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Research School of Pacific Studies ANU

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n.a.	**Not applicable**
..	**Not available**
-	**Zero**
.	**Insignificant**

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abstract

China's foreign trade system has been subject to a little over a decade of economic reform. The open door policy adopted by the Chinese government has resulted in increased efficiency in resource allocation and production of tradable goods and in exploiting the gains from trade. This has enabled China to become one of the largest of the world's trading nations.

This paper identifies three phases in reforms from 1979 to 1993 aimed to transform China from a centrally planned trade system to one more market-oriented. Four prominent reform measures are then outlined: decentralising foreign trade corporations; relaxing tradable commodity control; linking tradable commodity prices to the world market; and building a foreign exchange market.

China has not yet achieved a fully competitive foreign trade system. However, it is concluded that any exisiting problems result from the incomplete progress of the reforms and there is still scope for China to improve its trade position in the world economy.

Reforming a centrally planned foreign trade system: the Chinese experience

Fourteen years ago China was one of the world's most isolated economies with a 0.75 per cent share of world trade. Since then, China's foreign trade has grown at a dramatic rate of 12 per cent a year in nominal terms, more than twice as fast as growth in world trade. During this period, total trade has increased from US$21 billion in 1978 to around US$170 billion in 1992. Exports have increased five-fold in nominal terms comprising almost 80 per cent manufactures. China is now the eleventh largest trading nation in the world.

China's improved foreign trade position has been, to a great extent, a result of the economic reform and the open door policy adopted by the government since the late 1970s. The economic reform and the open door policy represent two fundamental policy shifts: transfer of resource allocation mechanisms from central planning to the open market and shift of development strategies from inward-looking to an outward-orientation. Foreign trade, being an interaction of the domestic and world economies, has played a key role in facilitating these transitions.

Prior to 1978, like other socialist countries, China's foreign trade system was characterised by state monopoly. All foreign trade transactions were conducted by a few national foreign trade corporations (FTCs) affiliated with the Ministry of Foreign Trade (MOFT). MOFT became the Ministry of Foreign Economic Relations and Trade (MOFERT) in 1982 after an amalgamation of the State Import and Export Commission, the State Foreign Investment Commission, MOFT and the Ministry of Foreign Economic Relations.

Each FTC was assigned the task of handling the export and import of a specific category of commodities. Provincial subsidiaries of these corporations purchased goods for export from domestic producers and delivered imports to end-users. Domestic sale prices of imports and purchasing prices of exports were fixed and separated from world markets so that the economy was closed.

Trade decisions were made through the central planning process. Import and export plans were incorporated into annual national plans which specified in detail the quantity and value of each commodity to be traded. Foreign exchange was also centrally controlled and allocated through plan channels.

Foreign trade corporations conducted foreign trade strictly according to planned quantities and prices. All profits resulting from trade were returned to

the central budget while losses were subsidised by the government. It was not the individual FTCs but the government that was responsible for the financial consequences of trade transactions. This trade system served to secure given quantities of imports and then ration them because demand far exceeded supply.

As trade decisions were made by a highly centralised bureaucracy on the basis of physical requirements set by central plans, potential gains from trade in terms of value-added were largely ignored. The apparent physical benefits from trade were achieved at high costs in the form of resource misallocation caused by trade specialisation that ran counter to comparative advantage. Hidden costs grew as trade had to be expanded to meet just the essential import demand. When China moved away from its self-reliance development strategy to adopt an open door policy in the late 1970s, the trade system was among the first areas to be reformed.

An examination of how China has reformed its centrally planned trade system is presented in this paper. It begins with a brief review of the goals and progress of the reform of China's foreign trade system since 1979. This is followed by a detailed account of the main reform measures adopted in the trade system. Finally, the impact of these reforms on domestic resource allocation is examined.

Foreign trade system reform

Goals of the reform

China's program of economic reform began in 1979 and has been implemented gradually and progressively. The goal of economic reform has been stated as development of a 'planned commodity economy' (Chinese Communist Party 1984:VII). This has often been interpreted to mean establishment of a market-oriented economy in which firms are guided by the market while the market itself is regulated by the state. This implies adoption of the market in place of the state as the principal mechanism of resource allocation and transforms the objectives of the state from direct planning to regulating economic activities through market forces. In 1992, the goal of reform was finally declared as being to establish a 'socialist market economy' in the Fourteenth Congress of the Chinese Communist Party (Jiang Zeming 1992).

The goals of the reforms were to minimise the role of central plans in determining foreign trade and enable enterprises to decide their export supplies and import demands on the basis of market signals. It was intended that participants in foreign trade would become financially independent.

Trade reform has been complicated because it has had to deal with internal and external markets. In the presence of serious distortions in domestic markets

resulting from prolonged isolation from world markets, decentralisation of the trade decision-making procedure alone is insufficient. The success of the trade reforms depends on the progress of economic reforms in other areas, such as price and taxation reforms, and the establishment of market mechanisms throughout the economy.

The economic reform of China's trade system has been in process for fourteen years and is far from complete. New reform measures are implemented constantly.

Progress of reforms since 1979

There has been three phases in the foreign trade reform program since 1979.

The first phase of reform, 1979–84. The foreign trade reform program began in 1979 with a series of policy measures designed to promote exports and boost foreign exchange earnings. Major measures introduced included

- decentralisation of the foreign trade administration enabling provincial and departmental authorities, as well as large export producing enterprises, to set up their own foreign trade corporations
- evaluation of domestic currency via the introduction of a higher internal settlement rate
- implementation of foreign exchange retention schemes for exporters
- establishment of special economic zones (SEZs)
- encouragement of foreign investment.

Central plans were significantly simplified and direct plan control over trade was gradually replaced by a number of other instruments, including guidance plans with profit-oriented targets replacing quantitative quotas, a licensing system, taxes and tariffs.

The second phase of reform, 1985–87. In September 1984, the State Council approved a MOFERT report on further reform of the foreign trade system. The new reform package re-emphasised the importance of separating government functions from FTCs' management, further simplified the central plan and reduced the number of commodities subject to central planning.

To tackle the problems associated with the remaining centralised financial system of foreign trade, an agent system was introduced. It was intended to transfer the functions of FTCs to independent agents operating on a commission basis and thus shift the financial responsibility for foreign trade transactions from FTCs to domestic producers of exports and users of imports.

The official exchange rate was devalued several times. The gap narrowed between the official rate and the average domestic currency costs of exporting. The dual-rate system was brought to an end in 1985 when the official rate was raised to a level equal to the internal settlement rate. A more dramatic development was the establishment of a secondary foreign exchange market in the special economic zones and a number of other major cities. For the first time foreign exchange flowed, at least in part, through non-centrally controlled channels.

This phase also included the institutionalisation of the reform measures adopted since 1979. Rigid central control over foreign trade was replaced by an array of indirect or regulatory instruments more easily adjusted to changing conditions in domestic and international markets.

The third phase of reform, 1988–93. In late 1987, the government announced an ambitious outward-oriented development strategy for the coastal areas which set the stage for a new round of trade reforms. The major change was the introduction of a foreign trade contract responsibility system in 1988 to guide the relationships between the central and provincial governments and between provincial governments and individual FTCs. The focus of the reforms shifted from decentralising the administrative and management structure of the foreign trade system, to improving the operational efficiency of FTCs and domestic producers in an attempt to make them financially independent.

Under the new arrangements, all subsidiaries of national FTCs under central government control were transferred to the jurisdiction of provincial governments. Each provincial authority and national FTC signed a three-year contract with the central government which covered three key State targets: foreign exchange earnings from exports, foreign exchange flowing to the central budget and the specified cost limits. The central government's assistance for exports and imports by FTCs was frozen by the contracts. Losses in excess of agreed levels were borne by provincial governments or the national FTCs, affiliated with MOFERT. Up to 80 per cent of foreign exchange earnings from above-quota exports could be retained. To enable FTCs to finance their exports, restrictions on the spending of retained foreign exchange were relaxed and the secondary foreign exchange market was further liberalised. Local authorities and FTCs were permitted to dispose freely of their retained foreign exchange to balance their export budgets.

Fixing financial assistance through contracts was a key step toward the abolition of trade subsidies which had burdened the central government since 1980. When the second round of foreign trade contracts were negotiated in 1991,

export subsidies were finally removed and a comprehensive tax rebate system was in place (Li Lanqing 1991). This completed an important transition in export promotion policy from direct financial assistance to a more conventional indirect form using tax incentives. The success of export reforms prompted the government to focus more on import reforms in 1992 and 1993.

Major reform measures between 1979 and 1993

The traditional foreign trade system in China was characterised by state monopoly or control. State control over foreign trade manifested in four major instruments: trading corporation control, tradable goods control, price control and foreign exchange control.

Decentralising foreign trade corporations

Prior to 1979, the Ministry of Foreign Trade had 15 affiliated national FTCs through which it controlled foreign trade. Each of the 15 national FTCs specialised in the trade of certain groups of commodities assigned to it by MOFT. Actual transactions were conducted by nationwide subsidiaries of these FTCs under the supervision of MOFT's local branches. Exports were purchased from domestic producers and imports were distributed to end-users. No other institutions were allowed to enter foreign trade activities.

The rigid control over FTCs was partially lifted in 1979 when the foreign trade administration structure began to be decentralised. Guangdong and Fujian were granted special privileges, among other things, to carry out their own foreign trade business. Other provincial governments, departmental authorities and large exporting enterprises were also allowed to establish their own trading companies to export non-centrally controlled products. Direct trading rights were granted to key export producers.

The administration of foreign trade was no longer monopolised by MOFT but shared by the central government and provincial authorities. MOFT affiliated national FTCs and other departmental FTCs were supported by the central government and financially related to the central budget. Provincial and local FTCs were either linked to provincial budgets or were financially independent. Provincial subsidiaries of MOFT's FTCs were partially under the local governments' jurisdiction and responsible for the fulfilment of provincial targets of exports. Since 1988, subsidiaries of MOFERT's FTCs have formally cut links with the central budget and have become a part of provincial foreign trade organisations. FTCs are now largely composed of two types: centralised FTCs including MOFERT's national and other departmental FTCs responsible only for

trade of a few commodities remaining under the control of the central government, and decentralised FTCs covering all provincial, local and export producing enterprises.

MOFERT itself has withdrawn from the business management of its affiliated FTCs and redefined its main functions as policy-making, coordinating and monitoring trade practices of FTCs through indirect economic and administrative means. Although decentralised FTCs were mainly under the local governments' jurisdiction, their establishment were subject to the approval of MOFERT. From 1988 provincial governments were authorised to establish their own FTCs without MOFERT approval.

Table 1 Number of foreign trade corporations, 1978–91[a]

1978	1984	1985	1986	1987	1988	1989	1991
170	600	800	1200	2000	5000	5300	4000

[a] Data unavailable for certain years.

Sources: Editorial Board of Almanac of China's Foreign Economic Relations and Trade, various issues. *Almanac of China's Foreign Economic Relations and Trade*, various issues, China Resources Trade Consultancy Co. Ltd. Hong Kong, 1987:45; 1992/93:39.

Decentralisation of the administration and management structure of trade led to a dramatic increase in the number of FTCs (Table 1). In 1978, there were about 170 FTCs nationwide belonging to 15 national FTCs. In 1987, the number was estimated at about 2000, among which 250 were established by enterprises (Editorial Board of Almanac of China's Foreign Economic Relations and Trade 1988). After the administrative authority of examining and approving the establishment of FTCs was partially transferred to the provincial level in 1988, nearly 2000 FTCs were approved across the country in a few months. The number of FTCs exploded to about 5300 in 1989. Some of them were not well qualified to undertake foreign trade. This led the State Council to call for a rationalisation of existing FTCs. After three years of rationalisation, in 1991 the number of FTCs was down to about 4000 among which 450 were export producers (Editorial Board of Almanac of China's Foreign Economic Relations and Trade 1992/93).

After the implementation of the foreign trade contract responsibility system in 1988, MOFERT virtually withdrew from export business. Provincial affiliates of

MOFERT-controlled national FTCs were all transferred to local government jurisdiction. By the end of the 1980s, MOFERT's monopoly over foreign trade was broken. Trade was largely shared by national and provincial FTCs. The former were composed of the original MOFERT's national FTCs and departmental FTCs established since 1979. Each of these was assigned the task of handling the staple trade of remaining planned commodities. The trade of other commodities was largely left to the provincial FTCs. In the early 1980s, provincial FTCs could only purchase local products for export. This restriction has since been lifted for most products and provincial FTCs can operate across provincial boundaries to purchase export commodities. Nationwide markets for these exportables have started to emerge.

In 1980, centralised national FTCs affiliated to MOFERT and other departments dominated about 98 per cent of total trade (Table 2). By 1991, 83.4 per cent of total trade was carried out by provincial FTCs. In particular, exports were almost exclusively handled by them.

Table 2 Shares of foreign trade of different types of foreign trade corporations, 1980 and 1991 (per cent)

FTCs	Total trade		Exports		Imports	
	1980	1991	1980	1991	1980	1991
MOFERT	96.4	10.6	96.6	1.5	96.2	20.8
Departmental	1.8	5.3	2.6	2.9	1.1	8.0
Provincial	1.4	83.4	0.4	95.2	2.3	70.1
Other	0.4	0.7	0.4	0.4	0.4	1.1

Source: Customs General Administration, 1981, 1992. *Annual Customs Statistics of the People's Republic of China (Zhonghua renmin gongheguo haiguan tongji nianbao)*, Beijing.

To coordinate import and export activities in such a decentralised environment, a number of 'chambers of commerce', as seen in Japan, South Korea and Taiwan, were established along industrial lines to consolidate provincial FTCs and enterprises with foreign trading rights, in their efforts to deal with the outside world. Six export chambers have been established since 1988. They are: minerals, metals and chemicals; light industrial, arts and crafts; agricultual products; textiles, garments and silk; machinery and electronics; and health care and medical products. These semi-governmental organisations are supervised by

MOFERT. It is compulsory for every exporter to join one such chamber and comply with its coordination in regard to prices, quantities and destinations of exports concerned.

Trade reform aimed to make FTCs financially independent, but this goal was unlikely to be achieved while domestic prices were heavily distorted and substantially different from the rest of the world. Since 1988, more serious attempts have been made to eliminate the subsidies inherent in the centralised financial arrangement of the trade system. Provincial FTCs, particular those importing goods for provincial uses, were among the first group of enterprises from which central government subsidies were removed. In recent years, as the trade system has been decentralised and market distortions reduced by reforms in price, taxation and enterprise regulation, the traditional financial links between FTCs and the government's budget have gradually diminished.

Since the introduction of the foreign trade contract responsibility system in 1988, the provincial subsidiaries of MOFERT's national FTCs have been financially separated from their national headquarters. They have been detached from the central budget and are now under provincial government control with the responsibility to fulfill provincial-contracted targets.

The contract responsibility system was intended to tackle the problem of export subsidies. As the first step, central government's export subsidies to FTCs were frozen at the 1987 level for a three year contract period from 1988 to 1990. This measure was successful in controlling the subsidies, but less successful in tightening FTCs' budgets because their financial losses were largely hidden in bad bank loans. By the beginning of 1991 when the contracts were to be renewed, the central government finally abolished export subsidies, devalued the domestic currency and provided domestic tax rebates for all exports. These measures marked the beginning of a new phase in China's trade reform.

Foreign trade corporations with central budget support now consist only of those national FTCs affiliated directly to MOFERT or other departments of the central government and assigned the task of managing staple imports of a few key commodities remaining under the control of central planning. Trade reforms in 1993 have focused on imports which will lead to a further scaling-down of import subsidies.

Relaxing tradable commodity control

In China's traditional trade system, exportable and importable commodities were grouped into ten broad categories. They were: cereal and vegetable oil; silk;

textiles; animal products; light industry products; arts and crafts; metals and minerals; chemicals; machinery; and engineering equipment. The business scope of national FTCs was limited by these categories so that each FTC exclusively handled one specific group of commodities. Commodities were traded strictly according to central plans which specified in detail quantities and values of goods purchased for exporting or importing. Export plans listed about 3500 commodities or groups (Chen Yiyun 1991) and import plans covered all imported goods.

When the administration of trade was partially transferred to provincial authorities in 1979, comprehensive central trade plans became inadequate. Guidance plans were introduced in addition to the traditional command plans. Guidance plans were not compulsory and mainly consisted of financial targets, such as profits and foreign exchange earnings. This planning was market-oriented in the sense that FTCs had a certain freedom in selecting commodities within their specified business scopes to maximise plan targets.

In 1985, the number of exportables under the command plan was sharply reduced to 101 categories of goods. All other exportables were covered by guidance plans, that is, they were only obliged to meet foreign exchange earning targets. MOFERT no longer formulated export purchase plans. The only remaining command plan target that had to be fulfilled by all FTCs was the total value of exports (State Council 1984b).

Similarly, the quantitative import plan was restricted to a few key imported commodities financed through the central budget and distributed through plan channels at uniform domestic prices. They included grain, chemical fertilizers, steel products, timber and complete plant equipment. Import plans for these products were only assigned to specialised national FTCs. For all other imports, the central government allocated foreign currency to end-users and allowed them to commission appropriate FTCs (State Council 1984b). In 1992, commodities imported under command plans accounted only for 20 per cent of the total value of imports (Tong Zhiguang 1992).

As the importance of central plans was diminishing and trade was more frequently carried out at lower levels of administration, it was increasingly difficult for the central government to monitor and control trade flows. A tradable goods classification scheme was used to facilitate the management of the decentralised foreign trade system.

This scheme was not entirely new. In the pre-reform period, exportables were divided into two categories labelled 'central' and 'local' commodities. The

centrally controlled goods were exclusively handled by national FTCs affiliated to various central government departments, including the Ministry of Foreign Trade. In 1982, it was replaced by a multi-tier export administration structure. Under this structure, exportables were classified into three categories and placed under the administration of different levels of authorities. Commodities in category I were staple exports or major foreign exchange earners. These were exclusively managed by the national FTCs affiliated with MOFERT and included crude petroleum, refined petrol products, rice, coal and cotton yarn. Commodities in category II fell into the business field of provincial FTCs, but required coordination by national FTCs because these goods either faced strong competition in foreign markets, such as fresh and live agricultural products exported to Hong Kong and Macao, or were subject to quotas from importing countries, such as textiles, clothing, footwear and steel products. In 1982, categories I and II accounted for 37 and 41 per cent of total exports respectively. Remaining commodities in category III were allowed to be exported by any FTC (State Council 1982).

The number of commodities in each category was frequently altered by MOFERT according to its assessment of the situation in internal and external markets. For instance, the number of commodities in category I increased from 23 in the early 1980s to 34 in 1983 when MOFERT attempted to regain control of foreign trade to mitigate the impact of internal competition and its tendency to depress export prices and so raise export losses. In 1984, when a new round of foreign trade reforms was announced, the number was reduced to 16 (State Council 1984b). In 1988, the number of category I commodities was 21 while that of category II was 91 (Chen Yiyun 1991). They were subject to command and guidance plans respectively. All other goods were open for exporting.

Similarly, a number of importable goods were singled out as essential to the economy and each of them was monopolised by a specific national FTC affiliated with MOFERT. The number of such goods dropped from 15 in the early 1980s to 7 in 1984. They were steel products, chemical fertilizers, natural rubber, timber, tobacco, synthetic fibres and grains (State Council 1984b). In 1988, tobacco was dropped and sugar and refined petrol products were added to the list of category I imports. This raised the total to nine. Category II imports were composed of eight commodity groups including wool, plywood, paper and some basic chemical materials (Chen Yiyun 1991). In 1989, cotton, pesticides, tobacco, plastic film and other materials for farm use were added to the list.

As central control of quantitative planning for tradable commodities was diminishing, a number of new measures were introduced to monitor the trading

activities of local government and departmental FTCs. This reflected a shift in trade control measures from direct plans to indirect levers such as import and export licensing and trade taxes.

Import and export licensing systems were introduced in 1980, at almost the same time as the administration of trade was decentralised (State Import and Export Commission 1980a). In 1984, the systems were formalised by state regulation (State Council 1984a).

Under the import licensing system, importable goods were divided into restricted and unrestricted goods. National and provincial FTCs were allowed to import unrestricted goods so long as those goods fell within their approved business boundaries. To import restricted goods, however, all FTCs needed to apply for licences. Unlike FTCs, unauthorised importers had to apply for licences to import virtually everything, no matter if the good was restricted or unrestricted.

The coverage of the import licensing system was comprehensive. Although import plans continued to play a role in controlling imports, it was the licensing system, not the import plan, that prohibited unauthorised imports. The licensing system was replacing import plans as the principal import control instrument.

Table 3 Number of restricted import categories, 1980–92

1980	1984	1985	1986	1987	1988	1989	1990	1991	1992
13	28	30	42	45	53	53	53	53	53

Sources:

1980: State Import and Export Commission 1980b. 'Notice on issuing "Interim Method of Import Administration in Foreign Trade" and "Interim Method of Local Import Administration in Foreign Trade"'(Yinfa 'duiwai maoyi jingko guanli shixing banfa','duiwai maoyi difan jingko guanli shixing banfa' de tongzhi), in Secretariat of the Central Committee (CCP), Research Office, Economic Division, 1985. *A Compilation of Documents on Open Door Policy* (*Duiwai kaifang zhengche wengjian huibian*), Party School Publishing House, Beijing:123–32.

1984–90/91: Editorial Board of the Almanac of China's Foreign Economic Relations and Trade (ACFERT), various issues. *Almanac of China's Foreign Economic Relations and Trade*, China Resources Trade Consultancy Co. Ltd. Hong Kong.

1991 and 1992: Tong Zhiguang, 1992. 'Chinese government wishes to restore its status as a GATT treaty member country' (Zhongguo zhengfu xiwang zhaori huifu guanmao zhongxieding diyueguo de hefa diwei), *Intertrade* (*Guoji maoyi*) 7:2.

Imports on the restricted list varied in accordance with policy priorities. The list also reflected the extent to which imports were controlled. From 1980 to 1992, the number of restricted importable goods increased from 13 to 53 (Table 3). Since 1983, responsibility for issuing licenses has been decentralised to two levels, MOFERT and its provincial levels, issuing import licenses for 17 and 36 restricted importable goods respectively. The 17 MOFERT licensed goods overlapped with planned imports and category I imports.

In addition to import licensing, the government also occasionally prohibited imports of certain commodities. For instance, in 1985 all second-hand garments and motor vehicles were prohibited from being imported .

The export licensing system was designed to serve three objectives: restriction of exports of scarce domestic resources, assurance of favourable prices for primary exports, especially to Hong Kong and Macao, and management of export quotas. Unlike import licensing, FTCs were allowed to export commodities outside the list without further approval so long as these commodities fell into their authorised business boundaries. The number of commodities subject to export licensing varied frequently (Table 4). In April 1985, there were 127 groups on the list. By February 1986, the number increased to 235, of which around 200 items were mainly exported to Hong Kong and Macao. This was a central government response to the rush in 1985 of 'illicit exports' of some commodities to the Hong Kong and Macao markets as a result of trade decentralisation. In addition to licences, quotas were also imposed on some staple, speculative, fresh and live goods. Licensed and quota-licensed exports amounted to roughly half of total export value, or about a quarter if crude petroleum and refined petroleum products are excluded (World Bank 1988:163). In the late 1980s and early 1990s, licensed exports included between 165 and 235 commodity groups and accounted for about two thirds of total export value.

To accelerate the process of liberalisation of foreign trade, MOFERT announced a new export administration procedure at the end of 1992. It cut the number of licensed exports by half to 114 in January 1993. These licensed exports were categorised into three types, the first two had quantitative restrictions attached. Plan quotas were imposed on 38 licensed goods, mainly energy and scarce natural resource goods or key intermediate inputs, 16 of which remained centrally controlled. Voluntary restrictions targeted 54 licensed exports including those commodities in which China had a dominant position in foreign markets. No quantitative restriction was imposed on the remaining 22 general licensed

exportables. In this case, the licensing was used as an instrument to ensure proper market order (MOFERT 1992).

Table 4 Number of licensed exports under the administration of different authorities, 1985–91[a]

	1985	1986	1987	1988	1989	1990	1991
MOFERT	15	32	30	35	22	22	29
SCO	40	42	42	56	62	75	121
Provincial	72	161	140	166	81	88	84
Total	127	235	212	257	165	185	234

a The issuing of export licenses was also decentralised, resulting in two levels of administration: MOFERT and its Special Commissioner's Offices (SCO) in port cities were in charge of key commodities, and provincial trade bureaus concentrated on other licensed goods.

Source: Editorial Board of the Almanac of China's Foreign Economic Relations and Trade, various issues. *Almanac of China's Foreign Economic Relations and Trade*, China Resources Trade Consultancy Co. Ltd. Hong Kong.

When the new export procedure was in place, the old export classification scheme was finally abolished. One of the main functions of the old scheme was to define business boundaries of various FTCs, therefore preventing competition among them. The new procedure lifted the ban on competition among FTCs for non-quota controlled exportables. Now, any FTC is free to enter export markets that were previously beyond its reach.

As the number of licensed exports fell, their share in total export values dropped from 66 to 30.5 per cent in early 1993 (*International Business*, 5 January 1993). The government intends to gradually reduce the number of licensed exports and further liberalise markets for exportable goods. This will certainly intensify the already fierce competition among FTCs and put more pressure on them to improve their productivity and efficiency.

Linking tradable commodity prices to the world market

A central part of the traditional centrally planned trade system was the separation of internal and external markets. To maintain this separation, tradable commodities had to be priced differently in the two markets. Exportables were

purchased at domestic prevailing prices no matter what the sales prices were in the world market while imports were priced in accordance with similar domestically produced goods. The tradable goods pricing policies thus became a key ingredient in the centrally planned trade system.

With the exception of Lardy (1992), most analysts have overlooked this important feature of the centrally planned trade system. Price determination was the key instrument isolating the domestic economy from the rest of the world. This isolation, combined with a long-running price stabilisation policy, resulted in a price structure substantially different from that of international markets. The price difference, in turn, reinforced the need for separate pricing of tradable goods to maintain stability in the domestic economy. For the open door policy to succeed and link the Chinese economy to the rest of the world, reform of pricing practices is vital.

Domestic pricing for exportables

Prior to 1979, because exportables were all procured by a few monopolised FTCs, domestic procurement prices of exports were in principle the same as domestic producer prices unless specific requirements were attached regarding specification, quality and packing. Only in two circumstances could the procurement prices diverge from their domestic levels.

- For industrial products with high domestic prices and profits which could potentially cause export losses and those with prices which, for some reason, could not be lowered, export procurement prices were allowed to be reduced.

- For industrial products with domestic prices so low that firms were unable to secure normal returns or even suffered losses, if the low prices could not be raised for some reason, the export purchasing prices could be raised separately to encourage firms to produce for export.

In both circumstances, the impact of the biased domestic prices on exports required re-adjustment of the pricing practice for some exports. However, the adjustments were partial and segmented. More importantly, they were not geared to world prices (State Council 1979).

Even the purchasing prices of products solely produced for export were based on domestic production costs plus a normal profit margin and taxes. Their international sales prices were rarely taken into account (State Council 1965 and 1979). As a result, domestic export producers had no idea of world market conditions facing their products.

This pricing practice was partially changed in 1979 when major domestic producers were allowed to set up their own trade companies or form trade

companies with established FTCs. For such producer-related FTCs, the policy of price isolation was broken.

In the 1984 MOFERT reform package, an agent pricing scheme was introduced. FTCs were required to operate on a commission basis and domestic producers were held responsible for the profits and losses of their exports. The agent pricing was designed to shift financial responsibility from the FTCs, and therefore from MOFERT, to domestic export producers. Through this system, prices of most goods were linked to export markets.

Most domestic prices remained distorted in 1984, so, a drastic shift of financial responsibility for exports, from FTCs to domestic producers, required a shift of financial subsidies from FTCs to export producers as well, otherwise a loss of export markets and a sharp fall in export revenues would have resulted. The government initially intended to use a multiple exchange rate system to solve this problem. It soon proved to be too complicated and impractical. In April 1985 the nationwide implementation of the export agent system was postponed and export subsidies to FTCs were resumed (Fang Xiangdong 1992).

This setback did not mean that the reform in export pricing had stopped. In fact, domestic prices consistently reflected world markets prices for two reasons. First, domestic markets for exportables were rapidly liberalised and more and more goods were priced according to supply and demand conditions. Second, FTCs were permitted to operate outside their geographic boundaries and could purchase exportables from across the country from 1985. Fierce competition among various FTCs narrowed the gap between domestic and international prices for most uncontrolled exportable goods and international prices were gradually passed onto domestic producers.

Export agent pricing has expanded rapidly since the introduction of the foreign trade contract responsibility system in 1988. In particular, the implementation of a tax rebate for exported goods facilitated the export agent pricing because unlike export subsidies which benefit trading companies, rebated taxes assist export producers. Exporting companies can now act as sole trading agents and rely on the quality and efficiency of their services to attract customers.

Domestic pricing of imported goods

China unified import pricing practices in 1964 (State Council 1963). The guidelines for import pricing were based on the idea of separating the domestic economy from outside influences. The prices of all imports were, in principle, pegged to the prices of comparable commodities domestically produced whenever such commodities were available. For commodities not available domestically, mark-up pricing was used. The domestic price was marked up by a

given margin after the c.i.f. price was converted into domestic currency at the official exchange rate. The mark-up rate was set equal to the difference between the official exchange rate and the average cost of earning foreign exchange through exports. Because most exports were unprofitable at the official exchange rate, this practice tended to raise the price of under-valued foreign exchange to a level sufficient to cover export costs and balance the trade budget. The mark-up prices of imported capital goods were also high enough to protect domestic industries. It was estimated that during the 1964–80 period, imports priced by reference to comparable domestic commodities accounted for 80 per cent of total import value and those priced by the mark-up method for only 20 per cent (Hu Bangding et al. 1989).

Reforms of import pricing after the early 1980s were characterised by reduced use of domestic comparable pricing and expansion of agent pricing with the clear intention of linking domestic and international prices.

Import pricing reforms were carried out in two phases after the early 1980s. The first phase was from 1981 to 1984 when an internal settlement exchange rate for commodity trade was put in place. The internal settlement rate was formulated on the basis of the average cost of earning foreign exchange through exports. Therefore, the foreign currency cost of imports, measured in domestic currency according to the internal settlement rate, should have been equal to, on average, the cost of earning foreign exchange through exports. Hence the Government was eager to restrict the use of mark-up pricing and replace it with agent pricing through which the financial responsibility for foreign exchange transactions could be passed to the domestic users of imports. The mark-up pricing practice was limited to a small proportion of imported goods, particularly mechanical and electrical equipment and instruments from socialist countries. The mark-up rate was 30 per cent for this group of imports on top of the c.i.f. costs converted at the official exchange rate. It should be noted that the exchange rate used in converting these prices was the official rate and not the internal settlement rate. After the 30 per cent mark-up, domestic prices were actually quite close to what they would have been had they been converted at the internal settlement rate through agent pricing practices.

Comparable domestic pricing practice was used only for planned imports paid for by the central government's foreign currency funds while all other imports were subject to agent pricing. The central government was keen to transfer the financial responsibility for decentralised imports to local authorities. As use of the comparable domestic pricing system decreased, use of agent pricing was

expanded and recommended as the principal import pricing policy in late 1984 (State Council 1984b).

The second phase of import pricing reform began with the abolition of mark-up pricing in 1985 after the internal settlement rate was phased out (State Administration of Commodity Prices 1985). Following this, all imported goods should in principle have been priced at their c.i.f. costs, converted at the official exchange rate, plus agent fees.

Table 5 Number of imported goods in China subject to domestic comparable pricing and their shares in total import value, 1978 and 1983–91

	Number of categories	Import share (%)
1978	..	80
1983	..	70
1984	..	57
1985	..	30
1986	31	..
1987	31	..
1988	28	20
1989	14	..
1990	8	..
1991	7	10

Sources: Wang Zhenzhi and Qiao Rongzhang 1988. *Review and Prospect of China's Price Reform* (*Zhongguo jiage gaige de huigu yu zhanwaung*), Chinese Material Publishing House, Beijing:202; Hu Bangding et al. (eds), 1989. *China Today: prices* (*Dangdai zhongguo de wujia*), Chinese Social Science Publishing House, Beijing:226, 230; State Administration of Commodity Prices, Foreign Affair Prices Department, and People's University of China, Research Team for Foreign Affair Prices 1991. 'Issues in price administration for imported goods and suggestions' (Jingko shangpin jiage guanli wenti ji jianyi), *China Price* (*Zhongguo wujia*), 5:5.

Since then, the number of categories of imports subject to comparable domestic pricing have fallen consistently (Table 5). In 1991, they included only seven commodity groups and accounted for about 10 per cent of the total value of imports. The prices for even this group of imports are no longer rigidly fixed at the uniform domestic plan price of comparable commodities. The planned imports are often transferred to end users at 'import transfer prices' *(Jinkou buojiao jia)* which are usually higher than uniform plan prices and lower than domestic

market prices. These transfer prices are also subject to variation if substantial changes occur in the world market.

The reforms in export and import pricing aim at eventually abolishing financial subsidies to FTCs. This objective cannot be accomplished if domestic prices fail to reflect the scarcity of resources.

Import subsidies were a heavy burden to the government in the first half of the 1980s because a large proportion of imports were still distributed at planned prices to domestic users. This was despite import costs increasing dramatically as a result of continuous domestic currency devaluation. This burden has eased since the introduction in the mid-1980s of agent pricing for imports and a two-tier price system for most intermediate inputs and producer goods. These reform measures gave the government a means to transfer the increased cost of imports to domestic users. By 1991, centrally controlled imports (funded by central government's foreign exchange) accounted for less than 30 per cent of total import value. Only one third of imports were distributed at domestic comparable prices. One important item in this group of imports was grains which remained in supply to urban residents at subsidised prices. As food subsidies are removed in 1993, import subsidies are expected to decline even further.

The situation is more complicated for exports. In the traditional centrally planned system export activity was hampered by overvalued domestic currency and arbitrary domestic prices. The way the government would achieve its foreign exchange earning targets using exports, without disturbing domestic supply, was to subsidise FTCs' exports. In this arrangement it was the central government that was restricted by budget constraints, not the FTCs which were only accounting units. The extent of export expansion was very much determined by the ability of the central government to subsidise. The introduction of the export agent system in 1984–85 was originally intended to break this arrangement and transfer the role of FTCs from government agents to sole commercial identities. Under this system, domestic export producers were held responsible for the financial consequences of their export decisions. As a combined measure to counter an ad hoc domestic price system, a multiple exchange rate system was proposed. It allocated a specific exchange rate to each group of commodities at which the foreign currency value of its exports was converted and therefore its export costs were calculated.

The introduction of the export agent system proved to be too radical and unfeasible in the largely unreformed environment of 1984–85. The proposed multiple exchange rate system was also impractical on technical grounds. In early

1985, the implementation of export agent pricing was postponed and fiscal subsidies for FTCs were renewed.

In the following years, the government tried to control the scale of export subsidies as export costs increased steadily. The government managed to share the burden with provincial authorities by limiting central subsidies to planned foreign exchange earning targets only. Above-quota exports had to be financed by whomever was responsible for those exports. Central subsidies for planned exports were finally frozen by the foreign trade contract responsibility system .

Another important development in ending export subsidies was the gradual expansion of the coverage of an export tax rebate scheme. The tax rebate for exports was first introduced in 1983 and covered only a small proportion of exportable goods. The implementation of a tax rebate system was seen as an important measure to make China's trade practices compatible with international convention. However, the implementation was complicated by China's domestic taxation system. China imposed differential turnover taxes for most goods. The tax levy on final goods depended very much on the number of turnovers of intermediate inputs involved in the process of producing the final products. It was difficult and time consuming to figure out precisely the percentage of taxes paid in the price of an exported commodity. After years of preparation, a comprehensive export tax rebate scheme was finally brought into operation in 1991 as part of the new foreign trade system. This enabled the government to terminate all direct fiscal subsidies to FTCs. As rebated taxes benefit directly export producers, FTCs can now operate as genuine exporting agents.

Use of agent pricing has also significantly enhanced the role of another tax levy, customs tariffs, in regulating trade flows. During the pre-reform years, customs tariffs had little impact upon domestic prices because almost all import prices were directly pegged to domestic prices and imports were directly distributed to domestic users. The major role of customs tariffs was to generate revenue. This role was so obvious that to simplify the procedure of collecting and distributing tariff revenues, the General Customs Administration was reduced to an office under the Ministry of Foreign Trade from 1964 to 1979. Tariff revenues were integrated into the Ministry's account and transferred as part of total trade income to the central budget.

In 1980 the General Customs Administration was restored as an independent administrative body. Since then, its main functions, in addition to collecting tariff revenue, have been the examination and release of traded goods upon verification of the required documents, such as import and export licences and commodity inspection certificates. The extension of agent pricing gives customs additional

leverage to adjust trade flows. Unlike the comparable domestic pricing policy, agent pricing requires import users to pay tariffs or other charges. The tariff thus becomes a component of domestic prices which must be taken into consideration in trade decisions.

Since the late 1980s, as trade decision-making has been decentralised, an increasing number of firms have to pay tariffs for their self-funded imports and exports. Customs tariffs are increasingly utilised to curb undesired exports or imports which are induced largely by the price disparities between domestic and international markets. Temporary surcharges, such as regulatory taxes on specified exports or imports, were implemented for this purpose.

Enhancing the role of customs is important for China in its effort to shift trade controls from quantitative mechanisms to value instruments so that the trade system is compatible with market economies. The government has recognised the importance of customs and frequently uses tariffs as a policy instrument. In 1985, customs tariff regulations were amended to incorporate revised tariff rates that had been in place for more than forty years. In 1991, a new customs tariff code system, consistent with the Harmonised System of the United Nations, was implemented.

Another motive for unilateral trade reforms is to facilitate the Chinese government's effort to restore China's status as a treaty state in the GATT. Import tariff rates for 225 items were cut in April 1992. In December 1992, import tariff rates for a further 3371 items in the tariff code were reduced, which brought the aggregate nominal protection rate down by 7.3 per cent, the largest unilateral tariff reduction since 1949. These changes in trade regulatory measures have brought China more in line with the trade practices of most market economies.

Building a foreign exchange market

In a market environment, the allocation of and the rate of foreign exchange are inter-related. The market-determined rate directs the allocation of foreign exchange among its potential users. In a centrally planned economy, however, these two processes are separated and determined administratively. The aim of reforming China's foreign exchange system is to rebuild the link between these two. This reform has been carried out on two fronts. First, a decentralised exchange reallocation system has been created through the introduction of a retention scheme and a secondary market for retained foreign exchange. Second, domestic currency has gradually been devalued to narrow the gap between the official exchange rate and the secondary market rate. The final goal of the reform

is to make the domestic currency, the Renminbi (RMB), internationally convertible.

Foreign exchange allocation

Foreign exchange control was a key component of China's traditional centrally planned trading system. As RMB was overvalued and the demand for imports was insatiable, the control over the allocation and price of foreign exchange had to be rigid. All foreign exchange-related transactions were conducted under the close supervision of the State Administration of Exchange Control. Earning and expending foreign exchange were separated. Domestic exporters had to submit all their foreign exchange earnings to the Bank of China which was specialised in handling foreign exchange. Import plans were assigned to each FTC with foreign exchange quotas attached. The foreign exchange quota was an entitlement right for its user to buy a certain amount of foreign currency from the Bank of China for an approved transaction. Only FTCs could hold foreign exchange quotas; the holding of convertible foreign currencies by domestic firms was strictly forbidden by law.

The first change in this highly centralised allocation system occurred in 1979 when a foreign exchange retention scheme was introduced as part of the first round of foreign trade reform. It was designed to provide incentives to exporters. Under this scheme, except for revenues from exports of about ten centrally controlled commodities, departmental authorities, provincial governments, FTCs and export producers were entitled to retain a proportion of their foreign exchange earnings for their own use (State Council 1979).

The retention rate was first set in 1979 on the basis of above-quota export procurements of the previous year (State Council 1979). This practice was modified in 1982 to base the retention rate on the current year's total foreign exchange earnings to encourage actual exports not export procurements (State Council 1982).

The retention rate has since been used by the government to pursue diverse objectives including industrial policy. For instance, in the early 1980s, machinery exports were encouraged by allowing 50 per cent of their foreign exchange earnings to be retained (State Council 1982). In the 1980s, the retention rate was more often used to promote the coastal development strategy. Coastal areas in general and the special economic zones, Guangdong and Fujian provinces in particular, enjoyed higher retention rates than most inland areas. This bias stimulated unequal competition for exportable goods between coastal and inland FTCs. In response to this problem, a new retention scheme was introduced in 1991. The retention rate was set according to commodity groups instead of

geographic locations of FTCs. Differential retention rates were intended to improve the commodity pattern of exports. The new scheme provided different regional FTCs with an equal opportunity to compete in the market for most exportable goods.

The foreign exchange retention rates have been on the increase since 1979. In the early 1980s, the retention rate was set at about 10 per cent of the annual foreign exchange earnings from exports (State Council 1982). In 1985, it rose to 25 per cent for uncontrolled exportables (State Council 1985). In 1988, the amount of foreign exchange submitted to the central budget was fixed by the foreign trade contracts between the central and provincial governments and any earnings above that could be shared by the central and local governments in the ratio of 2:8 (Wang Linshen 1990). Foreign trade companies and export producers under an experiment of being solely responsible for profits and losses of their exports (light industry, arts and crafts, and clothing) were permitted to retain 75 per cent of their total export earnings. Those producing automobiles, electronic and high-tech products for export could retain 100 per cent of their foreign exchange earnings (Wang Linshen 1990).

After the removal of export subsidies in 1991, the favourable treatment of coastal areas was abolished and the retention rate began to be determined on a commodity basis. The general retention rate was increased even further. For most commodities, 80 per cent of foreign exchange earnings could be retained. Of this, 20 per cent was shared equally by local governments and export producers and the remaining 60 per cent was retained by export companies. In addition to having 20 per cent of export revenues at the official exchange rate, the central government had the privilege of purchasing another 20 per cent of retained foreign exchange from FTCs at secondary market prices (Zhang Guanghua 1991).

The rapid expansion of retained foreign exchange has created a new category in China's foreign exchange system. Unlike centrally controlled foreign exchange, disposal of retained foreign exchange is normally under the discretion of its holders. According to government regulations, retained foreign exchange ought to be used to import new technologies and key equipment for improving export production. However, these self-funded imports are subject to various restrictions and often take a long time to be realised. Restrictions on the use of retained foreign exchange were particularly tight when a serious trade deficit occurred. In 1985, after a sharp fall in foreign exchange reserves, compulsory quotas were imposed on all holders of retained foreign exchange to curtail their self-funded imports (State Council 1985). These quotas remained in place until 1988.

The other option for holders of retained foreign exchange was to sell it for domestic currency to finance export costs. However, as the domestic currency was overvalued, to sell foreign exchange at the official rate was equivalent to paying an extra tax. There was, thus, little incentive for production and trade enterprises to follow this course.

To encourage a more effective use of retained foreign exchange, the Bank of China provided a foreign exchange swap service in 12 large and medium-sized cities on an experimental basis in October 1980 (State Administration of Exchange Control and Bank of China 1980). It was soon expanded to all the major provincial capitals. Through this service, FTCs and enterprises with excessive foreign exchange could, for the first time, sell their quotas to those in need at a slightly flexible rate, of a maximum 10 per cent above the official exchange rate (State Administration of Exchange Control and Bank of China 1980, 1981). This represented a breakthrough for the highly centralised exchange allocation system and marked the beginning of the establishment of a functioning foreign exchange market. From 1980 to 1985, however, the role of the exchange swap service was limited by various restrictions such as entry permits, administrative approval of transactions and a ceiling price.

The first real functioning exchange market emerged in December 1985 when Shenzhen Special Economic Zone (SEZ) set up a Foreign Exchange Swap Centre (FESC) on an experimental basis. Three other SEZs soon followed suit. In the Shenzhen Centre, administrative restrictions were largely relaxed so that sellers and buyers could negotiate the price at which foreign exchange was traded. Initially, there was a ceiling price of 5 yuan per US dollar in place. This was lifted in November 1986.

Encouraged by the Shenzhen experiment, three large cities set up their own FESC: Shanghai and Beijing in November 1986 and Tianjing in March 1987 (Sun 1989). Toward the end of 1988, 20 centres were operating nationwide. The rapid expansion in the number of FESCs across the country was also inspired by the relaxation in 1986 of restrictions on foreign enterprises and joint venture participation in foreign exchange trading (State Council 1986). By the end of 1992, over one hundred FESCs were in operation and each province, autonomous region and centrally administered city had at least one centre of its own.

Table 6 Volume of transactions of foreign exchange in Chinese Foreign Exchange Swap Centres, 1987–92 (US$ billion)

	Volume	As percentage of	
		Exports	Imports
1987	4.7	11.9	10.8
1988	6.3	13.2	11.3
1989	8.5	16.4	14.6
1990	13.1	21.4	25.0
1991	20.5	28.5	32.1
1992	25.1	29.5	31.1

Sources: *Economic Daily* (*Jingji Ribao*), 2 February, 1992; International Monetary Fund (IMF), September 1991. *International Financial Statistics*, yearbook, Washington DC; *People's Daily* (*Renmin Ribao*), overseas edition, 10 January 1992; 16 February 1993.

As the number of participants increased, FESCs became important players in the allocation of foreign exchange. The volume of foreign exchange traded through FESCs has risen rapidly since 1986. In 1987, the trading volume of FESCs across the country was US$4.7 billion, approximately 12 per cent of total import expenditure and 11 per cent of export earnings. Since 1988, when firms were permitted to dispose freely of their retained foreign exchange under the foreign trade contract responsibility system and the ceiling price was lifted for all FESCs, there has been a boom in the trading of foreign exchange in FESCs. The volume of foreign exchange trade jumped from US$6.25 billion in 1988 to US$25.1 billion in 1992, a fourfold increase in four years, and accounted for 31 per cent of import expenditures and 30 per cent of export revenues in the latter year (Table 6). To curtail black market trading, individual residents have also been allowed to sell and, to some extent, buy foreign currencies through swap centres since December 1991. It was reported that, in 1992, US$0.16 billion and US0.19$ billion were bought and sold by residents through swap centres (*People's Daily* (overseas edition), 16 February 1993).

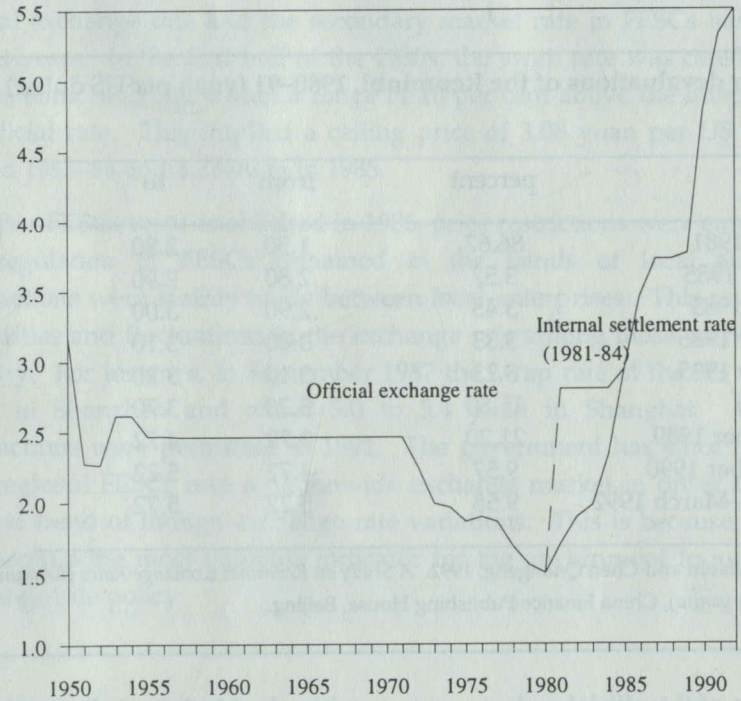
Foreign exchange rates

Changes in the domestic currency price of foreign exchange have a strong impact on the relative price of tradable goods and therefore on the current account balance. In China's traditional centrally planned system, however, the

current account balance was largely maintained through centralised trade plans instead of exchange rate adjustment. This control mechanism allowed the government to fix the exchange rate at an arbitrarily low level.

The official exchange rate was largely stable at RMB 2.46 yuan per US dollar prior to the 1970s. In the 1970s, the domestic currency gradually appreciated with world wide inflation and the depreciation of the US dollar. By the time China began its program of economic reform in the late 1970s, the Chinese currency was at its highest value since 1949 (Figure 1). This seriously undermined China's export efforts. Since 1980, the government has repeatedly devalued the RMB against all major foreign currencies in an attempt to bring the overvalued domestic currency down to an equilibrium level. Three major rounds of the RMB devaluation can be identified.

Figure 1. The Renminbi rate per US dollar 1950–91



Sources: State Statistical Bureau, Statistical Department of Trade and Materials 1990, *China's Commerce and Foreign Trade Statistics 1952–1988* (*Zhongguo shangye waijing tongji ziliao 1952–1988*), China Statistical Publishing House, Beijing:513

The first round of devaluation began in 1980 with the introduction of an internal settlement rate of 2.8 yuan per US dollar, which marked the beginning of a four year dual exchange rate system. The internal settlement rate was determined on the basis of the average cost of earning foreign exchange from exports in 1979 plus a 15 per cent margin. It was only used to settle merchandise trade transactions. The official exchange rate remained applicable to all non-merchandise trade transactions.

At the same time as the internal settlement rate was instituted, the domestic currency began to be gradually devalued. The official exchange rate reached 2.8 yuan per US dollar by the end of 1984 and the internal settlement rate was made redundant and abolished in early 1985.

The second round of devaluation occurred between 1985 and 1986. The RMB yuan to US dollar exchange rate slipped from 2.8 to 3.2 between January 1985 and July 1986 when the government announced a major RMB devaluation of 15.8 per cent from 3.2 to 3.7 yuan per US dollar. It then stabilised at 3.72 yuan through 1987 and 1988 (Table 7).

Table 7 Major devaluations of the Renminbi, 1980–91 (yuan per US dollar)

Date	percent	from	to
1 January 1981	86.67	1.50	2.80
21 August 1985	3.57	2.80	2.90
3 October 1985	3.45	2.90	3.00
23 October 1985	3.33	3.00	3.10
30 October 1985	3.23	3.10	3.20
5 July 1986	15.80	3.20	3.70
16 December 1989	21.20	3.72	4.72
17 November 1990	9.57	4.72	5.22
April 1991–March 1992	9.58	5.22	5.72

Source: Wu Nianlu and Chen Quangeng, 1992. *A Study on Renminbi Exchange Rates* (*Renminbi huilu yanjiu*), China Finance Publishing House, Beijing.

Stabilisation of the official exchange rate, combined with rising inflation, led to a real appreciation of the yuan in 1987 and 1988. The third wave of devaluation began at the end of 1989 when the value of the RMB fell by 21.2 per cent against

all other currencies, to 4.71 yuan per US dollar. Ten months later, on 17 November 1990, it was further reduced by 9.57 per cent to 5.22 yuan.

In most years of the reform period, Chinese currency foreign exchange rates were pegged to a basket of foreign currencies among which the US dollar was the most important. Large scale RMB devaluations were made periodically. After ten years of consistent devaluations, the problem of RMB overvaluation was eased. In April 1991, the government began to adopt a more flexible policy in which the RMB exchange rate was adjusted more frequently on a small scale. The adjustments were mainly based on developments in the balance of payments, in external and internal foreign currency markets and domestic costs of exports. By March 1992, the official exchange rate had been gradually depreciated to 5.73 yuan per US dollar.

The variations in the average annual RMB rate of the US dollar during the reform period are shown in Table 8

Simultaneously with domestic currency devaluation, the gap between the official exchange rate and the secondary market rate in FESCs has narrowed in recent years. In the first half of the 1980s, the swap rate was carefully regulated by the Bank of China within a range of 10 per cent above the internal settlement or official rate. This implied a ceiling price of 3.08 yuan per US dollar for the period 1981–84 and 3.23 yuan in 1985.

After FESCs were established in 1986, price restrictions were eased. However, the regulation of FESCs remained in the hands of local authorities and transactions were mainly made between local enterprises. This resulted in large disparities and fluctuations in the exchange rate among these markets across the country. For instance, in September 1987 the swap rate of the US dollar was 6.1 yuan in Shenzhen and about 5.0 to 5.4 yuan in Shanghai. Cross-regional transactions were permitted in 1991. The government has since been trying to link regional FESCs into a nationwide exchange market in order to monitor the general trend of foreign exchange rate variations. This is because the swap rate has become the most valuable indicator for the government to judge its official exchange rate policy.

Table 8 Foreign exchange rates in China, 1978–92 (average annual RMB yuan per US dollar)

	Official	FESC[a]	FESC/Official
1978	1.68	n.a	n.a
1979	1.55	n.a	n.a
1980	1.50	n.a	n.a
1981	1.71	3.08	1.10
1982	1.89	3.08	1.10
1983	1.98	3.08	1.10
1984	2.33	3.08	1.10
1985	2.94	3.23	1.10
1986	3.45	5.00	1.45
1987	3.72	5.70	1.53
1988	3.72	6.32	1.70
1989	3.77	6.38	1.69
1990	4.78	5.80	1.21
1991	5.32	5.90	1.11
1992	5.70	6.80	1.19

Notes: An internal settlement rate of 2.8 yuan per US dollar was used for merchandise trade in 1981–84.

[a] Foreign Exchange Swap Centre.

Sources: Official and internal settlement rates: International Monetary Fund, various years. *International Financial Statistics*, Washington DC.

Foreign Exchange Swap Centre (FESC) rates:

1981–1985: *Jingji Ribao* (*Economic Daily*), 2 February, 1992;

Wang Zhenzhi and Qiao Rongzhang, 1988. *Review and Prospect of China's Price Reform* (*Zhongguo jiage gaige de huigu yu zhanwaung*), Chinese Material Publishing House, Beijing;

1986 (rate in Shenzhen) and 1987 (average rate of Shenzhen and Shanghai centres): Sun Shangqing (ed.), 1989. *Markets in China* (*Zhongguo shichang*), Science Publishing House, Beijing:197–99;

1988 (average rate of five major municipal centres from May to December),Almanac of China's Finance and Banking Editorial Department, 1990. *Almanac of China's Finance and Banking 1989* (*Zhangguo jingrong nianjian*), Beijing:148.

1989–92: Yang Fan, 1993 'A study on the trend of RMB exchange rates' ('Renminbi zoushi yanjiu'), *China Price* (*Zhongguo wujia*), (3):3.

Despite the diversity of regional swap rates, a general trend can nonetheless be identified. In 1988, when the ceiling rate was lifted, the swap rate surged to above 6.32 yuan per US dollar, 70 per cent higher than the official rate. By 1991, after the

RMB was further devalued and more retained foreign exchange entered FESCs, the swap rate dropped to below 6.0 yuan per US dollar, less than 10 per cent above the official rate. This indicates that the successive devaluations since 1980, combined with the opening of foreign exchange markets, have substantially eased the problem of domestic currency overvaluation and brought the RMB closer to its equilibrium value relative to other major currencies. The convergence of the two exchange rates also paves the way for further liberalisation of central exchange allocation and the eventual establishment of a functioning foreign exchange market.

In 1992, China completed a three year economic adjustment program and the economy started to flourish after Deng Xiaoping's much publicised tour of the south. From mid-1992, swap rates in most FESCs started to rise consistently and the gap between swap and official rates began widening again. By February 1993 the swap rates had climbed to 9 yuan per US dollar, 40 per cent higher than the official rate of 5.72. The government was forced to act, imposing a ceiling price of 8 yuan to control the fall of the RMB value. This measure was largely unsuccessful because it dried up the trading in FESCs and drove many potential participants to black markets for their foreign currency needs. The ceiling price was lifted in June. Within a few weeks, swap rates jumped above 10 yuan per US dollar. This time the central bank intervened by selling US$20 million in the Shanghai Swap Centre and successfully engineered the yuan's dramatic recovery nationwide. It was the first time that China's central bank used policy-driven sales to rescue the yuan. The swap rate stabilised at about 8 yuan per US dollar, a rise of 22 per cent from its mid-June low of 10.92 yuan to the dollar (*Asian Wall Street Journal*, 12 July 1993).

The fluctuation of the yuan in late 1992 and early 1993 was a result of many factors: the relaxation of import controls and reduction of import quotas and tariffs; speculation of a further RMB devaluation due to the GATT negotiations and unpredictably rapid expansion of domestic demand. However, it should be pointed out that the volatile yuan also reflected the defects of a partially reformed system. With a yearly turnover of about half the nation's foreign exchange earnings, FESCs have already become a major player in China's exchange allocation, however, the old quota control mechanisms remain in place. This enables enterprises to hold large amounts of foreign currencies at very low cost and encourages speculative activities. It is urgent and also feasible for China to accelerate reform not only in its foreign exchange regime but throughout its entire financial system.

Impact of trade reforms

China's program of economic reform since the 1970s can be seen as an attempt to create market mechanisms in which domestic resources can be allocated efficiently. In addition, by opening up to the outside world, China will be able to exploit potential gains from trade and foreign investment.

The success of the economic reforms introduced thus far depends largely upon how far China has departed from its traditional centrally planned system and to what extent the market mechanism has developed. It is evident from the above discussion that a significant shift from the old to a new system has taken place in all major aspects of China's foreign trade. The changes can be summarised as follows:

- the MOFERT monopoly on foreign trade has been replaced by competition among a large number of decentralised FTCs
- direct control of exports and imports through central plans has been largely replaced by a number of administrative and indirect regulatory measures, including licensing, taxation and tariffs
- domestic prices of tradable commodities have been increasingly determined by market forces and, to some extent, linked to world levels. Thus, world market price signals have begun to be passed on to domestic producers of exports and consumers of imports
- a growing proportion of foreign exchange has been reallocated at flexible rates outside the centrally planned channels through secondary foreign exchange markets.

These changes indicate the departures of foreign trade management from central planning. It is true, nevertheless, that these changes still fall short of the mechanism necessary for a fully functioning foreign trade market. For market mechanisms to function, at least two basic requirements must be met: trade participants must be financially independent and enjoy decision-making autonomy, and the prices of commodities traded must be determined through competition. Competition has emerged in China as a result of the decentralisation of FTCs. The financial relationship between decentralised FTCs and the central or local governments, however, has not yet been completely severed. This has been the main cause of excessive competition frequently seen in the domestic markets for certain exportable commodities throughout the reform years.

Existing problems undoubtedly impair the functioning of the market to some extent. However, they seem unlikely to be severe enough to preclude the

emergence of a new market mechanism in China's foreign trade system. China's economic reform program is far from over and existing problems should be regarded as symptoms of the incomplete nature of ongoing reform. Most of the problems are likely to be corrected as the reform program proceeds.

Trade reforms have successfully opened the Chinese economy and transformed it into one of the world's largest trading nations. The emergence of domestic markets for tradable goods and the decentralisation of trade companies has led to a boom in foreign trade activities at all levels. The question is whether or not the economic reforms have improved efficiency in trade as well as in producing tradable goods industries.

It has been suggested in trade theory that a country's commodity trade should be conducted according to its comparative advantage or comparative costs of production so as to exploit fully potential gains from trade. Despite the remaining domestic distortions which complicate the assessment of foreign trade efficiency, recent empirical studies reveal that, during the reform period of the last decade, China's patterns of commodity trade have become more responsive to its underlying comparative advantage (Zhang 1993). This is an indication that trade reform has indeed improved the efficiency of China's foreign trade. It shows that the makeup of China's foreign trade pattern has gradually moved toward a commodity composition that will maximise potential gains from trade.

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