Navigating Adroitly: China’s Interaction with the Global Trade, Investment, and Financial Regimes

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This article explores who has most skillfully used the rules of the global economic regime — China, or the nations whose companies invest in her? We first analyse China’s adoption and implementation of WTO commitments in the automotive industry and the cultural goods sector. We then consider the liberalisation of China’s foreign direct investment (FDI) scheme and China’s use of FDI as a vehicle to acquire foreign technology, while also restricting FDI to protect the domestic banking sector. Finally, we analyse China’s engagement with the international financial regime, particularly its exchange rate policy, and whether this too represents a strategic implementation of reforms. Based on these four case studies, we conclude that while the West initially dictated the terms of China’s interaction with the global economic system, over time, China has deftly engaged with global rules so as to promote its own national interests.

I. INTRODUCTION ................................................................. 2
II. CHINA’S WTO COMMITMENTS AND DOMESTIC REFORMS UNDER THE TRADE REGIME .................................................. 3

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INTRODUCTION

This project arose from the question of who had more adroitly used the international trade, investment and financial regimes – China or the nations whose companies invest in her? The Organisation for Economic Co-Operation and Development (OECD) has predicted that China’s economy may well, on a purchasing power parity basis, become the largest in the world by 2016. However, the particular question we were interested in pursuing was not who has grown the most, or profited the most, from investments made in China. The question was who has most skillfully negotiated the rules governing China’s interaction with the rest of the world, and then most skillfully implemented and applied those rules?

To answer the question, this article analyzes the process of China’s opening up to the world in two periods: its unilateral opening-up from 1979 to 2001, and its later period of liberalization occasioned by its accession to the World Trade Organisation (WTO) in 2001. The article analyzes these issues in the three principal sectors of the international economic legal order: trade, investment

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and finance. In doing so, the research conducts six case studies, two in each sector. In trade, this article explores China’s strategic implementation of its WTO obligations within the automotive industry and the domestic cultural industry. In investment, this article analyzes China’s Foreign Direct Investment (FDI) policies on technology transfer and on its banking sector. Finally, in finance, this article considers China’s reforms of its foreign exchange regime and its observance of corresponding international obligations.

**CHINA’S WTO COMMITMENTS AND DOMESTIC REFORMS UNDER THE TRADE REGIME**

After a fifteen-year negotiating marathon, China finally became a member of the WTO on 11 December 2001, a landmark event in the history of the multilateral trading system. China’s accession was significantly delayed by a confluence of events between 1989 and 1999, and by opposition to accession from domestic interest groups and from governments in China and the West. However, the enormous potential benefits of accession for China and the world always made China’s eventual WTO membership probable.

Both the United States and the European Commission – the key parties who led the negotiations of China’s WTO admission – believed that a true World Trade Organization must have China as a member. They had high expectations that China’s WTO accession

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4 See Hearing before the H. Subcomm. on Trade of the Comm. on Ways and Means, 105th Cong. 57 (1997) (statement of Carla A. Hills) (“It makes little sense to talk about a World Trade Organization in which a country with 20 percent of the world’s population, having an almost $1 trillion economy, and which is the world’s eleventh largest exporter, is not a member.”); Qingjiang Kong, *China’s WTO Accession: Commitments and Implications*, 3 J. INT’L ECON. L. 655 at 665 (2000) (“The European Union claims to be ‘a consistent and
could bring significant economic benefits to their domestic stakeholders. Then United States Trade Representative (USTR) Charlene Barshefsky stated:

By opening the Chinese economy to U.S. goods, services and agricultural products, the WTO accession . . . will create significant new opportunities for American businesses, farmers and working people. . . . [W]e have won commercially meaningful and enforceable commitments that help Americans on the farm and on the job export to China by addressing the many layers of trade barriers and policies which limit access; strengthen guarantees of fair trade; and give us additional tools for enforcement and compliance.

Observers believed China’s accession would serve the United States’s economic interests by providing U.S. firms with greatly enhanced access to the world’s largest potential market in goods and services. It was also generally believed that China’s entry would allow the WTO’s wealthier nations to invoke the mechanism under the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) and compel China to protect intellectual property rights (IPRs).

China’s decision to seek WTO entry was driven by a host of factors, including enhanced market access to the 142 WTO Members, equality of treatment in key markets such as the US, including avoiding the humiliation of having to be the subject of an annual vote to confer upon China most favored nation status, further integration into the global economy and involvement in the formulation of global trading rules, and development of trade relationships with major trading partners. However, it has been vocal supporter of China’s entry into the WTO’. It ‘believes the WTO is not truly a “World” Trade Organization without China.’”.

6 Id. at 45–46.
8 WILLIAM H. COOPER, CONG. RESEARCH SERV., RS22398, THE JACKSON-VANIK AMENDMENT AND CANDIDATE COUNTRIES FOR WTO ACCESSION: ISSUES FOR CONGRESS, 2–3 (2012); DILIP K. DAS, CHINA’S ACCESSION TO THE WORLD TRADE ORGANIZATION: ISSUES AND
observed that the most important motivating factor was that WTO obligations could provide Chinese leadership with a powerful lever with which to facilitate and deepen the domestic economic and industrial reforms which China had been undertaking since the introduction of the “Reform and Open Door” policy by Deng Xiaoping in 1978. Long Yongtu, then China’s Vice-Minister of Trade and Chief WTO Negotiator, stated:

The fact that China’s accession to an international organization would have such a wide impact throughout the world is something we had not expected at all. The important thing is that we in China have successfully and skillfully handled the domestic side of the accession process and have transformed the pressure generated by these negotiations, both at home and abroad, and turned them into a promoter, a catalyst for China’s historic process of economic reform and opening to the outside world – a process started by Deng Xiaoping 23 years ago.

Jeffrey Gertler, then Secretary to the Working Party on the Accession of China, highlighted the benefits that China’s WTO membership would bring to its own economic reforms in these terms:

Accession should allow China to lock in the accumulated benefits of the trade-reform process that the Chinese government has undertaken to date, and provide a platform from which China can sustain its reform process into the future. By placing China’s reforms within the broader context of trade liberalization by all WTO members, Chinese producers and exporters can increase the returns from trade reform in China through reciprocal market access abroad, and help the Chinese government

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9 See LARDY, supra note 2, at 29–36 (discussing China’s unilateral reforms before WTO accession).
resist pressure domestically to reverse the process of reform.\(^\text{11}\)

Thus, the belief that WTO accession would significantly support China’s internal reforms was the principal reason for China’s eagerness to gain WTO membership. With these international obligations, the Chinese leadership secured substantial political leverage in the pursuit of reforms necessary for the continuous transition to a market economy, the transformation of inefficient state-owned enterprises (SOEs) and industries, the establishment of a system of rule of law, and the enhancement of transparency. These reforms were regarded as essential to enhancing the efficiency and competitiveness of SOEs and historically highly-protected industries, and to “achieve the goal of efficient allocation of resources and an improved standard of living.”\(^\text{12}\) It was also hoped that the development of a system of rule of law and increasing transparency would serve to curtail rampant corruption, and promote security and predictability of legal rights for both domestic and foreign business operators.\(^\text{13}\)

China made unparalleled commitments in order to join the WTO. As Ambassador Barshefsky confirmed, the concessions China made “far exceeded what anyone would have expected.”\(^\text{14}\) For example, for goods, China committed to reduce its overall tariff level to 10% by 2008, with the average tariff for industrial goods reduced to 9.1% and for agricultural goods to 15.1%.\(^\text{15}\) Additionally, China agreed to open up sensitive service sectors such as telecommunications, banking, and insurance, and to grant essential rights to foreign firms, such as trading rights and distribution rights.\(^\text{16}\) The breadth and depth of China’s market opening is unprecedented, far exceeding

\(^{11}\) Gertler, supra note 2, at 65.


\(^{13}\) Sylvia Ostry, WTO Membership for China: to be and not to be – is that the answer, in CHINA AND THE WORLD TRADING SYSTEM: ENTERING THE NEW MILLENNIUM, 31, 35–36 (Deborah Z. Cass et al. eds., 2003).

\(^{14}\) Barshefsky, supra note 5, at 53; see also Lardy, supra note 2, at 65–105 (providing an overview of China’s commitments).


\(^{16}\) See Lardy, supra note 2, at 66; Aaditya Mattoo, China’s Accession to the WTO: The Services Dimension, 6 J. INT’L ECON. L. 299, 300 (2003).
the concessions made by other developing countries and even most developed countries.\(^\text{17}\)

Furthermore, since accession, China has had an outstanding track record of implementing its commitments. To achieve compliance with various rules of the WTO, China amended or repealed “more than 3,000 laws and regulations at the central government level and 190,000 at the local government level, the largest-ever legislative revamp in history.”\(^\text{18}\) China “cut tariffs on over 5,000 products” and reduced the overall tariff level to 9.8%.\(^\text{19}\) China granted market access to foreign services providers “even in the most sensitive sectors, such as telecommunications and insurance.”\(^\text{20}\) China also liberalized trading rights, which have long been controlled by the government, allowing all entities, including foreign-invested enterprises (FIEs) and foreign individuals, to import and export goods, except for a handful of special goods subject to state trading.\(^\text{21}\)

By admitting China to the WTO, the key players, especially the United States and the European Union, secured enormous commercial opportunities for their domestic stakeholders.\(^\text{22}\) However, China has not delivered all the benefits the rich nations wanted. Issues such as China’s enforcement of IPRs, restrictions on trading rights in selected areas, and protection of sensitive goods and services sectors have yet to be addressed to the satisfaction of western countries and their domestic stakeholders.\(^\text{23}\) China’s non-

\(^{17}\) See Lardy, supra note 2, at 79; Mattoo, supra note 16, at 333 (observing that China’s commitments in services are “the most radical services reform program negotiated in the WTO”).


\(^{20}\) Id. at 12.

\(^{21}\) See infra pp. 14-20 (discussing China’s liberalization of trading rights).


compliance with WTO rules in these specific areas has been caused in part by various difficulties China encountered in implementing its sweeping WTO commitments. More significantly, however, China’s non-compliance reflects a strategic approach to implementation adopted so as to reap the full benefits of China’s WTO membership in foreign markets while simultaneously protecting the development of its key industries, and preserving its national values, culture and identity so that its opening up would serve its economic development. Therefore, China has been moving very slowly towards its committed levels of liberalization or compliance in a range of specific areas, including bulk agricultural goods, certain sensitive industrial goods and services sectors, cultural goods, and enforcement of IPRs, to name a few. Below, we discuss China’s strategic implementation of its WTO commitments in the automotive industry and the cultural industry as examples of this phenomenon.

Protection of the Automotive Industry

The automotive industry is one of the most sensitive industrial sectors in China. On one hand, the development of this industry has long been regarded as one of the key components and drivers of China’s economic reform and development, but on the other hand, this industry, which historically comprised groups of underdeveloped manufacturing and assembly sectors, had long remained vulnerable to foreign competition. Prior to China’s entry into the WTO, the auto industry was heavily protected by high tariffs, import quotas and other forms of non-tariff barriers. Upon accession, China committed to reduce its import tariff on cars from 100% to 25%, and eliminate import quotas by 2005. Due to this

25 See Long, supra note 10, at 35.
26 See U.S. TRADE REP., supra note 23, at 23–112.
29 See Harwit, supra note 27, at 663.
massive dismantling of trade barriers, some feared that foreign auto
products would flood into China’s market, creating overwhelming
competition which Chinese auto producers would not be able to
withstand. Close observers, however, have concluded that the
impact of foreign competition on China’s auto industry has been
moderate.30

It seems that China adroitly committed to liberalize its trade
barriers to the point that it would still be able to sufficiently protect
its automotive industry, so that foreign competition would drive the
enhancement of efficiency and competitiveness of the industry
without crippling it. During its decade of integration into the global
trade regime, China’s auto industry has not only survived foreign
competition but has made tremendous strides in capacity, efficiency,
productivity, technological innovation, and development of local
brands to the point that China has become one of the world’s
leading auto producers.31

The support of the Chinese government has been
indispensable to this rise in China’s automotive industry. One of the
most important and widely recognized governmental supports has
been the provision of super-national treatment to foreign companies
investing in the automotive industry, which will be discussed later.
Another form of support has been China’s strategic implementation
of its WTO obligations on market access for foreign automobiles.
Although China overhauled its border measures (i.e. import tariffs
and quotas) in accordance with its WTO commitments, it introduced
various forms of internal measures to restrict the impact of foreign
competition in 2004 and 2005. One key measure was the Policy on
Development of Automotive Industry32 issued by the National
Development and Reform Commission (NDRC) in 2004. Many
provisions of this Policy had the effect of limiting the volume of
imports, including limiting the number of ports of importation,
prohibiting storage of imported autos at these ports if the imports
are destined for domestic consumption, timing tariff collections so
as to adversely affect the cash position and liquidity of importers,

30 Id. at 665–669; LARDY, supra note 2, at 111–113.
31 See RACHEL TANG, CONG. RESEARCH SERV., R40924, THE RISE OF CHINA’S AUTO
INDUSTRY AND ITS IMPACT ON THE US MOTOR VEHICLE INDUSTRY 2–8 (Nov. 2009)
32 Policy on Development of Automotive Industry, Order No. 8 (promulgated by the Nat’l
Dev. and Reform Comm’n (NDRC), effective May 21, 2004) [hereinafter Auto Policy].
and restricting the number of distributors. By enacting these measures, the Chinese government evidenced a clear preference for domestic automotive products over imports. Whether or not these specific provisions comply with WTO rules has not been tested.

The Policy, together with several implementing rules adopted in 2005, stipulated that imported auto parts shall be treated as a complete vehicle if they are used in the production/assembly of a complete vehicle in China, and meet or exceed a specified quantity or value threshold. As mentioned above, China committed to bind its import tariffs on automobiles and auto parts at 25% and 10% respectively. These measures, therefore, had the effect of artificially inflating the import tariff on auto parts to the much higher level applicable to automobiles. In 2006, the European Union, the United States, and Canada challenged these Chinese measures, accusing China of violating its WTO commitments by subjecting imported auto parts to import tariffs in excess of its committed level. In 2008, the WTO found against China and recommended it make these measures consistent with its WTO commitments. On 31 August 2009, China reported to the WTO that it had taken the necessary steps to remove the WTO-inconsistencies and comply with the tribunal’s recommendations.

The approach taken by the Chinese government to protect its auto industry offers a perfect illustration of China’s strategic implementation of its WTO commitments. While the WTO obligations serve as a much-needed external force with which to counteract domestic resistance to economic reforms, it is impossible

34 See Measures for the Administration of Import Automobile Components and Parts Featuring Complete Vehicles, Decree No. 125, art. 21, 22 (promulgated by the General Administration of Customs (GAC), the NDRC, the Ministry of Finance (MOF) and the MOFCOM, Feb. 28, 2005, effective Apr. 1, 2005); Rules on Verification of Imported Automobile Parts Featuring Complete Vehicles, Announcement No. 4, art. 13, 14 (promulgated by the GAC, Mar. 28, 2005, effective Apr. 1, 2005)(LexisNexis)(China).
36 Minutes of Meeting of 31 Aug. 31, 2009, WT/DSB/M/273. 21 (Nov. 6, 2009)(WTO Dispute Settlement Body).
to foresee accurately all of the impacts of these market-opening obligations upon domestic industries. Therefore, when protection became economically and politically important for the auto industry, the Chinese government employed a strategic implementation approach in order to secure a safe environment for the development of this industry at the cost of foreign auto producers; and in defiance of its WTO commitments. Although the WTO dispute settlement mechanism corrected China’s opportunistic approach, it took two years for western countries to become aware of China’s measures and another three years to eventually secure China’s compliance. During those five years, those internal measures that were not tested under the WTO continued to constitute obstacles to the importation of foreign autos, and hence protected a “healthy” competitive environment for domestic automotive producers. Furthermore, even though the Chinese government has amended or abolished those measures found to be WTO-illegal, it is likely that other forms of protectionist measures will be readily and easily introduced if and when necessary.

Restriction on Trading Rights for Cultural Goods

For decades, trading rights – the right to import and export – were strictly controlled by the Chinese government. At the time of the launch of domestic reform in 1978, trading rights were dominated by 12 SOEs who were authorized to import and export all goods. The reform led to substantial liberalization of trading rights. Prior to WTO accession, the Chinese government had authorized 35,000 firms of all types to engage in foreign trade. However, significant restrictions on trading rights still remained: China had an “examination and approval” system under which, in order to become a “foreign trade operator” (FTO) entitled to trading rights, applicants had to satisfy a number of criteria set forth in the then applicable Foreign Trade Law (1994) and the implementing regulations. These criteria mainly included threshold requirements for registered capital, export performance and prior experience, as

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37 See LARDY, supra note 2, at 40.
38 Id. at 41–42.
well as limitations on the scope of imports and exports. According to the grant of trading rights was not automatic but was subject to the above-mentioned restrictions and the approval of the government. This “examination and approval” system for the grant of trading rights constituted a non-tariff barrier, with the effect of limiting the number and types of enterprises that could engage in importation, and consequently restricting the volume of imports.

In order to join the WTO, China agreed to gradually liberalize trading rights within three years, so that after 11 December 2004 there were to be no restrictions on who would be entitled to import and export goods, except for those goods for which China has retained the right of state trading. To implement this commitment China amended the 1994 Foreign Trade Law in July 2004. The revised Foreign Trade Law (2004) replaced the “examination and approval” system with a “registration” system under which all entities, domestic and foreign alike, were automatically granted trading rights upon registration. Registration was not dependent upon the satisfaction of the substantive criteria historically applicable under the “examination and approval” system but merely required the lodgment of documents containing basic information about the applicants such as business license and organization code. Goods explicitly exempted from China’s commitment on trading rights are still subject to state trading. However, for all other goods, it has been observed that the introduction of the registration system marks “a full liberalization of China’s general foreign trading rights regime as a WTO accession commitment.”

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41 Id., at 23–24.
42 WTO Accession Working Party, Report of the Working Party on the Accession of China, ¶¶83(d) & 84(a), WT/ACC/CHN/49 (Oct. 1, 2001); Protocol on the Accession of the People's Republic of China art. 5.1, Nov. 23, 2001, WT/L/432. (These exceptions, set out in Annex 2A of China’s Accession Protocol, include the importation of grain, vegetable oil, sugar, tobacco, crude oil, processed oil, chemical fertilizer, and cotton, and the exportation of tea, rice, corn, soy bean, tungsten ore and certain tungsten products, coal, crude oil, processed oil, silk, cotton, cotton yarn, certain woven cotton products, antimony, and silver).
43 Foreign Trade Law, supra note 39, at arts. 3, 4.
44 Id., art. 5.3.
45 ZHANG, supra note 40, at 41–44.
46 Id., at 31.
This observation is generally correct, except that for years following WTO accession, the Chinese government, through a web of administrative regulations and departmental rules, maintained the “examination and approval” system and state trading in relation to the importation of some cultural goods including reading materials (i.e. books, newspapers, magazines, and electronic publications), audio-visual products (i.e. videocassettes, video compact discs, and DVDs), and films for theatrical release. Although these goods are not contained in the list of goods exempted from China’s general commitment on trading rights, China confined the right to import these goods to approved or designated SOEs only. In 2007, the United States initiated a WTO proceeding – the China - Publications and Audio-Visual Products case, challenging Chinese measures restricting the right to import these cultural goods on the ground that FIEs, foreign enterprises and individuals had been deprived of trading rights which should have been granted according to China’s WTO commitments. In 2009, the WTO tribunals found in favor of the United States, ruling that China had breached its commitments on trading rights and urging China to bring the measures at issue into compliance with its commitments. Since then, China has taken steps to remedy its WTO violations. On 12 March 2012, China reported to the WTO DSB that by amending or abolishing the relevant measures it has achieved consistency with its commitments. However, given the economic and political

significance of these cultural sectors in China, it is still too early to ascertain whether China has liberalized the trading rights in practice.

It can be argued that the Chinese government has deliberately chosen not to liberalize the right to import these special goods regardless of the likely violations of its WTO obligations and is undertaking a strategic implementation of its WTO commitments. China’s non-compliance with commitments in this selected area suggests, at least, two policy considerations.

First, it reflects the policy inclination of the Chinese government to maintain the protection of its domestic cultural industry from foreign competition. The Chinese government has treated the reform and development of the cultural industry as being one of its policy priorities and accordingly has devoted a great amount of resources to achieving that goal. Although this industry has been reformed in recent years, it faces a range of problems and remains underdeveloped and considerably less competitive than that of developed countries. Therefore, although ambitiously promoting reforms and development of the industry, the Chinese government has believed that a transitional period is essential to allow the industry to gain efficiency and competitiveness in the global cultural market. One traditional way of affording protection to this industry is to confine the right to import cultural goods to a very limited number of SOEs designated by the General Administration of Press and Publications (GAPP) for reading materials and by the State Administration on Radio, Film and Television (SARFT) for films. Quantities of imports have thereby been strictly controlled so as to prevent the industrial reform and development being frustrated by a flood of highly competitive foreign cultural imports. As pointed out


54 See Chen, supra note 52, at 48–67 (discussing a “cultural exception and cultural ambition” approach adopted by the Chinese government in fostering development of its cultural industry).
by Long Yongtu, China had aimed to ensure its WTO commitments reflect “the level of maturity reached in each and every sector under negotiation” so that “these arrangements will not jeopardize the development of these industries.”\textsuperscript{55} Apparently, while the Chinese government did not manage to negotiate an exception to the general obligation to liberalize trading rights for its sensitive cultural sectors, it strategically ignored its WTO commitments in these sectors.

Second, apart from the economic considerations discussed above, China’s strategic implementation reflects a mix of cultural and political considerations of the specific nature of cultural goods that carry the content of social values and political orientation. Each society has unique values, but China considers its cultural heritage to be particularly rich and exceptional, and has put a high priority on preserving its national values, culture, and identity. Thus, while supporting China’s bid for the WTO membership, then Chinese President Jiang Zemin stressed that:

\begin{quote}
[A] few countries . . . have tried to force their own values, economic regime, and social system on other countries by taking advantage of economic globalization . . . we must take it as a crucial task in our cultural development to carry forward and cultivate the national spirit and incorporate it into our national education and the entire process of building spiritual civilization . . .
\end{quote}

Furthermore, cultural goods “serve as essential instruments in disseminating government policy and shaping public opinion.”\textsuperscript{57} China’s imposition of the limitations on the right to import cultural goods has therefore been considered important to (1) “combat perceived cultural colonialism” by western countries, especially the US, and (2) “regulate the cultural content its population consumes.”\textsuperscript{58} Accordingly, in the China - Publications and Audio-

\begin{thebibliography}{9}
\bibitem{long} Long, \textit{supra} note 10, at 32.
\bibitem{shi} Jingxia Shi & Weidong Chen, \textit{The ‘Specificity’ of Cultural Products versus the ‘Generality’ of Trade Obligations: Reflecting on ‘China – Publications and Audiovisual Products.’} 45 \textsc{J. World Trade} 159, 161 (2011).
\end{thebibliography}
*Visual Products* litigation, China argued vigorously that the trading rights limitations in these cultural sectors have played an essential role in protecting public morals by ensuring that the content of imports is reviewed by competent import entities and does not contravene the social norms and values in China.59 Although China lost the argument that restricting trading rights is a WTO-consistent way of protecting public morals, its prerogative to regulate the content of cultural imports was not questioned by the WTO tribunals. Therefore, China will almost certainly maintain censorship through other measures untested under the WTO, which may well constitute new forms of strategic implementation in the cultural industry.

In short, in restricting trading rights in the cultural sectors, the Chinese government restricts not only the quantity, but also the quality, of imports. Based on a mix of economic, political, social and cultural considerations, China has chosen to conduct a strategic implementation of its obligations whereby it denies market access to foreign cultural goods for the purpose of the reform and development of its own cultural industry.

**CHINA’S WTO COMMITMENTS AND DOMESTIC REFORMS UNDER THE INVESTMENT REGIME**

Another pillar of China’s economic reform has been the liberalization of its foreign investment regime. As a result of the liberalization, China has received steadily increasing foreign direct investment (FDI) inflows,60 and in the first half of 2012 it surpassed the United States to become the largest recipient of FDI worldwide.61 Many factors have underpinned the FDI boom in China, such as China’s market potential and cheap labor, but perhaps the most influential factor has been China’s opening up to,

and especially its provision for preferential treatment of foreign investment. The liberalization process can be divided into two major stages – the first being China’s unilateral opening up to foreign investment before joining the WTO and the second being China’s opening up according to its WTO obligations. We begin with an overview of the two stages of liberalization, followed by a discussion of how China has gained enormously from the liberalization of its investment regime and by aligning its policies and laws governing foreign investment tightly with its national development goals.

The launch of the “reform and open door” policy was a watershed in the history of China’s foreign investment regime. In July 1979, the Law of the PRC on Sino-Foreign Equity Joint Ventures (SFEJV Law) was enacted to allow foreign investors to establish equity joint ventures (JVs) with Chinese enterprises. Besides laying down the basic legal framework for FDI, the Law specified some tax incentives for foreign investors and for JVs with leading technology. Subsequently, in 1986 and 1988 respectively, the Law of the PRC on Foreign Wholly Owned Enterprises (FWOE Law) and the Law of the PRC on Sino-Foreign Contractual Cooperative Enterprises (SFCCE Law) were enacted to allow other forms of foreign investment. Several implementing regulations were also put into effect to provide greater details on

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63 See Tseng & Zebregs, supra note 62, at 11–17; K.C. Fung et al., Foreign Direct Investment in China: Policy, Recent Trend and Impact 33 Global Econ. Rev. 99, 99–105 (2004)(Apart from the references to specific Chinese laws and regulations, the following description is based on these two sources)
64 Law of the PRC on Sino-Foreign Equity Joint Ventures (promulgated by the Nat’l People’s Cong., effective July 8, 1979; amended by the Nat’l People’s Cong., effective Apr. 4, 1990; amended by the Nat’l People’s Cong., effective Mar. 15, 2001) [hereinafter SFEJV Law].
65 See SFEJV Law (1979), supra note 64, at art. 8.
68 Regulations for the Implementation of Law of the PRC on Sino-Foreign Equity Joint Ventures, Decree No. 311 (promulgated by the St. Council on Sep 20, 1983; amended by the St. Council on Jan. 15, 1986, then on Dec. 21, 1987, and most recently on July 22,
the formation and operation of these enterprises and implement other policies in favor of FDI. These policies involved an array of tax and non-tax incentives in designated regions of China, starting with five pilot Special Economic Zones (SEZ)\textsuperscript{69} and fourteen Open Coastal Cities (OCC)\textsuperscript{70} and then expanding to other areas nationwide.

The special tax incentives mainly consisted of income tax exemptions and reductions for a specified period of time, “exemptions of customs duties and the value-added tax for imported equipment and technology . . . full refunds for income tax paid on reinvested earnings, and no restrictions on profit remittances and capital repatriation.”\textsuperscript{71} Other non-tax incentives mainly pertained to the relaxation of government controls on the movements of goods, export and import, and the use of land, water and other resources and infrastructure. In order to regulate the direction of FDI, the Chinese government issued rules in 1995, classifying FDI projects into four categories: Encouraged, Permitted, Restricted, and Prohibited.\textsuperscript{72} While various restrictions were placed on foreign investment in the “restricted” and “prohibited” sectors (such as upper limits on foreign ownership shares and sectorial restrictions on foreign investment), particularly favorable tax and non-tax incentives were accorded to foreign investment in the “encouraged” sectors, especially to export-oriented FIEs and those employing new

\textsuperscript{69} The 5 SEZs include Shenzhen, Shantou and Zhuhai in Guangdong province, Xiamen in Fujian province and Hainan province.

\textsuperscript{70} The 14 OCCs are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang, and Beihai City.

\textsuperscript{71} Tseng & Zebregs, \textit{supra} note 62, at 15.

\textsuperscript{72} The Interim Provisions on Guiding Foreign Investment Projects was approved by the State Council on 7 June 1995, effective 20 June 1995. This interim rule was replaced by the Regulations Guiding the Orientation of Foreign Investment, Decree No. 346 (promulgated by the State Council Feb. 11, 2002, effective Apr. 1, 2002). Catalogue of Industries for Guiding Foreign Investment (Catalogue), order No. 5 (promulgated by the State Planning Commission (SPC), State Economic and Trade Commission (SETC) and the MOFTEC, effective on June 20, 1995). This Catalogue has been revised several times in 1997 (by Order No. 9 of the SPC, the SETC and the MOFTEC), in 2002 (by Order No. 21 of the SPC, the SETC and the MOFTEC), in 2004 (by Order No. 24 of the NDRC and the MOFCOM), in 2007 (by Order No. 57 of the NDRC and the MOFCOM), and lately in 2011 (by Order No. 12 of the NDRC and the MOFCOM).
and advanced technology. These policies and laws encouraging technology FIEs will be discussed further below. Furthermore, the Chinese government imposed many restrictions on FIEs in general, most notably local content requirements under which FIEs were required to purchase raw materials and components from domestic suppliers, and export performance and foreign exchange balancing requirements under which the amount of imports allowed by FIEs was conditioned upon their volume of exports and amount of foreign exchange earnings respectively.\textsuperscript{73}

In order to join the WTO, China further liberalized its foreign investment regime in a number of ways.\textsuperscript{74} First, China revised the \textit{Catalogue of Industries for Guiding Foreign Investment} (Catalogue), increasing the number of “encouraged” sectors for foreign investment from 186 to 262, and decreasing the number of “restricted” sectors from 112 to 75. Second, the restrictions on foreign equity were relaxed and the performance requirements, including local content, export performance and foreign exchange balancing, were removed pursuant to the WTO \textit{Agreement on Trade-Related Investment Measures} (TRIMs). Third, under its specific commitments attached to the \textit{General Agreement on Trade in Services} (GATS), China pledged to gradually open up its sensitive service sectors to foreign participation, such as telecommunications, banking, and distribution. China’s FDI policies in the banking sector will be further discussed below.

China’s liberalization of its foreign investment regime has provided great commercial opportunities for foreign investors.\textsuperscript{75} Having benefited from China’s unilateral opening-up, rich countries had high expectations that bringing China into the WTO would bring considerably more opportunities for their companies. In large measure, these expectations have been fulfilled.

\textsuperscript{73} See, e.g., \textit{SFEJV Law} (1990), supra note 64, at art. 9; \textit{SFEJV Regulation} (1987), supra note 68, at arts. 4(3), 14(7), 57 & 75; \textit{FWOE Law} (1986), supra note 66, at arts. 3, 15 & 18; \textit{FWOE Regulation} (1990), supra note 68, at arts. 3(2), 15, 45 & 46.

\textsuperscript{74} See generally Julia Ya Qin, \textit{Trade, Investment and Beyond: The Impact of WTO Accession on China’s Legal System}, 191 \textit{THE CHINA QUARTERLY} 720, 728–733 (2007) (China’s WTO accession liberalized China’s economy, resulting in huge growth in trade and investment); Fung et al., supra note 63, at 104–105.

\textsuperscript{75} See generally U.N.CONF. ON TRADE & DEV., \textit{WORLD INVESTMENT REPORT 2012: TOWARDS A NEW GENERATION OF INVESTMENT POLICIES}, U.N. Sales No. E.12.II.D.3 (2012) (estimating that China is likely to be the most attractive destination for FDI in the following three years until 2014).
However, it is submitted that China’s gains eclipse those of its foreign investors. China has continuously liberalized its market for foreign investment, and yet has regulated FDI in such a way as to ensure that it contributes to China’s economic reform and development without retarding the growth of its underdeveloped industries. For decades, foreign investment has been an essential driving force for China’s economic growth and transformation. Specifically, FDI has made tremendous contributions to the economic development of China by expanding the export of manufacturing goods, imparting new and advanced technology and management skills, enhancing industrial productivity and the competitiveness of Chinese goods and services, raising capital formation and accumulation, creating job opportunities, generating tax revenue, stimulating China’s transition to a market-oriented economy and raising the living standards of its people. The investment policies and laws adopted and implemented by the Chinese government in both stages of the liberalization—the unilateral opening-up stage and the WTO-mandated opening-up stage—have played an essential role in helping China to achieve such great success. Two typical examples will be discussed below: China’s encouragement of high-tech FIEs, and its selected liberalization of its banking sector.

**China’s FDI Policy on Technology Transfer**

Since the commencement of its reform, the Chinese government anticipated that FDI “would introduce new technologies, know-how and capital”, and committed itself to promoting FDI that facilitates transfer of technology to local firms. As established empirically, the diffusion of new and advanced technology,
expertise and knowledge has been one of the most significant benefits that FDI has generated for China’s economic growth. The productivity and technological capability of China’s industries have improved dramatically, at a pace much faster than many other developing countries.

The Chinese government’s strategy to use FDI as a vehicle for foreign technology transfer has been indispensable for the extraordinary technological development of China. In almost all FDI-related laws and regulations, foreign investment that led to the introduction of new and advanced technologies has been warmly welcomed and consistently promoted through a variety of preferential treatments. In each version of the SFEJV Law, the FWOE Law and the SFCCE Law as well as their corresponding implementing regulations, the use of new and advanced technologies was one of the most important requirements imposed on FIEs. Under each version of the Catalogue, foreign investment that fostered technological advancement and innovation in various sectors was consistently classified as ‘encouraged’. More specifically, as mentioned above, technologically-advanced FIEs were eligible for income tax exemptions and reductions on more favorable terms than those applied generally to most of the other FIEs.

During the initial stage of opening-up in the 1980s, while all FIEs were entitled to income tax holidays for the first two years and fifty percent tax reduction in the following three years, technology FIEs were granted an extension of the fifty percent tax reduction for another three years. In SEZs, the income tax rate applicable to technology FIEs (i.e. ten percent) was lower than that on most other FIEs (i.e. fifteen percent). Likewise, since the 1990s, the FIEs established in designated zones that contributed to technological

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80 INNOVATION AND GROWTH: CHASING A MOVING FRONTIER 41–43 (Vandana Chandra et al. eds., 2009).
81 See e.g., SFEJV Law (1979, 2001), supra note 64, at art. 5; SFEJV Regulations (1983), supra note 68, at art. 4(1); SFEJV Regulations (2001), supra note 68, at art. 3; FWOE Law (1986, 2000), supra note 66, at art. 3; FWOE Regulations (1990, 2001), supra note 68, at art. 3; SFCCE Law (2000), supra note 67, at art. 4.
82 Tseng & Zebregs, supra note 62, at 15.
83 Id.
progress enjoyed much lower income tax rates (i.e. fifteen percent versus thirty-three percent), additional periods of tax exemption and reduction, and a full tax refund upon direct reinvestment, amongst other benefits not received by other FIEs. Moreover, as foreign investment in the form of JVs began to be regarded as a better vehicle for the transfer of technology to domestic firms, equity JVs began to be granted more favorable tax treatment than foreign wholly owned enterprises.

In the auto industry, Sino-foreign JVs were the only permitted form of FDI primarily because these could most effectively help domestic firms acquire foreign technology. To ensure such acquisitions of technology, the establishment of auto JVs was conditioned upon foreign investors transferring technology to their Chinese partners. In the meantime, FDI in the auto sector was encouraged not only by these tax incentives but also by other financial incentives (such as preferential access to bank credit and loans).

In 2007, China enacted the Enterprise Income Tax Law (EIT Law), which came into effect on 1 January 2008. This law, which was formulated partly in response to growing domestic opposition to the super-national treatment of FIEs, considerably reduced these FDI-related tax incentives and unified the tax rates and policies for FIEs and domestic enterprises. While a twenty-five percent income tax is now being applied across the board, tax incentives for technology progress have been reinforced rather than reduced. For

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86 See Li, supra note 84, at 4.
88 Id.
89 Id. at 112.
91 See supra note 84, at 24–36.
instance, income earned from technology transfers is eligible for a fifty percent tax reduction or tax exemption.\textsuperscript{92} Enterprises with “high and new technology” enjoy a reduced tax rate of fifteen percent provided they satisfy certain specified criteria including, inter alia, ownership of core IPRs and sufficient devotion to technological development.\textsuperscript{93} Enterprises investing in unlisted medium and small high-technology enterprises are entitled to tax deductions for seventy percent of their total investment.\textsuperscript{94} The continuing provision of preferential tax treatment for technology enterprises is a corollary of the policy direction of FDI towards technological development. Both the eleventh Five Year Plan (2006-2010) and the twelfth Five Year Plan (2011-2015) have strengthened the role of technological innovation and advancement in bolstering further economic growth and reform in China.\textsuperscript{95} With respect to foreign investment, the focus has been shifted from the quantity of FDI to the quality of FDI, with a particular emphasis on encouraging and directing foreign investment in high-tech industries. Therefore, it is hardly surprising that the Chinese government has maintained the preferential treatment of technology FIEs while leveling the playing field for domestic and foreign-invested enterprises in most other areas.

Before China’s entry into WTO, its foreign investment policies mandating technology transfer aroused considerable concerns among foreign investors and their governments. Upon WTO accession, China committed not to condition the approval of foreign investment upon “the transfer of technology . . . or the conduct of research and development in China.”\textsuperscript{96} However, it has been noted that many Chinese laws and regulations remain geared toward encouraging technology transfer and research and development (R&D) by FIEs.\textsuperscript{97} For example, \textit{Several Opinions on

\textsuperscript{92} See \textit{EIT Law}, supra note 90, art. 27(4); \textit{EIT Regulations}, supra note 90, art. 90.

\textsuperscript{93} See supra note 90, art. 28(2); \textit{EIT Regulations}, supra note 90, art. 93.

\textsuperscript{94} \textit{EIT Law}, supra note 90, art. 31; \textit{EIT Regulations}, supra note 90, art. 97.


\textsuperscript{96} See \textit{Report of the Working Party on the Accession of China}, supra note 42, art. 7.3.

Further Improving the Work of Utilizing Foreign Investment explicitly directs FDI into high-tech industries and FIEs to engage in R&D activities.\(^8\) Even in areas where such policy direction is absent, technology transfer has still been treated as necessary for FDI approvals in practice by some Chinese authorities.\(^9\)

Although the WTO-consistency of these laws and practice has not been tested, they appear incompatible with China’s obligations to remove these requirements relating to technology transfer and R&D in approving FDI. However, given China’s long-standing and consistent commitment to economic reform and development through technological advancement and innovation, it is reasonable to believe that China will continue to flout its obligations under the WTO and utilize FDI to advance the technological progress of domestic industries. Undertakings relating to technology transfer and development, in one way or another, are likely to remain the price foreign investors will have to pay for market access.

Finally, as mentioned before, the developed world widely expected that China’s WTO admission, with its obligations under TRIPs, would lead to China’s enforcement of IPRs in favor of foreign investors. However, from China’s perspective, the primary motivation for undertaking the TRIPs obligations was that IPR protection is indispensable for attracting high-tech FDI and fostering indigenous technological innovation. As Long Yongtu stated,

> China has to create a favourable environment at home to provide enough incentives for its own people to advance scientific and technology innovation, which is crucial to China’s future status in international competition. The conclusion is that the protection of IPRs is not a favour for the foreigners; it is in the fundamental interest of China itself.

> In this connection, protection of IPRs has become a precondition for China to attract more FDI, especially in the high-tech area, as the preferential treatment

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\(^8\) Guowuyuan Guanyu Jinyuby Zu Hao Liyong Waizi GongZuo de RuoGan Yijian (国务院关于进一步做好利用外资工作的若干意见) [Several Opinions of the State Council on Further Utilizing Foreign Capital] (promulgated by the St. Council, Apr. 6, 2010, effective Apr. 13, 2010).

\(^9\) See United States Trade Representative, supra note 23, at 68.
provided in taxation and other incentives is not sufficient to maintain China’s appeal to foreign investors.\textsuperscript{100}

In summary, as with the liberalization of its foreign trade regime, China’s liberalization of its foreign investment regime has served its own national interest. While ambitiously promoting foreign investment, China adhered to its development goals and endeavoured to regulate FDI in ways that contribute to its economic growth and reform. China strategically ‘implemented’ its international obligations to utilize high-tech FDI to develop the technological capacity of its domestic industries. When WTO obligations stood in the way of China’s accomplishment of its policy goals (such as technological development through high-tech FDI), China deliberately ignored those obligations in pursuit of its domestic interests at the expense of foreign investors. This point can also be demonstrated by a brief discussion of China’s liberalization of its banking sector for foreign investment.

\textit{China’s FDI Policies in the Banking Sector}

Before WTO accession, and despite its general policy of attracting FDI, China maintained severe restrictions on foreign investment in a number of highly sensitive services sectors such as telecommunications, financial services and distribution services.\textsuperscript{101} In admitting China into the WTO, western countries managed to have China commit to gradually open up these sectors to foreign participation.\textsuperscript{102} However, China’s implementation of these WTO commitments has progressed significantly more slowly than in other areas, generating considerable concern.

One of the most protected and slow-developing services sectors in China has been the banking industry. During the period of unilateral liberalization, banking services were dominated by four state-owned commercial banks – namely Bank of China (BOC), China Construction Bank, China Agricultural Bank and China Industrial and Commercial Bank – and the sector was almost


\textsuperscript{101} See generally \textit{Lardy, supra note 2}, at 66–73.

\textsuperscript{102} See generally \textit{Mattoo, supra note 16}.
entirely closed to foreign banks. Foreign investment was subject to geographical restrictions, limited scope of business, and other entry barriers. In general, foreign banks were only allowed to provide foreign currency banking services. Although an increasing number of foreign banks were permitted to conduct RMB currency business from 1997, they were allowed to do so only in Pudong and Shenzhen and only to FIEs located in these two regions. The capacity of foreign banks to conduct RMB business was further restricted by limitations on their access to domestic currency, including domestic currency deposit ceilings and conditions that tied domestic currency deposits to foreign currency deposits.

Upon WTO accession, China pledged to progressively liberalize its banking sector for foreign suppliers by phasing out the above-mentioned restrictions by December 2006. As specified in its GATS Schedule, China’s major commitments relating to foreign investment in the banking sector include:

- allowing FDI in the banking sector by either establishing wholly foreign-owned banks or permitting investment in Chinese banks without placing limitations on foreign ownership or forms of foreign investment;
- gradually relaxing and eventually removing the limitations on the location, client groups and scope of business of foreign banks, such that upon the expiration of the phase-out period, foreign banks will be allowed to engage in domestic currency

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103 See Wenyan Yang, Domestic Banking under Financial Liberalization: Lessons for China as a Member of the WTO, in CHINA’S ECONOMIC GLOBALIZATION THROUGH THE WTO 35, 36 (Ding Lu et al. eds., 2003).
104 See LARDY, supra note 2, at 68–70.
105 Id. at 69–70.
business in all regions and to all Chinese clients; other than prudential measures, lifting all existing restrictions on the “ownership, operation, and juridical form of foreign financial institutions”; and

according national treatment to foreign banks so that they are entitled to terms or conditions at least as favorable as those applied to domestic banks.

China’s commitments to opening up the banking sector are more thorough and comprehensive than any those made by other WTO Members. However, China’s progress and overall implementation of these commitments have considerably lagged behind the expectations of foreign governments and investors, and indeed behind what the Chinese government has regularly asserted. Certainly, as in other sectors, the Chinese government has long planned to undertake reforms of its banking sector so as to enhance its efficiency and competitiveness. However, the particular sensitivity of the banking sector coupled with the long-standing state dominance of banking has significantly impeded the reform process. Thus, even though the Chinese government has realized that its banking system has constituted one of the largest impediments to China’s further economic growth, the political will has been inadequate to accelerate the pace of reforms. Consequently, despite the growing presence of foreign banks and branches of foreign banks in the Chinese market after China’s WTO accession, they have failed to gain more than a marginal share in China’s banking system.

The limited foreign penetration into China’s banking sector has much to do with the Chinese government’s measures governing FDI in this sector. For instance, in December 2003, the China Banking Regulatory Commission (CBRC) promulgated the Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions, which confines the

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107 The only conditions pertain to certain minimum asset requirement and operational requirements that foreign banks need to have had three years’ business operation in China and been profitable for two consecutive years prior to the application.

108 The only exception is the minimum asset requirement mentioned in note 107.


110 Id. at 6–7.
equity share of a single foreign investor in a Chinese bank to 20% and the total equity share of foreign investors to 25%. This requirement, which restricts foreign ownership in Sino-foreign joint banks, is arguably in conflict with China’s GATS commitments as listed above. In November 2006, the State Council issued the Regulations for the Administration of Foreign-Funded Banks, which was implemented by the CBRC’s Rules for the Implementation of the Regulations for the Administration of Foreign-Funded Banks. Amongst other conditions, these measures stipulate that foreign banks’ branches can only take RMB deposits of one million or more from Chinese citizens, and that in order to conduct RMB business, these branches must have a working capital of RMB 100 million. These conditions, which are not specified in China’s GATS schedule, have effectively restricted the capacity of foreign bank branches to engage in RMB business, and therefore may also constitute a violation of China’s WTO obligations.

Finally, in a recent WTO case, the United States challenged a range of Chinese measures that established a state monopoly in the provision of electronic payment services (EPS) for RMB payment

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112 See Crosby, supra note 106 at 91-96 (exploring whether China’s GATS commitments provide rights for qualified foreign financial institutions to acquire interests in existing Chinese banks).


115 Regulations on Administration of Foreign-funded Banks, supra note 113, art. 31; Implementation Rules for the Regulations on Administration of Foreign-invested Banks, supra note 114, art. 50.

116 See Crosby, supra note 106, at 97-101 (detailing the tension between China’s WTO obligations and the regulatory needs of China’s financial services market).
card transactions.\textsuperscript{117} As the United States claimed, these measures essentially required all EPS to be provided by a sole supplier – the China Union Pay, Co. Ltd. (CUP), which was founded under the approval of the State Council and the People’s Bank of China (PBC) in 2002. The panel found that: (1) in its GATS schedule, China had assumed the responsibility to grant all foreign financial institutions the access to conducting RMB business without any limitations other than prudential measures; (2) the EPS business in concern is a type of RMB business; (3) China has failed to allow EPS suppliers of other WTO Members to engage in the business; and therefore (4) China has infringed its commitments relating to foreign investment in its banking sector.\textsuperscript{118}

Upon the adoption of the panel report China has been obliged to remedy its violations, although China has negotiated with the United States a reasonable period of time to do so, with the sides ultimately agreeing on a deadline of July 31, 2013.\textsuperscript{119} However, given the dominant role of the CUP and the Chinese government’s support for such a monopoly, it remains uncertain as to whether the government will take effective steps to actually allow access for foreign EPS suppliers. Further, any action taken by the government is unlikely to occur soon. In addition to the formal measures above, the capacity of foreign banks to introduce new financial products has still been limited by red tape.\textsuperscript{120} The dominant control of the big four state banks over the RMB business has continued to significantly restrain the capability of foreign banks to acquire sufficient RMB deposits and consequently to conduct RMB business.\textsuperscript{121}

All in all, China’s selective liberalization of its banking sector for FDI provides another illustration of its strategic implementation of WTO obligations. China has not only been reluctant to eliminate pre-WTO restrictions or conditions on FDI, but it has also created

\textsuperscript{117} See Panel Report, China–Certain Measures Affecting Electronic Payment Services, WT/DS413/R (July 16, 2012) (findings regarding legal requirements relating to electronic payment services maintained by China).

\textsuperscript{118} Id. ¶¶7.571–575.

\textsuperscript{119} World Trade Organization, China – Certain Measures Affecting Electronic Payment Services, Agreement under Article 21.3(b) of the DSU, WT/DS413/8 (Nov. 26, 2012).

\textsuperscript{120} M.K. Leung & Ricky Y.K. Chan, Are Foreign Banks Sure Winners in Post-WTO China, 49 BUS. HORIZONS 221, 224 (2006).

\textsuperscript{121} Id. at 224.
new entry barriers in this sector. When international obligations conflict with domestic goals, China’s strategy has been to protect domestic interests at the cost of foreign players without due regard to its WTO obligations.

**China’s WTO Commitments and Domestic Reforms Under the Finance Regime**

The final key elements of China’s economic transformation have been its financial reforms and its integration into the international financial system. However, compared to China’s trade and investment regimes, the reform of its financial system has been relatively slow and inadequate, lagging behind overall economic reform and growth in China. At the forefront of contemporary debates has been China’s exchange rate policy. Below, we discuss this issue with a focus on China’s performance in the reforms of its foreign exchange regime and its observance of relevant international obligations.

*China’s Foreign Exchange Regime*

China’s exchange rate policy reform can be generally divided into three phases: the pre-reform period (1949-1979), the reform period (1979-2005), and the 2005 reform. Prior to China’s reform and opening in 1979, the Chinese government had maintained rigid controls over the value and convertibility of RMB with foreign currencies. The RMB exchange rate was fixed at a considerable overvalue (i.e. RMB 1.5 to a US dollar) for the purpose of facilitating the importation of capital goods necessary for domestic

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industrial development. In order to maintain the value of the RMB, the Chinese government introduced policies which restricted the circulation and holding of foreign currencies within its territory, required the deposit of foreign exchange earnings in the BOC and strictly controlled the outflow of foreign capital. This excessive RMB overvaluation severely constrained the exportation of domestically-made goods and foreign investment into China.

The Chinese government has since gradually relaxed these restrictions on foreign exchange and substantially devalued the RMB. In 1979, the Chinese government introduced a scheme to allow the retention of a certain portion of foreign exchange earnings by exporters and local governments. Since 1985, Chinese residents have been allowed to hold, deposit and withdraw foreign currencies, subject to specified upper limits. In 1986, the Chinese government approved the creation of foreign exchange markets, or swap centers, for Chinese enterprises to conduct RMB and foreign exchange trading under the supervision of the State Administration of Foreign Exchange (SAFE) and its predecessor. This was accompanied by expanding the application of the foreign exchange retention scheme to include all domestic entities, not just entities engaging in export.

Simultaneously, China introduced a duel-exchange rate regime, under which an official exchange rate and a swap market rate operated concurrently. This duel-exchange rate regime was abolished in 1994 and “a unified managed floating exchange rate regime based on market supply and demand” was instituted. Under this new regime, the two rates were unified “by moving the official rate to the then prevailing swap market rate” at around RMB 8.7 to a dollar. The foreign exchange retention scheme was then replaced by an interbank system, under which the sale and purchase of foreign exchange had to be conducted through authorized foreign exchange banks. In 1996, the Chinese government removed restrictions on foreign exchange for all transactions under the current account involving trade in goods and services.

This basket of changes constituted major steps in reforming China’s exchange rate policy from a centrally based system to a market-based system. However, the Chinese government was far

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124 The People’s Bank of China, supra note 123, at 149.
125 Goldstein & Lardy, supra note 123, at 6.
from prepared to adopt a fully floating exchange rate regime. Under this ‘managed float’ regime, the nominal exchange rate of RMB was pegged to the dollar at RMB 8.28 to a dollar, a rate that remained almost unchanged until 2005. Furthermore, in contrast with the full RMB convertibility under the current account, capital account convertibility was yet to be liberalized except for inbound and outbound FDI projects and a limited range of other transactions.126

In July 2005, the People’s Bank of China issued a policy announcement to further adjust the exchange rate regime, moving from a “de facto peg to the US dollar” to a system under which the RMB is pegged to a basket of foreign currencies and is allowed to “fluctuate by up to 0.3% (later changed to 0.5% in 2007 and 1% in 2012) on a daily basis against the basket.”127 The introduction of this new system signaled the willingness of the Chinese government to continue to move toward a more flexible market-based exchange rate regime.128 Thanks to the operation of the system, the nominal exchange rate of RMB appreciated by around 30% to RMB 6.35 to a dollar by the end of 2011.129 Despite this further reform and the appreciation of the RMB, the Chinese government has maintained a “managed float” regime130 under which measures have been taken to keep the RMB exchange rate stable. In order to offset upward pressure on the RMB, the PBC has continued to purchase foreign currency since 2001, which has led to massive accumulation of foreign exchange reserves.131 In the meantime, the Chinese authorities have maintained stringent controls over the capital account, inter alia, by subjecting foreign exchange inflows and

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126 See generally Nicholas Lardy & Patrick Douglass, Capital Account Liberalization and the Role of the Renminbi (Peterson Inst. for Int’l Econ., Working Paper 11-6, 2011); PBC, supra note 123, at 143–44.


128 Goldstein & Lardy, supra note 123, at 11.

129 Morrison & Labonte, supra note 127, at 1, 4.


131 See Goldstein & Lardy, supra note 123, at 21–24; Branstetter & Lardy, supra note 77, at 42.
outflows under the capital account to regulatory approvals and the utilization of foreign capital remitted into China for regulatory supervision.132

The Chinese government has been criticized for manipulating its currency, frequently with reference to economic studies which reveal that the RMB exchange rate has been significantly undervalued and would have appreciated faster, and to a greater extent, in the absence of the government interventions.133 Critics allege that China’s currency regulation and the resultant undervaluation of the RMB have created an unfair competitive advantage for Chinese exports.134 However, the Chinese government maintains that the purpose of its regulation is to “foster economic stability through currency stability,” which is essential to China’s economic development and growth.135 In response to the pressure on RMB appreciation, the Chinese government has begun to reduce value-added tax (VAT) rebates for exporters and has eliminated rebates on many export products.136 This indicates that the “management” of the RMB exchange rate serves policy priorities other than just providing financial support to exporters. One such policy consideration concerns the vulnerability of China’s banking system. China’s banking sector is still struggling with three key challenges: (i) the non-performing loans of major commercial banks,137 (ii) the low profitability of state-owned banks, and (iii) the over reliance on household savings as a funding source.138 It has thus

133 See the references in Christoph Herrmann, Don Yuan: China’s “Selfish” Exchange Rate Policy and International Economic Law, EUROPEAN YEARBOOK OF INTERNATIONAL ECONOMIC LAW 31, 33–35 (C. Herrmann & J.P., Terhechte eds., 2010); Morrison and Labonte, supra note 127, at 6–9, 17.
134 See Morrison and Labonte, supra note 127, at 6–9; Mercurio and Leung, supra note 132, at 1267–68.
135 See Morrison and Labonte, supra note 127, at 28.
136 See Branstetter and Lardy, supra note 77, at 42; Goldstein and Lardy, supra note 123, at 19.
138 Morris Goldstein & Nicholas R. Lardy, China’s Exchange Rate Policy: An Overview of Some Key Issues, in DEBATING CHINA’S EXCHANGE RATE POLICY 1, 12–13 (Morris Goldstein and Nicholas R. Lardy eds., 2008); Lardy & Douglass, supra note 126, at 6.
been observed that the stability of the RMB exchange rate is essential to the stability, ongoing reform and growth of China’s banking industry.\textsuperscript{139} Accordingly, it has been suggested that further reforms of China’s exchange rate system need to go hand in hand with “further strengthening of the banking system – and of the financial system more broadly.”\textsuperscript{140} Without a strong banking system, it is also advisable for China to keep the capital account relatively closed so as to avoid capital flight and the insolvency of local banks and firms that may result.\textsuperscript{141} The perils of financial sector liberalization preceding enhanced prudential regulation were well established by the Asian economic crisis of 1997.\textsuperscript{142} The stability of the RMB exchange rate has also been regarded as being essential to stabilizing employment in the export sector and ensuring social stability, both of which are fundamental to the further economic growth of China.\textsuperscript{143} China’s policy priority has shifted from promoting exports to preventing social unrest and promoting China’s overall economic growth by “managing” the pace of RMB appreciation.

Opinions are divided as to whether the Chinese government’s intervention in the foreign exchange markets has constituted a breach of China’s international obligations under the International Monetary Fund (IMF or Fund) and the WTO.\textsuperscript{144} As a member of the IMF, China is obliged to comply with the rules set out in the IMF Articles of Agreement\textsuperscript{145}, including Article IV, which contains the key obligations regarding exchange arrangements. According to Article IV:2, a member is free to determine the exchange rate regime that it intends to apply as long as this regime does not run

\begin{footnotesize}
\begin{enumerate}
\item[139] Goldstein and Lardy, supra note 138, at 13.
\item[140] Id.
\item[141] Lardy and Douglass, supra note 126, at 3.
\item[143] See generally He Xingqiang, \textit{The RMB Exchange Rate Interest Groups in China’s Economic Policymaking}, 19 CHINA SECURITY 23 (2011); CHARLES W. FREEMAN III. & WEN JINYUAN, \textit{China’s Exchange Rate Politics: Decoding the Cleavage between the Chinese Ministry of Commerce and the People’s Bank of China} (Report of the CSIS Freeman Chair in China Studies, Center for Strategic and International Studies (CSIS), 2011)
\item[144] See Goldstein & Lardy, supra note 138, at 38–42 (providing a brief overview of the debate).
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counter to the member’s obligations under Article IV:1. Article IV:1(iii) prohibits a member from “manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members” (emphasis added). Article IV:3 mandates the IMF to “oversee the compliance of each member with its obligations under [Article IV:1].” In 2007, the executive board of the IMF adopted an amended decision on “Bilateral Surveillance over Members’ Policies” providing guidance for the exercise of the oversight function of the Fund.

One guide, relating to the obligations under Article IV:1, provides that the Fund shall consider and may initiate discussion with a member who, among other things, is involved in “(i) protracted large-scale intervention in one direction in the exchange market.” Those who label China as a currency manipulator argue the Chinese government’s long-lasting intervention in the foreign exchange markets to resist RMB appreciation has constituted a violation of Article IV:1(iii) of the IMF Agreement. Other observers have expressed the view that any challenge against China under Article IV:1(iii) is unlikely to succeed because the embedded “intent” element of that provision would be hard to establish – China’s intervention may well serve policy objectives other than the prevention of effective balance of payments adjustment or the creation of an unfair trade advantage for Chinese exports. As discussed above, our analysis shows that the Chinese government has been seeking to safeguard domestic financial and social stabilities that are fundamental to China’s economic growth.

Allegations of China’s violations of its IMF obligations, especially under Article IV:1(iii), thus seem to be difficult to maintain. In addition, China’s achievement of current account convertibility is consistent with Article VIII:2(a) of the IMF Agreement, which prohibits members from “impos[ing] restrictions on the making of payments and transfers for current international transactions.” By contrast, the Fund Agreement does not similarly prohibit members’ restrictions on capital account convertibility. China’s imposition of capital account limitations is therefore not in breach of its obligations under the Fund.149

Debates on the WTO-legality of China’s exchange rate policy have mainly been based on Article XV:4 of the GATT and, more frequently, the prohibition of export subsidies under the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). GATT Article XV:4 prohibits WTO Members from taking exchange actions which frustrate the intent of the GATT. Despite allegations that China’s “management” of the RMB exchange rate has infringed Article XV:4,150 many commentators have observed that it is difficult to successfully challenge China’s foreign exchange policy under Article XV:4.151 This is because the legal obligations under Article XV:4 are too vague to be effectively enforced in practice and are unlikely to be interpreted by the WTO tribunals in such a way as to condemn China. The SCM Agreement prohibits export subsidies, and whether China’s exchange regime has amounted to such an export subsidy within the meaning of the SCM Agreement is also controversial. According to Articles 1.1, 2, and 3 of the SCM Agreement, for a measure to constitute an export subsidy, the measure must: (1) be a governmental financial contribution, (2) confer a benefit to a recipient, and (3) be specific in the sense that it provides a subsidy to a specific industry or group of industries. Presently, the subsidy must also be contingent on export performance.

149 Mercurio & Leung, supra note 132, at 1283–84.
150 See e.g., Bergsten, supra note 147.
151 See Mercurio & Leung, supra note 132, at 1285–90; Herrmann, supra note 133, at 46–48; Aaditya Mattoo & Arvind Subramanian, Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization, at 6 (Peterson Institute for International Economics, WP 08–2, 2008); Joel Trachtman, Yuan to fight about it? The WTO legality of China’s exchange regime, VoxEU (2010); Dukgeun Ahn, Is the Contemporary Chinese Exchange-Rate Regime “WTO-Legal”?, VoxEU (2010).
Opinions are divided as to whether the Chinese government’s intervention in the foreign exchange markets satisfies all three conditions. A significant number of leading analysts have recognized the difficulties in establishing each of the criteria for the WTO tribunals, in particular the requirement of specificity. Even if the Chinese government was found to have financially assisted Chinese exporters, its intervention would not be treated as an export subsidy if the alleged financial support was not solely afforded to Chinese exporters and the support was aimed at achieving macroeconomic objectives other than export performance. In short, it is unlikely that China’s “management” of the RMB exchange rate has violated WTO rules under either the GATT Article XV:4 or the SCM Agreement.

While there may not be enough evidence to prove a violation of the WTO rules. China’s action still lead to another question. Specifically, has China’s regulation of its exchange regime constituted strategic implementation of its international obligations? Compared to its trade and investment reforms, it is much less clear whether China’s exchange policy reforms conflict with existing multilateral rules. Certainly, the reforms in all three areas have aimed to stimulate China’s transition to a market-based economy, reform and develop domestic industries and strengthen the nation’s overall economic growth. However, China has approached these aims differently in each area. While reforming its trade and investment regimes, China has deliberately ignored certain WTO obligations that it considered to be inconsistent with the level of development of certain sensitive industries, such as the automotive industry, cultural industry and banking industry. By doing so, China has strategically implemented its WTO commitments for its own economic interests, at the cost of the interests of its trading partners.

In contrast, China has endeavored to meet its multilateral commitments in its foreign exchange reform. China has successfully utilized its international obligations to facilitate domestic reforms while at the same time exploiting “loopholes” or “grey areas” in multilateral rules to manage the pace of reforms. For example, in order to comply with Article VIII:2(a) of the IMF Agreement, China has liberalized the current account by removing restrictions on RMB convertibility for transactions involving trade in goods and services. Accordingly, this liberalization is in China’s interest because it coincides with its liberalization in trades of goods and services pursuant to its commitments under the WTO. In retrospect, this liberalization has played an important role in promoting exports, bringing a desirable level of foreign competition, and stimulating other aspects of economic reform and development in China. Moreover, even though there are no IMF requirements for China to liberalize the capital account, the Chinese government has allowed, to different degrees, RMB convertibility in inward FDI projects and, more recently, outward foreign investment transactions by Chinese enterprises. This has significantly contributed to attracting FDI and encouraging competent domestic enterprises to do business overseas.

Finally, while the Chinese government has allowed steady RMB appreciation in response to overwhelming pressure from the international community (especially the United States), the government seems to have taken a firm position that the progress of exchange regime reform and the RMB exchange rate must be regulated so as to avoid unwanted social and financial problems. Considering the fragility of China’s financial system and various other economic sectors, a step-by-step reform with reasonable government regulation seems to be more socially and economically sound than a fully-liberalized reform. Meanwhile, despite external pressure from diplomatic channels, the Chinese government has insisted that its intervention in the exchange regime is not in contravention of any treaty obligations.

Even if China’s exchange regime was found to violate the IMF Agreement or and the WTO Agreement, it is likely that China would continue to regulate its exchange regime in pursuit of

154 See Lardy & Douglass, supra note 126, at 8–10.
domestic policy and economic goals. Since China has explicitly
engaged in selective implementation of WTO obligations in the
reform of its trade and investment regimes, it is reasonable to
anticipate that China would undertake a similar strategic approach
to reforms of its exchange regime, if required. It has been observed
that the IMF’s influence on China’s behavior and practice would be
quite limited even if China were found to be in breach of IMF rules,
due to the lack of an effective enforcement mechanism and a lack of
leverage attributable to China not needing IMF financing. Under
the WTO, the most likely allegation is probably that by suppressing
the price of the RMB, the Chinese government has subsidized the
export sector in the form of (prohibited) export subsidies. However,
as discussed above, any attempted challenges against China on the
ground of currency subsidies would be difficult to substantiate. This
is partly why the United States Department of Commerce (USDOC)
has consistently refused to instigate petitions against China’s
currency subsidies. In addition, the USDOC is probably unwilling
to deal with this longstanding political hot potato. As Magnus and
Brightbill have observed,

Such an investigation would admittedly be dramatic,
and perhaps even traumatic. It would push Commerce
to the centre of the political spotlight concerning a
difficult international issue on which the Treasury
Department has led for many years. And merely
preparing, much less actually sending to the Chinese
Government, a CVD questionnaire aimed at eliciting
information that would be needed to make a “benefit”
determination on currency would create diplomatic
shockwaves.

Thus, while the Chinese government has been under pressure to
allow the RMB to appreciate according to the demand and supply of
the market, China has also exerted considerable pressure on its
western counterparts, including the United States, to avoid
escalation of this issue to formal disputes or even trade wars. Given

Staiger & Sykes, supra note 148, at 28; Mattoo & Subramanian, supra note 151, at 6–8.

John R. Magnus & Timothy C. Brightbill, China’s Currency Regime is Legitimately Challengeable as a Subsidy under ASCM Rules, VoxEU (Apr. 16, 2010), http://www.voxeu.org/print/4960?quicktabs_tabbed_recent_articles_block=1

Id.
the firm stance of China and the stakes associated with keeping the RMB stable, it is likely that the Chinese government will maintain its controls over the foreign exchange markets regardless of legal challenges, sanctions or retaliations from western countries either taken unilaterally or under the WTO.

CONCLUSION

The rules of China’s engagement with the global trading system were set by the West in the accession negotiations, and the West has received enormous economic benefits from China’s rise. Despite this, our initial research suggests that it is China who has most skilfully navigated the rules governing its interaction with the rest of the world, and implemented its international obligations so as to protect its national agenda.

A full assessment would require a multi-year research project and the results would fill at least one major volume. Short of such an exercise, an appraisal such as this will be necessarily somewhat subjective and partial. However, the snapshot we have taken provides a useful starting point for evaluating who has best utilized the international economic legal order. Our research suggests that China has proven highly adept at furthering its national interests in the application and implementation of, and strategic compliance with, the rules governing the global economic system. While reforming its trade and investment regimes, the Chinese government has enforced the rules that have suited it and disregarded the international obligations that have conflicted with its domestic goals. Conversely, China’s financial reforms have mostly satisfied its multilateral commitments but often very slowly and well after compliance was due. The West, for its part, has pushed more softly than it might have for full and strict compliance – despite having set these rules.

There can be no doubting that, for a newcomer to the global regulatory regime, China has proven exceptionally skilful at bending or selectively ignoring the rules to favor itself.