. By November 1999, the United States and China were in accord and reached a bilateral agreement. In the same month, another bilateral agreement was signed by China and Canada.

In January 2000, China and the EU held bilateral talks on several outstanding issues covering market access, tariffs, investment, and industrial goods. Other unresolved issues included market access for telecom and insurance companies. In February, China and India signed a bilateral agreement, which increased the trade volume between both countries. By May, China had agreed to concessions pushed by the EU, which resulted in the signing of a bilateral agreement. China made a commitment to lift restrictions on insurance business, which would include allowing foreign operators to sell the same products as their Chinese competitors. Restrictions on location of foreign insurers were relaxed—previously foreign insurers were permitted only in the cities of Shanghai and Guangzhou. Also, foreign partners in Chinese life insurance joint ventures would be permitted to exercise effective management control, for they could choose their Chinese partners and secure a legal guarantee of freedom from any regulatory interference in private contracts on a fifty-fifty equity basis. Additionally, in May 2000, China signed a bilateral agreement with Australia, after reaching an agreement to liberalize access to 1,000 product categories across agricultural and manufacturing exports and to key service sectors.

In September 2000, China and Switzerland reached a bilateral agreement. This left only Mexican-Chinese negotiations as the last remaining obstacle before the WTO accepted China as a member. In September 2001, China and Mexico wrapped up bilateral negotiations. China made concessions to extend its current countervailing duties on 1,300 Chinese products in textiles, garments, footwear, and toys for six years. It also permitted an antidumping measure, which allowed Mexico to maintain the import duties after a six-year period if it discovered dumping. The eighteenth meeting of the WTO China working group finalized legal documents on China's accession; China was formally approved as a member at WTO's November Doha meeting.[5]

Regulatory Changes

China made a variety of commitments to the WTO for membership. A summary of the eight subject areas follows:[6]

1. *Trading rights and distribution services:* China agreed to grant full trade and distribution rights to foreign enterprises by the end of 2004 (with some exceptions, such as for certain agricultural products, minerals, and fuels).
2. *Import regulations:* Import regulations largely concern general and product specific import tariffs. In addition to a number of specific tariff reductions, Beijing agreed to reduce the average tariff imposed on industrial goods and agricultural products from 24.6 percent and 31 percent to 8.9 percent and 15 percent, respectively (with most cuts made by 2004 and all cuts completed by 2010).
3. *Export regulations:* China agreed to accept GATT Article XI, which generally prohibits export restrictions other than duties, taxes or other charges related to the cost of administering an export regime. Exceptions are made for certain sensitive products, such as those whose export could compromise national security.
4. *Internal policies affecting trade:* China agreed to abide by the core GATT 1994 principles of MFN nondiscrimination (known in the United States as normal trade relations) and national treatment, which requires that foreign firms operating in China would be treated no less favorably than Chinese firms for trade purposes, especially as such treatment relates to taxation, regulatory transparency, and price controls.
5. *Investment:* China agreed to eliminate local content and foreign-exchange balancing requirements from its laws, regulations, and other measures. Importantly, China also agreed that importation or investment approvals would not be conditioned on requirements such as technology transfer and export offsets.
6. *Agriculture:* China agreed to limit subsidies for agricultural production to 8.5 percent of the value of farm output and eliminate export subsidies on agricultural exports.

7. *Intellectual property rights:* China agreed to implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement immediately upon accession. The TRIPS agreement sets down minimum standards for most forms of intellectual property regulation—copyright and related rights, industrial designs, patents, trademarks, and trade secrets—within all member countries of the WTO.
8. *Services:* China agreed to open the banking system to full competition from foreign financial institutions by 2007. Beijing also agreed to permit various degrees of foreign ownership in joint ventures in insurance and telecommunications.

Status of China's World Trade Organization Commitments

China met four significant WTO commitments in 2005. These areas are advertising, banking, freight forwarding, and insurance. In advertising, it met the commitment by allowing wholly foreign-owned enterprises (WFOEs) in advertising services when the Regulation on Management of Foreign-Invested Advertising Companies took effect on December 10, 2005. With regard to banking, China met its commitment when the China Banking Regulatory Commission announced on December 5 that it would allow foreign banks to expand their local currency business into Ningbo, Zhejiang; and Shantou, Guangdong. China opened Shenyang, Liaoning; and Xi'an, Shaanxi, in December 2004. In fact, China went beyond its WTO commitments and opened five other cities—Changchun, Jilin; Harbin, Heilongjiang; Lanzhou, Gansu; Nanning, Guangxi; and Yinchuan, Ningxia—in December 2005. In the area of freight forwarding, China met its commitments by allowing WFOEs in freight-forwarding agency services and to apply national treatment to capitalization requirements for foreign-invested freight forwarders. Another fulfilled commitment is insurance. Foreign-invested insurers no longer need to cede to the China Reinsurance Corporation a portion of the lines of the primary risk for nonlife, personal accident, and health insurance. The China Insurance Regulatory Commission also lowered the minimum required total asset level for an insurance brokerage license from $300 million to $200 million. The lower asset requirement took effect on December 11, 2005.

In 2006, China's new commitments were:[7]

- *Architectural, engineering, and urban planning services:* China will allow WFOEs in architectural, engineering, and integrated engineering services. Urban planning WFOEs have been permitted since May 2003.
- *Banking:* China has to lift all geographic and customer restrictions on their local currency businesses on foreign-invested banks. Moreover, China is scheduled to eliminate any nonprudential measures that restrict the ownership, operation, and operational form of foreign-invested banks. The combined phase-in of these commitments should mark the full opening of China's banking sector to foreign companies. It will allow wholly foreign-owned banks to provide local currency services to any Chinese client in any city. Full implementation of these commitments is made particularly important by the likelihood of continuing

restrictions on foreign investment in domestic banks, which is capped at 25 percent for all foreign investors and less than 20 percent for any one foreign investor.

- *Distribution and retail:* China is scheduled to allow WFOEs and other foreign-invested wholesalers and commission agents to distribute chemical fertilizers, processed oil, and crude oil. Implementation of this commitment will remove the last remaining product prohibitions for foreign-invested distributors, except for restrictions on salt and tobacco, which are to remain under state control.
- *Retail:* WFOEs and other foreign-invested retailers with 30 or fewer outlets should be allowed to sell chemical fertilizers. Foreign majority-owned chain retailers with more than 30 outlets should be allowed to sell motor vehicles. Implementation of these commitments will mark the completion of WTO-mandated openings in China's retail sector, though China will retain the right to prohibit foreign-majority owned chain retail outlets with more than 30 stores from selling tobacco products, certain chemicals, some agriculture items, and specific processed oil products.
- *Insurance:* The last of China's WTO commitment in insurance requires it to allow wholly foreign-owned insurers to engage in reinsurance; international marine, aviation, and transport insurance; and brokerage for reinsurance and large-scale commercial risks, international marine, aviation, and transport insurance.
- *Telecom:* China is scheduled to lift all geographic restrictions on mobile voice and data telecom services for Sino-foreign joint ventures. Foreign-invested mobile voice and data telecom providers were restricted to operating in 17 cities, including Beijing, Chongqing, Guangzhou, and Shanghai. After the geographic restrictions are lifted, China will have fully implemented its WTO commitments in these services. China's WTO schedule does not require it to lift the 49 percent cap on foreign ownership in a mobile service provider. In domestic and international services, China is scheduled to expand the number of cities and regions in which Sino-foreign joint ventures may operate and raise the cap on foreign ownership. Foreign-invested fixed-line telecom providers could operate only in Beijing, Guangzhou, and Shanghai. China's 2006 WTO commitments allow these service providers to expand into many of China's most important business centers: Chongqing; Chengdu, Sichuan; Dalian and Shenyang, Liaoning; Fuzhou and Xiamen, Fujian; Hangzhou and Ningbo, Zhejiang; Nanjing, Jiangsu; Qingdao, Shandong; Shenzhen, Guangdong; Taiyuan, Shanxi; Wuhan, Hubei; and Xi'an, Shananxi. In addition, the cap on foreign ownership should rise from 25 percent to 35 percent and should rise again to 49 percent by the end of 2007.

BEIJING 2008 OLYMPICS

Several months before China gained WTO membership, the International Olympic Committee (IOC) named Beijing as the host city for the 2008 Olympic summer games (Table 1.6). Accession into the WTO gave China MFN status with all its trading partners. The prestige of the Olympics has provided the government an extraordinary opportunity to showcase Beijing and China. Immediately after winning the bid, the Beijing Organizing Committee for the Games of the Twenty-ninth Olympiad (BOCOG) released a $34 billion plan featuring new highways, new railways, urban regeneration, and environmental initiatives to become ready for hosting the games. The marketing slogan is "One World One Dream."

China plans to use the 2008 Olympics to focus on the urban development of Beijing. The massive improvements to infrastructure together with the enhanced image displayed on the world stage will lead to a long lasting economic lift. Beijing's $34 billion plan covers five areas that will, after the event, continue to serve a broad range of needs for the economic, social, and cultural life of Beijing. The five areas are specialized sports facilities, infrastructure, environmental initiatives, urban regeneration and cultural heritage, and tourism promotion and hotel development.

In its initial plan, the Beijing Olympics committee proposed 37 facility sites for the 2008 games. Among those sites, 15 are existing facilities with five requiring refurbishment and 22 new facilities. To improve infrastructure, Beijing has budgeted $11 billion for transportation addressing road systems, bus systems, urban rail, and airport. Along with an improved transportation system, China is also working on enhancing infrastructure for utilities and telecommunications, with an additional $5.4 billion budget. The Olympics has been an important stimulus to Beijing's actions to improve the environment in the city. Beijing has budgeted $8.6 billion to bring blue skies back to the city by 2008, promising cleaner air than Paris. Measures target reducing pollution, a new waste treatment system, water and sewage plants, and the 125-kilometer tree belt (the forested area surrounding the city). The tree belt is one component of the larger "Green Great Wall" to forestall desertification throughout China. The urban regeneration Beijing makes in preparation of the 2008 Olympics has significantly impacted the real estate market, residential as well as business.

TABLE 1.6 Olympics Hosting Cities

Year	*City*
1972	Munich
1976	Montreal
1980	Moscow
1984	Los Angeles
1988	Seoul
1992	Barcelona
1996	Atlanta
2000	Sydney
2004	Athens
2008	Beijing

Beijing will demolish several older, inner-city housing structures and build new ones. Beijing will also develop new areas of the city and expand the infrastructure to service this area. Furthermore, the BOCOG is calling the 2008 Olympics the People's Olympics to place its culture and heritage on display for the world. Hotels and tourism will certainly enjoy a sharp uptick during the extended period surrounding the Olympics.

CONCLUSION

China's economy grew 10 percent despite the serious setback by the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003. The economy continued to expand at 10 percent in the subsequent three years. We reviewed the important elements of the Chinese economy and the growing influence of its rising foreign exchange reserves. The open-door policies and the establishment of the special economic zones were the foundation for the economy's expansion. The 2008 Olympics has presented an opportunity for China to upgrade Beijing's environment for long-term benefits of the economy.