

**A NON-MARKET ECONOMY'S ADMISSION TO THE GENERAL  
AGREEMENT ON TARIFFS AND TRADE - CHINA'S UNIQUE  
SITUATION**

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## Abstract

China's GATT application has been regarded as a unique case. This thesis attempts to explore the unique features of China's GATT application. It starts to review the historical background. It will examine the inherent conflict between GATT and non-market economy system. GATT's previous experience with non-market economy countries will be reviewed as well.

China's economic reform and its impact on the GATT application are the focus of the thesis. It will discuss the achievements made through the economic reform and its positive influence on China's GATT membership. It will also address the weakness and insufficiency of the reform, and their negative impact on the GATT application.

The author concludes that as long as both GATT and China take a practical approach, a compromise is not impossible. The author suggested a variety of accession mechanisms for China to obtain the membership. Although each of the mechanisms has pros and cons, they all provides useful references for China and GATT. The recent U.S. declaration to support China's GATT application and the new compromise made between both China and U.S. serves as a good example.

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**Introduction**

In July 1986, the People's Republic of China announced its intention to rejoin the General Agreement on Tariffs and Trade (GATT)<sup>1</sup>. Since China has great potential as a trading partner, its request for the GATT membership aroused considerable attention in the international trading community.

China's decision was widely welcomed by the major trading countries. They saw it as an opportunity to explore China's vast internal market, and also as an opportunity to bind China, a country with tremendous trading potential, to GATT obligations.

From China's point of view, GATT membership would allow it to acquire many trading advantages currently unavailable in its existing trade pattern. More importantly, membership would allow China to play a leading role in the formation of international trade rules and policies.

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<sup>1</sup> Southerland, *China Formally Says It Wants to Join GATT*, Washington Post, July 10, 1986, at E3.

China's application to the GATT raises unique and complicated legal, economic and policy issues. The GATT trading system is based on principles of free trade in free market economy system. GATT rules make little sense in the case of trade involving non-market economies (NME)<sup>2</sup>. Therefore, integrating China's economic, political and social structures to a trading system which is based on market economy principles presents a big challenge to the GATT Contracting Parties as well as the Chinese government.

In reviewing the history of the GATT, GATT actually does not exclude non-market economy countries' participation in its system. GATT has certain flexibility in this respect. Several Eastern European countries with non-market economies acceded to the GATT under special arrangements during the 1960's and 1970's.<sup>3</sup> Their experience will provide valuable precedents for China.

On the other hand, compared to East European countries, China is much larger in terms of its population and trading potential.<sup>4</sup> Therefore, as a potentially powerful country, the significance of its participation in the GATT will be

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<sup>2</sup> The term "non-market economy" is commonly used to describe countries where good and resources are allocated by government planning agencies rather than by prices freely set in a market. John Jackson, W. Davey, Legal Problems of International Economic Relations, Cases Materials and Text, at 175, (2d, ed. 1986).

<sup>3</sup> These countries are Cuba, Czechoslovakia, Yugoslavia, Hungary, Romanian and Poland. See Jackson, *supra* note 2, at 1183.

<sup>4</sup> China's population has reached 1.1 billion by 1990.

much more profound than those of the Eastern European countries. This makes China's application more unique. Thus, the GATT will most likely treat China as a special case, even considering its non-market economy.

China has been undergoing market-oriented reform since 1978. Its domestic economic structure and the foreign trade system has been decentralized to a substantial degree. The success and extent of these reforms will significantly affect the prospect of GATT membership. At present, however, China's economy still lacks the basic requirements of a market economy system. This makes China's application to the GATT difficult.

This thesis will explore the primary legal, economic and policy issues raised by China's application to the GATT, particularly from a non-market economy's perspective.

This thesis will be divided into five chapters.

Chapter I will review the historical background of China's GATT applications. The Chapter will first go through the historical period accompanying China's experience with the GATT. Then it will discuss the primary advantages of the membership and their implication to China. Finally, it will examine the procedure issue which has raised much political dispute for both China and GATT from historical point of view.

Chapter II will address the issue of GATT and Non-Market Economy. This chapter will first examine the basic conflicts between the GATT system and NME system. It will review the GATT provisions dealing with State-Trading enterprises---Article XVII. Finally, it will review the GATT experience with NME countries. Emphasis will be given to two types of NME's accession to the GATT: Yugoslavia---accession based on tariff concession alone, Poland and Romanian---accession based on import commitment.

Chapter III will review China's domestic economic reform and its impact on the GATT application. The domestic economic reform will be examined from two aspects: agriculture reform and urban economic reform. In discussing the urban economic reform, the focus will be on the State-owned enterprise reform. Comparison will also be made between the enterprises and "corporation" in western capitalist society. It will focus on the insufficiency of the reform in this sector.

Chapter VI will review China's foreign trade reform. It will first review the achievements made through the reform. Then it will go through the insufficient aspects of the reform and its implication for the GATT membership. China's unfair foreign trading practice will be discussed in detail. It will examine the import barriers maintained by the Chinese government. Then it will review a variety of export promotion measures adopted by the Chinese government, which

are inconsistent with the GATT principles. Following this GATT provisions dealing with unfairly traded export will be discussed. Other mechanisms to deal with the problem, such as selective safeguard measures and quantitative restriction measures will be discussed as well.

Chapter V will explore the possible compromises made by both China and GATT. This section will discuss the possibility of adopting the traditional arrangement between GATT and NME countries, such as admission on tariff concession alone, import commitment. Emphasis will be on China's unique situation.

## CHAPTER I

### HISTORICAL BACKGROUND

#### I. Time Table

When The General Agreement on Tariffs and Trade was founded in 1947, China was one of the original members<sup>1</sup>. Since then, the relationship has been through various historical stages, during which both China and GATT have experienced dramatic changes. The historical period can be divided into three stages:

- (1) GATT membership from 1947 - 1949;
- (2) Absence from GATT: 1949 - 1980;
- (3) Re-Approaching GATT: 1980-.

#### (1) GATT Membership: 1947-1949

The General Agreement on Tariffs and Trade was signed in late 1946 by twenty-two countries<sup>2</sup>, including China<sup>3</sup>. As

<sup>1</sup> China submitted its Instrument of Acceptance of the Protocol of Provisional Application of the General Agreement on Tariffs and Trade on April 21, 1948. See Li Chong Zhou, *Resumption of China's GATT Membership*, 21 Journal of World Trade, at 26, (1987).

<sup>2</sup> A Protocol of Provisional Application was signed in late 1946 by the original 22 member countries. It is only through this protocol that GATT applied. See Jackson, *supra* note 2, Introduction of the thesis, at 295.

<sup>3</sup> During 1912-1949, China was governed by the Nationalist (Kuo Min Tang or KMT). In 1949, Nationalist forces were exiled to Taiwan, where they established the Republic of China (ROC) which is not recognized by the People's Republic of China (P.R.C.).

a member country, China enjoyed tariff concessions and other trade advantages negotiated with the other GATT members. At that time, China was ruled by the Nationalist government. On October 1, 1949, the government was replaced by the People's Republic of China (P.R.C.), and the Nationalist government established itself in Taiwan. However, China maintained GATT membership until 1950 when it notified the United Nations Secretary-General of its decision to withdraw from the GATT. The P.R.C. government never recognized the validity of the withdrawal<sup>4</sup>.

**(2) Absence from GATT: 1949 - 1980**

After the withdrawal from GATT by the Nationalist government, China showed little interest in GATT until 1980. During this period, the P.R.C. government advocated a "centrally planned economy"<sup>5</sup>. Most GATT member countries withdrew the tariff concessions they had previously negotiated with China<sup>6</sup>. The P.R.C. government carried out the so-called "Self-Reliance, Hard Struggle" foreign trade

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<sup>4</sup> See Li, *supra* note 1, at 26.

<sup>5</sup> "Centrally planned economy" (CPE), also called "non-market economy" (NME), is used to describe countries whose goods and resources are allocated by government planning agencies rather than by prices set in a free market. Jackson, *supra* note 2, Introduction of the thesis, at 1140.

<sup>6</sup> See Li, *supra* note 1, at 28.

policy<sup>7</sup> and refused to do business with western industrial countries. Based on this policy, the P.R.C. government did not make efforts to resume its GATT membership. Foreign trade was mainly conducted with the Third World countries.

During the 1970's, China's trade with GATT member countries gradually resumed<sup>8</sup>. However, it was mostly conducted through bilateral trade agreements, rather than through multilateral trade regimes<sup>9</sup>. For example, China entered into a trade agreement with the United States in July, 1979<sup>10</sup>.

### (3) Re-Approaching GATT : 1980 - the Present

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<sup>7</sup> In Chinese, "self-reliance, hard struggle" is called zi li geng shen, jian ku fen dou. The idea of the policy can be traced back to the traditional Chinese notion that China should be an entity unto itself, restricting its dealings with the outside world in order to limit the corrupting effects of foreign influence. Under this policy, China cut back its foreign economic and trade ties with foreign countries, particularly western industrialized countries. A.Doak Barnett, China's Economy in Global Perspective, at 4, (1981).

<sup>8</sup> During the period of time, under the influence of other Chinese leader, such as Premier Chou En-lai, China's foreign trade policy gradually acquired a more outward-looking orientation. Foreign trade and the importation of technology from western industrial countries, including many GATT member countries increased rapidly. See Barnett, *supra* note 7, at 5.

<sup>9</sup> Usually, the bilateral agreement provides for Most Favored Nation treatment, but it is less favorable than those specified in the multilateral system, such as GATT since the bilateral trade agreement can create discriminatory policies. See Kostechi, *East-West Trade and the GATT System*, at 58, (1979).

<sup>10</sup> For the text of the agreement, see *The Sino-U.S. Trade Agreement*, *The China Business Review*, 24-30 (July-August, 1979).

Since 1980, China has undertaken economic reform and adopted an "open door" policy<sup>11</sup>. Abandoning the strategy of "self-reliance", the government has adopted a series of measures designed to encourage trade and investment with western countries. Accordingly, the amount of trade and investment with western countries have been increased tremendously. For instance, from 1977 to 1979, trade with western industrial countries rose 121 percent to \$15.716 billion<sup>12</sup>.

Due to the discriminatory nature of bilateral trade agreement, trade conducted on the basis of bilateral agreements benefited China less favorably if they had been in the GATT system<sup>13</sup>. Realizing that a multilateral trade agreement would be a better mechanism for its international trade, the Chinese government decided to re-approach GATT.

In 1980, China sent a delegation to attend GATT commercial policy training courses which have since been

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<sup>11</sup> China's new policy have proclaimed that "modernization" is the country's priority. In order to achieve this goal. China has to learn as much and as far as possible from many different types of countries, especially western industrial countries. The old "self-reliance" policy has been abandoned for all the practical purpose, and the new "open door" policy has been implemented. Barnett, *supra* note 7, at 4-7.

<sup>12</sup> Barnett, *supra* note 7, at 163.

<sup>13</sup> For detailed discussion of the discriminatory nature of bilateral trade agreement, see Kostechi, *supra* note 9, at 58.

regularly attended by Chinese officials<sup>14</sup>. In 1980, China joined the International Monetary Fund (IMF), and the World Bank<sup>15</sup>. In 1983, China joined the Multi-Fiber Arrangement - a multilateral textile agreement implemented under the auspices of the GATT<sup>16</sup>. This move could be interpreted as an attempt by China to gain experience in multilateral trade organizations.

In 1982, China obtained an "observer" status in the GATT which allowed it to attend the annual meetings of the member countries<sup>17</sup>. In 1984, China was granted a "special observer status" in the GATT, allowing it to attend meetings of the GATT Council and other subsidiary GATT organizations<sup>18</sup>.

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<sup>14</sup> In the past few years, Chinese trade officials have attended the GATT seminars in Geneva and Beijing. In 1980, China sent its first official to a GATT training course. *See China Attends GATT Course*, Wall St. J., Aug. 27, 1980, at 18, col.3.

<sup>15</sup> Karen Green and Sharon E. Ruwart, *International Economic Organizations Are Bringing Changes to China Joining the World Economy*, the China Business Review, at 32, (May-June 1988).

<sup>16</sup> The accession of China became effective on January 18, 1984. *see Trade in Textiles*, GATT Basic Instruments and Selected Documents (BISD), 294-97 931ST SUPPL 1985.

<sup>17</sup> As an "observer", a non-member country can attend the annual sessions of the member countries, but can not vote on any issues raised. *See GATT Rule of Procedure for Sessions of the Contracting Parties*, reprinted in BISD, *supra* note 14, at 11 (12th Supp. 1964). Regarding China's observer status, see GATT Doc. C/M160, at 2 (Sept. 24, 1982); GATT Doc. C/M173, at 2 (Nov. 16, 1983).

<sup>18</sup> *See China to Attend Future GATT Council Meetings*, Xinhua, FBIS Daily Report, Nov.9, 1984, at A2.

Finally, the Chinese government decided it would attempted to resume China's GATT membership. On July 10, 1986, China formally notified the Director General of GATT that China wished to rejoin GATT<sup>19</sup>. In February 1987, China submitted a memorandum on its foreign trade system<sup>20</sup>. The GATT then formed a committee to work on China's application<sup>21</sup>. The substantive negotiations between China and GATT Contracting Parties are currently underway.

## II. The Advantages of GATT Membership

China's request for GATT membership is significant, not only because of its enormous potential as a partner in international trade, but also because this represents a clear change of China's development strategy. Resumption of GATT membership constitutes an element of its "open door" trade policy aimed at achieving a greater degree of integration in the world economy. The requests reflect the shift in development strategy from an emphasis on self-sufficiency to a more outward-looking approach.

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<sup>19</sup> *China Formally Says It Wants to Join GATT*, Washington Post, July 10, 1986, at E3, col. 5.

<sup>20</sup> GATT Activities 1987-An Annual Review of the Work of the GATT, at 14.

<sup>21</sup> *Id.*

From China's point of view, GATT membership will provide a number of advantages. First, GATT membership will provide China with more trading concessions than it currently receives under bilateral trade agreements. Foreign trade conducted on the basis of bilateral trade agreements could create discriminatory trade policies, whereas a multilateral trade framework, such as GATT, would offer greater protection against such trade discriminations<sup>22</sup>. The discriminatory nature of bilateral agreements can be illustrated from the Most Favored Nation (MFN) treatment. Under the MFN policy, trade advantages granted to one country that has MFN status must be granted to the others as well<sup>23</sup>. MFN treatment can be established through bilateral or multilateral agreements. Under a bilateral agreement, the benefit of MFN treatment could be reduced or nullified by other provisions in the agreement, such as "quantitative restrictions"<sup>24</sup> or "selective

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<sup>22</sup> Mr. Kostecki pointed out that foreign trade conducted on the basis of bilateral trade agreements could involve discriminatory trade policies. For example, the agreement containing a preferential tariff treatment between two countries would have the effect of discriminating against other countries. For the detailed discussion, *see* Kostecki, *supra* note 9, at 58.

<sup>23</sup> For detailed discussions on MFN treatment, *see* Jackson, *supra* note 2, Introduction of the thesis, at 428-455.

<sup>24</sup> Quantitative restrictions refer to the measures that restrict the volume of imports into a country, not by artificially raising the cost of importing - as is the case when a tariff is imposed - but by placing direct limits on the quantity or value of imports that may enter the domestic market. *See* Jackson, *supra* note 2, Introduction of the thesis, at 421.

safeguard" measures<sup>25</sup>. For instance, in the China-EEC agreement, Article 5 provides that China will give favorable considerations to imports from the EEC and ensure that EEC exporters can participate fully in opportunities for trade with China. The EEC undertakes to strive for an increasing liberalization of imports from China and endeavors progressively to expand the list of products of liberalized imports from China<sup>26</sup>. This formulation assumes that discriminatory quota restrictions are the norm in EEC-China relations and the EEC's undertaking in the bilateral agreement to progressively liberalize such quotas constitutes a concession to China.

However, under a multilateral trading system, the MFN treatment is unconditional. Article I of the GATT specifically prohibits discriminatory treatment among the member countries<sup>27</sup>. Other discriminatory trade measures which are commonly used in a bilateral trade agreement, such as quota restriction, are also restricted or prohibited

<sup>25</sup> Selective safeguard measure refers to the measures adopted by an importing country to control imports from a particular country which is injuring its domestic industry. See Jackson, *supra* note 2, Introduction of the thesis, at 538.

<sup>26</sup> Harish Kapur, China and the EEC, the New Connection, at 143, (1986).

<sup>27</sup> Article I of GATT provides "... any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other Contracting Parties". See Article I, GATT, Jackson, W. Davey, Documents Supplement to Legal Problems of International Economic Relations, at 4, (1986).

under the GATT<sup>28</sup>. Therefore, when MFN treatment is established through a multilateral framework, it is more stable and complete.

A Multilateral trade regime would also provide China with more obligations from the member countries. Under a bilateral agreement, a violation of a bilateral agreement would only be a matter between the two countries involved. However, a violation of GATT rules could create an adverse precedent which could be used against the violating member country by other GATT member countries. Thus, GATT member countries would be less likely to violate China's trade rights under the multilateral GATT rules than they would under a bilateral agreement.

Secondly, GATT membership combined with China's status as a developing country, would also make China potentially eligible to receive benefits from the U.S. under the Generalized System of Preferences (GSP)<sup>29</sup>. Since the GSP is preferential to the MFN treatment, and considering that China's exports to the U.S. are a significant part of its

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<sup>28</sup> Article XI of the GATT, *supra* note 27, at 17.

<sup>29</sup> The GSP is a program maintained by 20 industrialized countries designed to assist developing countries by preferential reduction of tariff on imports of specified products from those countries. For detailed discussions, see Jackson, *supra* note 2, Introduction of the thesis, at 1154-1158.

total exports, it would be advantageous for China to gain GSP treatment from the U.S.

According to U.S. law, the U.S. cannot grant GSP benefits to communist nations that are not members of GATT and the IMF and who do not receive MFN treatment<sup>30</sup>. China is already a member of the IMF and is receiving conditional MFN treatment. According to the member classification of IMF, China is also a developing country<sup>31</sup>; therefore, GATT membership would make China eligible to receive GSP benefits from the U.S.

Thirdly, GATT membership would allow China to help to develop and refine GATT rules. It would give China the opportunity to participate in GATT meetings and other functions where new problems are explored and to be involved in negotiations where new rules are formulated. This right to participate in the rule-forming process may be more important than the gain of immediate legal rights, as it will allow China to shape the rules under which other countries will expect it to operate. For example, China's membership in the MFA gave it more influence in textile

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<sup>30</sup> 19 U.S.C. §2462(b)(1), 1982.

<sup>31</sup> International Monetary Fund Annual Report of the Executive Board for the Financial Year Ended April 30, at 180-181 (1985).

negotiations and allowed China, a major exporter, to play a key role in the negotiations of the MFA<sup>32</sup>.

Fourthly, GATT membership would provide the Chinese government with a great deal of valuable information on the policies and activities of other nations which might affect China's opportunities in the world markets. Through both formal and informal processes, participation in the GATT provides information on how the new member countries are behaving, how their policies are being formulated, what their disputes are, which actions they will react to, and which ones they will disregard. Such information gained immediately upon membership could be valuable in China's own policy-making.

However, China's application to the GATT also presents potentially difficult economic, legal and political issues. Its admission to the GATT would present challenge to the free market principles of the existing GATT members<sup>33</sup>. Although GATT had been involved with non-market economy countries<sup>34</sup>, it has never accepted any non-market economy

<sup>32</sup> *U.S. Textile Import Regulations Condemned at the GATT*, Xinhua, FBIS Daily Report, Oct. 18, 1984.

<sup>33</sup> The GATT trading system is based on the principle of free market economy. The GATT rules make sense in that context. They make much less sense in the case of trade involving non-market economies. See Jackson, *supra* note 2, Introduction of the thesis, at 1175.

<sup>34</sup> GATT has admitted several NME countries as members, such as, Hungary, Poland, Romania, Yugoslavia, Cuba, Czechoslovakia. See Kostechi, *supra* note 9, at 9.

countries with China's enormous trading potentials. The member countries fear that by providing China with GATT benefits, such as tariff concessions, the Chinese may flood their domestic market with its cheaper labour products through the benefit of government subsidies<sup>35</sup>. They are also concerned that the access to China's market could be blocked by a variety of administrative measures<sup>36</sup>.

In response to GATT member countries' concerns, China has claimed that its economic structure has decentralized substantially over the past decade and that they are conforming to the GATT system<sup>37</sup>. The Chinese government submitted a memorandum to the GATT committee which describes its decentralization movement in its domestic economy and foreign trade system<sup>38</sup>. The question now is whether China

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<sup>35</sup> Under NME systems, the cost of exported products do not accurately reflect the market demand and supply because of government subsidies.

<sup>36</sup> The main benefit of GATT membership is tariff concession. Under NME, such as China, governments can manipulate the production of domestic products, such as fixing lower prices, subsidizing the production, which makes foreign products less competitive in China's market. Therefore, tariff concessions would not have much effect as they are supposed to. For detailed discussion, see Chapter 4 of the thesis.

<sup>37</sup> At the meeting of the Working Party on China's request for the resumption of the status of the GATT, China's Deputy Minister, Mr. Shen Juren stated that in China "a new system is taking shape in which the state regulate the market and the market oriented enterprises". See GATT Activities 1988, An Overview of the Work of the GATT, at 14.

<sup>38</sup> *Id.*

has decentralized enough to satisfy the GATT. Practically, the question will be under what terms China would be admitted and what kind of compromise will be made from both sides.

### III. The Procedural Issue: Resumption v. Accession

In addition to substantive issues, the procedural issue is a unique feature of China's GATT membership. As China was previously a member, it claims that it should be allowed to resume its membership in GATT, and not be required to join GATT as a new member.<sup>39</sup>

The significance of "resumption" versus "accession" lies more in the issue of political sensitivity than in the actual benefits gained by both sides, particularly for China. From China's point of view, the resumption of membership will enable China to acquire all the benefits previously negotiated by the former government, including the tariff concession, without having to negotiate the terms of admission into the GATT. However, admittance into GATT as a new member would imply that withdrawal by the Nationalist government was legal. This would be contrary to

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<sup>39</sup> Chinese officials have stated that China need not apply to the GATT as a new member. Instead, they argue, China needs only to resume the "old China seat" vacated by the Nationalist government. see Feng Yu-shu, *China's Membership of GATT: A Practical Proposal*, 22 *Journal of World Trade*, at 64, (1988).

China's political view. China sees the P.R.C. as the legitimate government of China, not the Nationalist government.<sup>40</sup> Thus, China will likely view any objections to resuming its membership as an offense to its national sovereignty.

The Chinese government's argument is supported by the fact that most international organizations, including the United Nations and its affiliated organizations, have recognized the P.R.C. as the legitimate representative of China<sup>41</sup>. The GATT has indicated that it follows the U.N. decision on this question<sup>42</sup>.

Even though the GATT is not a specialized agency of the United Nations<sup>43</sup>, shortly after the U.N. decision to admit the P.R.C. in 1971, the GATT Member Countries reviewed the

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<sup>40</sup> *Id.*

<sup>41</sup> In 1971, the United Nations recognized the P.R.C. as the sole representative of China in the General Assembly and in all the organizations affiliated with it. see G.A. Res. 2758, 26 U.N. GAOR Supp. (No. 29) at 2, U.N.Doc. A/8429 (1972). The General Assembly also stipulated that the Assembly resolutions of representation issue "should be taken into account" by other organs of the United Nations. See G.A. Res. 396, 5 U.N. GAOR Supp. (No. 20) at 24, U.N.Doc. A/1775 (1950).

<sup>42</sup> *See the Interim Commission for the International Trade Organization and the General Agreement on Tariffs and Trade*, 1971 U.N.Y.B. 758, U.N. Sales No.E.73.I.1.

<sup>43</sup> While GATT is not technically a specialized agency of the U.N., it does maintain an informal working relationship with the U.N. and is based in part on the aborted International Trade Organization of the U.N. The GATT is also required by its own terms to consult and work with the International Monetary Fund - one of the U.N. specialized agencies. See Kunuqi, *State Succession in the Framework of GATT*, 59 Am. J. of Int'l L. 268, 269 (1965).

question of the China seat<sup>44</sup>. At the time, the P.R.C. was not requesting the seat. However, since 1965, the R.O.C. had been participating as an observer at the meetings of the Contracting Parties<sup>45</sup>. Thus, at the first meeting of the Contracting Parties following the U.N. decision, a proposal by the Chairman that "Representative of the Republic of China should no longer attend sessions of the Contracting Parties as observers" was accepted. This proposal noted that the Contracting Parties had earlier agreed to follow the decision of the U.N. on essentially political matters relating to the Chinese seat<sup>46</sup>. Thus, the same reasoning that led to the termination of the R.O.C. observer status should be applied to the present question regarding whether China should be allowed to resume its original seat in the GATT.

Other international organizations have allowed China to resume its seat without having to apply as a new member, even though no Chinese representatives had participated in these organizations for many years. For example, China was an original member of the Food and Agricultural Organization (FAO), one of the United Nations specialized agencies. In 1951, the R.O.C. withdrew from the FAO<sup>47</sup>. Yet, in 1971, the

<sup>44</sup> GATT Doc. SR.27/1, at 1-3 (Nov. 19, 1971).

<sup>45</sup> GATT Doc. SR 27/1 (March 16, 1965).

<sup>46</sup> GATT Doc. SR 27/1. *supra* note 286.

<sup>47</sup> *Representation of China Within the United Nations System*, 11 I. L. M. at 561, ( 1972).

FAO decided to follow the U.N. decision on the China question and allowed the P.R.C. to resume its original seat without applying as a new member<sup>48</sup>. The FAO reasoned that the P.R.C., as the proper representative of China, had no say in the R.O.C. withdrawal, therefore, the withdrawal could not be held against it<sup>49</sup>.

In response, the GATT member countries could argue that even though China had been admitted as a member of GATT after the withdrawal, it did not actually participate in GATT activities in the past 35 years, such as the trade-liberalization negotiations. Therefore, it did not behave as a member. Moreover, China's political and economic structure have altered dramatically since 1948 when China first joined the GATT. Trade concessions made by the R.O.C. in 1948 are largely inapplicable to modern China.

Since the inception, the GATT and its Contracting Parties have also changed dramatically. There have been eight rounds of multinational negotiations, resulting in a significant reduction of average tariff levels of the GATT members<sup>50</sup>. Significant progress has also been made in

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<sup>48</sup> *Id.*, at 563.

<sup>49</sup> *Id.*

<sup>50</sup> The eight rounds are: Geneva(1947), Annecy(1948), Torquay(1950), Geneva(1956), Dillon Round(1960-61), Kennedy Round(1964-67) and Tokyo Round(1973-79) and Uruguay Round. (The first five of these rounds focused on negotiations for the reduction of tariffs. Although the original goal for

reducing non-tariff barriers. The volume of trade among GATT nations has expanded tremendously, and GATT member countries have become increasingly interdependent in their trade with each other<sup>51</sup>. Many industries are now international, depending on resources, manufacturing facilities, and markets in different countries. The economies of the major trading nations have changed so much that, even if the GATT rules ceased to exist, the economies would still remain open to foreign trade much more extensively than they were in 1950. In light of the various changes in the world trading community, immediate resumption of the membership would be regarded by some GATT members as giving China the immediate benefits of GATT membership vastly expanded since 1950, even though China's domestic economy has evolved in an unsteady direction for thirty-five years without changing to conform to the GATT standards<sup>52</sup>.

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the sixth round was reduction of non-tariff barriers, it turned out to focus on tariff reduction as well. The seventh round was predominantly concerned with non-tariff measures, although considerable attention was still given to tariff reductions. *See Jackson, supra* note 2, at 324-325.

<sup>51</sup> For detailed discussions, *see* L. Moore, The Growth and Structure of International Trade Since the Second World War, (1985).

<sup>52</sup> For instance, the U.S. government used to take the aggressive role in resisting to grant immediate GATT benefit to China. It has resolved not to let China admitted to GATT without first making substantial reforms. The U.S. government has proposed a five-point framework that would greatly increase the consistency of China's foreign trade policy. *See* Karen Green and Sharon E. Ruwart, *supra* note 15. U.S. attitude has been changed since October 1992 when U.S. and China entered into an agreement that U.S. will support for China's GATT application in exchange for China's concession on its foreign trading system. *See People's Republic of China-United States: Memorandum of Understanding Concerning Market Access (MOU)*, Signed at Washington, October 10, 1992, *cite in* 31 I. L. M. 1247 (1992).

GATT member countries, particularly the United States, may prefer that China join the GATT under the accession procedures laid out in Art. XXXIII. This Article provides that a country may accede to the GATT on terms to be agreed upon between itself and the Contracting Parties. This was designed to permit individualized contractual arrangements with nations entering the GATT system, in order to consider specific questions raised by the new relationship. The member countries may feel that the Article XXXIII procedure would enable them to address the special problems resulting from the centrally-planned, non-market nature of China's economy, which cannot be resolved effectively through a contractual arrangement by China on restrictions of rights by member countries.

The voting procedure in Article XXXIII may also be favorable to member countries positions. If China's membership is treated as a new accession, a two-thirds affirmative vote by GATT members is required<sup>53</sup>. However, if China's membership is treated as merely a question of proper government representation, a simple majority vote would be enough. The importance of the voting issue should not, however, be overstated. In practice, most GATT actions are the result of consensus of all members. Therefore, It is

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<sup>53</sup> GATT, Art. XXXIII, *supra* note 27, at 48.

unlikely that voting margins will be a deciding factor in determining China's membership application.

In evaluating the positions of both China and the GATT member countries on the procedure issue, the political implications should not be over-emphasized. China's argument is more important in theory than in practice. The primary concern of the GATT member countries will be that China's law and practices are altered sufficiently to afford access to China's market roughly equivalent to the access that China will enjoy in their markets. Namely, if China agrees to the major trade and tariff concessions sought by the member countries, the procedural method will be unimportant. If this substantive goal is achieved, membership could occur either through a protocol of accession of China as a new member under Art. XXXIII, or through an ad hoc agreement upon GATT recognition of China's old membership. An ad hoc agreement could contain essentially the same provisions as a protocol of accession executed upon China's entry under the normal accession procedure.

The GATT member countries do not have to take an overly technical approach to China's accession problem. Practically speaking, even if China resumes its old seat, the country is a different economic and political entity than it was in 1948. China's institutions have not adapted to economic

interdependence as have those of most other countries. Thus, China will still be a "new member" in fact.

In summary, the substantive issues involved in China's membership application are likely to be much more difficult to resolve than the procedure problems discussed here. It would seem to be in the best interests of all the parties to avoid discussing procedural issues at the early stages of negotiation since the political sensitivity of the issue might destroy a cooperative atmosphere for the negotiations on the more important substantive issues.

## **Chapter 2**

### **GATT and Non-Market Economy**

China's application to GATT raises difficult legal, economic and policy issues, such as market access, unfairly traded exports, accession procedures, etc. The fundamental problem underlying these issues is how China, a large non-market economy (NME), or so called "central-planned economy", can be integrated into the GATT trading system which is based on a free-market system. In order to address this issue, this chapter will examine the basic conflicts between the two systems.

The chapter will first discuss the fundamental incompatibilities between the GATT system and the NME regime. Then it will examine the existing GATT provisions related to NME and its inadequacies dealing with the NME. Finally the chapter will review the GATT experiences with NME countries.

#### **I. GATT and NME - A Conflict of Basic Assumptions**

GATT is based on the presumption of free trade in a free market system. Under this market philosophy, trade competition enables resources to be effectively and efficiently allocated, reducing the waste and cost of production, thereby increasing real income. The price and quantity of a commodity are determined by consumer

preference. The export and import business is based on commercial considerations and, in theory, is free from government interference.<sup>1</sup> Therefore, the price of domestic and export commodities reflects the actual economic cost of the commodities.

The situation is reversed under the NME system. The State, not the market forces controls the price, quantity of commodities<sup>2</sup>. The price and quantity of commodities are set by state planning authorities according to its estimated economic goals<sup>3</sup>. For instance, in China, the state planning authorities - the State Planning Commission and the State Price Commission set up the plans for the quantity and price of most products and supervise the implementation of the plans<sup>4</sup>. Due to the arbitrary nature of central planning, the targets set by the two commissions rarely reflect the market supply and demand. For instance, they set lower prices for domestic goods even if the production cost is much higher, so that the Chinese products can be more

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<sup>1</sup>. Under the GATT system, government interference is not absolutely prohibited. However, it has to be limited to the extent that it is observable. GATT itself has devices to deal with these problems, such as Article VI - Anti-Dumping Duty Rule, Art. XVI Countervailing Duty Rule.

<sup>2</sup> For detailed discussion on the operation of NME's international trading system, see Jackson, *supra* note 2, Introduction of the thesis at 1174-87.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

competitive against similar foreign products made in the domestic market. Therefore, in the Chinese market, a Chinese T.V. or refrigerator is much cheaper than a Japanese made product, such as Toshiba or Sony. The result is that Japanese products become less competitive than Chinese domestic products. The same strategy could also be extended to export products. State Planning authorities may set lower prices for export products so that they can compete efficiently with foreign products in foreign markets. In other words, the GATT system is undermined in NME countries.

GATT itself contains various rules to govern trading among its member countries. These rules reflect the mechanism of a free-market economy which contradicts the trade practices of a NME system. The conflict between the two systems will be examined in the following contexts:

**(1) Tariff Concession Is Not Meaningful in NME**

The tariff is an essential instrument for a country to control foreign trade. When a country wants to increase the imports of a particular product, it will usually reduce the tariff rates for the product. When a country wants to reduce the import of certain product, it will raise the tariff rate. Thus, the tariff becomes an important instrument to control imports and exports. Tariff concessions or reductions comprise the fundamental obligations among GATT member countries. GATT requires that member countries limit

their tariffs on particular goods to specified levels.<sup>5</sup> The purpose of tariff concessions is to reduce the trade barriers among member countries and to encourage the free flow of products.

From an exporting country's point of view, tariff concessions are beneficial to them because it will result in the increased exports. However, this mechanism only works in a market economy system. In a NME country, tariffs do not play a significant role in controlling import and export since there is no necessary connection between domestic and foreign prices. As previously noted, domestic price is set by the State planning authority in an NME country. The price is usually lower than its actual cost so foreign products become less competitive in the import country's market. Therefore, reducing or eliminating tariffs will not necessarily increase imports. Thus, from an export country's point of view, tariff concessions from an NME country are not very significant.

**(2) MFN Treatment Is Not Significant under NME.**

MFN treatment is the most important benefit enjoyed by the GATT members.<sup>6</sup> It provides that "any advantage, favor,

<sup>5</sup> See Jackson, *supra* note 2, Introduction of the thesis at 395.

<sup>6</sup> The unconditional MFN treatment is the cornerstone of GATT. Jackson, *supra* note 2, Introduction of the thesis, at 428.

privilege or immunity granted by any contracting party to any product originally in or destined for any other country shall be accorded immediately and unconditionally to the like product origination in or destined for the territory of all other contracting parties"<sup>7</sup>. The central theme of MFN treatment is to prevent discriminatory treatment and promote free trade among GATT member countries. The anti-discriminatory nature of MFN treatment is an incentive for many countries to join GATT.

However, in a NME country, the MFN treatment may not eliminate discrimination. For example, the MFN treatment requires that the quantitative restriction are applied equally to all GATT member countries (This is called a "global quota"-a quota not allocated to specific countries or sellers<sup>8</sup>). However, under a NME, domestic policy and administrative measures can easily result in the application of quantitative restriction to certain or particular GATT member countries (This is called a "specific quota"<sup>9</sup>). Thus, it favors the other countries which the restriction is not applied to, but discriminate against the countries which the restriction imposed on.

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<sup>7</sup> GATT Article I, *supra* note 27, Chapter 1 of the thesis, at 4.

<sup>8</sup> See Kostechi, *supra* note 9, Chapter 1 of the thesis, at 53.

<sup>9</sup> *Id.*

**(3) The Observation of the National Treatment Is Difficult to Assess.**

Another important non-discriminatory principle underlying the GATT is "national treatment"<sup>10</sup>. This provides:

"the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly, or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products".<sup>11</sup>

The purpose of the national treatment obligation is to prevent a country from discriminating against imported products by imposing more stringent requirements on them than on domestic products. Observation of the national treatment obligation requires examination of domestic regulations. In a market economy, government regulation in this field is more visible. However, in a NME, since the government substantially controls the economy and heavily subsidizes the domestic industry, it is usually reluctant to

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<sup>10</sup> National treatment obligation, like MFN obligation, is a rule of "non-discrimination". The difference between the two obligations is that the MFN prevents the discrimination between foreign-made products whereas the national treatment prohibits the discrimination between the domestic-made and foreign-made products. See Jackson, *supra* note 2, Introduction of the thesis, at 484.

<sup>11</sup> GATT Article III 2, *supra* note 27, Chapter 1 of the thesis.

make the relevant regulations public. Thus, the observation of the national treatment is difficult to assess.

## II. GATT Provisions Related to NME---Article XVII: State Trading

GATT itself does not have any particular mechanisms specifically designated to deal with NME<sup>12</sup>. Therefore, the provisions now in GATT do not provide adequate rules about NME countries. A provision that is tangentially related to NME is Article XVII - State Trading<sup>13</sup>. This provision requires that state trading enterprises, like any other trading enterprises<sup>14</sup> are obliged to

- (1) act in a manner consistent with the general principles of non-discriminating treatment<sup>15</sup>;

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<sup>12</sup> The U.S. draftsmen had originally proposed an article entitled "Expansion of Trade by Complete State Monopolies of Import Trade", to be applied to NME countries. Since the Soviet Union, the only important NME country then did not become a member of the International Trade Organization (ITO), this article was removed. See Kostechi, *supra* note 9, Chapter 1 of the thesis, at 1-2.

<sup>13</sup> I refer the provision as "tangentially" related to NME because this provision should not be regarded as primarily dealing with NME. "State Trading" exists in both market economy and NME. Mr. Kostechi refers "state trading" in a free market economy country as "occasionally state trading" and those in NME country as "state trading system" which has a complete or substantially monopoly of its trade. See Kostechi, *supra* note 9, Chapter 1 of the thesis, at 43-64.

<sup>14</sup> State trading enterprises referred either to an instrumentality of government which has power to buy or sell to a non-government body with such power and which the government has granted exclusive or special privileges - GATT Basic Instruments of Selected Documents (BISD), 183-184 (1961).

<sup>15</sup> GATT Article XVII 1(a), *supra* note 27, at 26.

- (2) act in accordance with commercial consideration which include price, quality, marketability, transportation and other conditions of purchaser or sale, etc.<sup>16</sup>;
- (3) requiring the governments which maintain state trading enterprises to notify the member countries about its enterprises' imports and exports, import mark up and other information about their operation to carry out this provision<sup>17</sup>.

The general view is that the Article is drafted to deal with occasional state trading in a free market system<sup>18</sup>.

Although some of these provisions are of general validity and may also apply to the state trading system in the NME system, The following remain:

- (1) The "state trading enterprises" are not clearly defined.

State trading is deemed to exist where a member country "establishes and maintains state enterprises . . . or grants to any enterprises . . . exclusive or special privileges . . . in its purchase or sales involving either imports or

<sup>16</sup> GATT Article XVII, 4(b), *supra* note 27, at 26.

<sup>17</sup> Article XVII (4), *supra* note 27, Chapter 1 of the thesis, at 26.

<sup>18</sup> Kostechi, *supra* note 9, Chapter 1 of the thesis, at 46.

exports . . . ."19. The vagueness in this provision is obvious. It is not clear as to what constitutes "special privileges". This ambiguity resulted in variety of interpretation<sup>20</sup>.

(2) The notification requirement is undermined by broad, subjective criteria. In a state trading system, where tariffs are not the primary method of foreign trade control, the monitoring non-compliance with the duty of non-discrimination is difficult.<sup>21</sup> This problem is exacerbated where in NME countries as considerable reliance is placed on the countries to voluntarily to report the non-compliance. In a NME country, such as China, reporting non-compliance with the GATT would be self-incriminating since it benefits substantially from trade practices which are inconsistent with the GATT principles. The Article requires the member countries to provide information on a regular basis about the existence and activities of state trading enterprises. This gives NME countries discretion as to whether to provide the information.

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<sup>19</sup> GATT Article XVII (1), *supra* note 27, Chapter 1 of the thesis, at 26.

<sup>20</sup> See Roy Baban, *State Trading and the GATT*, 11 *Journal of World Trade Law*, at 339.

<sup>21</sup> There are different ways to restrain foreign trade other than tariff. the other ways of restraining foreign trade are termed as non-tariff barriers (NTB), such as import licensing, subsidy, etc. Tariff is regarded as more visible and easier to monitor than non-tariff barriers. See Jackson, *supra* note 2, Introduction of the thesis, at 366.

(3) The definition of "acting solely in accordance with commercial considerations" is so ambiguous that it is hard to tell whether it imposes national treatment obligations. Although Article XVII(1)(b) specifies certain criteria, such as price, quantity, accountability, etc., it still falls short of improving national treatment obligations.

Due to the weakness of this provision, Art. XVII is far from satisfactory for dealing effectively with problems in NME countries.

### III GATT Association with NME Countries

Since GATT does not have sufficient mechanisms to deal with NME, the accession of a NME country to GATT is difficult. However, GATT does not exclude NMEs. Article XXXIII provides: "a government not a party to this agreement . . . may accede to this agreement . . . on terms to be agreed."<sup>22</sup> "On terms to be agreed" implies that GATT is flexible to admit a new member. Several Eastern European NME countries have been accepted to GATT "on the terms to be agreed". The "terms" are primarily based on the extra GATT obligations—"import commitment" with one exception<sup>23</sup>. The

<sup>22</sup> GATT Article XXXIII, *supra* note 27, Chapter 1 of the thesis, at 48.

<sup>23</sup> Yugoslavia is the only NME country acceded to GATT without taking additional commitments. See the following discussion.

accession of the other NMEs to GATT provide useful examples for China's application. Therefore, it is necessary to review their experience with GATT. So far, NME's accession can be divided into two types:

**(1) Accession to the GATT by Yugoslavia: The Role of Tariffs**

Yugoslavia is the only NME country admitted to GATT based on tariff concessions<sup>24</sup>. The country had undertaken extensive economic reform before it obtained full GATT membership. The GATT member countries are satisfied that Yugoslavia's reforms are sufficient enough to reduce the trade barriers so that tariff alone would maintain open market to member countries. Strictly speaking, Yugoslavia's accession to GATT should be regarded in free market terms.

Some feel that Hungary's accession is also based on tariffs alone. According to Ms. Petterson, Hungary made a commitment during the working party session on its protocol to increase imports from Member Countries<sup>25</sup>. Therefore,

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<sup>24</sup> Yugoslavia's accession to GATT took about 6 years during which it undertook significant economic reform. See Heinsteins, *China & GATT, Legal, Economic and Policy Issues raised by China's Participation in the General Agreement of Tariffs and Trade*, 1986, 18 Law & Policy in Int'l Business, at 385.

<sup>25</sup> Eliza R. Petterson, *Improving GATT Rules for Non-Market Economy*, 20 Journal of World Trade Law, (1986).

Hungarian accession did not occur under circumstances identical to Yugoslavia.

**(2) Poland and Roumanian Accession to GATT---"Import Commitment"**

Most NME countries admission to GATT is based on an additional "import commitment" obligation. This provides that NME country increases imports by a specified amount from the GATT member countries<sup>26</sup>.

In October, 1969, Poland was admitted to GATT after committing to increase its total import value from member countries by not less than 7% per annum<sup>27</sup>. Initially, Poland applied to become GATT member on tariff concessions alone. GATT member countries were not satisfied that Poland's economic development had proceeded far enough to allay their fears. Thus, it did not grant Poland full membership on that basis. Poland subsequently proposed to make the import commitment and was accepted by GATT<sup>28</sup>.

Romanian is another NME country that acceded to GATT on import commitment. Romanian committed to increase imports

<sup>26</sup> Herzstein, *supra* note 24, at 386.

<sup>27</sup> Kostechi, *supra* note 9, Chapter 1 of the thesis, at 27.

<sup>28</sup> *Id.*, at 29.

from member countries as a whole at a rate not smaller than those of its total import targets provided by its "five year plan"<sup>29</sup>. Like Poland, Romanian intended to join GATT without substantially changing its central controlled economy<sup>30</sup>. This goal was achieved through the import commitment mechanism. It is interesting to note that Politics played important role in Romanian case. The Romanian application to GATT coincided with political changes as they were the first Eastern European country to take advantage of the Sino-Soviet dispute<sup>31</sup>. During the 1950's and 1960's, Romanian gained independence by forming policy towards other East European countries while attempting to establish economic relationship with western countries<sup>32</sup>. Romanian gained considerable sympathy from the West for its independence against Soviet control<sup>33</sup>. Therefore, the negotiation between Romanian and GATT was conducted in a very favorable atmosphere.

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<sup>29</sup> *Id.*, at 96.

<sup>30</sup> *Id.*, at 30.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

The NME countries experience with GATT indicates that although GATT is based on the assumption of free market economy system, it does not have adequate mechanisms to deal with MNE, extra arrangements can be worked out. In this regard, GATT has been flexible and pragmatic. However, the mechanisms of import commitments has not been proved wholly satisfactory for the following reasons:

- (a) The commitment is calculated on current prices, thus, if inflation rates are high, the effect of the commitment will be undermined. For instance, in Poland, from 1968 to 1974, the real percentage of import increase every year never reached the required rate which is 7% because of the inflation<sup>34</sup>. The inflation factor diminishes the function of import commitments and made it less meaningful.
- (b) The commitment is in the form of a particular currency, thus, its real value can be affected by manipulation of exchange rate by the government<sup>35</sup>.
- (c) The commitment may create discrimination between Western GATT countries and GATT NME

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<sup>34</sup> Table 6.1 on Nominal and Real Import Increase Required of Poland under the GATT, see Kostecki, *supra* note 9, Chapter 1 of the thesis, at 115.

<sup>35</sup> *Id.*, at 188.

countries, especially the member countries of the Council of Mutual Economic Co-operation which are composed mainly of East European NME countries. The commitment takes the form of "global commitment"<sup>36</sup>, under which the increased import percentage is generally applied to all the Contracting Parties<sup>37</sup>. It didn't specifically state whether imports from NME Contracting Parties are to be included in fulfilling the percentage objectives. Therefore, it seems possible for free market economy Contracting Parties to argue that it discriminates against them insofar as NME countries.

- (d) Most importantly, is that the import commitment is inconsistent with the GATT principle of preventing and reducing government interference with economic activities and the foreign trade system. The implementation of fixed import commitments would inevitably lead to government administrative measures and interference needed to guarantee the fixed import levels. Thus, decentralization and economic reforms a towards free market would be

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<sup>36</sup> *Id.*

<sup>37</sup> Romanian agreed to develop and diversify its trade with the GATT Contracting Parties as a whole and undertake to increase imports from Contracting Parties as a whole at a rate not less than the growth of its total imports provided in its five-year plan. *see* BISD, at 10 (1971).

discouraged. This appears to be totally contrary to the GATT's basic principle.

In summary, GATT does not absolutely prohibit NME's accession. On the contrary, it accommodates them to certain extent; such as the cases of Yugoslavia---accession on the basis of tariff alone when its economy was decentralized enough and Poland and Romanian---accession on import commitment. However, the accommodation scheme, particularly the import commitment system has not been satisfactory to either GATT member countries or NME countries seeking entry. Exploration of a better solution to facilitate China's accession is necessary.

### Chapter 3

#### China's Domestic Economic Reform---The Impact on Its GATT Application

After examining existing GATT provisions dealing with NME and its experience with NME countries, one might easily come to the conclusion that China is not eligible to join GATT at this moment.<sup>1</sup> However, this conclusion ignores the impact of the massive economic reforms which have been underway in China since 1978. The undergoing economic reform raises the questions: Has China been changed? Is China still a NME country? How far away is the current Chinese economic system from those of GATT?

In order to answer these questions, it is necessary to review the progress brought about by China's current economic reform. Domestic reform will be the focus of the chapter.

#### I. Central Planned Economy Prior to the Economic Reform

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<sup>1</sup> Mr. Heistein pointed out that the GATT expects that each participating country will open its markets to roughly the same extent as the others. In China, however, the trading decisions traditionally have not been based solely on commercial considerations, but to a large extent on central planning requirements. Therefore, it would be premature to accept China as a GATT member. See Heistein, *supra* note 24, Chapter 2 of the thesis, at 374.

Prior to the economic reform, the domestic economic system in China was entirely centralized. This can be illustrated from two aspects: Firstly, the State retained the so called "public ownership system" (known as gong you zhi) under which the State owned all the main production means, such as, land, factories, equipment, etc. Private ownership of the production means was strictly prohibited<sup>2</sup>. Secondly, the domestic economy was entirely controlled by the central planning authority. In both agriculture and industrial fields, the State sets the plans for production<sup>3</sup>. The plan essentially sets the quantity of products, and the sale and purchase price for them<sup>4</sup>. Local production units<sup>5</sup> had no authority to change the plan, only to fulfill it.

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<sup>2</sup> Although the Chinese Constitution recognizes three different types of ownership: Wholly-state owned (quan min suo you zhi), Collectively- owned (ji ti suo you zhi) and Individually- owned (ge ti suo you zhi), the wholly-state owned form is still the dominant ownership. See Article 6, the Constitution of the People's Republic of China, *adopted* at the 5th Session of the 5th National People's Congress and *promulgated* by the Proclamation of the National People's Congress on Dec. 4, 1982, *reprinted in the Law of the People's Republic of China*, at 7, (1979-1982) *compiled* by the Legislative Affairs Committee of the Standing Committee of the National People's Congress of the Peoples Republic of China. See Liu Guoguang and Wang Ruisun, *Restructuring the Economy in China's Socialist Modernization*, at 104-105, (1984).

<sup>3</sup> For detailed discussion on China's planning system, see Christopher Howe, China's Economy, A Basic Guide, at 50-65, 1978.

<sup>4</sup> *Id.*

<sup>5</sup> In agriculture sector, there are three levels of production units: "commune" (gong she), "brigade" (shen chan da du), and "team" (shen chan xiao du), see Rosalie L. Tung, Chinese Industrial Society after Mao, at 70, (1982). In industrial sector, the local production unit is called "industry enterprises" (gong ye qi ye), or "factory" (gong chang), see Christopher Howe, *supra* note 3, at 38.

Even when the market fluctuated, producers still have to adhere to the original state plan..

This situation started to change in 1979 when the economic reforms started in the agriculture sector.

## II. Agriculture Reform

In December, 1978, the third Plenary Session of the 11th Central Committee of the Communist Party of China, created the reformed agricultural policy<sup>6</sup>. The central theme of this policy is to implement an agriculture production responsibility system<sup>7</sup>, which allows farmers to contract with the State on the quotas of production as household units<sup>8</sup>. During the contractual period, a household has autonomy to own and use the farm land<sup>9</sup>. This changes the

<sup>6</sup> The detailed policy on the agriculture reform is contained in the *Drafted Decision on Several Questions on Speeding Up the Agriculture Development ("decision of agriculture reform")* adopted by the 4th Plenary Session of the 12th Congress of the Central Committee of the Chinese Communist Party on September 28, 1979, see the *Communique of the 3rd Plenary Session of the 11th Congress of the Central Committee of the Chinese Communist Party*, adopted on December 22, 1978 at the 3rd Plenary Session of the 11th Congress of the Central Committee of the Chinese Communist Party, reprinted in 1 Red Flag Journal (hongqi zazhi), at 7, (1979).

<sup>7</sup> See the "Decision of the Agriculture Reform", reprinted in Selection of Important Documents Since the 3rd Plenary Session of the 11th Congress of the Central Committee of the Chinese Communist Party, compiled by the Documentary Research Office of Central Committee of the Chinese Communist Party, vol.1, at 185, (1982).

<sup>8</sup> In Chinese, it is called "bao chan dao hu". For the details, see Lu Feng, Luo Huan Zheng, Huang Wei Ping, An Overview and Prospect of Our Country's Economic Reform, at 31-34, (1987).

<sup>9</sup> *Id*

notion that land has to be absolutely owned by the State<sup>10</sup>. The farmers also decide how to use the land and what to produce on it according to market demand and supply<sup>11</sup>. They can retain goods produced in excess of the state quotas<sup>12</sup>. Therefore, the farmers are more motivated and concerned about the efficiency of production. This reform has been extremely successful<sup>13</sup>. In 1986, the agriculture production value increased 6.2% compared to 1978; average farmer's income increased from \$134 in 1978 to \$424<sup>14</sup>.

Another key aspect of the agriculture reform is the reform of the sale and purchase system. Prior to the reform, the sale and purchase of agricultural products was conducted according to the policy of "unitary purchase and sale"<sup>15</sup> which provided that all the agriculture products for

<sup>10</sup> *Id.*

<sup>11</sup> Prior to the reform, most agricultural land was only used to grow grain due to the shortage of grain supply in China. Usually farmers did not have authority to grow other products on the agriculture land. Now, they can decide what to grow on the land in response to the market demand. *See A World Country Bank Study, China: Between Plan and Market*, at 38, (1990).

<sup>12</sup> *See* Lu, Luo, Huang, *supra* note 8, at 32.

<sup>13</sup> Until the end of 1983, the household production units amount to 90% of the total farm households in the country, *see* Lu, Luo, Huang, *supra* note 8, at 42.

<sup>14</sup> *Id.*, at 46-47.

<sup>15</sup> In Chinese, it is called "tong gou tong xiao".

consumer use had to be purchased from farmers and sold to the market by the State. Trade between individuals were strictly prohibited. Moreover, price were set by the State, usually below the market price. This policy was changed in 1978 when the Central Committee of the Chinese Communist Party decided to raise the price of the agriculture products<sup>16</sup>. According to this decision, the purchase price for grain has been increased 20% since 1979, and other main agriculture products such as cotton, oil products, sugar etc. have been increased 24.80%.<sup>17</sup> Some agriculture products can be sold to the market directly without going through the State sale and purchase channel<sup>18</sup>.

Due to reform, central control of the agricultural sector has been relaxed, and the price of agriculture products reflects the market supply and demand of the market more than before. However, this does not necessarily mean that the market economy has entirely substitute the central planned economy in the agriculture sector. This can be illustrated from the aspect of ownership of land.

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<sup>16</sup> See the "Decision on Agriculture Reform", *supra* note 7, at 186.

<sup>17</sup> *Id.*

<sup>18</sup> For instance, in October, 1983, The types of medicine subject to the state sale and purchase have been reduced from 54 to 30; the agriculture products reduced from 46 to 21 types. *Id.*

Under the current reform, land is still not unconditionally owned by farmers. The "household contracting system" provides farmers with the right to own and use land during the contracting period. After the contract expires, farmers do not own the land any more. Ultimately, land is still owned by the State. This view has been supported by Chinese academic authorities. Many legal and economic scholars think that the household contracting system is not like the private ownership in market economy system<sup>19</sup>. They pointed out:

"the characteristics of private economy is that land and other basic production means are owned by individuals. It has nothing to do with collectives. Household contract is different in the following aspects: First of all, land and other basic production means are still owned by the collectives. They are contracted to household only for use during the contract period. Households are allowed to transfer the land to others through leases but not sales. Secondly, apart from paying the agriculture tax and fulfilling the quota requirement in the contract, a household must fulfill the quotas imposed by the collectives. Therefore, it is not appropriate to characterize the household contracting system as a phenomenon of private economy, it should be regarded as the socialist agriculture production responsibility system"<sup>20</sup>.

Moreover, decentralization of the state sale and purchase is far more from complete. Some products are still going through this channel, such as tobacco<sup>21</sup>. The so-called

<sup>19</sup> See Lu, Luo, Huang, *supra* note 8, at 46-47.

<sup>20</sup> *Id.*, at 47-48.

<sup>21</sup> *Id.*, at 60.

first class products subject to State control are still not abolished, although its scope has been reduced.

In summary, the agriculture reforms has brought in significant market influences to the once-entirely central planned economy. However, the market economy is not yet fully in place of central planned economy in the agriculture sector. The State still maintains certain degree of central control.

### III. The Urban Economic Reform

The success of agriculture reforms encouraged Chinese government to extend the reform to the urban areas. In October, 1984, at the third Plenary Session of the 12th Communist Party Committee, the government announced major urban economic reforms<sup>22</sup>. The main object of this policy is to expand the autonomy and invigorate urban industrial enterprises<sup>23</sup>.

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<sup>22</sup> See the Decision on the Reform of the Economic Structure adopted at the 3rd Plenary Session of the 12th Congress of the Central Committee of the Chinese Communist Party on October 20, 1984 ("Decision on Economic Reform"), reprinted in Selection of Important Documents since the 12th Congress of the Central Committee of the Chinese Communist Party, compiled by the Documentary Research Office of the Central Committee, vol.2, at 558-587, (1986).

<sup>23</sup> The "Decision on Economic Reform" states "improve the invigoration of industrial enterprises, particularly the large and medium size enterprises is the center of the urban economic reform", *supra* note 22, at 564.

The new policy calls for the reduction of "mandatory planning"<sup>24</sup>, and increases the use of "guidance plan"<sup>25</sup>. It also recommends price structure reforms<sup>26</sup>. Extensive reform had been carried out in the urban economic sector, in which the urban industrial enterprises reform have emerged as the key aspect.

**(1) Implementation of the "Contracting Management Responsibility System" and the "Factory Manager Responsibility System"**

The main purpose of industrial enterprises reform is to grant enterprises more autonomy in production, separating their management function from government administrative control<sup>27</sup>. In order to achieve this goal, a system called "contracting management and responsibility" has been implemented<sup>28</sup>. Under this system, an enterprise is required to contract with the State to fulfill production quotas and

<sup>24</sup> In Chinese, it is called zhilingxing jihua. It means that the plan must be fulfilled by the enterprises and the modification of the plan is not allowed. See A World Bank Country Study, *supra* note 11, at 73.

<sup>25</sup> In Chinese, it is called zhidaoxing jihua. It means that the plan could be implemented as a guidance, and the enterprises do not have to fulfill it strictly. They could adjust it according to market demand. see the World Bank Country Study, *supra* note 11, at 73.

<sup>26</sup> See the "Decision of Economic Reform", *supra* note 22, at 570.

<sup>27</sup> *Id.*, at 572.

<sup>28</sup> In Chinese, it is called qiye chengbao jinyin zerenzhi.

profit goals<sup>29</sup>. An enterprise is entitled to retain the profits above the quota provided in the contract. If an enterprise fails to fulfill the quota, it is liable for the loss<sup>30</sup>. Within the scope of the contract, the enterprise has management authority with respect to the quantity of production, fixing the price for its products, distribution, etc<sup>31</sup>.

Compared with the former centrally controlled system under which an enterprise had to submit all its profit to the State<sup>32</sup>, the new system gives enterprises substantial freedom and incentive. The new system has led to substantial improvements. According to Chinese statistics, up to the end of 1988, the industrial enterprises subject to the new system amounted to 88% of total production, among which the large and medium sized enterprises takes 93.4%, and the total profits increased 10% compared to 1987<sup>33</sup>.

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<sup>29</sup> Under the new system, an enterprise still has to fulfill the quota set in the government plan. It can sell the above quota part products in the free market. *See Tung, supra* note 5, at 158.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Prior to the reform, the State set up production plans for an enterprises regarding the supply of raw materials, equipment, and production targets. An enterprise had to fulfill all the plans. In addition, it has to hand in the above quota profits to the State. *see Tung, supra* note 5, at 157-158.

<sup>33</sup> Wang Wei Cheng, Gao Shang Quan, Liu Guo Guang, the New Thoughts on the Economic Reform, at 212, (1988).

The "factory manager responsibility system"<sup>34</sup> gave the enterprises more autonomy and make them independent of government control. Moreover, the legal recognition of enterprises formalizes the system<sup>35</sup>. Prior to the reform, the Communist Party Committee in the factory made business decision. Factory managers had no authority to make their own decision but had to implement the policies made by the Party Committee. Now, under the new system, factory managers have been given power and responsibility regarding management decisions. This authority includes: (1) making production management decisions, (2) making decisions on or requesting approval for all products in accordance with the law and the regulations, (3) appointing and dismissing middle level personnels in the factory, (4) drawing up plans for wage readjustments and distribution of bonuses and formulating major rules and regulations<sup>36</sup>.

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<sup>34</sup> In Chinese, it is called qiye changzhang fuzezhi.

<sup>35</sup> The "factory managers responsibility system" is provided in Part IV (Article 44-48) of the *State-owned Industrial Enterprises Law of the Peoples Republic of China (SIEL)*, adopted by the First Session of the 7th National People's Congress on April 13, 1988, reprinted in the Law Year Book of China, at 124, (1989). The law directly applies to more than 90,000 State-owned industrial enterprises operating in China, and accounting for 70% of the total industrial output value of the country. see Clement Shun, *the State-owned Industrial Enterprises Law in the P.R. C.* Business law Review, May, 1989, at 125.

<sup>36</sup> Article 45, SIEL, the Law Year Book of China, *supra* note 35, at 124.

The power given to the factory managers, make the enterprises independent of the State control and the Party's leadership. Also, the powers given to the factory managers resembles, in many ways, those of the directors and president of a corporation in the modern capitalist country.

The urban economic reform also suggests that the distorted economic system created under central planning authority has been restored and that China's domestic economy is moving towards a more market-oriented direction which might give rise to its GATT expectation. For example, reform of the pricing system has resulted in free flow of prices of many products, particularly, consumer goods<sup>37</sup>. Also, reform of the planning system has reduced the scope of "mandatory panning", and increased the use of the "guidance planning" to a substantial scale<sup>38</sup>.

## **(2) The Adoption of the Bankruptcy Law and Issuance of Securities**

In addition to the reforms mentioned above, there are two significant steps taken by the Chinese government. The

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<sup>37</sup> Prior to the reform, the prices of most consumer goods were set by the State. Many of them were artificially low and did not reflect the market supply and demand.

<sup>38</sup> See Asia-Pacific Report-Trends, Issues, Challenges, at 28, (1986).

first one is the passage of the Bankruptcy Law in 1986<sup>39</sup>. This law provides that a State-owned enterprise can declare bankruptcy when it suffers serious losses caused by management and is incapable to repay the debts<sup>40</sup>. This implies that an state-owned enterprise is liable for its own losses. In the past, many State-owned enterprises had been running at a loss for many years, but the government still subsidized them. There were never been any State-owned enterprises which were forced to close down. Also, the employees of these enterprises were still paid wages and salaries regardless of their poor performance, a phenomena known as "iron rice bowl"<sup>41</sup>. This created the problem that the State-owned enterprises did not care about improvement of management. The implementation of the Bankruptcy Law has imposed financial responsibility on both the enterprises and the employees. Thus, the "iron rice bowl" has be broken to some extent.

The second aggressive step taken by the Chinese government is the issuance of securities. Regarded as a

<sup>39</sup> See the *Enterprise Bankruptcy Law of the P.R.C. ("Bankruptcy Law")* adopted by the 18th Session of the Standing Committee of the 6th National Peoples Congress on December 2, 1986, reprinted in the Law Year Book of China, at 119-121, (1987).

<sup>40</sup> Article 3, the *"Bankruptcy Law"*, *supra* note 39, at 119.

<sup>41</sup> In Chinese, it is called "tie fan wan". It is described by the Chinese economist Xue Mu Qiao as "workers are hired but not fired, promoted but not demoted, a phenomenon which we call the "iron rice bowl". see Xue, China's Socialist Economy, at 210, (1980).

typical capitalist vehicle, equity securities were eliminated in the Chinese economy since 1949<sup>42</sup>. Starting in 1984, selected enterprises have been permitted to reorganize as joint stock companies and issue securities. It is estimated that by 1988, approximately 6,000-10,000 enterprises have issued shares worth *Renminbi* 7.5 million shares<sup>43</sup>. Although this amounts to only a small percentage of all Chinese enterprises, "it represents a stunning increase over the negligible level of activity of the previous 30 years"<sup>44</sup>. It also signifies the Chinese government's further commitment of reforming towards a free market economy system.

### (3) The Insufficiency of the Economic Reform

Summarizing the progress of the economic reform, one might come to the conclusion that the central planning aspect of domestic economy do not exist any more, and market force are in place. The management decisions of enterprises are now made by the independent factory manager, thus, they are no longer subject to the central planning authority. The price system is not arbitrarily controlled by the

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<sup>42</sup> Paul Schroeder, *Rebuilding China's Securities Markets*, China Business Review, at 20, (May-June 1991).

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

government, but subject to the economic standard of supply and demand. Therefore, the basic principle of GATT seems to be complied with.

However, it is still premature to conclude that the China's economy has conformed to the market economy. A number of factors indicates that despite the extensive reform, the domestic economic system is still far short of basic characteristics of those of the free market economy. Three primary aspects of the Chinese economy which do not conform with free market principles are as follows:

**(a) The "Corporation" in the Modern Capitalist Economic System Does Not Exist in China.**

The reformed industrial enterprises resembles some aspects of the "corporation", however, they still lack several fundamental characteristics. Most importantly, the ownership of the enterprises has not been changed. The government still owns the enterprises<sup>45</sup>.

In the modern capitalist economy, a "corporation" is an independent economic and legal entity which is privately owned by individuals through the form of "share" or

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<sup>45</sup> Ownership of socialist enterprises has been legally problematic in China. According to the socialist theory, only the State or Collectively-owned enterprises can carry out big economic transactions. Even with the economic reforms of last decade, these two basic forms of ownership haven't been changed. See James V. Feinerman, *The Evolving Chinese Enterprises*, 15 *Syr. J. Int'l L. & Com.*, at 204, (1989).

"stock"<sup>46</sup>. "Shareholders" are the owners of the corporation<sup>47</sup>. Their liability to the corporation is usually limited to their respective investment in the corporation<sup>48</sup>. Therefore, a corporation is not only managed by individuals independent of government control<sup>49</sup>, but also owned by individual "shareholders". This makes government interference more difficult. In recent years, the governments in capitalist countries have tended to increase their interference with corporate activities by the way of supply of money, increase interest rate, etc.<sup>50</sup>. However, government interference with private business has not substantially changed the nature of a "corporation" in capitalist society. As Mr. Hadden stated: "The underlying commitment to the principles of free competition and consumer sovereignty has remained"<sup>51</sup>. The privately owned

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<sup>46</sup> Hadden, Company Law & Capitalism, at 25-26, 9-12, (1977).

<sup>47</sup> *Id.*, at 75.

<sup>48</sup> A corporation is a legal entity entirely distinctive in law from its shareholders. It can own its own property and business, it can sue and be sued in its own name, and it bears liability as a corporation independent of its shareholders. *see* Hadden, at 46, at 103.

<sup>49</sup> In the modern capitalist society, the people who manage a corporation, such as directors or managers, are usually not shareholders. This is particularly true in large corporations which have many shareholders and the daily management responsibility are entrusted on a relatively small group of people. *see* Hadden, *supra* note 46, at 81.

<sup>50</sup> Hadden, *supra* note 46, at 26.

<sup>51</sup> *Id.*

business corporation "... has been for all of the 20th century the most important business form ..."52.

Although the industrial enterprises operating in China are named as "corporation" or "legal persons"53, they are still fundamentally different from the "corporation" in the western capitalist countries.

According to the State-owned Industrial Enterprise Law of P.R.C.(SIEL) promulgated in 1988, a "legal person" should satisfy the following conditions: 1. It must be established in accordance with the law; 2. It must possess the necessary property or funds; 3. It must possess its own name, organizational structure and premises; 4. It must be able to assume civil obligation independently54.

Then, what constitutes a "corporation" in capitalist society? In his book "The Law of Corporation", Mr. Hamilton describe it as follows:

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52 Alfred F. Conard, Robert L. Knauss, Stanley Siegel, Corporations, Cases, Statutes and Analyses on Enterprise Organization, at .2, (1972).

53 In Chinese, it is called fa ren. The law requires that an State-owned industrial enterprise must obtain the status of a "leal person" in accordance with the law. *see* Article 2, *the State-owned Industrial Enterprise Law in the P. R. C. (SIEL)*, *supra* note 36, at 124.

54 Article 37, SIEL, *supra* note 35, at 124.

"The simplest and usually the most useful way of viewing a corporation is to consider it a fictitious being or artificial entity independent of the owners or investors. This artificial entity may conduct a business in its own name much in the same way that a 'real' person could. Business is done, assets acquired, contracts entered into, and liabilities incurred, all in the name of the corporation rather than in the name of any individual. Also, the artificial entity may sue or be sued as though it were a person, it pays taxes, it may apply for business licenses in its own name, it may have its own bank account, it may have its own seal, and so forth".<sup>55</sup>

From a simple reading of the description of a "corporation", we may come to the conclusion that an industrial enterprise in China is very similar to a "corporation" in a capitalist country because the requirements for a "corporation" are very close to those of an enterprise as was provided in SIEL. However, if we look at the ownership aspect of a "legal person", the conclusion would be different. The fundamental difference between an enterprise legal person and a "corporation" lies in the following:

First of all, an enterprise "legal person" does not own its assets. Its right to property referred to in the second requirement above only means that it has right of management on the property rather than the ownership of the property<sup>56</sup>.

<sup>55</sup> Robert W. Hamilton, The Law of Corporations, at 1, (1990).

<sup>56</sup> Chinese scholars distinguish the "right of management" (jing ying quan) from the "right of ownership" (suo you quan) in respect of the relationship between the State and an enterprises. In their view, an enterprise does not own its own assets. Rather, it "manage" (jingying, or guanli) the assets on behalf of the State. For detailed discussion, see Qi Ming, *The Ownership Right and Management Right of Enterprises*, in Comments on the State-owned Industrial Enterprises Law, at 33-34, (1988).

"The ownership of the enterprise belongs to the State. The State is the only body that can own the assets of the enterprise"<sup>57</sup>.

Secondly, an enterprise legal person has no right to independently dispose its assets. According to the forth requirement cited above, a "legal person" must independently assume civil liability. The question arises: how can a State-owned enterprise bear independent civil liability? In other words, if an enterprise does not own its assets, how can it be responsible for its civil liability? For instance, if an enterprise goes bankrupt, how can the enterprise pay off its creditors if it does not own the assets, such as land, building, machines etc.? Article 41 of SIEL provides that a State-owned "legal person" bears civil liability to the extent of the property the state has allocated to it to operate and manage<sup>58</sup>. Therefore, it is the State who ultimately bears the responsibility, rather than enterprise itself. Therefore we can hardly say that these enterprises bear civil liability "independently". Therefore, Article 41 of SIEL conflicts with the forth requirement provided in Article 37 of SIEL.

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<sup>57</sup> *Id.*

<sup>58</sup> Article 41, SIEL, *supra* note 35, at 124.

Finally, the change of ownership to the private sector is not even intended by the government. The 1984 Decision of the Central Committee of the Communist Party of China on the Reform of Economic Structure stressed the "law of value"<sup>59</sup>, and emphasizes the continuation of the "public ownership". As professor Feinerwen pointed out "even with the economic reforms of the last decade, there has been little erosion of the two basic fundamental forms of ownership---"State-owned" and "Collective-owned"<sup>60</sup>.

These factors led to the conclusion that an enterprise "legal person" fundamentally differs from a "corporation" in the modern capitalist society.

It has been noted that the Chinese government has encouraged some enterprises to become shareholding companies and allowed them to sell shares or stock to the public<sup>61</sup>. This reform is still at an experimental stage, and it has not been implemented in the majority of large enterprises in the country <sup>62</sup>.

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<sup>59</sup> In Chinese, it is called jia zhi guilü- "the law of value" which stands for the market demand and supply.

<sup>60</sup> J.V. Feinerman, *supra* note 45, at 203.

<sup>61</sup> *See Communist China Makes Two small but Significant Capitalist Move*, Washington Post, August 8, 1986, at 17A.

<sup>62</sup> *Id.*

Thus, it would be logical to conclude that the industrial enterprise reforms have not resulted in ownership reform, rather it is reform in the sense of internal management reform. Even in this regard, the reform is not sufficient to resemble the management process of a western corporation. The factory manager lacks real control in both the financing and operation of the enterprise. The State plan still plays important role. The allocation of necessary inputs for production, and prices for the products are not determined by the enterprises themselves<sup>63</sup>. Facilities which are not within the enterprises, such as communications, transportation, are all beyond their control. Access to capital, particularly foreign exchange, is restricted by the State. Moreover, under the "contract management responsibility system", the enterprises still must fulfill the quotas designated by the State. Thus the State interference in these areas are inevitable.

At present, the Chinese industrial enterprise is still far from the "corporation" in the free market economy system.

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<sup>63</sup> See Wang, Gao, Liu, *supra* note 33, at 316.

**(b) The Price Reform Is Not Sufficient to Reflect Market Supply and Demand.**

Despite substantial progress made in liberalizing the prices of a large number of the consumer goods, price distortion still exists, especially in energy sectors, such as, petroleum, coal etc<sup>64</sup>. Equally important is the underpricing of financial capital, for instance, interest rate are one of the important sources of price distortion leading to excess demand for investment<sup>65</sup>.

**(c) A Competition Mechanism Has Not Been Established.**

A competition mechanism is one of the essential elements in a market economy<sup>66</sup>. Markets will only function efficiently if enterprises are exposed to vigorous and fair competition. The competition mechanism is not self sustained. Instead, it reliant on the outside market environment. Factors which have substantial influence on it

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<sup>64</sup> Energy industry in China has been largely allocated administratively, with market forces playing only a minor role. Energy prices reflects neither scarcity nor production costs. For example, official prices for coal barely cover operating costs. See A World Bank Country Economic Report, China: Long-Term Development Issues and Options, at 71, (1985).

<sup>65</sup> World Bank, China, External Trade and Capital, at 82, (1988).

<sup>66</sup> Hadden, *supra* note 46, at 26.

are labor, capital and raw materials<sup>67</sup>. Despite a decade of reform, none of the factors exist in China at this stage<sup>68</sup>.

**(i) Distribution of the Labour Forces**

Despite of the ongoing reform in the labour area, the big "iron rice bowl" is not broken yet. Since 1980, the Chinese government has been exploring ways of reforming the domestic labour system. The ultimate objective of the policy appears to be to create free flow of labour force in order to allocate labour in response to market demand<sup>69</sup>. Under the new policy, an enterprise is authorized to choose employees through examinations and to hire them on a contract basis<sup>70</sup>. Individuals will be allowed to choose their jobs within the constraints of the market<sup>71</sup>. Although the initial implementation of the system has been successful<sup>72</sup>, it still remains at the experimental stage. A lot of the employees in

<sup>67</sup> According to Adam Smith, free market competition in the various factors of production, labour, capital and raw materials can operate to produce the most democratic distribution of goods and services in a given economy. Hadden, *supra* note 46, at 26.

<sup>68</sup> See China Reforming Labour System in the State-owned Enterprise, Recruitment of New Worker Based on labour Contracts, People's Daily, September 10, 1986.

<sup>69</sup> See Henry R. Zheng, *An Introduction to the Labour Law of the People's Republic of China*, 28 Harvard International Law Journal, at 391, (1987).

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> By October, 1986, there were about 3.5 million contract employees in China, *id.*, at 392.

the State-owned enterprises are not subject to the new contract employment system<sup>73</sup>. Tenured employment for industrial workers still exists<sup>74</sup>. Further decentralization of the administrative authority of a State-owned enterprise is required<sup>75</sup>. Moreover, the labour reform has not extended to the employees in other professions, such as professors, doctors, lawyers<sup>76</sup>. Due to the shortcomings, it is premature to say that a free flow labour market has been formed in China.

#### (ii) Allocation of Capital

The current condition of capital market in China is far from those of free market economy countries. In a capitalist economy, the stock market is the primary mechanism for the allocation of capital<sup>77</sup>. An individual investor can make his

<sup>73</sup> Up to 1986, 3.5 million of the employees of the State-owned enterprises are covered under the contract employment system. This implies that the rest of them are still subject to the old job assignment system, *id.*, at 392.

<sup>74</sup> A World Bank Country Study, *supra* note 11, at 72, (1990).

<sup>75</sup> Despite the recent reform, State-owned enterprises still exercise broad administrative authority. For example, the labor contract regulations expressly authorize enterprises to "manage" employees (*see Regulations on the Implementation of Labour Contract in State-Owned Enterprises, promulgated in July, 1986, reprinted in People's Daily, September 10, 1986*). This implies powers of administrative discipline. *See Zheng, supra* note 69, at 430-431.

<sup>76</sup> The labour reform is required in the area of white collar employees. Some Chinese lawmakers have advocated a comprehensive reform plan which covers such employees. Since such a step would affect those situated at the upper levels of the employment hierarchy, the Chinese government will likely adopt a cautious approach in this area. *see Zheng, supra* note 69, at 431.

<sup>77</sup> Hadden, *supra* note 46, at 69.

investment choice according to the market supply and demand<sup>78</sup>. In the past, China essentially eliminated any role for debt and equity securities in its economy<sup>79</sup>. This phenomenon has been changed since 1980. The first step was that the government issue a treasury type of bond<sup>80</sup>. Following this, selected enterprises are given permission to reorganize as joint stock companies and issue stocks to the public<sup>81</sup>. Although this represents a significant change of attitude towards the adoption of the capitalist vehicle, the reform has not been sufficient enough to resemble the operation of security market in western capitalist countries.

Regarding the issuance of the treasury type of bond, as Mr. Paul Schroeder pointed out: "the motivation behind these issues was not so much to create an efficient capital market as to finance government activities, in many cases, workers

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<sup>78</sup> In a free market, the individual investor will ideally choose to make his money available to those new or existing enterprises which offer the best prospect of immediate or continuing profit. Also, he is entitled to withdraw his money from a less profitable enterprise by selling his shares as long as he can find a buyer and to reinvest it, he will continually be looking for new and more profitable opportunity for his money. *see* Hadden, *supra* note 46, at 29.

<sup>79</sup> Paul Schroeder, *supra* note 42, at 20.

<sup>80</sup> In Chinese, it is called guo ku juan. From 1981 to 1988, the government issued about 145 million renminbi worth guo ku juan. *see* Schroeder, *supra* note 42, at 20.

<sup>81</sup> *Id.*

were compelled to purchase bonds or receive them in lieu of cash salary"<sup>82</sup>.

With respect to issuance of stock, the current Chinese practice is far behind the stock exchange system in western countries. Firstly, the stock or shares traded in the market differs from those of the western country. Most types of securities are like bonds, have fixed interest rate and no ownership attached<sup>83</sup>. "Common shares"<sup>84</sup> are relatively rare since it carry an implicit share of ownership and thereby conflicts the fundamental principle of public ownership<sup>85</sup>.

Secondly, the security market is not well regulated. Although there are some local regulations on security trading<sup>86</sup>, they have not provided sufficient protection to public investors. For instance, in a capitalist society, one of the most important way of regulating securities exchange

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<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> In western economy, the holders of "common shares" or "ordinary stocks" have the rights to share the profits of the company, voting at the shareholders meeting of the company and receiving dividend from the company. They are the people who own the company. see Gower, *infra* note 87, at 373-375.

<sup>85</sup> *Id.*

<sup>86</sup> Security regulations are generally issued at the local level and changed often, creating uncertainty, *id.*

is so called "disclosure requirement"<sup>87</sup>. This provides that a public company must make accurate and updated disclosure about its financial status, operation and other aspect of the company which may affect an investor's decision<sup>88</sup>. The reason behind this requirement is to allow investors to be well informed of the situation of the company and assist them to make right decision. In China, however, there is no legal obligation for enterprises to disclose such information<sup>89</sup>. Moreover, the current accounting system make it difficult to monitor the financial situation of the enterprises<sup>90</sup>. Thirdly, the security system has not been nationalized. Although there are a number of stock exchange centers in China<sup>91</sup>, they are strictly limited to certain economically developed areas.

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87      The fundamental principles underlying the company law has been that of disclosure, see L.C.B. Gower, Principles of Modern Company Law, at 447, (1992).

88      The disclosure requirement provides that a public company listing its shares in a security exchange center must publish its financial statement certified by a profession auditor. Gower, *supra* note 87, at 447.

89      See Schroeder, *supra* note 42, at 21.

90      *Id.*

91      The stock exchange centers have been established in Shanghai, Beijing, Shenyang, Wuhan, Tianjin, Chongqing, Guangzhou, Harbin, and Shenzhen. see Schroeder, *supra* note 43, at 20.

In short, the current security system in China is still in its very preliminary stage. It will take long time before the establishment of a western type of security system.

**(iii) Production and Distribution of Raw Materials**

Traditionally, the production and distribution of raw materials has been subject to direct central control<sup>92</sup>. An enterprise which is involved in the production and distribution of raw materials is subject to multi-level government administration. Raw materials are classified as three categories; the first category is called "unified distribution materials (tongpei wuzi)" which refers to those of the vital importance of the national economy, such as coal, steel, timber, etc.<sup>93</sup> This type of material is subject to the mandatory planning of the State Planning Commission. The second category is called "ministerial-managed materials" (buguan wuzi) which are more specialized, such as drilling equipment for petroleum industry<sup>94</sup>. This type of materials is subject to the control of relevant Ministries. The third category is the materials not contained in the first and second categories. They are usually locally

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<sup>92</sup> See section 5, *the Regulations on the Management of Raw Materials*, in Chinese Economic Law Text edited by Fei Zongwei and Xu Jie, at 252, (1990).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

produced and distributed and subject to planning and control of the provincial Planning Commission<sup>95</sup>.

This multilateral control system gives enterprises little freedom to make their own decisions. Despite the reform, the basic structure of the management system on materials still remains the same<sup>96</sup>.

Moreover, the prices of most raw materials have been subject to mandatory planning<sup>97</sup>. the enterprises cannot set the price for their own products according to market demand, since government has heavily subsidized the production of raw materials, the price structure has been quite irrational<sup>98</sup>.

The situation has not been changed much since the reform. On the contrary, the government created more centralized control in the production and distribution of raw materials. In its notice to the relevant industries of

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<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> The prices of raw materials and other important production means within the quota limit are still fixed by the government. *see Zhao Ziyang, the Current Economic Status and the Economic Structure Reform-A Government Report at the Third Plenary Session of the Sixth National People's Congress, March 27, 1985, reprinted in Selection of the Important Document Since the Twelfth Congress of the Central Committee of the Chinese Communist Party, vol.2, at 700, (1986).*

<sup>98</sup> *See D Gale Johnson, Progress of Economic Reform in the P.R.C., at 21, (1982).*

the country, the State Council stressed that all requirements concerning the raw materials subject to the "mandatory plan" must be strictly fulfilled<sup>99</sup>. According to this notice, the free flowed price applies to only a few raw materials, and those prices must be set by the State Price Committee, State Materials Administration Committee and the relevant Ministries according to the general supply level of the materials<sup>100</sup>. Therefore, an open market for production of materials has not been established yet.

**(d) The Capitalist Economy Is Not the Goal of the Economic Reform.**

What is the goal of the economic reform? Is it intended to be moving towards entirely free market economy which is like those of most GATT member countries? Some may argue that the reform will eventually lead towards free market economy. However, many indications from the Chinese government suggests that they are not willing to go that far. On a number of public occasions, government officials have stated that the public ownership system is going to be retained and that the central planning will apply in the

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<sup>99</sup> See the State Council Approval of the Notice on Strengthening the Management of the Unified Distributed Materials Issued by the State Economic Commission, the State Planning Commission and the State Materials Administration Bureau, September 9, 1986, reprinted in the Law Year Book of China, at 399-400, (1987).

<sup>100</sup> The Law Year Book of China, *supra* note 99, at 340.

macro economy<sup>101</sup>. Even in its GATT application, the Chinese government did not declare that all market distortions have been abolished nor did they promised not to use central planning. Instead, it described the goal of reform as "a planned commodity economy"<sup>102</sup> which mean that the government control is maintained through the usage of "economic levels" such as prices, taxes and the interest rates<sup>103</sup>. The government also frequently use the expression "establish the socialist economy with the Chinese characteristics"<sup>104</sup>.

### Summary

In summary of the domestic economic reforms, one can not ignore the significant changes have been brought in: in the agriculture field, the economic structure has been substantially decentralized; in the urban area, the industrial enterprises have become more independent

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<sup>101</sup> When the government encourages development of different types of ownership, the "public ownership" (gongyouzhi) still takes dominant position. see the "Decision of Economic Reform", *supra* note 22, at 568.

<sup>102</sup> you jihua de shangpin jingji, *supra* note 22, at 568.

<sup>103</sup> *Id.*

<sup>104</sup> Deng Xiao Ping, *Establishing the Socialism with Chinese Characteristics* (part of the speech at the meeting with the Japanese Delegation of Japan-China Unofficial Delegates on June 30, 1984), reprinted in Selection of the Important Documents Since the Twelfth Congress of the Central Committee of the Chinese Communist Party, compiled by the Documentary Research Office of the Central Committee of the Chinese Communist Party, vol.2, at 515, (1986).

commodity producer; the pricing reform has resulted in the free flow of many products; and the reform of the planning system has caused a substantial reduction of the "mandatory plan". However, the reform is not far-reaching enough to convert the domestic economic structure from a highly centralized regime to a free market system. There still remains extensive areas where further decentralization is required for China to benefit from an efficient trade sector. Further decentralization is also necessary for China's GATT entry.

## Chapter 4

### Reform of Chinese Foreign Trade System

#### I. Achievements through the Reform

The foreign trade reform is crucial to China's GATT application. This is especially clear when we review the foreign trade practice before 1978. Since 1949, when the Communist Party took power, China's economic development strategy was essentially "self-reliance", and trading with foreign countries played a supplemental function. Foreign trade was conducted through a highly centralized bureaucracy---Ministry of Foreign Economic Relations and Trade (MOFERT)<sup>1</sup>. Its function was surprisingly broad, including the formulation of import and export plans, formulating foreign trade policy, determining tariff levels, issuing import and export licenses, etc.<sup>2</sup>. There were twelve Foreign Trading Corporation (FTC) under the MOFERT's control<sup>3</sup>. Each FTC had monopoly powers within its specified scope of business, and they would procure all goods from

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<sup>1</sup> China's foreign trade apparatus is headed by MOFERT, which was established in 1982 as an amalgamation of two former ministries and two commissions: the Ministry of Foreign Trade, the Ministry of Foreign Economic Relations, the Foreign Investment Commissions and the State Import-Export Commission. For detailed discussion, see Jamie P. Horsley, *The Regulation of China's Foreign Trade*, in Foreign Trade, Investment and the Law of P.R.C., at 9, (1988).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*, at 10.

the domestic market for export purposes and sell all required imports at the domestic price<sup>4</sup>. Enterprises other than FTC were prohibited to engage in foreign trade.

Since 1979, the centralized system has changed rapidly, The FTC have lost their monopoly powers due to the emergence of many new local and ministerial foreign trading corporations and individual enterprises with the foreign trading authority to compete with FTC. The government's new foreign trade policy allows local governments and some industrial enterprises to conduct foreign trade directly<sup>5</sup>. Since 1982, nearly 1,000 enterprises had been given authority to conduct foreign trade<sup>6</sup>. In addition, a system of "foreign exchange retention" has been established<sup>7</sup>. It allows the foreign trading company to retain the above quota profit, which is a significantly progressive step from the former system under which the enterprises had to submit all the profit to the State<sup>8</sup>.

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<sup>4</sup> Each FTC handles a separate category of commodities or services, such as chemicals, textiles, arts and crafts, etc. The FTCs have local branches in various cities that are supervised by the local authorities. *see* Christopher Howe, China's Economy-A Basic Guide, at 142, (1978).

<sup>5</sup> Horsley, *supra* note 1, at 10-11.

<sup>6</sup> The director of MOFERT 's Foreign Trade Administration Bureau, Shen Jueren estimates that, as of the end of 1982, about 1,000 enterprises had authority to engage in foreign trade. *World Economic Herald*, Dec.13, 1982, at 1-2.

<sup>7</sup> China University of Politics and Law, An Overview and Prospect of the Economic Reform of Our Country, at 165, (1987).

<sup>8</sup> In the past, each FTC, like other State-owned industrial enterprises had to submit all its profit to the MOFERT. *Id.*

However, it would be premature to say that China's foreign trade system has been changed to the extent that market supply and demand plays a dominant role, and tariffs alone are serve as the vehicle of foreign trade control. The current foreign trade policy of Chinese government and its trade practice suggests that the central control of import and export still exists. MOFERT still plays significant role in import and export planning<sup>9</sup>. FTC has not been replaced by the newly emerged foreign trading corporation<sup>10</sup>. The way the FTC operate still impede trade efficiency. Their monopoly deprives the trading system of the competition that efficiency requires.

Moreover, MOFERT's import and export plan still covers wide range of products. From 1978 to 1986, the number of products governed by the export plan dropped from 3000 to 120; however, in value terms, that component still governs about 50-60% of all exports<sup>11</sup>. An import command plan still governs 7 key raw materials which account for 40% by value of all import, and a guidance plan governs a further 30%<sup>12</sup>.

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<sup>9</sup> MOFERT continues to prepare an annual import plan distributing to the major industrial enterprises which set out the import products required.

<sup>10</sup> FTC continue to be responsible for handling foreign trade on behalf of entities not authorized to trade directly and with respect to commodities beyond the scope of authorized trading scope of various entities and for the export and import of major and staple commodities. Speech by Jia Shi, a Vice-Minister of MOFERT, China Handbook, at 539, (1982).

<sup>11</sup> The World Bank, External Trade and Capital, at 20, (1988).

<sup>12</sup> *Id.*

The following will review unfair trade practices in the import and export areas and examine their incompatibility with the GATT principle.

## **II. Current Import Barriers Maintained by Chinese Government**

Previous import barriers have not been abolished by reform. The existence of these barriers is incompatible with the GATT principles. The most important barriers are import licensing system, foreign exchange control, import substitution, import pricing, customs tariffs, import inspection.

### **(1) Import Licensing System**

China's import licensing system was established in 1984 when the *Interim Regulation on Licensing Import Commodity of P.R.C.* was promulgated<sup>13</sup>. Under this system, only certain types of enterprises are qualified to import certain products<sup>14</sup>. Namely, both the enterprises seeking the required license and the products it wishes to import must meet the requirements of the import licensing regulations<sup>15</sup>.

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<sup>13</sup> China's first import licensing regulation came out in 1957. *see Almanac of China's foreign Trade Economic Relations and Trade*, at 69, (1987).

<sup>14</sup> Only State-owned enterprises with required licenses can import certain products. *See* Articles 3-4, *Interim Regulation on Licensing System for Import Commodities of P.R.C.*, *supra* note 13, at 69.

<sup>15</sup> For instance, China National Cereal and Oil Import and Export Company is able to get an import license for its products, whereas other companies in the same area are not eligible to be issued the license.

Generally speaking, production enterprises are separate from the foreign trade companies. They are not allowed to import their products directly from the international market. They have to import their products by submitting their request to FTC which will negotiate and conduct the import on their behalf<sup>16</sup>. The effect of the license requirement for the enterprises is that the import will be excluded if there is no entry authorized to deal with in the particular commodity. Therefore, no matter how good the Chinese enterprise is, it can still be excluded from the market by the import licensing system.

Another important aspect of China's import licensing system is that it restricts the types and the amount of the import products. The import licensing regulation of 1984 provides that 28 products were under import licensing control<sup>17</sup>. Moreover, the number of items tends to be growing. As of January 2, 1987, there were 42 items subject to the import licensing system, the import value of which account for one-third of the total value of China's imports<sup>18</sup>. The most recent list of goods which need

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<sup>16</sup> Horsley, *Supra* note 1 at 10-11.

<sup>17</sup> *List of Controlled Imports Permitted by the P.R.C. Appendix. Detailed Rules for Implementation of the Interim Regulations on Licensing System for Import Commodities of the P.R.C.*, May, 1984.

<sup>18</sup> *People's Republic of China, China's Status as a Contracting Party: Memorandum on China's Foreign Trade Regime*, GATT Document, No. L/6125, at 34, Feb.18, 1987

import licenses has been increased to 53 items<sup>19</sup>. It has been reported that China intends to make all imports go through the import licensing procedure<sup>20</sup>. Apart from the ordinary import license, special licenses were required for some goods, especially consumer goods such as vehicles, household appliances, electronics, etc.<sup>21</sup>. Recently, officials for China Ministry of Foreign Trade and Economic Relations have reiterated that China would strictly control the import of luxury consumer goods from 1989<sup>22</sup>. This makes it very hard for a foreign exporter to sell their products in China's market.

During the process of implementing the import licensing system, the local foreign trade agency may have discretion to impose more restrictions. For instance, they may arbitrarily increase the number of import controlled products even though in theory the central government is supposed to supervise the implementation<sup>23</sup>. Therefore, in practice, the restricting effect of the import licensing

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<sup>19</sup> *Items of Commodities Under Import Licensing System Partly Restored*, International Business, February 19, 1988.

<sup>20</sup> John Kamm, *Import Controls in China - Protectionism with Chinese Characteristics*, The China Business Review, at 43, (January-February 1987).

<sup>21</sup> China Economic News, at 2, October 11, 1982.

<sup>22</sup> Vice-Minister of the Ministry of Finance, Wang Bing Qian said that local import administration should be strengthened and foreign exchange should be used to import urgently needed raw materials and important technology, and luxury consumer goods, such as vehicles and appliances, should be strictly controlled, International Business, October 25, 1988.

<sup>23</sup> See Kamm, *supra* note 20, at 44.

system is exaggerated by the local government. This growing tendency of protectionism by using the import licensing system is also reflected in the recent rules of punishment for the violation of import and export licensing<sup>24</sup>. The rule imposes stringent penalties for the violation of import licensing regulation. It lists more than ten situations under which the import licensing system may not be complied with and provides more specific punishment than those of import licensing regulation. For instance, in the case of forgery of an import license, a fine of at least 70% of the value of the goods will be imposed as well as confiscation of the goods<sup>25</sup>. The stated reason behind the new punishment rules is that the violation of the regulations have increased<sup>26</sup>. However, this is one of the measures taken by Chinese government to restrict imports of foreign products in order to protect domestic industry.

In terms of international trade, while tariffs are the most essential import restraint, there are a variety of other ways by which a country can restrain imports<sup>27</sup>. Most of these other ways are termed as "non-tariff barriers

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<sup>24</sup> In February 1989, China implemented *Punishment Rules for Violation of Import and Export Licensing*. See *Custom Strengthens Import and Export Commodity Licensing System and Imposing New Penalties on Violation*, People's Daily February 10, 1989.

<sup>25</sup> *Penalty Rules Concerning Import and Export Commodity Licensing Administration System*, People's Daily, February 13, 1989.

<sup>26</sup> *Id.*

<sup>27</sup> See Jackson, *supra* note 2, Introduction of the thesis at 365.

(NTB)"<sup>28</sup>. One most prominent non-tariff barrier is the quota" or "quantitative restriction"<sup>29</sup>. The quota is a specified amount or quantity of a particular good which a country will allow to be imported<sup>30</sup>. China's import licensing system has the same effect of quantitative restriction because it could restrict and limit the amount and types of import products by issuing licenses to the foreign trade companies only for certain products.

International trade policy has generally favored tariffs over all other types of import restraints<sup>31</sup>. It is believed that tariffs are more visible and easy to monitor<sup>32</sup>. Tariff reduction is also easier to negotiate<sup>33</sup>. However, quotas are thought to entail the risk of government corruption in the licensing process<sup>34</sup>. They also tend to conceal from the public the degree and cost of the protection being afforded to domestic producers<sup>35</sup>.

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28 *Id.*, at 366.

29 *Id.*

30 *Id.*

31 GATT is basically designed to prefer tariffs. Many of the provisions of GATT are designed to prevent the use of non-tariff barriers for protective reasons, but tariffs are permitted by GATT. *see* Jackson, *supra* note 2, Introduction of the thesis, at 367.

32 Tariffs do not need license to administrate, do not require government funds to support, and give a specific amount of protection. *Id.*, at 366.

33 *Id.*

34 *Id.*

35 *Id.*

Based on these considerations, the GATT prohibits quantitative restriction except in certain circumstances<sup>36</sup>. Thus, many aspects of China's import licensing system are not compatible with GATT principles. This presents a big obstacle for China's admission to the GATT.

## (2) Foreign Exchange Control

China maintains a policy of centralized control of foreign exchange by the government<sup>37</sup>. The Bank of China is the specialized bank in China's financial structure responsible for foreign exchange matters. No other institutions are permitted to engage in foreign exchange business without first getting the approval of the State Administration for Exchange Control (SAEC)<sup>38</sup>. Under this system, the central government allocates foreign exchange to a foreign trade company, usually a FTC. The allocation of foreign exchange can severely limit the volume of imports purchased by the FTC. There are a number of types of foreign exchange allocations, each of which is subject to control regulations or methods. For instance, under central foreign exchange allocation, there is the so-called condition, "using imports to promote exports", namely, foreign

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<sup>36</sup> See GATT Articles XI-XIV, *supra* note 27, Chapter 2 of the thesis.

<sup>37</sup> Article III. *Provisional Regulation on Foreign Exchange Control*, East Asia Executive Reports, at 21, (February 15, 1981).

<sup>38</sup> *Id.*

exchange is only used to import raw materials for processing into export goods<sup>39</sup>.

Although this allocation system is gradually being replaced by a system in which enterprises can borrow foreign exchange from the bank and pay interest on the funds<sup>40</sup>, it still has the effect of an import control since the bank assesses the economies of the proposed import transaction before granting the loan<sup>41</sup>. On the other hand, the Chinese government imposes a variety of internal regulations and targets on enterprises for them to get foreign exchange. Foreigners have no access to those internal regulations and targets. Thus, it is very hard for them to know whether their Chinese business partners have enough foreign exchange to buy their products. The difficulty of identifying qualified business partners has also created a barrier for foreigners to penetrate the Chinese market.

The manipulation of exchange rates also creates restriction on foreign trading. At present, China maintain a floating exchange rate system under which the exchanged rate is based on development in the balance of payments and movements in costs and exchange rate of China's major

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<sup>39</sup> See Kamm, *supra* note 20, at 45.

<sup>40</sup> *Id.*

<sup>41</sup> Banks are much more willing to grant a loan for foreign exchange if it will promote exports. In some locals as much as 70% of foreign exchange spent on imports goes for items that will, in turn help china increase exports. see Kamm, *supra* note 20, at 45.

trading partners. However, this has only limited impact on the trading decisions. Foreign trade are still largely determined by authority of administrative planning<sup>42</sup>.

### (3) Import Commodity Inspection

Import commodity inspection is another effective way to restrict imports. Since the 1950s, China has established a series of import commodity inspections administrative bureaucracies headed by the State Administration for the Inspection of Import and Export Commodity<sup>43</sup> and has promulgated a set of regulations and rules for import commodity inspection<sup>44</sup>. The Chinese government stated that the administrative system of import commodity inspection is designed to ensure the quality and quantity of the imported products and protect Chinese purchasers from substandard foreign goods<sup>45</sup>. Nevertheless, many aspects of China's current practice on import commodity inspection has been considered a "non-tariff barrier" for foreign imports. For instance, the *Interim Procedures For*

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<sup>42</sup> World Bank: China's External Economy and Capital, (1988).

<sup>43</sup> Guiding Book on Trading with the P.R.C. at 133, (1989).

<sup>44</sup> The rules and regulations are: *Regulations on the Inspection of Import and Export Commodities of the P.R.C.* promulgated in January 1984; *Provisions for Supervision and Control over the Quality of Import Commodity* promulgated in 1988; *Interim Procedures for the Inspection and Control of Household Electrical Applications*, promulgated in 1985.

<sup>45</sup> According to Zhu Zhenyuan, Director of the State Administration of Import and Export Commodity Inspection, substandard imports has become a chronic problem for China. 10.3% of import goods were found substandard in 1987. See *Commodity Inspection - 40 Years' Experience*, People's Daily, February 27, 1989.

*The Inspection And Control of Household Electrical Appliances* which was promulgated in 1985<sup>46</sup> requires minute inspection of every appliance in every imported shipment<sup>47</sup>. This type of inspection has been regarded as a time-honored Japanese means of restricting a foreign exporter's market access to the importing country<sup>48</sup>.

The recent provisions on import commodity inspection<sup>49</sup> also reflect this tendency of import restrictions. First, the provisions provide a long process of inspection involving many departments and units to conduct inspection. This is a quite time-consuming and complicated procedure. For instance, not only the State Administration of Import and Export Commodity Inspection and its branch offices at the local level conduct the import commodity inspection, all the agencies and units involved in the import transaction, such as, the transportation unit, the storage unit, the consignee and user unit are also required to inspect the commodity<sup>50</sup>. For certain important commodities, the provision requires preliminary inspection

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<sup>46</sup> See Communique of State Council, at 23, October 1985.

<sup>47</sup> Kenneth T.K. Wong, *Taking Aim and Substantial Imports The New Import Quality Control Measures*, East Asia Executive Reports, at 10.

<sup>48</sup> *Id.*

<sup>49</sup> See *Provisions for Supervision and Control over the Quality of Import Commodities*, China Data Base Economics and Foreign Trade, October 28, November 30, 1987.

<sup>50</sup> Article 17-19, *supra* note 49.

in the exporting countries<sup>51</sup>. This preliminary inspection procedure can also be time-consuming and delay the entry of the commodity into China. Moreover, "certain important commodities" are not defined in the provision<sup>52</sup>. This could give rise to administrative manipulation. Second, the provision contains rules for penalties and rewards<sup>53</sup>. The reward system provides that the Ministry in charge is to recommend and reward the outstanding achievements of units and individuals in their inspection responsibilities<sup>54</sup>. This reward system may stimulate the inspection units to be over-enthusiastic in inspection of import commodities and in pursuing a claim for damages<sup>55</sup>. In practice, the rewarding system has been adapted effectively. It is reported that Hu Bei, Shandong, Shanxi and Liaoning provinces have adopted bonus systems: 1% of the value of any claim for defective import goods goes to the units or individuals who contribute to the discovery of defects<sup>56</sup>.

#### (4) Import Substitution

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51 Article 8, *id.*

52 *Supra* note 47, at 9.

53 Article 25, *supra* note 49.

54 *Id.*

55 *Supra* note 49, at 10.

56 *What to Expect from New Import Inspection Rules*, 20 *Business China*, at 154, (1984).

Although it has already abandoned the dogma of "self reliance" to conduct trade with foreign countries, China still protects and relies heavily on domestic industry. Most of its imports focus on products which are in short supply or can not be produced by domestic industry<sup>57</sup>. If the products can be made by domestic producers and the quality is the same as similar products abroad, the imports of the like products will be substituted by domestic ones<sup>58</sup>. Chinese leaders have supported this method and regarded it as significant national policy for import control<sup>59</sup>. As a result of the policy, imports of many kinds of products have been decreased rapidly. For example, since Chinese domestically produced T.V. has improved, China has curbed the import of foreign made color televisions. The amount of imported color televisions was reduced to 100,000 sets in 1987 from 2,000,000 sets in 1985<sup>60</sup>. Meanwhile, domestic production of televisions climbed to 5,000,000 sets from

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<sup>57</sup> See Horsely, *supra* note 1, at 17.

<sup>58</sup> In practice, the criteria governing the quality of domestic-made products is quite subjective since they are determined by the Chinese government. As a matter of fact, the quality of domestic-made products do not reach the level of foreign products, they are still subject to import substitution.

<sup>59</sup> China's former Premier Zhao Zi Yang and former Political Bureau member Hu Qili said, "We will not import the product we can produce by ourselves", when they visited the exhibition of domestic-made cars on October 10, 1988 in Beijing. *See Domestic Made Cars Is in Silent Growth*, People's Daily, December 5, 1988.

<sup>60</sup> *Homemade Household Appliance Have Amounted for 45% in Our Domestic Market*, Economic Daily, Dec. 7, 1987.

4,000,000<sup>61</sup>. A similar situation has occurred in the import of cars and other products<sup>62</sup>.

The implementation of the import substitute measure is supplemented by administrative manipulation. The Ministries in charge of the relevant industry are responsible for recommending and publishing the list of substitute products. For example, the Committee of Machinery and Equipment publishes a list of 50 import substitute products ranging from generators to the machines for production of instant noodles<sup>63</sup>. Moreover, the list of substitutes is increased from time to time<sup>64</sup>. As to the criteria used to determine whether domestic products can replace imported goods, discretion is given to the relevant ministries according to their investigation and evaluation<sup>65</sup>. This also gives rise to administrative manipulation again.

Since 1986, a particular type of import substitution has been implemented. This is so-called "inviting bids domestically", which is particularly applied in the field

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61 *Id.*

62 It is reported that China was speeding up the production of cars so that by 1990, it will produce 700,000 s and will not import cars anymore, *supra* note 59.

63 *The Commission of Machinery & Equipment First Recommends 50 Kinds of Import Substitute Products*, Economic Daily, August 4, 1987.

64 *Id.*

65 *Id.*

of electrical and machinery equipment<sup>66</sup> Under this system, before importing electric and machinery equipment, the Chinese importers must invite bids publicly in its own domestic markets. If domestic producers can make the same or a similar quality product, the importers must buy the domestic one instead of the import<sup>67</sup>. In order to implement this system, China Bidding Center for Electric and Machinery Equipment has been set up and eight specialized companies in this field have been established in eight major cities<sup>68</sup>. This measure has been effective in discouraging imports of electronic and machinery products. The success rate of domestic bids amounts to 80%<sup>69</sup>.

#### (5) Import Pricing

Import pricing has the most direct influence on the market access of foreign products since the level of price will directly determine the quantity of the imported products. In free market economy, the price of imported products is directly link to the price of the like products which are domestically made. Therefore, if the price of imported products is low, the products will be competitive in the importing country and the quantity of the imports

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<sup>66</sup> *The Measure of Inviting Bids First on Electric and Machinery Equipment in Domestic Market Is Good*, People's Daily, Sep 18, 1987.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

will subsequently increase. In NME country, since the government impose various administrative measures on import pricing, the price of import products does not reflect its real cost. This makes the foreign products less competitive in the domestic market of the imported country.

China's import pricing system is of a typical NME type. Administrative measures play a more significant role than market supply and demand. For example, under the present "import agency pricing system"<sup>70</sup>, the government can manipulate any components of the system<sup>71</sup>. The official *Renminbi* to United States dollars exchange rate is set unilaterally by the People's Bank<sup>72</sup> and it has devalued many times<sup>73</sup>. This devaluation factor can simply change the equation of import pricing under the agency system and increase the domestic price of the imported products.

The most abused part of China's import pricing system is "Ministry Mark-Up" which means that if the import price is not high enough to protect the domestic industry, the concerned industry may determine to impose a price mark up

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<sup>70</sup> It is called "jinkou jiage daili zhidu" which is the primary method used by Chinese government to calculate the price for import goods. See *Memorandum*, *supra* note 18, at 34.

<sup>71</sup> Under the system, the domestic price of imported goods is the CIF price multiplied by the official exchange rate and customs duty plus industrial commercial tax plus import regulatory tax plus foreign trade commission plus banking plus insurance plus other charges. Obviously, the government can manipulate any parts of the equation. *Id.*

<sup>72</sup> People's Bank is the Central Bank in China.

<sup>73</sup> Thomas Chan, *RENMINBI Devaluation on the Cards*, China Trade Report, August 1987.

on the goods<sup>74</sup>. For example, the Ministry of Chemical Industry and the Ministry of Foreign Economic Relations and Trade issued a "joint notice" on the pricing of imported chemicals<sup>75</sup>. The notice states that if the imported chemical whose *Renminbi* prices, after all agency mark up are still below the prices of domestic ones, a price mark up would be granted on the application by the domestic producer to the Ministry<sup>76</sup>. This price mark up has the effect of raising the domestic price and making the imported goods less competitive in China's market. Moreover, the practice of price mark up has been legitimized by relevant regulations<sup>77</sup>.

China's pricing system for domestic made goods also undermines the competitiveness of imported goods. Generally speaking, the prices of domestic goods are fixed by the government<sup>78</sup> and do not reflect the real value of the goods<sup>79</sup>. The price of many goods might be much lower than their real value. Thus, the irrationality of the domestic

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<sup>74</sup> See Kamm, *supra* note 20, at 48.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> An import regulation on import commodity pricing was promulgated in 1980. However, it is considered as an internal document, and was never published. See Kamm, *supra* note 20, at 49.

<sup>78</sup> The government agency which are responsible for fixing the price of domestic goods are mainly the National Price Administration Bureau and National Industrial and Commercial Administration Bureau. *Id.*

<sup>79</sup> *Id.*

price may prevent imported goods from competing with domestic ones.

### III. China's Current Unfairly Trade Export Practices

This section will review the unfairly traded export practice in China. It will be followed by the discussion on the relevant provisions of GATT, particularly the Anti-Dumping rules and Countervailing duty obligation and their weakness. Finally, it will explore the application of selective safeguard measures and quantitative restrictions. GATT prohibits unfairly traded export among the member countries. For instance, Article XVII requires a state trading enterprise must act "in a manner consistent with the general principle of non-discriminatory treatment"<sup>80</sup>, and make trade decisions "solely in accordance with commercial considerations"<sup>81</sup>. Moreover, Article VI of GATT specifically prohibited export subsidy by government and authorizes imposition of a Countervailing duty offset the advantage created under the subsidy<sup>82</sup>.

The Chinese government has repeatedly asserted that as a result of the economic reform, its foreign trade enterprises have been operated according to the market

<sup>80</sup> GATT Article XVII,1, *supra* note 27, Introduction of the thesis.

<sup>81</sup> GATT Article XVII paragraph 1(b) defines "commercial considerations" as price, quality, availability, marketability, transportation and other conditions of purchase and sale. *Id.*

<sup>82</sup> GATT Article VI, *id*

supply and demand<sup>83</sup>. However, as discussed in Chapter 3, this goal has been only achieved to a certain extent. Further decentralization is required, particularly in the export area. The government interference in the area is not even reduced, but increased. In order to make urgent needed foreign currency, the government has attached great significance to the export trade. A variety of export promotion measures have been implemented by the government.

In 1984, China started an ambitious export promotion scheme. The State Council worked out a series of strategies for export promotion, such as developing coastal areas to boost an "out-looking" economy<sup>84</sup>, promoting exports in the machinery and electrical industry<sup>85</sup>, supporting export production bases and networks<sup>86</sup>, etc. Both central and local governments invest huge amounts of funds to realize these strategies. For example, Guangdong Province invested \$150,000,000 (U.S.) to establish its export production<sup>87</sup> network in 1987. The Chinese government issued a number of rules and regulations to encourage exports. In 1985, MOFERT

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<sup>83</sup> See Memorandum, supra note 18.

<sup>84</sup> The coast areas have better industrial bases and transportation facilities, and have better trained workers.

<sup>85</sup> *Creating the New Situation for the Export of Machinery and Electrical Products*, The World Economic Herald, August 1, 1988.

<sup>86</sup> Rural enterprises has big potential for export because of their cheap labour resource. *Rural Enterprises Has Big Potential for Export*, The World Economic Herald, December 28, 1987.

<sup>87</sup> *Reform Let Export Energy Come Out*, Economic Daily, August 25, 1987.

issued *Detailed Rules Concerning Rewarding Export Performance*<sup>88</sup>, which is an important document in this field. In 1986, the State Council issued No. 17 and No. 18 documents on measures of export promotion<sup>89</sup>.

If China obtains GATT membership, the other member countries will be obliged to open their markets to Chinese exports at an increased volume according to the MFN clause. As discussed in Chapter 2, at present, China enjoys MFN treatment through bilateral trade agreement. The MFN treatment under the multilateral framework---GATT would provide it with more stable benefits than those of the bilateral agreements. China's export would benefit from the low tariff schedules previously negotiated among the member countries in the earlier GATT rounds. A more persuasive incentive for China to seek GATT membership is the opportunity to use the multilateral trade regime's obligations to eliminate non-tariff barriers on its exports in the other member countries. Most developed countries still maintain protectionist barrier against Chinese exports. For example, Chinese textile exports, one of the most significant export source, are subject to quantitative restriction in almost every developed country<sup>90</sup>.

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<sup>88</sup> This rule is mentioned in *Intertrade* (at 36, April 1986). It was never officially published.

<sup>89</sup> *Id.*

<sup>90</sup> Meade, *Textile Import Quotas and United States-China Trade Relations, The Danger of Protectionism*, 10 *Brooklyn Journal of International Law.*, at 465, (1984).

Eliminating the barriers and increase its exports to the member countries has become one of the important incentives for China to join GATT.

The GATT member countries are not be willing to open their market to China because they fear that the unfairly traded exports from China would distort their domestic markets. As previously noted, the price system in NME country does not reflect the market supply and demand. Even with the substantive reform, the price of many products in China is still subject to the State control<sup>91</sup>. The price of export products has been set lower than the real cost so that the products are more competitive in the foreign market. In addition, China's massive cheap labour force exacerbate the fear<sup>92</sup>.

At present, Chinese exports has not presented a substantial threat of displacing foreign producers. The GATT member countries are more concerned with its great export potentials. The existing GATT provisions providing remedy to the unfairly traded exports. However, they were proved to be difficult to apply to exports from NME countries. GATT member countries would most likely demand additional restrictions in this regard.

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<sup>91</sup> For detailed discussion, see Part III of this Chapter of the thesis.

<sup>92</sup> China's labour force is estimated to be 460 million, see *China's Economic Development Strategies and There Effect on U.S. Trade, Investigation No.332-168*, USITC. Publication, at 107, 1645, February 1985.

GATT prohibits government subsidies to export production. It has specific provisions to deal with the problem, such as Article VI---Antidumping Rules and Article XVI---Countervailing Duty Rule<sup>93</sup>. Most importantly, there is a Countervailing Duty Code which is phrased to interpret Article VI and Article XVI<sup>94</sup>. The Code provides an illustration<sup>95</sup> which defines what an export subsidy is. The main subsidies in the list are:

- (a) direct subsidies: direct aid to a firm based on export performance. This is the most obvious situation for subsidies;
- (b) currency retention practice which involves a bonus on exports;
- (c) favorable transport charges to aid exports;
- (d) delivery by the government involved for products of imports that will ultimately be exported, when the delivery of those imports is on favorable terms: cheaper, easier, etc.;

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<sup>93</sup> For detailed discussion, see Part III of the Chapter.

<sup>94</sup> The *Countervailing Duty Code* was reached in 1979 during the Tokyo Round. The code is phrased to interpret Article VI and Article XVI of the GATT. It goes further than Article XVI in the sense that it expressly prohibits export subsidies on non-primary products although there are some exceptions. See Article 9, the Countervailing Duty Code *reprinted in* Jackson, Havey, Documents Supplement to legal Problems of International Economic Relations, at 95, (1987).

<sup>95</sup> *Id.*, at 95-97.

- (e) exemptions or remissions of direct taxes<sup>96</sup> payable by the enterprises;
- (f) advantage in the calculation of the base by which direct taxes are charged;
- (g) exemption or remission of indirect taxes in excess of those levied on products sold domestically;
- (h) special export credit guarantees, special loan rates given below market terms.

This list is significant because it illustrates specific criteria allowing the importing country to recognize the subsidies involved in the exporting country's practice. However, it is not a comprehensive list and it is not intended to list every prohibited export subsidy<sup>97</sup>. Therefore, we cannot say if a country's conduct does not fit expressly in the list, it will not be liable for its act.

Many tools used by Chinese government to promote exports constitute export subsidies which fall into the categories of the *Subsidy Code*. The following will review China's current practice in this area.

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<sup>96</sup> The term "direct tax" means taxes on wages, profits, interest, rents, royalties, and all other forms of income and the taxes on the ownership of real property. *see supra* note 94, at 96.

<sup>97</sup> Other practices inconsistent with the spirit of the Code can also be export subsidies, *Id.* at 97.

### (1) Direct Price Supports

In April of 1985, MOFERT announced that any State-owned foreign trade company can apply for direct price support for exported products if there is an overall profit on exports that would be obtained by the enterprise<sup>98</sup>. Thus, direct subsidies are given to exporting enterprises. Within this category, if the exporting enterprise does not have a profit, price support can still be obtained if the exported products are labour intensive or consume little energy<sup>99</sup>. Also, traditional export commodities that are perceived as having growth potential can obtain price support<sup>100</sup>.

### (2) Foreign Exchange Retention

The current Chinese foreign trade system allows exporting enterprises to obtain a portion of foreign exchange if the enterprise makes profits on its exports<sup>101</sup>. This is an important measure in the reform of foreign trade. But it falls into the category (b) of the subsidy list. The amount of foreign exchange obtained by a particular exporting enterprise becomes more directly connected with

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<sup>98</sup> Karl Herbst, *Export Incentive and the GATT PRC Practice* (Remarks delivered to the American Chamber of Commerce in Hong Kong), at 7, September 10, 1986.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> Zhang Sontao, *The Problem of Our Country's Foreign Trade Reform*, 5 International Trade Issues, at 20, (1989).

its export performance. If foreign trade enterprises export more, they will have more foreign exchange retention. The amount of retention varies in different areas. For example, Shanghai gives 50% of retained foreign exchange to the exporting enterprise, Guangzhou has said it is giving 60% to those enterprises producing above quota<sup>102</sup>.

### (3) Direct Rewards

Under GATT terms, this is called a bounty or grant. Enterprises are directly rewarded for meeting or exceeding their foreign exchange quotas<sup>103</sup>. For example, HongHu county in Hu Bei Province announced that they granted \$2,080,000 (U.S.) as rewards to their enterprises. The method they used was to grant Chinese Yuan 0.04 to the enterprise if it made \$1 (U.S.) profit, within the foreign exchange quota. Chinese Yuan 0.20 was granted if the enterprise made \$1 (U.S.) profit beyond the quota<sup>104</sup>. Another way of rewarding foreign trade enterprises is to set up a special fund to reward the enterprises that have made a significant performance in exports, like Shanghai's<sup>105</sup>.

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102     *Supra* note 98, at 8.

103     *Id.*

104     *How We Develop the Export Production of Rural Enterprises*, 4 International Trade Issue, at 40, (1987).

105     *Supra* note 98, at 8.

#### (4) Tax Rebates or Exemption

Item (e) on the subsidy list of the GATT *Subsidy Code* provides that exemption or remission of direct tax payable to the exporting enterprise constitutes an export subsidy. This is what China has been doing. Shanghai has announced a reduction or exemption of the adjustment tax on enterprises that are primarily exporting<sup>106</sup>. Recently, Shan Xi province said that it would encourage development of new export products by giving a reduction or exemption of income tax within three years to the enterprise which develops new export products, based on the amount of excess foreign exchange they make<sup>107</sup>. In addition, some industries, for instance, the enterprises product electrical and machinery products are allowed to retain part of their depreciation funds<sup>108</sup>.

#### (5) Preferential Loan

This is also prohibited by item (h) of the Subsidy List of the *Subsidy Code*. Granting special loans or export credit guarantees to exporting enterprises is common in China. For example, in Zhejiang Province, special loans in both United

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<sup>106</sup> *Id.*

<sup>107</sup> *Developing the Advantage of Natural Resources to Promote Foreign Trade*, 4 *Intertrade*, at 24, (1989).

<sup>108</sup> *Expanding the Export of Machinery and Electrical Products, Strengthen the Foreign Trade of our Country*, 8 *Intertrade*, at 47, (1988).

States dollars and Chinese Yuan are granted to the rural exporting enterprises by the branches of the Bank of China, China Bank of Agriculture and China Bank of Industry and Commerce<sup>109</sup>. In May 1987, the Bank of China granted loans of \$700 million (U.S.) at preferential rates to the exporting enterprises in the coastal areas<sup>110</sup>. The head of the Bank said the policy of granting the loan is that whoever exports, whoever will be supported by the loans<sup>111</sup>.

#### **(6) Preferential Access to Raw Materials and Other Facilities**

This measure is also widely used by both central and provincial governments to encourage exports. Jiling Province announced in April 1989, that the provincial government would give priority to 22 major exporting enterprises in the province in supplying electricity, raw materials and arranging of transportation<sup>112</sup>. Also, the prices of some raw materials, which are in short supply, such as beef, beans, lumber, etc., will be fixed to a ceiling price in order to guarantee that exporting

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<sup>109</sup> *The Prospect of Developing Rural Exporting Enterprises is Promising*, 4 *Intertrade*, at 38, (1988).

<sup>110</sup> *Economic Daily*, May 31, 1988.

<sup>111</sup> *Id.*

<sup>112</sup> *Jiling Province Take Measures to Promote Export, International Business*, April 4, 1989.

enterprises can buy them more efficiently<sup>113</sup>. Many other provinces have the same or similar measures<sup>114</sup>.

#### (7) Worker Rebates

Workers rebate is among the most unusual export promotion measures. It is viewed as a part of breaking the "big rice bowl" system<sup>115</sup>. But it violates GATT rules and is regarded as a subsidy. There are two kinds of worker rebates: one is tied to the export performance of the enterprise. If the enterprise makes a good profit on its exports, the workers of the enterprises will be able to get certain amounts of wage rebates<sup>116</sup>. The other one is for individuals who make exceptional contributions to exports. For example, a foreign trade enterprise in Beijing announced that it "would award Yuan 10,000 to a designer who designs a new fashion cloth which will be ordered by foreign buyers at above 100,000 items"<sup>117</sup>. The designer's salary in this factory is on average Yuan 260<sup>118</sup>, so the award will be

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<sup>113</sup> *Id.*

<sup>114</sup> *Jiangsu Province Works Out Measures to Encourage Export*, International Business, September 22, 1988. *Qing Dao Take Initiatives to Implement Export Plans*, International Business, February 2 1988. *Guang Zhou Adopt Four Measures to Export*, International Business, July 26, 1988.

<sup>115</sup> Prior to the reform, Chinese workers got the same pay more or less, no matter how hard they worked and what quantity of their work was. This is the so-called "iron rice bowl" system.

<sup>116</sup> *Beijing Fulfills the Task of Foreign Trade Last Year*, International Business, February 2, 1989.

<sup>117</sup> *Shunhua Textile Factory Encourage Developing New Products*, International Business, September 22, 1988.

<sup>118</sup> *Id.*

about 375 times of designer's salary, which is a huge wage rebate.

The seven kinds of export subsidies discussed above are typically unfairly traded export promotion measures. There are many other forms of subsidies as well, such as indirect subsidies by providing artificially low priced imports and raw materials, etc. Even these subsidies do not fall into the categories of the list provided in the *Subsidy Code*, they might still constitute subsidies because the list is not comprehensive. Therefore, all these subsidies would be subject to countervailing duty actions by the member countries.

### **III. Rules Against the Unfairly Traded Export Practises**

#### **(1) Anti-dumping And Countervailing Duty Rules Under GATT---An Unsatisfactory Solution**

GATT has several provisions dealing with unfairly traded exports<sup>119</sup>. The so-called anti-dumping and countervailing duty provisions are among the most important one that are designed to offset the influence of unfairly traded exports.

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<sup>119</sup> These provisions are: Article VI, Article XVI, Article XVII, and Article XIX.

Article VI sets out the mechanism of anti-dumping and countervailing duties. It provides:

"dumping by which products of one country are introduced into the commerce of another country at less than the normal value of the products is to be condemned if it causes or threatens material injury to an established industry in the territory of a member country"<sup>120</sup>.

An anti-dumping duty will be imposed on the export country to offset the advantage gained by its dumping conduct. The amount of the duty will be less than the margin of the dumping of the product<sup>121</sup>. Normally, it is the difference between the "normal values" and the "dumping price".

With respect to countervailing duties, Article VI provides that when one Contracting Party grants a bounty or subsidy directly or indirectly upon the manufacture, production or export of any product, and the export of the product is such as to cause or threaten material injury to an established industry of the importing country. A countervailing duty will be levied on the product<sup>122</sup>. The amount of countervailing duty will not be in excess of the estimated bounty or subsidy<sup>123</sup>.

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<sup>120</sup> GATT Article VI, *supra* note 27, Introduction of the Thesis.

<sup>121</sup> GATT Article VI(2), *id.*

<sup>122</sup> GATT Article VI.3, *id.*

<sup>123</sup> GATT Article VI.3, *id.*

Article XVI specifically deals with the subsidy issue. Three clauses are particularly important in this article. Article XVI, paragraph 1 requires Contracting Parties maintaining production subsidies to report this to other Contracting Parties. Paragraph 3 admits that a subsidy may have harmful effects on the market of the importing country. Paragraph 4 seeks to eliminate export subsidies in non-primary products<sup>124</sup>. This clause tries to get a commitment to phase out export subsidies in non-primary products dealing particularly with those subsidies that allow a product to be exported at prices lower than the domestic level.

The application of anti-dumping and countervailing duty rules to NME countries have presented some difficulties. This is mainly reflected in two aspects: determination of the "normal value" and the finding of a "subsidy".

**(a) Determination of "Normal Value"**

The anti-dumping rule which is contained in Article VI provides that dumping occurs when the price of the exported goods is below the "normal value"<sup>125</sup>. What constitutes a normal value? GATT provides several alternatives.

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<sup>124</sup> GATT Article XVI.4, *id.*

<sup>125</sup> GATT Article VI, paragraph 1, *id.*

The first one is the price of like products in the domestic market of the export country<sup>126</sup>. This created problems in applying to the NME countries. As previously discussed, in NME countries, the domestic price of products do not usually reflect the real cost of the production. It is decided to a large extent by political reason, instead of by market forces. For example, the price of grain in China's domestic markets is very low because the government subsidizes it heavily to keep balance between the rural and urban areas<sup>127</sup>. This happens to other products, such as coal, oil, gas, etc.<sup>128</sup>. If choosing the domestic price as the "normal value", the result of the comparison will be that no dumping exists since the price of the like products of export country would be higher than those of the importing country. Thus, in theory, the method of determining the normal value by looking at the domestic price in the export country is not reliable.

In practise, the method is also criticized and has proved unsuccessful<sup>129</sup>. In the United States, the weakness

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<sup>126</sup> Article VI, paragraph 1, *id.*

<sup>127</sup> *A Notice on Increasing the Amount of Fertilizer for the Production of Grain, issued by the State Council on Dec. 11, 1988, reprinted in Adjusting Economic Environment, Reorganizing the Economic Orders, Developing the Reform, at 127-128, (1989).*

<sup>128</sup> See D. Gale Johnson, Progress of Economic Reform in the People's Republic of China, at 21, 1982.

<sup>129</sup> The main problem of the application of the method is that many NME countries are reluctant to allow other countries to scrutinize their internal economic data and policy. See Eliza R. Patterson, *Improving GATT Rules for Nonmarket Economies*, 20 *Journal of World Trade Law*, at 196, (1986).

of the method was first recognized in the case of Bilks from Czechoslovakia, which is the first NME dumping case which resulted in the determination of less than "normal value"<sup>130</sup>. In the *Jalousie-Louvre-Sized Sheet Glass* from Czechoslovakia case<sup>131</sup>, the United States Treasury Department refused to use the Czechoslovakian domestic price<sup>132</sup>. Later on, in the case *Portland Cement* from Poland<sup>133</sup>, the Treasury Department concluded that Poland domestic price was not qualified in sales "in the ordinary course of trade", as required by the Anti-dumping Act of 1921<sup>134</sup>.

The second alternative of determination of "normal value" which is provided in GATT Article VI is that comparing the export price in an exporting country with the export price of the like products to any third country<sup>135</sup>. This approach also suffers from the unreliability of the NME countries' export price. The reason is obvious because NME countries may also dump their products to the third country and, thus, the export price in the third country is below

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<sup>130</sup> 25 Fed. Reg. 5, 657 (1960).

<sup>131</sup> Gary Horlick, Shomnon Shuman, *NME Trade and U.S. Anti-dumping/Countervailing Duty Laws*, 18 International Lawyer, at 808, (1984).

<sup>132</sup> *Id.*

<sup>133</sup> 27 Fed. Reg. 8,457 (1962).

<sup>134</sup> 28 Fed. Reg. 6,660 (1963).

<sup>135</sup> GATT, Article VI, 1(b)(i).

the "normal value". The United States Commerce Department recently has rejected this approach in the case involving *Romanian Carbon Steel Plate* in 1982<sup>136</sup>.

Due to unsatisfactory application of the approaches on determination of normal value under GATT Article VI, a new method called "surrogate country" approach was created. Under this approach, the price of like products of a third country is chosen as a substitute for the comparison. The third country must be at a comparable level of economic development with the exporting country<sup>137</sup>. For example, the United States has been using the surrogate country method to determine the "fair value"<sup>138</sup> in dumping cases involving NME countries<sup>139</sup>. In the case *Natural Menthol* which involves menthol dumping from China, the Department of Commerce selected Paraguay as a surrogate country for the purpose of deciding the comparison price<sup>140</sup>, since the Department of Commerce considered that Paraguay overall economic level is closer to China's<sup>141</sup>.

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<sup>136</sup> 47 Fed. Reg. 35,666 (1982) 48 Fed. Reg. 317 (1983), Horlicki and Shuman, *supra* note 131, at 819.

<sup>137</sup> *Id.*, at 814.

<sup>138</sup> The "fair value" in the U.S. law is equivalent to "normal value" in the GATT.

<sup>139</sup> *Supra* note 131, at 821.

<sup>140</sup> William P. Alford, *When is China Paraguay? An Examination of the Application of the Anti-dumping and Countervailing Duty Laws of the People's Republic of China and Non-Market Economy Country*, Southern California Law Review, at 79, (1987).

<sup>141</sup> 46 Fed. Reg. 3258, 3260, 1981.

The "surrogate country" method suffered from a number of weakness. First, there are no specific rules about choosing the "surrogate country". Even it is said that the economic level of the surrogate country should be at the "comparable level" with the exporting country, it failed to define "comparable level". The U.S. law is a good example. The United States regulations use per capita gross national product and similarity of infrastructure development as criteria of "surrogate country" and export country to determine whether they have a "comparable level"<sup>142</sup>. However, the law and regulations do not provide how the gross national product is to be measured<sup>143</sup>. Instead, the figures collected by the World Bank has been used. But these figures are said to be not reliable for this comparison<sup>144</sup>.

Second, the "surrogate country" may not be willing to cooperate with the importing country in the investigation. Thus, it creates difficulty for an importing country to get reliable information. The reason for the reluctance of the "surrogate country" is that it regards its manufacturing and commercial data as highly confidential and, thus, it would not like to provide the information to foreign governments. This happened quite often when the

<sup>142</sup> 19 C.F.R. 3538(b) 1986, *supra* note 140, at 91.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

United States applied the "surrogate country" method in its anti-dumping cases to NME countries.

For example, in the 1982-83 case involving Chinese shop towels, the United States Department of Commerce sought surrogates for China by considering Pakistan, Malaysia, Hong Kong, the Dominion Republic and Columbia<sup>145</sup>. However, each of the countries refused to supply the information about their domestic production.

From the exporting country's point of view, the "surrogate country" method is not satisfactory. It has been opposed for the reason that it "presumes that non-market producers are never the most efficient producers of a product"<sup>146</sup>. Also, the exporting country cannot effectively predict what country will be chosen as a surrogate and it is unable for it to get its export price to avoid a charge of dumping<sup>147</sup>.

To date, there has been no effective method created to determine the problem of "normal value" under the GATT anti-dumping rule when it is applied to NME countries.

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<sup>145</sup> 48 Fed. Reg., 37,055 (1983).

<sup>146</sup> *Id.*

<sup>147</sup> Sullivan, *United States Trade Law Hinder the Development of U.S.-P.R.C. Trade*, 22 Columbia Journal of Transnational Law, at 135, (1987).

(b) The Determination of Countervailed Subsidies

The most difficult problem on application of countervailing duty rules to NME countries is the determination of Countervailed duty. It is recognized that a Countervailed subsidy cannot be found within a NME system because the entire economy in an NME is regulated through government intervention<sup>148</sup>. Thus, it is unlikely to single out any one of the many subsidies under the determination under the GATT Countervailing Duty rules.

In addition, in order to determine the existence of a Countervailed subsidy, there must be certain "market-based norm" or commercial standards against which to compare government interaction. For instance, the Countervailed duty will be identified if the government grants more benefits to the exporter than the same situation based on market forces. In NME countries, there are not such norms or standards. Due to these difficulties, many countries refuse to apply the countervailing duty rules to NME countries. Several U.S. cases illustrated this point.

In the case *Carbon Steel Wire Rod* from Czechoslovakia and *Carbon Steel Wire Rod* from Poland, the United States Commerce Department decided that no subsidy could be formed within an economy determined to be a NME<sup>149</sup>.

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148 *Id.*

149 49. Fed. Reg. 19,370; 49.Fed. Reg. 19,474.

The basic assumption of the Commerce Department's analysis was that subsidies are distortions to free market economy and that the concept doesn't make sense in NME<sup>150</sup>. Thus, the countervailing duty should not be applied to the NME case.

Summarizing the application of the GATT's anti-dumping and countervailing duty rule to exports from NME countries, difficulties remain. Even a variety of approaches have been suggested and employed, none of them could satisfy either the market economy or non-market economy countries.

## **(2) Other GATT Provisions on Unfairly Traded Exports**

Apart from anti-dumping and countervailing duty rules, there are some other GATT provisions dealing with the problem of unfairly traded exports. These may provide some remedies to the unfairly traded export from NME countries. On the other hand, they also suffer from some problems. These provisions are provided in Article XVI, State Trading<sup>151</sup> and Article XI, Safeguard Measures<sup>152</sup>.

Article XVII is a general provision about State trading enterprises. Although it does not specify the

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<sup>150</sup> *Supra* note 130, at 850.

<sup>151</sup> GATT Article XII, *supra* note 27, Introduction of the Thesis.

<sup>152</sup> GATT Article XI, *id.*

problem of unfairly traded exports, it lays down the basic principle for State trading enterprises, which is that they should make the trading decisions "solely in accordance with commercial considerations"<sup>153</sup>. Applying the principle to the issue of unfairly traded exports from the NMEs, this means that NME countries should regulate their export trade in response to market force instead of government control, i.e., reducing or eliminating export subsidy, setting the price of export goods in accordance with supply and demand force in the international market. Thus, the principle is important in the sense that it imposes the obligation on NME countries to act "solely in accordance with commercial consideration" even though it is not designed solely to deal with NME countries<sup>154</sup>. However, Article XVII has been criticized as too general and ambiguous<sup>155</sup>. This makes its application to NME countries difficult.

GATT Article XIX is a more detailed provision providing relief from injury for an import country caused by unfairly traded export. The Article provides that when the import from an exporting country is increased to such quantities that cause or threaten serious injury to a

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<sup>153</sup> GATT Article XVII, paragraph 1(b), *id.*

<sup>154</sup> State trading enterprises exist not only in NME countries but are also in a free market system.

<sup>155</sup> As to what constitute "according to commercial considerations", it is not clear whether the standard of "national treatment" should be applied. *see* Ivan Bernier, *State Trading and the GATT*, in M. M. Kostechi State Trading in the International Market, at 245, (1982) and the previous discussion in Chapter 2 of the thesis.

domestic industry, the importing country could withdraw tariff concessions or impose temporary import restrictions<sup>156</sup>.

However, this provision also suffers from several weakness. The most serious problem is that the provision is based on MFN treatment<sup>157</sup> which means that the safeguard measure will not be only imposed on the exporting country who cause the increased quantity of export and cause serious injury to the importing country's domestic industry, it also applies to all the countries which export the same products to the importing country. This would not likely be acceptable to the importing country because it will prevent the imports of the same product which is needed within its tolerable capacity. Also it will offend other exporting countries which export their products to the importing country in a legitimate quantity justified by the GATT rules. In addition, the test for injury is too strict to prove for the importing country since it requires that it was caused as the result of both "unforeseen" developments and of the effect of the obligations incurred by Contracting Parties under the GATT<sup>158</sup>.

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156 GATT Article XIX(1)(a), *supra* note 27, Introduction of the Thesis.

157 *Id.*

158 *Id.*

**(3) Selective Safeguard Measures and Quantitative Restrictions Effective Solutions to the Unfairly Traded Export Problem?**

Since the existing GATT provisions cannot provide adequate remedies for unfairly traded exports from China, GATT member countries may request additional "safeguard" measures. "Selective safeguard" and "quantitative restriction" may be suggested as solutions to remedy against the unfairly traded exports from China.

**(a) Selective Safeguard Measure**

The selective safeguard measure refers to the safeguard mechanism provided in the GATT Article XIX on a non-MFN basis. GATT member countries would most likely use it as a measure against unfairly traded exports from China. Namely, they would suspect their obligation in whole, or in part or to withdraw or modify their concessions only to the particular products exported from China instead of the same products from other countries when they find that increased quantities of the imports cause or threaten serious injury to a domestic industry. These restrictions can be maintained for such time as a member country deems necessary to prevent or remedy the alleged injury.

The economic rational of taking selective safeguard measures is that it can penalize the most efficient

producers<sup>159</sup>. From the importing countries' point of view, it has the advantage of avoiding the risk of massive retaliation or potential for widespread political antagonism engendered by global import restrictions<sup>160</sup>. This measure will help to alleviate the fears among the GATT member countries of China's huge labor-intensive industries and unfairly traded export practice.

This mechanism has been subject to a lot of criticism. Critics argue that the selectivity will not deal with the problem of international reallocation of resources<sup>161</sup>. Since it is directed against the "trouble maker" which is the most efficient competitor, it contradicts with the needs of optimal world allocation of resources and of the efficiency of the international trading system<sup>162</sup>. Also, the penalized country will sell its surplus on a third country's market which may cause a chain reaction<sup>163</sup>.

Selective safeguard measures have been employed to other NME countries when they join the GATT. The protocols of Poland, Rumania and Hungary contain the provisions that

<sup>159</sup> Victoria Curzon, *Price Surplus Capacity and What the Tokyo Round Failed to Settle*, 2 World Economy, at 305-312, (1979).

<sup>160</sup> Under MFN based safeguard measures, since the importing restriction has to be imposed on all the countries exporting the same products, all these exporting countries may retaliate against the import country. See M.C.E.J. Bronckers, Selective Safeguard Measures in Multilateral Trade Relations, at 69.

<sup>161</sup> Patrizio Merciai, *Safeguard Measures in GATT*, Journal of World Trade Law, at 51-52, (1981).

<sup>162</sup> *Id.*, at 52.

<sup>163</sup> *Id.*

allow Contracting Parties to take emergency action solely against that non-market economy country responsible for injurious imports<sup>164</sup>. The provision, however, have important disadvantages for these countries. As the only countries subject to this special safeguard clause, these countries may find it difficult to lift import restrictions to negotiate compensatory remedies for the reason that they have fewer means of retaliation than a group of countries hurt by withdrawal of concessions under Article XIX of GATT<sup>165</sup>. In addition, although the protocols of these countries allowed the member countries to gradually relax all the existing discriminatory restrictions, including selective safeguard measures against the acceding country, there were no clear target dates or objective guidelines provided in the protocols<sup>166</sup>.

Same problems would happen if selective safeguard measures apply to China. China would feel that its retaliation act would be less effective than working with a group of other countries.

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<sup>164</sup> All three protocols allowed GATT Contracting Parties to restrict trade if imports from that country "caused or threatened serious injury to domestic producers of like or directly competitive products". See *Protocol for the Accession of Poland to the General Agreement on Tariffs and Trade*, BISD, at 46, June 30, 1967; *Protocol for the Accession of Romanian to the General Agreement on Tariffs and Trade*, BISD, at 5-7, (October 15, 1971), (18th Supp. 1976); *Protocol for the Accession of Hungary to the General Agreement on Tariffs and Trade*, BISD, at 3-5, August 8, 1973, (20th Supp. 1974).

<sup>165</sup> Kostechi, *supra* note 9, Chapter 1 of the Thesis, at 107.

<sup>166</sup> *Id.*

### (b) Quantitative Restrictions

The GATT member countries may place direct limits on the quantity (or value) of the imports solely from China in case market disruption occurs. These quantitative restrictions are generally prohibited by GATT<sup>167</sup>. Also, GATT was opposed to imposing discriminatory quantitative restrictions<sup>168</sup>. In practice, however, these measures were maintained by some member countries, particularly by the EEC and Nordic countries against the products from NME countries. The accession protocols of Poland, Hungary and Romanian each contain a paragraph permitting the use of discriminatory quotas with certain limitations<sup>169</sup>. These provisions, however, are not successful.

Aside from the problem of vaguely worded provisions, disputes over interpretation arose because there is no target date for elimination of the quantitative restrictions. Poland has not been able to negotiate a final date for the so-called transition period at the end of which complete elimination of quotas is to be achieved<sup>170</sup>. The Romanians were able to negotiate a termination date for the

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<sup>167</sup> GATT Article XI, provides for the general prohibition of quantitative restrictions. There are, however, some exceptions such as allowing imposition of quota in case of safeguarding foreign exchange resource, etc.

<sup>168</sup> GATT Article XIII, *supra* note 27, Introduction of the Thesis.

<sup>169</sup> Kostechi, *supra* note 9, at 107, Chapter 1 of the Thesis.

<sup>170</sup> *Id.*

transition period, but only as an objective, and with the condition that, "for exceptional reasons", "a limited number" of restrictions could remain in force thereafter, subject to review by a working party.<sup>171</sup> But one can question whether there is any substantive value to this objective as it was only "the objective" not "the obligation" to eliminate the quotas by the final date. As to Hungary, no target date for the complete elimination is provided in the protocol, but notification and examination of any quota remaining after 1 January 1975 is required<sup>172</sup>. These "notifications" and "examinations" created controversial.

In addition, there is a problem of monitoring compliance (enforcement). Although the member countries are required to notify the GATT, and working parties are required to examine measures taken to achieve the elimination of quotas, NME countries complain that information on such measures is insufficient to permit meaningful monitoring<sup>173</sup>.

From the Chinese government's point of view, it would strongly oppose to the imposition of selective safeguard measures and quantitative restriction on its exports to the

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<sup>171</sup> *Protocol of Romanian's Accession to the GATT, BISD, supra note 164.*

<sup>172</sup> *Protocol of Accession for Hungary, BISD, supra note 164.*

<sup>173</sup> *Supra note 254, at 194.*

GATT member countries on the basis that it is discriminatory treatment and, thus, contrary to the GATT principles. The Chinese government views that the employment of selective measures and quantitative restrictions serves only to perpetuate discriminatory restrictions by major trading partners against imports from itself and other developing countries<sup>174</sup>.

The Chinese government also argues that the additional controls of its export are unnecessary because the economic reform has brought in rationalization of foreign trading system<sup>175</sup>. The price of export products reflects market supply and demand. Subsidies granted by the government have been reduced. If the assertion was true, the additional control would have been unnecessary. However, as previously discussed, the economic reform has not been carried out to the degree stated by the Chinese government. In the export area, the distortion of price of exported products still remain. Subsidies appear to be reduced as they are seldom referred to in the publications<sup>176</sup>. However, subsidies continue to exist in various hidden forms. Therefore, the argument of Chinese government is not convincing.

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<sup>174</sup> Li, *supra* note 1, Chapter 1 of the Thesis, at 36.

<sup>175</sup> Li, *id*, at 38.

<sup>176</sup> A variety of Chinese publications, especially the newspapers and trade magazines used to report the achievement of foreign trade industry. Government support such as subsidy, was in the content of the reports.

#### (4) Generalized System of Preference

China has argued that since it is a developing country, it should benefit under the Generalized System of Preference (GSP)<sup>177</sup>. Under the GSP, a developing country is allowed to enjoy special tariff concession granted by developed countries. The system is a derogation from the MFN principle of GATT. China currently enjoy GSP benefit for many of its export programs from most of the developed countries except the United States.

China's claim in GSP benefit seems logical from the historical point of view that China has been granted the benefit bilaterally from most developed countries. It also can be justified under the provisions of GATT. Part IV of GATT provides the basic principle of preferential treatment for a developing country. Article XXXVI explicitly stipulates that developed countries should provide "increased access in the longest possible measures"<sup>178</sup> to the products<sup>179</sup> from developing countries considering that the export earnings of developing countries depends on its essential imports<sup>180</sup>. Thus, China would argue that as a developing country, its export earnings play a vital role in

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<sup>177</sup> Li, *supra* note 1, Chapter 1 of the Thesis, at 30.

<sup>178</sup> GATT Article XXXVI, 4, 5, *supra* note 27, Introduction of the Thesis.

<sup>179</sup> The products includes primary processed and manufactured goods. *Id.*

<sup>180</sup> GATT, Article XXXVI, 1(b).

its economic development and it relies on essential imports from other countries, therefore, it is entitled to "increased access" under more favorable conditions to GATT member countries.

From practical point of view, China's claim on GSP may not be acceptable by the member countries. GATT member countries are reluctant to give China the absolute GSP benefit without the guarantee of further commitment on China's part. They are afraid of a flood of Chinese products into their market. The U.S. attitude towards China in the past was a typical example.

The U.S law formerly prohibited the extension of GSP tariff concessions to China's exports although there was a provision in the 1979 U.S.-China Trade Agreement expressly recognizing China as a developing country<sup>181</sup>. The 1984 Trade and Tariff Act contains a general prohibition against extending GSP treatment to communist countries<sup>182</sup>. The prohibition may be lifted at the President's discretion in cases of certain communist countries that are members of the I.M.F. and member countries to GATT<sup>183</sup>. However, GATT membership is only a prerequisite to the invocation of the

<sup>181</sup> *Agreement on Trade Relations Between the United States and China*, 31 U.S.A. 4651, Article II, paragraph 3 states: "The Contracting Parties note, and shall take into consideration in the handling of their bilateral relations, that, as its current state of economic development, China is a developing country".

<sup>182</sup> 19 U.S.C. 246(b)(1)(1982).

<sup>183</sup> *Id.*

discretionary criteria. The President must examine in determining a country's eligibility for GSP status. There are other requirements which are political in nature, such as the President must consider whether the country seeking eligibility is providing satisfactory protection to intangible intellectual property of foreign nationals; whether the country is properly recognizing international arbitration awards etc.<sup>184</sup>.

The U.S. attitude against granting GSP to China as part of China's GATT membership has been changed since October 1992 when U.S. signed the agreement (*the P.R.C.-U.S. Memorandum of Understanding Concerning Market Access*, hereafter refer to "MOU"). In MOU, the U.S. specifically states that it will support China's application to the GATT<sup>185</sup>. Thus, the prerequisite for granting GSP is met. However, the actual granting of the status will depends on the further negotiation between the two countries.

### **Summary**

China's unfairly foreign trade practices present significant threat to the GATT system. The existing GATT rules are inadequate to deal with NME. Also, in practice,

<sup>184</sup> 19 U.S.C. §2462(1)-(c).

<sup>185</sup> Article VIII of MOU provides: "The U.S. government will staunchly support China's achievement of contracting party status to the GATT and will work constructively with the Chinese Government and other GATT contracting parties to reach agreement on an acceptable "Protocol" and then China's rapid attainment of contracting party status."

the application of the rules to NME countries is far more from satisfactory. Given China's huge labour resources and its status of one of the world's largest central planned economy countries, it is impossible for GATT to grant China the membership within the existing GATT framework. Additional commitment has to be undertaken by China.

As to the additional commitment, the traditional methods, such as selective safeguard measures and quantitative restrictions, used by GATT to deal with the unfairly traded export from NMEs have many problems. Moreover, the Chinese government will feel being offended by accepting the additional commitment because of its discriminatory nature.

China's claim of GSP status is reasonable in the sense that it is a developing country. The previous resistance against the granting GSP to China, particularly from the U.S. has been lessened due to the recent agreement between the two countries (MOU).

The ultimate solution to the problem will depend on China's further economic reform. Although the reform of the past decade has resulted significant changes in the domestic economy and the foreign trade system, it is far more from sufficient to allay the fears of GATT member countries. Further decentralization in the export area is needed as well as in other aspects of the economy.

## Chapter 5

### China and GATT - A Possible Compromise

The previous discussion indicates that despite the substantial economic reform, neither China's foreign trade system nor its domestic economic structure has been changed to the degree of market orientation required by the GATT. This might lead to the conclusion that China's GATT application should be rejected.

From practical point of view, the conclusion is not acceptable to either China or GATT. Given the size of China's population and its potential impact on the world economy, China should not be excluded from GATT---one of the most important international trade organizations. As one commentator pointed out:

"with a country the size of China excluded, GATT can hardly claim to be global. The refusal of China's application would be close to an admission that GATT is not capable of dealing effectively with economies other than those of western industrial democracies."<sup>1</sup>

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<sup>1</sup> Paul D. McKenzie, *China's Application to the GATT: State Trading and the Problem of Market Access*, 24 J. of W. T. L., at 151, 1990.

Moreover, GATT membership does not only means rights and benefits to China, it also imposes on China a number of obligations. The most important obligation will be that China must continue reforming its economic system to conform to the GATT principles. Excluding China from GATT would discourage China's economic reform, and might push it back to the former centralized economy. Therefore, "the disruptive threat of the Chinese economy is greater outside the GATT than within it.... There is no better way to do that than to tie its economy into the liberal regulatory structure of the GATT."<sup>2</sup>

In short, despite the insufficiency of the Chinese economic reform and the uncertainty of its future direction, GATT member countries are still motivated to facilitate China's membership application. No doubt, this will require serious efforts from both GATT and China to facilitate the process. The following will discuss the possible compromises which might be reached between the both sides.

#### **I. The Possibility of Accession Solely on the Basis of Tariff Concessions**

As discussed in Chapter 2, reducing the tariff rate in China will not automatically result in increased imports

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*Id.*

from member countries. China, however, might point to Yugoslavia accession as precedent for its admission on the basis of tariff concessions alone. But, the situations in Yugoslavia is quite different from those in China. Yugoslavia implemented more significant economic reform prior to becoming a full GATT member.

In Yugoslavia, by the time of GATT accession, its economic structure and foreign trade system was extensively decentralized<sup>3</sup>. The Report of GATT Working Party on Accession of Yugoslavia illustrated the significant change as follows<sup>4</sup>:

(1) The enterprises were independent entities. They have independent authority to determine the output, quality, and prices of their products according to market supply and demand. They also have authority to decide on how profits and wages were to be distributed. This system also apply to the foreign trade enterprises. This makes foreign products competitive in the Yugoslavia domestic market.

(2) The government increasingly limited its intervention. The enterprises were not subject to

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<sup>3</sup> China Academy of Social Science Delegation Report on the Economic Inspection to Yugoslavia and Romanian, at 277.

<sup>4</sup> Basic Instrument and Selected Documents (BISD), at 52-53, (1966).

the control of both central and local government except the normal financial and health controls. The National Social Plan set out the main targets such as, gross national product rather than specific targets. The targets would be achieved through the market forces. Government control could be only exerted through credit, monetary and budgetary means.

- (3) The price reform had led to removal of the price s previously fixed by government for certain basic industries. Price control only remained in the field of daily necessity goods. Generally speaking, Prices are determined by the enterprises themselves.
- (4) The banking system had been reorganized and all banks reformed to become independent enterprises. The previous state-owned banks had become commercial or investment banks which channel the funds to the most productive line of investment. Enterprises reliance on public funds for investment and working capital had thus been greatly diminished.
- (5) Even though Yugoslavia still used import restrictions, they were "purely for the purpose of safeguarding the balance of payments and the monetary reserves and their administration is

fully in accordance with relevant provisions of the GATT."<sup>5</sup>

These reforms made GATT member countries feel that trade-distorting internal controls had been reduced to the extent that tariff reduction would create an open market in which foreign suppliers could compete effectively with local producers.. Therefore, Yugoslavia was allowed to accede to the GATT solely on the basis of tariff concessions.

Compared with Yugoslavia, China's domestic economic structure and foreign trading system have not reached a level of market responsiveness which will be able to provide sufficient market access to the member countries. Even after the ten year's of economic reform, neither its foreign trading system nor the other aspects of its economic system have necessary economic elements like those in Yugoslavia. As previously discussed, the government plan still maintains an important role in the national economy. The majority of goods are still produced under the central plan<sup>6</sup>. The prices of many products are still fixed by the state; enterprises do not have enough freedom to get supplies of raw materials,

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<sup>5</sup> Id.

<sup>6</sup> *Exploring the Planning System with Chinese Characteristics, Essays on China's Economic Reform*, at.17.

fix prices or choose buyers<sup>7</sup>. As to the foreign trading system, the central government, especially MOFERT still has strong powers to control the major foreign trading companies. FTC still carries out the major portion of imports and exports even after the emergence of many other trading companies<sup>8</sup>. Moreover, China maintains a number of quantitative control measures over imports<sup>9</sup>.

Since China's situation is different from Yugoslavia, GATT member countries would likely to object to any assertion by China that merely making tariff concessions will provide adequate access to China's market.

## II Import Commitment - A Possible Solution?

Another possible solution to the market access problem is the so-called "import commitment" which means China will undertake to import a specified amount of goods from the GATT Contracting Parties. Some NME countries, Poland and Romanian have used this mechanism to resolve the market access problem<sup>10</sup>.

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<sup>7</sup> It is reported that apart from the price of coal has been reformed, the prices for other raw materials still fixed by the government. See Xu Xing, The Implication of China's Economic Reform, at 248.

<sup>8</sup> Horsley, *supra* note 1, Chapter 4 of the Thesis, at 10.

<sup>9</sup> See the discussion on Import Licensing System in Chapter 4 of the Thesis.

<sup>10</sup> Poland undertook to increase its imports from GATT Contracting Parties by at least 7% each year. Romanian agreed to increase imports from GATT Contracting Parties at a rate not smaller than the growth in total Romanian imports provided for in its "5 year plans", *Protocol for the Accession of*

The advantage of import commitment is that it will ensure the import amount would be increased from the export country. Since it specifies a certain percentage of import increase. Also, it provides specific data which will be easy to verify. However, as previously noted, the mechanism suffers many material weakness. Both Poland and Roumanian experience on import commitment are far more from successful.

In the case of China, the same problem could happen if the import commitment mechanism is employed. Moreover, due to China's unique situation, new problems would likely come up. Firstly, the import commitment mechanism would not be compatible with China's current economic reform. Under the reform, many decentralization measures have been implemented, such as adoption of the "guidance plan", making the prices of many products free flouting, granting autonomy to industrial enterprises, decentralizing foreign trade system. However, the implementation of fixed import commitment would, to a large extent, rely on centralized control by the Chinese government. For instance, the government has to designate some foreign trade companies and industrial enterprises to buy the imported goods to fulfill the fixed import

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*Poland to the GATT, BISD at 46, (1967). Protocol for the Accession of Romanian to the GATT, BISD at 10, (1971).*

commitment. Due to the reform, more economic entities have been allowed to engage in foreign trade business<sup>11</sup>, and the government has exercised less control. Thus, if the foreign trade company or enterprises do not comply with the government designation, the government cannot force them to do so and therefore, it would difficult for them to fulfill the import commitment.

Secondly, the inflation factor would significantly undermine the effect of this type of import commitment mechanism if the commitment is based on current RENMINBI<sup>12</sup>. Although the same problem exists in other NME GATT member countries, like Poland and Romanian, China's situation is much more threatening. The Chinese inflation rate has been increasing very rapidly over the past several years<sup>13</sup>. If RENMINBI remain devalued at the current inflation rate, the import commitment would be meaningless.

Thirdly, the commitment could create serious economic and social problems in China. The import commitment would result in the importation of a substantial amount of products into China's market. Thus it would threaten China's domestic industries. Since the development of most domestic

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<sup>11</sup> Horsley, *supra* note 1, Chapter 4 of the Thesis, at 3.

<sup>12</sup> Renminbi, (RENMINBI) is current Chinese currency.

<sup>13</sup> Lu Fanzhi, China's Economic Reform and Adjustment, at 286, (1986).

industries in China is still far behind many developed GATT member countries, the Chinese government has always stressed the necessity of protecting infant domestic industries from the distortion of foreign producers<sup>14</sup>.

Because of these problems, the fixed import commitment mechanism may not be appropriate for China. From the GATT Contracting Parties' point of view, the mechanism may not be satisfactory for them either. Since the commitment fixes a maximum percentage of import, once the percentage is reached, the foreign exporter would not be allowed to export any more. Thus, it would not provide equivalent market access in return for giving GATT benefits to China.

Moreover, the import commitment mechanism does not restrict administrative measures on import restriction. On the contrary, it would encourage the Chinese government to decide what kind of products should be imported. the foreign exporter may find that their products have difficulty competing with Chinese domestic product. The substantial weakness with the import commitment scheme suggests that neither China nor the GATT member countries would be likely to accept an import commitment as a proper solution for China's GATT admission.

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<sup>14</sup> Li, *supra* note 5, Chapter 1 of the Thesis, at 38.

### III Other Alternatives

#### (1) Restriction on "Mark-Up"

It has been suggested that China could be required to restrict the mark-up it adds to the price of imports to prevent it from pricing imported products so high that they have no chance to compete with domestically-made products<sup>15</sup>. This approach may not work for China either. Even if the price of an imported product is kept low by restricting the mark-up, the central planning measures, such as the requirement to purchase domestic products or reduction of prices of domestic-made products, could still prevent Chinese consumers from purchasing the imported products. Moreover, the economic reform make it difficult for China to control the prices established by independent economic entities.

#### (2) Adoption of "Transparent Criteria"

Another alternative would be for China to adopt the "transparent criteria" which is provided in the GATT Government Procurement Code<sup>16</sup>. This would require China to publish the bid opportunities and explain the criteria by which purchasing decisions would be made<sup>17</sup>. This approach

<sup>15</sup> See Heinstein, China & GATT, *supra* note 24, Chapter 2 of the Thesis, at 390..

<sup>16</sup> See *Agreement on Government Procurement*, BISD, 26th Supp. at 33, (1980).

<sup>17</sup> Article V, *Id.*

might help to solve the problems caused by the arbitrary purchase decisions made by the Chinese government

However, the implementation of this approach present difficulties. It would be difficult for the Chinese government to publish its major decisions on imports. In the past, the decisions relating to import and export are "important national economic information"<sup>18</sup>, thus subject to the confidentiality requirements. The document containing the decisions is labelled as "internal document"<sup>19</sup> which means that public has no access to it. The government sensitivity to its foreign trade information has not been much changed even with the economic reform. This can be illustrated from the recently adopted the State Secret Law and its Implementing Procedure. According to the law, any information "damaging the political or economic interests of the State in its foreign-related activities" are subject to the scope of confidentiality.<sup>20</sup> This makes the adoption of the "transparent requirement" difficult.

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<sup>18</sup> In Chinese, it is called guojia zhongyao jingji qingbao. The reason for the government to include the information regarding foreign trade is that a lot of the foreign trade policies and practices are inconsistent with those of international trade, such as subsidy (for detailed discussion, see Chapter 4 of the thesis.). Therefore, public disclosure of these information will be against its interest.

<sup>19</sup> In Chinese, it is called nei bu wen jian.

<sup>20</sup> Article 4, iii, *P.R.C. Maintenance of State Secrets Law Implementing Procedures*, reprinted in 4 *China Law and Practice*, at 44, (1990).

A compromise which might be reached between GATT and China was suggested in the recent Sino-U.S. negotiation regarding market access issue<sup>21</sup>. In the memorandum of understanding (MOU) reached between the U.S. and China in October, 1992, China agree to publish all current laws, regulation and policies concerning its custom administration, import and export restrictions, etc.<sup>22</sup>. This information will be published in an official journal designated by Chinese government<sup>23</sup>.

It is interesting to note that this disclosure requirement does not extend to "the confidential information which would impede law enforcement or otherwise be contrary to the public interest or would prejudice the legitimate commercial interests of particular enterprises, public or private."<sup>24</sup> Obviously, the exemption of disclosure of the confidential information reflected the compromise made from the U.S. side. However, it suffers from ambiguity. For

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<sup>21</sup> *People's Republic of China-United States: Memorandum of Understanding Concerning Market Access (MOU)*, Signed at Washington, October 10, 1992, Cite as 31 I.L.M. 1274, (1992).

<sup>22</sup> Article I(1) MOU provides "The Chinese Government will publish on a regular and prompt basis all laws, regulations, rules, decrees, administrative guidance and policies pertaining to the classification or valuation of products for customs purposes, or to rates of duty, taxes or other charges, or to requirements, restrictions or prohibitions on imports or exports or the transfer of payments therefore, or affecting the sale, distribution, transportation, insurance, warehousing, inspection, exhibition, processing, mixing or other use of imports or exports. Such information will include the quantity or value to be imported of any products intended to be imported, and other relevant commercial information, such as projects which could involve imported products." *supra* note 21, at 1275.

<sup>23</sup> Article I(4) of MOU, *supra* note 21, at 1275.

<sup>24</sup> Article I(1) of MOU, *supra* note 21, at 1275.

instance, what constitutes "the legitimate commercial interests of particular enterprises"? This term is not defined in the MOU. The ambiguity of the term may allow Chinese government to argue that a lot of the information is within "the legitimate commercial interests of particular enterprises", thus exempt from disclosure.

Despite of the ambiguity, MOU reflects the serious efforts made by the U.S. and China to solve the transparency problem. This indicates that the transparency problem can be resolved between GATT and China through the similar type of agreement.

### **(3) The Milestone Approach**

The other possibility to solve the problem is the "milestone approach" suggested by Mr. Heinstein<sup>25</sup>. He suggested that China's accession to GATT should be realized in a series of steps---information gathering, establishment of milestones, tariff negotiations, experimental association, phase in of GATT benefit, and finally GATT membership<sup>26</sup>. This approach has several advantages. It addresses the concern of member countries that immediate full membership to China would cause unbalanced benefit. Also, it gives China time to further reform its economy. In

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<sup>25</sup> Heinstein, *supra* note 24, Chapter 2 of the Thesis, at 410-414.

<sup>26</sup> *Id.*, at 410-413.

the meanwhile, the member countries can monitor China's reform progress. However, this approach has been criticized as not appropriate for China<sup>27</sup>. McDonnell thinks that pace of China's economic reform is slow, thus it may take long time to achieve the first stage. He would rather adopt a "one but for all" policy to provide China with positive spur to change. His argument seems plausible given the way China's reform takes and the goal intended to achieve by the Chinese government.

**(4) Negotiated Accession - the 1992 U.S.-P.R.C.  
"MOU" Approach**

GATT article XXXIII provides that a country can accede to GATT "on terms to be agreed" between the country and the GATT 28 (referred to as "negotiated accession"). The advantages of this approach are : 1. flexibility: the terms of the agreement does not have to be set out exactly as those of GATT. Parties to the agreement can set out the terms which they think of importance to them. 2. bilaterally: the agreement can be reached upon between two parties, for example, China and U.S., rather than among multilateral parties.

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<sup>27</sup> McDonald, *China's Move to Join the GATT System, An Epic Transition*, 10 World Economy, at 346, (1987).

<sup>28</sup> GATT article XXXIII, *supra* note 27, Introduction of the Thesis.

This approach has been reflected in the MOU. In MOU, Chinese government agreed to undertake the following commitments:

1. eliminating all import restrictions quotas, licensing requirements on the products provided in the Annex of the MOU<sup>29</sup>;

2 assuring that it has abolished all import substitution regulations, policies and will not subject any products to any import substitution measures in the future<sup>30</sup>;

3. confirming that it will reduce tariffs that were raised since 1988 in certain areas<sup>31</sup>;

4. assuring that it will publish all current laws and regulations concerning custom administration and import restrictions in a designated official journal subject to the confidential requirement. China will maintain tribunals and procedures for review of administrative actions<sup>32</sup>.

In exchange for these commitments from Chinese government, the U.S. agrees to

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<sup>29</sup> Article II of MOU, *supra* note 21, at 1275.

<sup>30</sup> Article III of MOU, *id.*

<sup>31</sup> Article V of MOU, *id.*

<sup>32</sup> Article I of MOU, *id.*

1. considering liberalizing export control lists and procedures, and considering liberalized treatment of computer exports for civilian use<sup>33</sup>;
2. terminating the ongoing investigations of the market access barriers of China; and supporting China to become a GATT member<sup>34</sup>.

Although there are some ambiguity in the agreement and thus require further interpretation, the MOU reflects the serious efforts made by both China and U.S.. It proves that a compromise can be made between the GATT member countries and China as long as the both sides are taking practical approach to solve the problem.

### Summary

The issue of integrating China-a big NME country into the GATT system is a difficult one. Other GATT NME countries' experience may serve as precedent. But since China's situation is different, GATT would treat China as a special case. China's economic reform may provide a satisfactory solution to the issue if it is sufficient and far reaching. However, the frequently changed policy of the

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<sup>33</sup> Article VI of MOU, *id.*

<sup>34</sup> Article VII of MOU, *id.*

Chinese government and unstable speed of the reform make future directions the reform uncertain. Thus GATT is reluctant to admit China as a member under the current economic conditions. GATT requires China to take further economic reform and eliminate massive central control before it obtains the membership.

However, a new approach has been taken by the U.S. recently. The agreement between U.S. and China on the market access issue serves as an example that a compromise can be worked out under China's current economic condition. Thus, GATT does not need to wait for China to become a market economy country in order to grant it the membership. This requires both China and GATT to make serious commitments. Therefore, as long as the both sides are realistic and willing to make the compromise, the issue China's GATT membership should not be too difficult to resolve.

## Conclusion

NME countries' participation in the GATT system presents difficult problems, both in theory and in practise. As one of the largest NME country in the world, China's application to the GATT presents more challenges to the GATT system.

The experience of other NME countries' accession to the GATT might provide precedents for China to some extent. However, due to substantial weakness of the scheme, it may not be appropriate for China. Moreover, given China's huge trading potential and the status of the one of the largest NME countries, the GATT will demand China to pay more "admission fees" than those NME countries which have obtained the GATT membership.

During the past decade, China has been going through the economic reform which has brought in significant changes to its economic system. No doubt, the reform will have positive influence on China's GATT application. However, the reform is far from sufficient to meet the GATT requirement. As previously discussed, at present, the domestic economics structure still lacks the basic characteristics of those in the free market economy system. The foreign trade system has not been substantially decentralized. Moreover, the uncertainty of the future direction of the reform remains.

These factors will make the GATT reluctant to give China full and immediate membership.

However, practically speaking, GATT should not exclude China-a big trading partner in the world. Thus, a variety of accession methods have been proposed, including import commitment, gradual accession (milestone approach), and negotiated approach (the MOU approach). These methods all have pros and cons. The traditional import commitment will not be an attractive method due to its rigid requirement and difficulty of practical implementation. Gradual accession may be a good mechanism since it gives both GATT and China time to familiarize and adjust to each other. However, it may take long time before China obtains the membership. The MOU approach provides a practical solution. It allows China to be admitted to the GATT under the current economic condition. This accession is based on the commitments from the both U.S. and China. Therefore, as long as the both sides are willing to make commitments and make compromise, China's immediate accessions to the GATT is not impossible.

With respect to the procedure issue, although the political significance may not be ignored, it should not be overstated because the issue will, to a large extent, depend on the substantial issues.

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