

## **China's accession to WTO: its consequences on income distribution and development**

by Diana Hochraich

Chinese and American officials considered China's accession to WTO a great victory for two main reasons. From the diplomatic point of view, both sides claimed the successful conclusion of the protracted negotiations as "their own" victory. Looked at from the economic standpoint, the Chinese President has contended that it was a "win-win" agreement. However, apart from the negotiators themselves, the agreement has evoked not much enthusiasm. Nobody has denied that the negotiations were very difficult and that reaching an agreement meant a very hard fight for both sides. It is for this reason, that one can suppose that there are not only winners but also losers.

The agreement has meant a turning point for China. Let us discuss its main consequences on economic growth and on the living condition of the bulk of the working population in the cities and in the countryside. Both have a decisive impact on development.

From the standpoint of growth, the defendants of the treaty contend that opening up foreign trade and introducing more flexibility in the labour market lead to the better allocation of resources. From the standpoint of social welfare, they claim that even here the State has to withdraw and allow private actors to play a part.

### **A more efficient allocation of resources without full employment?**

Let us consider the assumption that opening up and introducing labour flexibility conveys more efficiency in resource allocation. This assumption supposes two prerequisites<sup>1</sup>: first, that the level of activity remains at least the same, and second, that it corresponds to full employment of all the factors of production, i.e., full employment in the neo-classical sense and not in the Keynesian<sup>2</sup> sense, which is less restrictive. As soon as production does not imply full employment of productive factors, the economy is not at the frontier, i.e. it has not reached the Paretian optimum. As a matter of fact, in the neo-classical theory, any shift from one equilibrium point to another supposes that it moves along the frontier line, defined by a combination of fully employed productive resources. Only relative prices allow deciding which combination is optimal.

So in the short run, all other things being equal – assuming that demand remains constant – opening up means that a rise in imports fatally entails a reduction in the share of demand met by domestic supply. This is the beginning of a downward spiral, with less

---

<sup>1</sup> Patnaik, Prabhat (1997): *A Note on the Redistributive Implications of Macroeconomic Policy*. Contribution to a working meeting organised by SEPED-BPPS, UNDP. January

<sup>2</sup> Full employment, in the Keynesian sense, means that output is constrained by supply and not by a deficiency of demand.

activity leading to less employment, less income, less investment, less production and so on.

Short run effects are not supposed to last more than one or two years. But to counter them means a set of conditions that are not necessarily met by China's current situation. China's labour market is nowadays far from full employment. Conversely, it is flooded with redundant labour force that has two main sources: the new entrants in the labour market, mostly *shiyè*<sup>3</sup> and the *xiagang*. These are old workers from State-owned enterprises who have been dismissed due to the restructuring of factories in most industrial sectors, but especially in textiles, coal mines, oil industry, steel and other heavy industries including the automobile industry. Dismissals are the consequence of reforms being implemented to enable China to face competition in a more open economy. Nobody denies that when this policy is fully implemented, the situation in the labour market will still worsen. Under these conditions, there is no doubt that the downward spiral will persist for more than two or three periods and that allocation of resources will not improve.

### **A more suitable international specialisation?**

Let us now consider long-term consequences, for instance those concerning China's place in the international division of labour. The Bretton Woods institutions again claim that developing countries must specialise according to their comparative advantages. This implies that these countries have to remain exporters of primary products and of lower end industrial goods, such as textiles and apparel, consumer electronics and so on. This idea is debatable: industrialisation was possible in developing countries because developing countries rejected a specialisation based on comparative advantages. Despite its shortcomings, industrialisation was the origin of faster growth and development in countries slow to industrialise.

Unlike Ricardo's theory that focuses on finished goods, the Heckscher Ohlin Samuelson theorem (HOS) focuses on the availability of factors of production themselves and considers that a country must specialise in the production of those goods that contain more of the factor(s) that are abundant in the country. In the case of developing countries, the more abundant factors are generally land and unskilled workforce, while capital and skilled labour are scarce.

Unlike the comparative advantages theory, the HOS theorem acknowledges that in this specialisation there are winners and losers: a more intensive use of the more abundant factor of production results in an appreciation this factor. Conversely, the scarcer productive factor will become cheaper, as the demand for it will ease. China is constrained on land, on water supply and on capital goods. According to the HOS theorem, China should switch from foodgrains to vegetables and fruits, as far as agriculture is concerned. In the manufacturing sector, China should abandon capital-

---

<sup>3</sup> In Chinese rhetoric, a *shiyè* is a person who is merely unemployed and whose name is written down in an employment bureau, as a job seeker. A *xiagang* is a former worker from a SOE that is still on the payroll, but who is no longer paid its salary. It has not cut all links with the former employer; it can live in a house belonging to the labour unit and benefit from some conveniences, such as the hospital or the schooling for his children. This category of unemployed is supposed to disappear in the forthcoming months.

intensive goods, such as machinery, chemicals, sophisticated electronics, heavy industries and automobile and focus on textiles and apparel, toys, consumer electronics and so on. The OECD, the World Bank and the IMF have very strongly recommended that China follow this pattern.

This assertion calls for the following remarks:

- Obviously Northern China, where cereals other than rice grow, suffers from scarce water. Is this a good enough reason to abandon foodgrains production and to replace it with vegetables? There is no evidence for that. Vegetables need to be located near cities and not far from them, as would be the case with the Northern plains. There is in China nowadays a transportation problem as well as a preservation problem. Nobody would dare to say that these problems are easy to solve in the short run.
- As far as prices go, foodgrain prices, as well as those of labour-intensive manufactured goods, should rise. And capital goods prices should fall. But in the case of China, prices are expected to fall as foodgrain imports will substitute domestic production. Chinese agriculture is subsidised; opening this market would be inconsistent with subsidies (as subsidies mean higher prices, which will not be sustainable in front of imported, cheaper goods). OECD experts contend that this would be good for both urban workers (in case they can keep the nominal wage level) and entrepreneurs, (in case real wage levels are maintained). But the losers would be Chinese peasants, who live very close to the poverty line and whose income lags far behind the urban income. It is not unlikely that some time after this “beneficial effect” of imports, the steady pressure of Chinese demand on the world grain market would push up world prices; it is on the contrary, very likely. From this rise, Chinese peasants will hardly benefit, as their market share would have shrunk to the benefit of importers. Instead, this movement would be mostly beneficial to American farmers.
- And what about the large numbers of peasants on the fringes, living on auto consumption, in the most remote places in China? They will not be affected by this opening, OECD experts say<sup>4</sup>. Poor as they are, their situation will not change. This is very debatable too. For the time being, no one can live in complete autarchy and there is no doubt that for these people, relative prices would be, in any case, unfavourable. Furthermore, how can an expert accept that a section of the rural population who live under the poverty line would be untouched by such radical reforms? Is it not awfully cynical?
- Let us now consider relative prices between manufacturing and agriculture. Opening up means a very likely stoppage of subsidies on fertilisers, which are the main industrial inputs in agriculture. Yet there is no hint that fertilisers price will fall. Besides, as Chinese agriculture is not mechanised<sup>5</sup> there is little hope that the fall in prices of capital goods would benefit Chinese farmers. Instead, it is very likely that the rise in prices of daily necessities and agricultural inputs would negatively impact on the relative prices between agriculture and manufacturing.

---

<sup>4</sup> See, OECD: *Dialogue with China*

<sup>5</sup> This is due to the tiny size of parcels (half an hectare by family) on one hand and to the demographic pressure on the land on the other.

But herein arises a fundamental contradiction in the policy implemented currently and its lasting consequences in future years. China has to face a sagging households demand, on account of unemployment and the consequent drop in urban income, which exerts a downward pressure on domestic growth. To counter this effect, Chinese authorities have implemented since 1997 a programme of public works – infrastructure – that has been sometimes quite inefficient. In doing this, the government intends to keep the Chinese growth rate at 7 percent, below which the unemployment rate becomes explosive.

For this reason, China needs to enlarge its domestic market; its peasants could be a part of the potential market. Notwithstanding this need to enlarge the market, there is no question of it happening as long as farmers' incomes are plummeting.

China's policy faces a contradiction between the need to enlarge effective demand and its imposed need to open the economy to foreign competition. Under prevailing conditions, the opening up of China will not lead to a better allocation of resources as it leaves huge numbers of people unemployed. Unemployment depresses demand and this leads to a scaling down of supply and to underutilisation of capital goods. So, neither the HOS theorem nor the comparative advantages theory is relevant. They deter technological improvement and lead to a specialisation that conveys stagnation in the long run.

### **A “lighter” State**

For the IMF, World Bank and OECD officials, States seem to be the “bête noire”, particularly in developing countries. To their understanding, States bother MNCs and their home governments, especially when they try to defend the interests of their own countries. The only context in which States prove to be useful is when private agents in developing countries cannot reimburse debts contracted with foreign creditors. Then the State substitutes for private agents and has to pay for the excesses.

Multilateral institutions recommend a “lighter state” in China. It should withdraw from the productive sphere; leaving to the private sector the privilege of providing public services, not only in electricity, telecommunications, water supply and other vital services but also in matters such as health care, schooling and retirement pensions. Private (thus foreign) financial institutions are supposed to provide for these services. But in China, social protection and the above mentioned social services are in a critical state as a consequence of the dismantling of state-owned enterprises (SOEs), on which social security previously relied. Switching from a work-unit based social protection to a territorial one is not an easy task. The result is quite unsatisfactory, as most of the working population is left uncovered.

On the one hand, the rural population (around 70 percent of the total population) never had any social protection except familial solidarity (that is why peasants have many children despite the “one child policy”). On the other hand, the urban population has less and less social coverage. Education and healthcare are no longer free and has become awfully expensive. Retirement fees are not paid on account of the bankruptcy of most of SOEs. For these reasons, unemployment has become more than a serious problem and deeply troubling for officials as increasing social unrest jeopardises Communist Party rule.

But the failure to implement an effective social protection – on account of the need to avoid heavier fiscal expenditure – is a false problem. Public expenses on social coverage in China represents no more than 1.5 percent of GDP, the smallest amount in all countries in the area.

The declining tendency in consumption is very costly in terms of growth and hinders fiscal resources, as these rely on growth. Furthermore, Chinese authorities are forced to sustain growth by means of a very expensive policy of public works that proved quite inefficient. Since 1997, the government has had to devote 1.5 percent of GDP every year to achieve a growth rate of about 7 percent; otherwise it would fall below the fatidic 7 percent number! Every year, expenditures needed to sustain growth become bigger. In 2001, it amounted to 2 percent of GDP. It involved the building of airports that are oversized, a costly port in deep water for Shanghai, while Ningbo Port is only 150 miles away, and a 5,000 km pipeline to convey gas to Shanghai, the profitability of which is quite doubtful. The multiplier effect of these measures proves very weak. Instead, all these expenses contribute to build up a public debt that increases at a fast rate. This is not precisely what we may call a “light” State.

### **What about the financial system?**

Before the middle of the 1980s, a Chinese financial system was nonexistent. There was only the Popular Bank of China, which at the same time was the Central Bank and the secondary bank, with branches in nearly every little village. In the mid-1980s, four specialised banks were set up. They were created with the purpose of financing activities of the main sectors of the economy: the Commercial and Industrial Bank financed the manufacturing industry; the Agricultural Bank, for rural activities; the Bank of China financed foreign trade; and the Development Bank was created to finance public works. On account of the previous way of operating, public enterprises never took into account that they had to reimburse loans. Bank managers never applied prudential rules before agreeing to give a loan. More than 70 percent of loans extended were to SOEs; the private sector has no credit, because there is no moral hazard, which is almost the only principle on which loans are agreed. So, public banks have been overloaded with non-performing debts<sup>6</sup> and their returns on capital are near zero<sup>7</sup>. Chinese banks are virtually insolvent but they still hold because of they are bailed out by the government. Despite these circumstances, Chinese public banks are always liquid as they drain most of private savings and because they have been extremely reluctant to grant new credits since 1998, when the managers become responsible for non-performing loans.

In 1997, private foreign banks were allowed under very restrictive conditions: they had to be established in only particular areas (Pudong area, near Shanghai, or Shenzhen); they could operate in local currency only for limited amounts, and they could not accept deposits from domestic agents. In a couple of years, China’s compliance with WTO rules will signal the end of this situation, but Chinese banks will not be ready to face the competition of private foreign banks, as they will not be able to get rid of non-performing

---

<sup>6</sup> The amount of non-performing debts is difficult to assess, but it has been estimated at about 30% of GDP.

<sup>7</sup> See Lardy, N.: *China’s unfinished revolution*, Brookings Institution, Washington.

loans as long as the problem of SOEs is not solved<sup>8</sup>. This problem can never be definitely solved on account of unemployment.

Foreign banks will drain most of the private savings and take a huge market share in profitable activities (for instance, loans for housing and cars, insurance, floating bonds for private companies, listing corporations in the stock market and trustees). Public banks will keep the unprofitable activities linked with the dying SOEs. The Chinese authorities will not be in a situation to implement an industrial policy that would give the needed push to the economy that would be consistent with their own targets of development.

China's public financial system runs the risk of actually being insolvent – not only virtually, as is the current case – and forced to go bankrupt, like in the case of the banks in Argentina. If the consequences of such a situation were not so dangerous (on account of possible riots, given the place of China in Asia), we can easily imagine that such a huge bankruptcy and plunder of the people's savings would not in the least bother the multilateral institutions. But they cannot neglect the possibility in China. Though it is difficult to imagine how things will turn out, we can already bet that it will not be easy.

### **National sovereignty seriously jeopardised**

Opening all the sectors to foreign companies and banks endangers national sovereignty. Foreign capital will not only pervade manufacturing, but also the banking system and the mineral sector. These manoeuvres may result in China's loss of control of its mineral resources. This is a right that the United Nations has recognised for every independent country in 1949.

The more conspicuous case involves the oil sector. Last year, the three main oil companies were listed in the New York and Hong Kong stock exchanges. Exxon Mobil, BP Amoco and Royal Dutch Shell are associated with the Chinese companies. These foreign companies are meant to participate in drilling as well as in refining and manufacturing (plastics, synthetic fibres and so on).

### **Conclusive remarks**

Entry into the WTO is the means by which the international community will try and very likely succeed in forcing China to implement a "liberalisation-cum-structural adjustment" policy. Its consequences will be twofold: on the one hand, China's market will be open to the greed of foreign capitalists; and on the other, China will specialise according to its static comparative advantages. As a result, China is doomed to be the sweatshop of Asia, a continent that is already doomed to be the world's sweatshop.

This already entails a terrible setback in the living conditions of the Chinese population, as indicated by statistics of urban poorness, unemployment and inequalities, which are on the rise. The regressive distribution of income is so flagrant that after 50 years of

---

<sup>8</sup> This assertion holds true despite the implementation of four-asset management companies devoted to write down bad debts in public banks. Debts are bought at its facial value and they are put in a special account. They still overload public finances.

socialism, a new social stratification has appeared. This situation creates conflicts between the former apparatchiks – who have become current entrepreneurs – to urban workers; urban workers to rural workers; dismissed workers to employed ones; and retirees to *xiagang*. A steep deterioration in human resources (as education, healthcare and social security go beyond the means of the Chinese people) is inconsistent with further development. These will be the perverse effects of the shifts in distribution.

As the Indian economist Prabhat Patnaik puts it: “There are four different kinds of distributional shifts that the ‘liberalisation-cum-structural adjustment’ package brings about: first, there is a shift from workers to the capitalists; second, there is a shift from petty producers and small capitalists to large capitalists; third there is a shift from domestic capitalists to foreign capitalists and finally, there is a shift from entrepreneurs to rentiers or from producing interests to financial interests... These shifts do not override one another; all of them manifest themselves more or less clearly in the so-called market-friendly regimes...”

The only open question is how can Chinese society cope with such a situation without a social explosion.



## Highlights of the treaty between China and the US

On joining the WTO, China has to comply with the following conditions

*Tariffs reductions: Non-tariff barriers to agricultural goods* have to be dismantled. Tariffs cannot surpass 3 percent. Tariffs on farm products have to be reduced to 17 percent from 22 percent, but U.S. preferential tariff will be 14.5 percent<sup>9</sup>. Tax on manufactured goods will be, on average, 9.4 percent (7 percent in the case of US goods). High tech imported goods will be tax exempted. Taxes on automobiles will be at 25 percent in 2006, against between 80 and 100 percent currently. Most of the reductions will take place during the first year. In 2006, auto parts and components will be taxed at 10 percent only.

*Quotas on imported goods* must be dismantled in the 5 years following accession, but quotas on American goods will be dismantled as soon as China enters WTO.

*Distribution:* unlike the current practice in China, American importers will be authorised to distribute their products inside China, without the intervention of Chinese intermediaries.

China will open the *telecommunications sector* to foreign investors. It will dismantle all geographic barriers. Foreign enterprises will be able to own up to 49 percent of the capital as soon as China enters WTO; it will be possible to own 50 percent of capital 2 or 3 years later.

*The insurance market* has to be opened to foreign companies; all geographic barriers must be dismantled 5 years after accession.

Foreign investors will be allowed to operate in the *social protection sector*. They would be able to get a license, without any reference to economic needs.

As soon as China enters the Organisation, foreign participation in joint ventures will equal 50 percent in the beginning and it will be able to reach 51 percent for other risks, barring life insurance.

In the 5 years following the accession, the Chinese banking system must be completely open to American banks without any geographic limitation. But two years after accession American banks will be able to accept deposits from Chinese firms and give them credit. Households would be accepted in the 3 years following accession.

Foreign Non Banking Financial companies will be able to grant loans to households to buy cars; there will be no reference to economic needs to grant licenses to these companies.

Foreign participation in broker's companies operating on domestic stock exchanges can reach up to 33 percent in the beginning, 49 percent three years after the accession.

---

<sup>9</sup> All countries will enjoy US. preferential tariffs as soon as China enters WTO.