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CHINA'S MYRIAD CUSTOMS REGIMES AND THEIR IMPLICATIONS FOR OPENNESS (WITH REFERENCE TO STEEL IMPORTS)

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ABSTRACT

The aim of this paper is to provide an institutional outline of China's various Customs regimes. According to recent data, only approximately one-third of China's imports were subject to "ordinary" rates of duty and to "ordinary" non-tariff barriers, rules and regulations. A large proportion of merchandise imports are exempt from "ordinary" or "normal" requirements. These exemptions come into play when the importers can demonstrate that the imported goods are sourced from particular countries or locations, or will be used for prescribed purposes (most notably, export processing and capital goods imports). Although such institutional arrangements are common to many countries, the degree and extent of their application in China is seemingly without parallel. The importance of these arrangements in China's case holds qualitative implications for how China's trade policy should be viewed, and also for assessments of China's "openness" to foreign trade. In the present paper, the impact of the various regimes is illustrated with reference to their affect on imports of iron and steel products into the Chinese mainland.

1 THE SIGNIFICANCE OF SEGMENTATION

China's trade is highly segmented, with different tariff and non-tariff treatments accorded to imports based on the status and location of the importer, and on the purpose to which the imported good will be used or applied. To an extent, segmentation of trading rules is a fact of life, true of all countries and not just China. Tariff rates specified for particular goods are virtually never universally applied. Exceptions inevitably arise, and Customs authorities around the world are empowered with, and invariably forced to use, discretion in the application of everyday rules, regulations and rates of duty. For example, what do Customs authorities do when they damage goods in the act of inspection — do they insist that the person collecting the goods still pay the full dutiable amounts? Should Customs authorities assess full tariffs on goods temporarily imported into the country, such as film production equipment for making movies on location, or equipment temporarily imported to undergo repairs? Should duties be levied on capital goods to be leased and then returned to the lessor's home country? In these and other circumstances, Customs authorities may have to provide concessions or exemptions on the normally applicable trade controls and tariff rates.

In countries with low tariffs (eg. the United States, EU or Japan) and negligible non-tariff barriers, the existence of discretionary treatments and regulatory exemptions usually does not carry a significant capacity to change economic outcomes. For example, exemptions or draw-backs on a 2 percent tariff will not create for the importer as significant a change in costs and therefore incentives as would an exemption applicable to a 25 percent tariff.

However, in Asian countries, where general tariff and non-tariff treatments often carry large disincentives for imports, and remain in many cases geared to a mentality of import substitution — a mentality which persists despite the orientation of these countries towards export promotion — the existence of regulatory exemptions to the standard treatment is of huge significance. Many East Asian countries offer concessions for export processing activities, involving processing "in bond" or else eventual refund or drawback of duties.

Export processing schemes have played an enormously important role in the development of China's import and export trade, as statistics in this paper demonstrate. In fact, over the last 10 to 15 years, the "processing with customer's materials" (*lailiao jiagong*) and "processing with purchased materials" (*jinliao jiagong*) schemes established by the Chinese government have remained very important items of business. Swathes of industrial facilities throughout southern China, particularly Guangdong, but also in other parts of the country, owe their existence to activities aimed at meeting the requirements of

export processing contracts. Arguably, China's trade would never have "got off the ground" in the way it has done if these (and other) concessional arrangements were not present so as to allow for a reduction of costs to feasible levels. Indeed, without risk of exaggeration, if Chinese export processors and their foreign clients were forced to rely on China's tough "ordinary trade" regime (*yiban maoyi*) in order to bring necessary components and materials into the country, processing trade would probably have been still born or stone dead.

Issues discussed in this paper are as follows. First, statistical evidence is presented to demonstrate the relative size and scope of the various types of Customs regimes, both for imports into China in general, and for steel imports in particular. Second, concerns held by the domestic Chinese steel producing sector in relation to the operation of preferential Customs regimes are outlined. Third, the paper provides an overview of the rules, regulations and other observations pertinent to the operation of the most important types of Customs regimes — including ordinary trade, processing with customer materials (PCM), processing with purchased materials (PPM), bonded warehouse imports, FIE investment imports and barter trade. Along the way, other issues such as the whys and wherefores of smuggling under the guise of processing trade, the cancellation of concessions on "luxury" and FIE investment goods imports, and a query regarding the statistical measurement of FIE imports for export processing purposes, are also discussed.

2 CHINA'S CUSTOMS REGIMES: STATISTICAL PROPORTIONS

Overall merchandise imports

China collects statistics on some 25 types of import regime, each with its own regulatory framework. (There are also regimes not included here, such as "contracting projects", which are applicable only to exports). The 25 import classifications are listed as follows:

(1) Ordinary trade.
(2) International Aid.
(3) Donation by Hong Kong, Taiwan, Macau or foreign citizen ethnic Chinese.
(4) Compensation trade.
(5) Processing with customer materials (PCM).
(6) Processing with imported materials (PPM).
(7) Consignment trade.
(8) Border trade.
(9) Equipment imported for PCM.
(10) Goods on lease.

(11) FIE investment imports.
(12) Outward processing.
(13) Barter trade.
(14) Duty-free commodities on payment of foreign exchange.
(15) Bonded warehouse trade.
(16) Other.
(17) Duty free.
(18) PCM imports sold domestically.
(19) PPM imports sold domestically.
(20) SEZ imports sold domestically.
(21) Returned goods (quality not acceptable).
(22) Returned goods (delays in delivery).
(23) Returned goods (other reasons).
(24) Transfers in and out of bond-tariff zones.
(25) Transfers between bonded warehouses and domestic market.

In terms of actual throughput, many of the categories listed above are not important. Table 1 illustrates shares of China's total imports occupied by the more important regimes. Residual categories not explicitly included in Table 1 summed to just under 5 percent of total import values in 1994 (even less in other years). The statistics also show that the most important trading categories are those occupied by processing activities (which amounted to nearly 46 percent of total imports for 1996) — "processing with customer's materials" and "processing with purchased materials", together with associated equipment imports.

TABLE 1
Percentage composition of China's merchandise imports classified by Customs regime

Regime:	1992	1993	1994	1995	1996
Ordinary trade	44.5	39.6	33.2	32.8	28.4
Processing with customer materials (PCM)	15.7	12.5	13.1	12.3	12.8
Equipment imported for PCM	1.5	1.3	1.1	0.9	0.8
Processing with purchased materials (PPM)	23.4	22.5	28.1	31.9	32.0
Customs warehouse imports	-	-	-	4.5	5.2
FIE investment goods imports	10.0	16.0	17.5	14.2	17.9
Barter trade	-	3.8	2.1	1.1	0.6
Residual	-	4.3	4.9	2.3	2.3

Sources: Customs (Monthly) (December editions, 1993-1996); 1992 figures calculated by author.
Note: "-" indicates data not available.

Imports into bonded Customs warehouses are also important for assessing the extent of export processing activities, since the greater part of these imports will ultimately be used for processing purposes. Bonded Customs warehouse imports may therefore be added to the total for processing activities to gain a more complete picture of the importance of the processing sector with China's overall import trade — this arithmetic suggests processing activities accounted for approximately 50 percent of China's imports in 1995 and 1996.

Even this statistic of 50 percent may understate the importance of export processing activities in China's total import trade, because there are also minor Customs categories, such as compensation trade, goods on lease, and outward processing, which are wholly or at least partly associated with export processing activity. For example, outward processing involves the export of materials and components to be assembled, processed or machined in locations outside China, ultimately to be returned to China in completed form — yet often in fact the re-imported goods are themselves semi-finished products to be used in export processing before eventual export to consumer markets abroad.

Besides processing trade, "ordinary trade", and investment goods brought in by foreign-invested enterprises (FIEs) also constitute significant proportions of total imports. Statistics show that the proportion of total imports occupied by "ordinary trade" — which is simply the basic category under which no preferential or concessional treatments are afforded — has fallen dramatically over recent years. In 1992, ordinary trade occupied roughly 44.5 percent of total imports, but by 1996 the percentage had fallen to just under 30 percent.

FIE investment imports (capital goods used for establishing factories or otherwise meeting the investment commitments of foreign investors) constituted approximately 18% of China's total imports in 1996. This figure does not indicate the full extent of imports by FIEs, since these enterprises will also make imports under other categories, including ordinary trade and processing activities, in much the same way as state or collectively owned enterprises. Special treatment for *new* investment projects supposedly terminated in April 1996, but the policy change is subject to a grandfather clause, and clearly, the 18% statistic shows that a large amount of duty-exempt investment imports continued in 1996.

Of the remaining categories, barter trade is amongst the most important — particularly when attention is confined to steel products alone (cf. Table 2). Whilst Table 1 shows that the overall importance of barter trade has diminished greatly in recent years; the decline in the percentage of steel products imported via the barter trade regime has been slower.

Steel imports

Chinese authorities do not directly publish a breakdown on the value of steel imports flowing through each of the different Customs regimes. However, some statistics may be found in the Chinese-language newspaper "World Metals" (*Shijie Jinshu Daobao*), which maintains reports on latest ebbs and flows in the steel imports tide. The industry newspaper's sporadic surveys in this respect reflect Chinese steel industry concern about the level of import competition. Chinese steel makers are particularly concerned by the possibility that steel imports may be able to evade import controls applicable to the "ordinary" trade regime, by utilising the concessional treatments available under other Customs categories. Statistics consolidated from various "World Metals" reports and presented in Table 2 (below) are not complete, but sufficient cumulative (year-to-date) data is available to gain an understanding of the composition of iron and steel imports.

TABLE 2
Percentage composition of iron and steel imports classified by Customs regime

Month of January to → Regime:	May 93	Oct 93	Dec 93	May 94	Oct 94	Dec 94	May 95	Jun 95	Jul 95	Aug 95	Sep 95	Oct 95	Dec 95	May 96	Jun 96	Jul 96	Aug 96	Sep 96	Oct 96
Processing trade	-	-	14	-	-	21	37	38	38	37	37	38	36	32	31	31	31	31	31
Ordinary trade	60	55	-	46	43	43	27	-	27	27	28	28	-	27	29	29	29	29	29
FIE investment purposes	-	-	-	-	-	-	15	-	14	14	13	13	-	17	18	19	19	19	19
Bonded warehouse trade	-	-	-	-	-	-	17	-	19	18	18	18	-	18	17	17	17	17	16
Barter trade	-	-	-	-	-	-	-	-	-	4	4	3	-	-	3	3	3	2	2

Sources: *SJD* (various issues, 1993-1996). Note: "-" indicates data not available.

Table 2 shows, for example, that between January and October 1993, 55 percent of steel imports by volume were brought into the country under the normal or "ordinary" trade regime, and therefore subject to the full gamut of tariffs and trade controls. Since then, the percentage occupied by ordinary trade has declined, to 43 and then 27.7 percent for the January to October period in 1994 and 1995 respectively — although rising slightly to 29.2 percent for the comparison period in 1996. Meanwhile, the latest 1996 data shows that 31.3 percent of steel imports were for processing purposes ("processing" here encompasses both *jinliao jiaogong* (PPM) and *lailiao jiagong* (PCM), but excludes imports into bonded warehouses); 16.5 percent of steel was imported into bonded warehouses; and nearly 19.5 percent of steel was imported for establishment purposes by foreign invested enterprises.

The available statistics on steel imports echo the general picture for merchandise imports overall, particularly in the relative importance of ordinary trade vis-a-vis processing, investment and other regimes. The main differences between Table 1 and Table 2 lie in: (1) A greater tendency to store imported steel in bonded Customs warehouses (between

January-October 1996, almost 16.5 percent of imported steel was stored in Customs warehouses, as opposed to just 5.21 percent of overall goods imports during the period January-December 1996). (2) An apparently smaller percentage of steel imports used in export processing than for overall merchandise imports (note that "processing" in Table 2 includes both PCM and PPM categories of Table 1). But a significant share of the steel imports stored in bonded warehouses would ultimately be used for processing purposes (for evidence, see below), so in the final analysis, it is likely that processing activities are just as important for steel imports as they are for goods imports as a whole.

Concerns held by China's steel producers

China's state-owned steel manufacturers are deeply concerned about steel imports made through the avenue of Customs schemes allowing for exemptions on tariffs and licensing requirements. Their general desire is to avoid or at least minimise competition — imports are viewed as a serious threat. But the Chinese producers also recognise that imposition of tariffs and controls on the *ordinary* trade regime mean that it should be possible for domestic production to be price competitive with even the cheapest imported steel. The concern is that either through legitimate diversion or else smuggling, somehow imported steel is able to utilise preferential Customs regimes as a route into the domestic market, thus avoiding controls and levels of duty that would otherwise reduce its competitiveness.

Comprehensive evidence of the concerns held by Chinese steel producers, as recently as November 1996, is provided in the Appendix at the end of this paper in the form of translations from the newspaper "World Metals" (*Shijie Jinshu Daobao*). The message in these translations is clear-cut — producer disapproval of the importation system is obvious.

It is interesting to note from the translations comparisons made between the prices of domestically-produced Chinese versus imported Russian or Ukrainian wire rods (see articles dated 6 and 13 September 1996). Prices on steel materials imported from CIS countries are taken as the benchmarks with which Chinese producers must compete, as the product mix of imports from the CIS is similar to that of Chinese output (in contrast, there are fewer domestic substitutes available for the premium steels typically imported from Japan), and since CIS countries provide one of (if not "the") cheapest sources of steel imports.

The crude comparisons outlined in the newspaper articles suggest that *if* the normal amounts of duty are paid on wire rod imports from the CIS, then Chinese producers would have a price advantage of some 160 yuan per ton by the time products are sold on the domestic market. But if importers are able to utilise duty and licensing exemptions

available in processing and (or) FIE capital-goods import regimes, then the Chinese product becomes uncompetitive with the cheap Russian or Ukrainian imports (*SJD* 6 & 13 Sep 1996).

An implication of the view held by Chinese steel producers that steel imports were finding their way onto the domestic market through the avenue of tariff-exempt regimes is that imports must have been diverted — illegally — from ostensive processing or investment purposes. One newspaper report states (see translation 25 October 1996 in the Appendix):

> … the State's formulation of preferential import policies has conditions attached (*you tiaojian*), is focussed (*you zhenduixing*), and the preconditions for enjoying import tariff exemptions are that the materials will be used in processing for exports or will be used for one's own consumption, or will be placed in bonded storage, and it is not permitted for the materials to flow into common areas or to enter the market. Therefore, in theory, these steel imports should not threaten the domestic market.

Note emphasis here on the fact that preferential import policies are "focussed", operating with strict conditions attached. Goods imported for processing or investment purposes must not be casually diverted for sale on the domestic market, and as shall be seen later, there are regulations in place to prevent just such an outcome. The article continues:

> But at present, to reduce costs and to elbow their way into the domestic market, traders are using all sorts of methods to evade normal tariffs — importing "in bond" (*bao shui*) or "completing formalities" (*zuo shouce*) for processing trade; under-invoicing imports; using the pretext of processing to make imports, but reducing the volume of verified re-exports and then diverting to the domestic market; or else, importing using the pretext of investment purposes, but actually diverting to sale on the domestic market.

The above provides an indication of the *illegal* methods used bring imports into China. As noted, the letter of the law is strict — unambiguous regulations govern operation of China's preferential import regimes. If avenues cited above are being used to bring imports to the domestic market, then actions which infringe regulations must be occurring. Smuggling need not only take the form of "boats landed in the dead of night". Other means are also used, many of which follow official procedure *up to a point*. But a critical common feature uniting all forms of smuggling is that somewhere along the line a deliberate transgression of Customs regulations occurs (some transgressions could be quite technical in nature).

Given the overwhelming importance of the various types of Customs regime to China's trade in general, and to steel imports in particular (Tables 1 & 2), the following sections attempt a more detailed explanation of the nature and operation of the various regimes, concentrating on those schemes which comprise a large proportion of China's steel imports.

3 ORDINARY TRADE

Imports under the ordinary trade regime are subject to normal Customs treatment and no special concessions or exemptions are offered. Importers pay duties according to the standard rates, and must comply with other requirements such as licensing and registration. For some goods imported into China, the "ordinary trade" requirements can be formidable.

Ordinary trade is the most interesting category when China's trade is viewed from a strict "market access" perspective. Imports made for the purposes of sale on China's domestic market must, by and large, pass through the "ordinary trade" gateway. Smuggling aside, the small scale and limited nature of alternative channels to import goods for domestic sale, such as "consignment trade", reinforce the singular importance of ordinary trade as the way to "get goods onto shop shelves". Consignment trade involves importing consumer goods for domestic sale on an sales-agency rather than title basis. However, according to official Customs materials, in 1995, consignment trade was limited to imports of cosmetics, foreign magazines, handicrafts, washing powders, adhesive tape, chewing gum, cigarettes, alcohol, instant coffee, Coca Cola and other beverages. A total of just nine trading enterprises were approved to make consignment imports of these products, the import of which was specifically aimed at satisfying demand by foreign residents or tourists in China (Customs 1995: 154-5). In 1995, officially-recorded consignment trade comprised less than 0.01 percent of China's total trade, and less than one-thousandth of a percent in 1996.

The regulations also explicitly prohibited importation of televisions, VCRs, air-conditioners, washing machines and other household appliances on an official consignment basis. This prohibition also extends to spare parts for after-sales service of foreign products in China. A point of clarification here is that there may[1] be nothing to stop any Chinese importer (not just the nine noted above) from acting as sales agent for imported foreign goods (including spare parts and household electricals) — only that China's Customs authorities will treat the import transaction as "ordinary trade", and all normal rates, regulations and rules will apply.

Given that ordinary trade remains the only legal market access channel of any significance worth emphasising, at least so far as non re-exported products are concerned, the following point should be made: there has been a tendency to view countries as being relatively

[1] It is unclear from 1997 and 1995 guidelines (Customs 1997: 175-76; 1995: 153-54) whether explicit concessions are offered for goods imported on consignment – eg. delayed duty payment, until domestic retail sales are recorded – or whether the intention of the guidelines is to comprehensively restrict all forms of "sales agency" to the officially condoned ones outlined above. As discussed in Dickson (July 1996), Chinese trading enterprises have traditionally possessed an "order-taker" mentality, unwilling to act as sales agents for foreign companies. Perhaps there are institutional reasons for this unwillingness, such as the provisions on consignment trade.

"open" to trade if the total value of imports and exports represents a large percentage of GNP. But China is not necessarily "open" in a more common English-language sense of the word. The significant proportion of China's trade comprised by processing activities has helped inflate China's trade to GNP ratio — every import entering China for processing purposes self-perpetuates an export of equal or greater value (assuming smuggling-diversions are not a problem). Barry Naughton (1996: 18-19) has warned against drawing simple conclusions about China's market openness based on crude trade to GNP ratios:

> ... aggregate statistics give a misleading impression of China's openness to foreign trade. The argument here is distinct from, and complementary to, that of those who argue that China's trade is overstated because GNP is understated from a purchasing power parity standpoint … the more important generalisation may be that, if the export processing regime is put to one side, China's openness to foreign trade remains modest and still subject to numerous restrictions.

If processing and other activities are eliminated from the trade aggregate, and "ordinary" trade alone measured against GNP, then using 1995 statistics and an exchange rate of 8.35 yuan to the dollar, China's trade-to-GNP ratio falls from 40.9 percent to just 16.7 percent. Ordinary trade is the most restrictive of the various Customs regimes, in the sense that it is beset by licensing, registration, canalisation and other non-tariff barriers (Dickson 1996).

4 PROCESSING TRADE

Processing with customer materials

In Chinese language, processing using materials supplied by the foreign customer is known as "*lailiao jiagong*" (or more completely, "*lailiao jiagong zhuangpei*", indicating the trade encompasses "assembling" activities in addition to "processing"). The abbreviation "PCM" is used in text below. Processing with customer materials is a form of contracting activity, basically involving the allocation of factory resources to a foreign client for a fee.

PCM involves the provision of raw materials by the foreign client, but factory equipment can also be provided. After the Chinese factory has fulfilled the processing contract, the equipment can either be returned to the foreign supplier, or else paid for by deduction from the processing fee charged to the foreigner. Other methods of paying for the equipment, if not retained by the Chinese factory, can also be found (eg. compensation trade was an option, at least until recently). Equipment imported specifically for PCM purposes (*lailiao jaigong zhuangpei jinkou de shebei*) is treated as a separate category, distinct from PCM itself, in Chinese Customs statistics (see Table 1). Imports of equipment used in processing for foreign customers have declined as a percentage of overall imports, from 1.5 percent in 1992 to 0.8 percent in 1996, perhaps indicating that over time, Chinese factories

have become progressively better equipped, and are now more readily able to complete contract work from foreigners without any need to import special machinery.

Preferential treatment is afforded to PCM imports and exports. First, materials supplied for processing purposes are exempt (100%) from tariffs and other taxes assessed by Customs. Second, imports of equipment and machinery used directly in the processing work are also exempt from tariffs (including associated safety, pollution control, packaging and loading equipment). Equipment for improving the management of contracting Chinese factories may be imported duty free (such as, fax machines, computers and closed circuit television monitoring systems).[2] A "reasonable amount" of materials for fastening or securing factory equipment (eg. steel beams) may also be imported tariff free. The same applies for fuel necessary for running equipment. A 100 percent exemption from export taxes is granted.

Intermediate *materials* imports are not subject to import licensing, although *equipment* imports are scrutinised. If products made using the equipment are exclusively for export, then import licenses are not required. Otherwise, where licensing requirements would normally apply, the Chinese party is expected to make application to relevant authorities.

As a general rule, concessional processing activities in China do not operate on a draw-back basis, that is, Chinese processing importers are *not* first expected to pay tariffs and then apply for a refund at a later date. Rather, processing activities operate "in bond", with tariffs simply not levied in the first-place. However, Customs authorities operate various verification systems (*hexiao zhidu*), which differ according to type of processing regime.[3] For processing with customer materials (PCM), Customs authorities record details of each batch of exports made towards completing the processing contract. Within a one month time period after the final batch of finished goods is exported, the Chinese processor is expected to report to Customs for final verification. If some of the materials supplied by the foreign client remain unused, then the Chinese party is expected to pay the full rate of tariffs on the surplus amounts (however, import licenses are not required for the surplus amounts).

One question worth raising relates to PCM in particular, and to processing activities in general. Do the tariff treatments granted by Chinese authorities represent "*concessions*", or are these treatments better characterised as "*exemptions*"? From the above description, and from the treatments afforded to compensation trade and to the other processing schemes,

[2] This concession was partly revoked at the beginning of 1995. See discussion on "luxury" goods below.

[3] A question dealt with later concerns the enforcement of verification systems.

clearly "exemption" is the most accurate characterisation. There is sometimes some confusion about the discretionary power of Chinese authorities to assess varying rates of duty on particular imports. Whatever the actual practice, the written rules are clear: there is little discretion to assess differential rates of duty — if the import qualifies for export processing purposes, then a 100 percent exemption is granted "full-stop" (one exception is barter trade, where a 50 percent concession is or was granted for non-governmental barter deals — see Section 7 below). To the extent that differential or *ad hoc* treatments do begin to emerge, this is not so much due to differences in actual rates of tariffs assessed (unless Customs officials are acting illegally or improperly), but rather, in the determination of what proportion of the imported commodities are to be subject to full tariffs, and what proportion is to be completely exempt. This question is determined at the end of the processing cycle, after the last finished goods have been exported back to the foreign client.[4]

Although Chinese processing schemes such as PCM do not operate on a "draw-back" basis, Customs authorities are nonetheless empowered to insist on pre-payment of tariffs, to be drawn-back after export shipment, if they see fit. Usually this will occur in cases were the applicant has a poor history of fulfilling Customs regulations, or where Customs authorities might otherwise suspect the possibility of smuggling or evasion by the applicant.

In 1995, PCM deals were banned for 18 kinds of product[5] — including prohibitions aimed at ensuring that foreigners do not using processing schemes as a way to circumvent China's strict controls on the export of tungsten and rare earth oxides.

Foreign clients were prohibited from taking possession of finished products within China's territorial boundaries — the goods must be exported out of China with declaration made to Customs. There is also a ban on foreign clients signing contracts directly with manufacturing enterprises in China. The foreign party is expected to contract with an approved import-export organisation, which in turn subcontracts with domestic manufacturing-

[4] Although for "processing with purchased materials" (PPM), the proportions to which full tariffs will be applied is partly determined at the start of the processing cycle, when materials are imported, as well as at the end. The "PPM" scheme is discussed later.

[5] According to Customs (1995: 166) the 18 products were: (1) cotton yarn and cloth – pure or mixed with artificial fibres; (2) bleached cotton cloth – pure or mixed with artificial fibres; (3) "Arabic-style" robes or trousers; (4) silk; (5) drawnwork; (6) pearls – for polishing, piercing or threading; (7) leather work-gloves; (8) toilet paper, corrugated cardboard for lining in packaging, hessian cloth – for supply to Hong Kong or Macau; (9) intended exports to Hong Kong of import-quota restricted perishable frozen goods; (10) products for which foreign countries have implemented quota restrictions on Chinese exports; (11) products to be used in processing activities whose import into China is prohibited – for example, environmentally polluting scrap materials, pornographic materials etc; (12) tungsten products; (13) antimony oxide; (14) rare earth products containing yttrium oxide; (15) PCM proposals which involve dismantling old automobiles; (16) cony or rabbit hair; (17) pure wool carpets; (18) mushrooms – tinned or in salt solution.

capable enterprises to produce the required goods. However, Chinese authorities recognised that foreign clients would wish to have greater say over the organisation and management of production. Foreign business people were therefore permitted to participate in the management of production, in the provision of technical advice, in the recruitment of labour, and in generally acting as a consultant to the domestic manufacturing enterprise.

Under these circumstances, the fact that foreign businesses are required in the first instance to sign contracts with approved trading entities may become something of a formality — in practice, their main dealings were with the domestic manufacturing enterprise. Nonetheless, this "formality" is too important to ignore, as it gives trade-approved import and export enterprises an economic stake in activities in which they might not otherwise participate.[6]

Chinese government awareness of the needs of subcontracting activity has even extended to allowing foreign businesses commissioning PCM contracts to apply for residency permits to station personnel within China, and to import vehicles and other items for the exclusive use of their expatriate staff (although these privileges may have been affected by the cancellation of tariff exemptions on so-called "luxury" goods imports — more on this below).

The substantial degree of cooperation, supervision and influence (if not control) that a foreign party can gain over actual factory operations, underlies the fact that PCM contracts have in the past been seen as an elementary alternative to direct foreign investment — a consideration important to China's collective enterprise sector. Rural collectives often lack the formal prerequisites necessary to establish contractual or joint equity enterprise vehicles with foreigners. One the other hand, the somewhat looser, more flexible contracts to process customer materials have given rural collective enterprises a foot in the door so far as foreign economic cooperation is concerned. As one source states: "... because processing using materials supplied by customers is simple, easy and convenient to carry out, and because this activity turns a profit quickly, it is a much easier type of business to develop that either contractual or equity joint ventures" (MOFTEC 1993: 73).

As with "processing with purchased materials" (PPM, discussed below), PCM has made a significant contribution to China's economic growth over the last decade and a half. The numbers of enterprises established in China and specialising in PCM contract work was said to number 40,000 at the beginning of the 1990s, of which, 20,000 firms were located

[6] An analogy might be requirements that lawyers do real-estate conveyancing, when clerks could easily do the job!

in Guangdong province alone (MOFTEC 1993: 71). As noted, PCM has also made a particular contribution towards internationalisation of rural collective enterprise activities.

Processing with purchased materials

In Chinese, "processing with purchased materials" translates as "*jinliao jiagong*", and in text below is abbreviated PPM. A major difference between "processing with customer materials" and "processing with purchased materials", is that in the latter, the Chinese firm actually purchases, taking legal title to, the imported materials to be processed.[7]

It appears that the Chinese firm need not have signed an export contract in order to apply for import processing tariff exemptions (this point requires further verification). In general, processing with purchased materials appears to involve less in the way of client initiation of contracts, or direction of production, features sometimes integral to "processing with customer materials" (PCM). Processing with purchased materials (PPM) is undertaken, by and large, at the initiative of the "Chinese" firms themselves, who are able to identify international market opportunities and act on them by importing the required materials.

The "Chinese" firms initiating PPM contracts are frequently FIEs. Indeed, in 1995, 74 percent of exports using purchased imported materials were made by enterprises with a foreign ownership stake (at minimum, 25 percent foreign equity) (Naughton 1996: 6-7).

Whilst PPM ventures are more often than not initiated by firms resident in China, overseas clients themselves occasionally instigate the ventures. Counter-contracts (*duikou hetong*), whereby the Chinese side agrees to purchase raw materials from the foreigner, with the foreigner buying back the completed product, enjoy advantages under PPM. Authorities may find it easier to ascertain, or have faith in, the applicant's credentials if a hard and fast export contract already exists, and for this or other reasons advantages are offered which are unavailable under more general terms (more on this below). Counter-contracts are also spiritually-close to "processing with customer materials", and may be treated as such if settlement involves cancelling-out amounts so that the Chinese party does not actually remit payment to the foreigner. The various Customs regimes are divided by hazy borderlines.[8]

[7] A literal translation of *jinliao jiagong* is "processing with imported materials". But after all, materials used in the *lialiao jiagong* (PCM) scheme are also imported. Hence, "processing with purchased materials" is used here for *jinliao jiagong* – this rendering captures the essential feature distinguishing PPM from PCM, the question of who owns the materials.

[8] Another hazy division is between compensation trade *(buchang maoyi*) and PCM (*lailiao jiagong*).

As with PCM, factory enterprises not approved to engage in international trade are not permitted to sign direct contracts to import materials. A typical PPM business proposal may be visualised as a contract between a factory enterprise (*jiagong shengchan qiye*) and an "operating enterprise" (*jingying danwei*). The operating enterprise is approved to engage in international trade, and takes responsibility for buying requisite import materials, and finding sales outlets for the final product abroad. Of course, no such partnership is required for foreign invested enterprises, which possess their own rights to engage in import and export operations (on the imports side, FIE rights are limited to "self-consumption" purposes).

Goods imported and exported under PPM qualify for the following exemption: 85 percent of the total import shipment will be exempt from tariffs, whilst 15 percent of the shipment will be subject to full tariffs (obviously, it does not matter whether value or volume is used as the basis of these proportions). However, in 1995 there were 15 types of commodity which qualified for a more favourable ratio of 95 percent exempt, 5 percent dutiable.[9]

These percentages may reflect the General Customs Administration's confidence about the ability of processors to devote imported materials to the stated export purpose without wastage or leakage. If, at the time of final verification — to be undertaken within one month after the last export shipment — operating enterprises can demonstrate higher usage ratios, then they may qualify for a refund of some or all of the duties previously paid on the 5 or 15 percent components. But if verification reveals that the operator used less than 85 or 95 percent of the imported materials in manufacturing the exported goods (which would, in any case, be considered an offence — exceptions noted below), then they will be required to pay full duties on the surplus amounts not actually used (not including the portions on which duties have already been paid). The same system applied for other taxes assessed by Customs, such as VAT (although may have been affected by changes to VAT rebates).

There are, however, a number of circumstances under which the processing ventures will qualify for immediate full duty exemptions on 100 percent of the imported goods instead of the usual 85 or 95 percent. One has already been described, viz. "counter contracts" (*duikou hetong*). The requirement is that the Chinese party buy materials and sell finished products to the same foreign partner, although "consolidated contracts" (*duikou lianhao hetong*) in which materials are purchased from, and final goods sold to, different concerns may also be entertained under certain circumstances.

The other circumstances in which the imports in totality, rather than just 85 or 95 percent, are accorded exempt tariff treatment will be detailed further at a later stage. To provide a brief mention at this juncture: full exemptions may be granted when Customs approved bonded warehouses or bonded factory facilities are utilised. "Bonded enterprise groups" (*baoshui jituan*) is an additional possibility not detailed in this paper.

[9] The 15 commodity types which qualified for the more favourable 95 to 5 ratio were (Customs 1995: 191): (1) untawed fur or pelts; (2) tawed fur or pelts; (3) raw or untanned hides; (4) leather; (5) synthetic leather; (6) cotton cloth – wider than 64 inches; (7) cloth from cotton but mixed with other fibres – wider than 64 inches; (8) wool yarn or tops; (9) clothing linings made from pure wool, pure cotton, chemical fibres or other filament blendings; (10) pearls; (11) ivory; (12) coral or amber; (13) cut or uncut precious stones or diamonds; (14) pre-made packaging materials; (15) components for electrical products.

In all cases, however, there is a final verification process to determine actual percentages of imported materials consumed in manufacturing the exported product, with operating enterprises expected to pay duties on any left-over amounts. Imported materials do not require import licences (in circumstances were these would otherwise be required), but in any case, enterprises seeking to register a PPM business proposal with Customs authorities (a necessary preliminary) must first seek approval from the same kinds of government agencies which would grant licenses in the first place. But if owing to accidental circumstances imported materials cannot be used or exhausted as originally intended, then the operating enterprise may apply to Customs to sell the materials on the domestic market — in these cases, normal import licenses must also be secured before approval is given. Tentative evidence, in the form of lower-than-expected foreign exchange returns generated by processing activities (q.v. Table 3) suggests that such "accidents" may occur quite frequently in practice. Such accidental reasons might include foreign customers refusing to accept delivery of the processed goods or else falls in market prices for export products.

The other circumstance in which Chinese authorities recognise that there may be additional left-over materials is when the enterprise has improved its manufacturing efficiency. However, incentives for improved efficiency seem rather weak — exemptions are only available for surplus amounts less than 2% of total amounts of the imported material used *and* less than 5000 yuan in total value (3000 yuan in the case of PCM).[10] Thus, incentives for X-efficiency will be reduced, as part of the efficiency gain will be taxed away by the tariffs on any surplus amounts. However, efficiency incentives may be unimpaired for risk-loving entrepreneurs with the ability to smuggle or divert unused materials to market.

Concessions granted under the PPM scheme often apply for imported components which retain their physical shape or basic properties. For example, a microprocessor remains a microprocessor regardless of whether it is a loose, unattached component or fixed inside a finished electrical product. But Customs regulations also allow for processing imports of "reasonable amounts" of chemicals, catalytic agents, seeds, stock feeds and other materials which will be consumed "without trace" but yet contribute to the production of the final export product. The World Bank (1994: 58) notes that administration of China's processing arrangements is "relatively well developed ... the relationship between inputs and exports is defined according to specified coefficients and a small allowance is made for loss and wastage." Whether by sighting the actual input in the finished product, or otherwise making use of fixed coefficients, the task of Customs is to ensure that there is no undue wastage, leakage, diversion or smuggling of the imported input materials.

[10] The total value of 5000 yuan seems astonishingly small for a manufacturing venture, whose through-put must surely be greatly in excess of that amount. And yet that is in fact what the regulations say (Customs 1995: 190).

So far as potential diversion of materials is concerned, in addition to duties on 15% or 5% of the import materials that must be paid up-front, Customs has the power to insist on pre-payment of all duties, with later refunds, for enterprises whom Customs deem troublesome.

Products exported as the result of "processing with purchased materials" are exempt from export taxes. There exist an additional four products for which special approval must be obtained before export as part of a "processing with purchased materials" venture.[11]

Exemptions from *export licenses* are almost never given — for PCM and PPM, and for many of the other trading categories operated by Chinese authorities. The government does not have a great deal of flexibility to grant exemptions from export licensing or export quota arrangements now in force. A number of export quota arrangements have been introduced by the Chinese government in recent years (despite their general economic inefficiency — in fact, the previous trend in China was to repeal such barriers to exports) to ensure that a strong grip is maintained over export goods subject to EU or American restraints (textiles, bicycles etc) or over exports which could easily trigger anti-dumping actions (eg. in western countries including Australia). Through greater supervision, China aims to minimise the chance of giving ammunition to partners keen on prosecuting trade cases against China.

From Table 1, it may be observed that in 1996, PPM was the single most important component within China's total imports (in 1996 PPM supplanted ordinary trade as the top category). As with processing with customer materials, PPM has played an important role in China's economic development. The contribution to employment has been particularly significant. For example, it was said that the numbers of people employed in the city of Tianjin and engaged in PPM activities in 1992 exceeded 300,000 people (in some hundreds of enterprises; although quite possibly these enterprises would have also been engaged in other business operations as well). The contribution to employment in other localities — south China in particular — has been similarly impressive. Crude but elucidatory statistics suggest that each $10,000 invested towards a PPM venture could create up to 20 jobs, and that the PPM scheme overall helped maintain employment for 28 million people in China in 1991 (MOFTEC 1993: 64).[12] Also based upon 1991 statistics: the claim that from processing activities adding value to each dollar's worth of imported materials, the central government was able to collect 1.5 yuan in profit taxes (MOFTEC 1993: 64).

[11] The four product types were (Customs 1995: 189): (1) musk – used in Chinese medicine; (2) bezoar – also used in Chinese medicine; (3) cooper and acid-bronze alloys; (4) platinum.

[12] These statistics imply, improbably, that $14 trillion has been invested in PPM ventures! One way of reconciling the statistics is to note that the factories concerned must have completed other work besides PPM contracts.

Foreign exchange returns

Whilst PPM and PCM have been profitable (one pertinent question concerns the distribution of returns between Chinese and overseas clients or partners), and whilst employment and revenue generating effects can be pointed to, there is a question mark over the foreign exchange returns generated by the schemes — see Table 3. (By way of reference, statistics for "ordinary" trade are also provided in Table 3, although the focus of discussion in paragraphs below is on foreign exchange returns to PPM and PCM schemes).

Table 3
Value of exports as a percentage of import values (by regime and ownership, in 1995)

Ownership:	Ordinary trade	PCM	PPM
Total	165	127	126
State owned enterprises	177	131	182
Collective enterprises	329	142	140
Foreign invested enterprises	82	108	114
Foreign contractual joint ventures	86	113	115
Foreign equity joint ventures	74	105	109
Wholly foreign owned venture	146	113	120

Source: Customs (Monthly) (Dec 1995: 12-13).

1993 sources state that the government's policy objective for the processing with purchased materials scheme (PPM) was to attain a 30-50 percent rate of foreign exchange generation (*chuang hui lu*) (MOFTEC 1993: 65). Roughly speaking, the venture should be able to earn foreign exchange receipts 30-50 percent greater than the amount of foreign exchange spent on acquiring intermediate inputs. Table 3 suggests that during 1995, the state owned enterprises and collective enterprises involved in processing activities reached that target (PPM exports were 82 and 40 percent greater than imports for these two ownership sectors respectively). But PPM as a whole (generating total export values 26 percent greater than import values) did not quite meet the government's objectives (cf. Table 3).

Lower than expected foreign exchange earning ratios recalls the question — hinted at above — of *for whom* processing trade has been most profitable. Processing trade is, or was, lucrative, otherwise China (particularly Guangdong) would never have seen the huge tracts of processing-oriented industrial facilities in evidence today. But competitive entry into the industry may have reduced the profits initially available. Large numbers of processing enterprises may have driven down prices, increasing surplus available to foreign business clients (and, ultimately, foreign retail consumers) when the exported products are disposed of on the overseas markets, and also reducing the margins between the foreign exchange value of imported intermediates and the final product (as seen in Table 3).

Examination in Table 3 of the different classes of foreign invested enterprise reveals the strikingly "poor" performance of joint equity ventures in meeting foreign exchange targets. In 1995, the value of joint equity venture exports under PPM was just 9% greater than imports — far short of the 30-50 percent target. The extent of under-performance was even greater for the PCM scheme, where joint equity ventures yielded a margin of just 5%.

Why did foreign invested enterprises — joint equity ventures in particular — generate such low export returns when compared with the value of their imports? One explanation is that FIEs may source a higher percentage of intermediate inputs from abroad when compared with state owned enterprises engaged in processing trade. Foreign investors are attracted to China's low labour costs, not necessarily to Chinese-made raw materials or semi-finished products — the problem of China's non-competitive production of intermediate goods is highlighted in conclusions from the World Bank (1994: 75-77). On the other hand, state owned and collective enterprises will source a greater proportion of inputs domestically, which will increase the ratio of foreign currency earned to spent.

Transfer pricing may play a role in the particularly low foreign exchange generation ratios for FIEs seen in Table 3 — although usually transfer pricing is motivated by tax advantages of the various jurisdictions across which operations occur, and China's tax regime as an FDI host country is more competitive than many of the home countries.

Another conjecture for the differential performance of the various ownership sectors may be presence of "fake" FIEs (*jia hezi qiye*), whose foreign equity partner is often no more than a Chinese-owned company domiciled in Hong Kong. Partnerships with foreign (or pseudo-foreign) companies conveys benefits to Chinese domestic firms. One benefit would be the legal right to undertake ordinary trade imports (for self-consumption purposes); another would be the right to manage the foreign trade side (not just manufacturing subcontracting) of PPM and PCM processing activities. The low percentage returns on both ordinary trade (–26%!) and processing trade for joint equity ventures is consistent with the presence of a group of pseudo-foreign joint ventures whose real purpose is to manipulate trade rules in order to import or smuggle goods into the country. A substantial proportion of foreign capital in China (61% of annual FDI inflows between 1983 and 1994)[13] comes from Hong Kong — some of which may be recycled Chinese capital (also see Naughton 1996: 14-15).

[13] This statistic calculated by Chen Chunlai, University of Adelaide.

Export processing by foreign invested enterprises

Rows in Table 3 relating to "processing with purchased materials" and "processing with customer materials" include imports made for these purposes by FIEs (also see MOFTEC 1993: 577). But importation by FIEs for processing purposes is apparently administered under a separate regime (*waishang touzi qiye wei luxing chanpin chukou hetong jinchukou huowu*), with its own forms and paperwork (Customs 1997: 232-34; 1995: 220-21). The FIE regime, whilst offering essentially the same concessions as the general PPM and PCM schemes, does not appear to make any distinction as to whether the goods imported by the FIE are purchased (whether from foreign affiliates, parent companies, or third parties), or alternatively supplied free-of-charge by an export customer. This raises the question as to how Chinese Customs authorities distinguish between FIE imports for PPM as opposed to PCM purposes when collating the statistics seen Tables 3 (the statistical data on PCM and PPM imports includes a breakdown by ownership, be it state, collective *or foreign*).

Diversion of materials

Smuggling is a major problem in China's import trade. PCM and PPM are amongst the most important conduits for smuggling activities. In 1994, Chinese officials tracked down 465 cases of smuggling involving processing trade — a figure which accounted for 61 percent of the total value of smuggling cases actually detected and prosecuted during that year (SWB 29 Feb 1996: Fe/2548 S1/1). Whilst the fact that processing concessions have been subject to abuse is widespread knowledge, less clear is the question of which precise rules and regulations were broken, within the ambit of PPM and PCM schemes, in order for the smuggling to have taken place. What do the smugglers actually do in order to escape the well-established verification procedures existing under the PCM and PPM regimes?

Smuggling-diversions of materials might proceed by hoodwinking Customs officials. For example, falsification of invoices. Unlike ordinary trade, the purpose of under-invoicing processing-trade imports is not to minimise tariffs, as processing regimes enjoy 100% duty exemptions anyway (on most if not all of the shipment — a percentage of PPM imports are dutiable). Rather, the objective is to allow for the value of goods not declared to Customs to be diverted to domestic sale. The ruse could proceed by under-invoicing imports and (or) by over-invoicing exports. The fraudulent invoicing needed to facilitate diversions of either imported materials or export goods to the domestic market would tend to widen — not reduce — the gap between reported import and export values. Therefore, this kind of deception is more likely to be practiced by state and collectively owned enterprises than by FIEs, given the narrow gap in import and export values seen for the latter (cf. Table 3).

However, Customs verification to match processed exports with the original imports may rest primarily on a system of technological coefficients and not on reports of the value of each shipment. To give an example — Customs will seek to ensure that two imported peddles results in one exported bicycle. Unit values of the imported peddles and exported bicycle may be immaterial; what is important is that physical coefficients are observed (in which case, deception of Customs would centre on falsifying volumes instead of values).

Another possibility is that Customs authorities simply do not see all the exports they should — exports that ought to eventuate from processing ventures go "AWOL". If so, this would bring down the total value of exports relative to imports under processing schemes (consistent with the general picture in Table 3). Some of the missing exports would reflect diversion of materials. Rather than misleading declarations and invoices, the problem may, therefore, be one of enforcement — or complicity — on the part of Customs services. Customs should possess information to determine if a processing venture has exceeded time limits for completion of processing contracts. If ventures are not reporting on time, or if required exports are not declared to Customs, it may reflect a failure, whether deliberate or inadvertent, by Customs officials to use available information to chase-up the offenders.[14]

Commencing April 1996, China has instituted new rules, requiring processing ventures to make deposits into "guarantee accounts" held at local Bank of China branches. The venture may only cancel these bank accounts if Customs verifies the completion of the processing operation within the allotted time period (SWB, 2 Apr 1996: Fe/2576 S1/1; 29 Feb 1996: Fe/2548 S1/1). Such rules may have been introduced so as to reduce the need for direct enforcement and cross-checking by the Customs Administration itself, increasing instead the incentives for self-motivated compliance. Whilst Bank of China branches will not actively pursue enforcement, they must nonetheless be transacted with if applicants are to have security deposits returned. The government's decision to bring this additional checking mechanism into play represents an unofficial verdict that, whether due to corruption or lack of resources, the General Customs Administration could not be trusted to handle the task.

[14] It is interesting to note the frequent appearance in the MOFTEC-run newspaper "International Business" (*Guoji Shangbao*) of lost property notices (*yishi shengming*). Reported in these notices, the loss of verification documentation for processing trade (*dengji shouce; hexiao dan*). Loss of documentation is supposed to be a serious matter – the owner must bear the consequences if lost documentation is abused (Customs 1995: 192). Customs authorities must be notified, serial numbers must be publicly advertised, and the documentation is proclaimed invalid (*shengming zuofei*). And yet the regular appearance of these notices suggests it is not uncommon for documentation to go missing. Circulation of invalid documentation may present a problem for Customs enforcement.

Some diversions out of the processing stream are legitimate. Officially, Customs may only grant approval to sell goods domestically in the event of "accidents" — but accidents may be relatively frequent in practice. Accidents might include a foreign client's refusal to accept delivery, or else adverse price falls in destination markets (however, the approved remedy in the latter case is temporary storage in bonded Customs warehouses until circumstances improve, rather than allowing domestic sale of the goods). In all cases the processing venture is expected to pay tariffs on any goods diverted to the domestic market.

5 CUSTOMS WAREHOUSE IMPORTS

Goods may be imported and stored in secure Customs warehouses without paying tariffs. Table 1 shows that goods imported into bonded Customs warehouses formed a relatively important part of China's trade — in fact, at 5.2%, this type of trade represented the 5th most important category in 1996. What are the advantages of this particular form of trade?

Approved uses of bonded warehouses include storage of the following types of imported goods:[15] (1) goods brought in for sale under consignment; (2) parts needed for after-sales service of foreign products; (3) spare-parts and fuel to be used by foreign airline and shipping companies; (4) imports which owing to dispute or accident are stored temporarily (payment of duties is deferred pending resolution). But these uses of Customs warehouses seem specialised, unlikely to generate the large volume of trade which passes through the warehouse system (5.2% of total goods imports and over 15% of steel imports in 1996).

In fact, probably the most important uses of bonded warehouses are for storage of goods imported under (5) processing with customer materials and (6) processing with purchased materials. PCM and PPM arrangements allow for the initial deposit of imported materials into bonded Customs warehouses, to be retrieved when necessary for processing, assembly and ultimately re-export. But then what is the attraction of importing into bonded Customs warehouses? Imports made for export-processing purposes are virtually exempt from all duties anyway, so why the need to access the tariff-free status of bonded warehouses?

The advantages and contingencies of various arrangements are no doubt most readily apparent to the business-people involved. Practitioners in the field would understand the kinds of inconveniences they suffer under particular regulatory regimes, and appreciate the benefits that may accrue from a slight change of rule here or there. Essentially, bonded

[15] Storage of *ordinary trade* imports in bonded warehouses (or in similarly regulated bonded port zones) is banned – irrespective of whether tariffs are ultimately paid or not (*yiban maoyi jinkou huowu bu yunxu cunru baoshui cangku*) (Customs 1995: 203). Yet the personal observations of Professor Andrew Watson (University of Adelaide) suggest this

Customs warehouses provide a slightly different regulatory environment to that available under standard PCM and PPM schemes. This word of caution about the uncertain nature of advantages available aside, bonded warehouses seem to offer the following benefits.

First, so far as the PPM regime is concerned, under normal circumstances, duties must be pre-paid on 5-15 percent of imported components and materials (as already discussed). But goods imported and delivered immediately to a bonded warehouse are completely exempt from pre-payment of tariffs (ie. on 100 percent of the shipment), and this remains the case when the goods are collected from the warehouse for processing under PPM.

Second, under both PCM and PPM schemes, at the time of final verification, the enterprises concerned will be required to pay tariffs on surplus imported components (except for the 15 or 5 percent already paid in the case of PPM). By storing goods in bonded warehouses, processing enterprises may be able to effect a system of just-in-time inventory management whereby collections are declared to Customs and goods brought to the factory only when needed. Increasing the options to manage inventories may reduce the chance of dutiable surpluses. Enhanced ability to manage inventories may assist the enterprise in controlling factory scheduling, cash-flow and expenditure issues. In general, deferring tariff payments allows enterprises to minimise capital sunk in idle stocks as opposed to performing assets.

Third, another aspect of inventory management comes to the fore when it is considered that bonded warehouses effectively offer an extension of time period to execute PCM or PPM processing contracts. Under both schemes, imports must be processed and re-exported within one-year after the date of import (with verification formalities to be completed within one month after the last batch of exports). But goods may also be stored in bonded ware-houses for up to one year, with longer time periods possible upon application to Customs. This suggests an extension of the time-span over which processing can be stretched, from one to two years. Imports can be stored in the bonded warehouse, and only when collected would the clock start counting down the one year time limit on the processing venture.

Bonded warehouses are subject to approval by Customs before they can be established, and must satisfy set requirements. But the warehouses are managed by independent operators (eg. the processing firms themselves), rather than by the Customs Administration directly.

injunction was violated in the case of Tianjin Port Bonded Area, whose main item of business appeared to be showrooms for retailing of imported foreign luxury vehicles.

6 INVESTMENT IMPORTS BY FOREIGN ENTERPRISES

The ever-extending grandfather clauses

Capital goods imports necessary for meeting FIE investment commitments have hitherto been granted preferential treatment under Customs regulations. The regime providing for investment imports is rather different in nature from the processing schemes thus far discussed in this paper. Investment imports are not considered "bonded imports" (*baoshui zhidu jinchukou*), as is the case for imports under PPM, PCM, or into Customs warehouses. Unlike these latter schemes, there is no re-export requirement for FIE investment imports.

According to announcements at the end of 1995, and to subsequent regulations (MOFTEC 4 Apr 1996: 12-3), concessions previously enjoyed on FIE investment imports were to be cancelled after 1 April 1996 — but subject to grandfather clauses which extended the pre-existing treatment for all agreements to invest in China signed before that date. If the value of a proposed investment project agreed prior to 1 April 1996 exceeded $30 million, the foreign investor could continue to enjoy investment import concessions up until the end of 1997. For projects less than $30 million, investment concessions were supposed to end on 31 December 1996. It is notable that in "the first three months of 1996, foreign firms signed contracts committing to invest a total of $27.4 billion in China, an increase of 86.8 percent over the same period in 1995" (Nee & Parnell 1996: 32). The development may reflect a rush to access the grandfather clauses, also explaining why a sizeable 18 percent of China's total imports (19 percent of steel imports) in 1996 were FIE investment imports.[16]

1997 is likely register a non-negligible proportion of FIE investment imports — for the first month of 1997, duty-exempt investment goods accounted for 18 percent of total imports.[17] The reason why investment imports will continue in importance throughout 1997 is that the Chinese government has recently extended the grandfathering of pre-April 1996 investment agreements. For contracts less than $30 million in value, duty-exemptions were extended until 31 December 1997, with exemptions on contracts greater than $30 million lasting until July 1998 (CDBW 13 April 1997). The current tendency is for "foreign investors to revert from medium and small projects to large undertakings" (*ibid.*), a trend which suggests that the proportion of imports devoted to duty-free investment goods may remain

[16] Other evidence can be found in Financial Times (24 Nov 1995): "China Tax Shift Starts Import Rush".

[17] Year-to-September figures show the 1997 trend slackened, with FIE investment imports comprising 11% of the total.

significant in 1998. The Chinese government has also signalled its willingness to entertain extensions for individual negotiated cases beyond the July 1998 deadline.[18]

[18] The latest episode in the saga is Zhu Rongji's hint (in September 1997, at the 50th Anniversary World Bank meeting in Hong Kong) that China may *reintroduce* duty exemptions for foreign investors (FEER 2 Oct 1997).

Under the provisions supposedly now being wound-down, the following items were 100% tariff and sales tax exempt for both wholly foreign-owned and joint-equity investment ventures. First, equipment, spare parts and other materials (such as construction steel for building factory facilities) pledged as part of the investment contract (the value of imports must not to exceed the pledged investment value). Second, additional equipment, spare parts and other materials difficult to obtain in China domestically. Third, transportation equipment — "special vehicles" (*tezhong cheliang*) — limited to reasonable amounts and within the total value of pledged investment. Fourth, special import allowances and provisions (not detailed here) apply in case of FDI in China's hotel and hospitality industry.

Similar provisions apply in the case of *contractual* joint ventures, which have historically been the investment vehicle of choice for foreign investors in China's oil extraction industry, and are also the likely mode of investment for build-operate-and-transfer (BOT) projects for future energy and infrastructure developments. However, contractual joint ventures with foreigners to operate chain restaurants, photograph-development stores and other services are not exempt from paying the standard rates of duty on their capital goods imports.

As to licensing requirements, both joint equity ventures and contractual joint ventures are required to obtain import licenses where these would normally be required. Wholly-foreign owned enterprises are exempt from import licensing in the case of imports to be "self-used" (*zi yong*). There is another class of FIE — *sibao qiye* — compatriot enterprises whose overseas partner is either ethnically Chinese or else from Hong Kong, Macau or Taiwan. These ventures are exempt from import licensing in cases where the good is tariff exempt.

Investors seeking to import equipment, machinery or other capital goods in order to meet investment obligations are required to first lodge application with Customs. If the proposed imports qualify, Customs will issue the foreign enterprises with the necessary document-ation to gain concessional treatment at the time of making the import declaration. Customs is supposed to keep records to ensure that investment imports by the venture do not exceed total value of the investment contract originally approved by Chinese authorities.

Customs exercises supervision over the equipment for a fixed number of years after import-ation, in order to ensure that the imports are used solely for specified investment purposes. In the case of materials used for building of ships, aeroplanes and factory facilities (such as steel and glass), supervision lasts 8 years. For vehicles and household

electrical goods, the period is 6 years. For other types of equipment and materials, supervision lasts 5 years. At the conclusion of these time periods, Customs supervision ends and FIEs are then free to dispose of items as they see fit. The different time periods involved may reflect Custom's estimation of length of useful working life that should be accorded to the various types of good. The different durations may also reflect the degree of disruption likely from any leakage of goods onto the domestic market (a form of "quarantine"). Steel, cars and house-hold electricals (all of longer supervision durations) are viewed as key import substitution sectors, and the economic impact of their leakage may be seen as especially deleterious.

Cancellation of exemptions on "luxury" imports

Cancellation of duty exemptions (if it actually happens) on FIE capital goods imports after July 1998 will usher in a new era for China's trade regime. Attempts to scale back investor privileges are not without precedent. On 1 January 1995, the Chinese government suddenly cancelled all import duty exemptions on a group of 20 products classified as "luxury" items, listed below — although in some cases, where contracts were signed prior to the end of 1994, tariff exemptions could still be enjoyed until 31 March 1995 (Customs 1995: 257-8).

Air-conditioners	Mobile phones
Cameras	Photocopiers
Cooking spices (*can liao*)	Refrigerators
Electronic calculators	Stereo equipment
Electronic typewriters	Stored program telephone systems
Fax machines	Telephones
Film cameras	Television sets
Furniture	Video cameras
Lamps	Video cassette recorders
Personal computers	Washing machines

Duty exemptions were cancelled regardless of whether the goods were imported under FIE investment provisions or for any other purpose or modality, including goods carried into the country in the passenger baggage of temporary resident foreigners and overseas Chinese.[19] The twenty types of good affected by the changes would previously have qualified for concessional treatment under investment or export-processing regimes on the basis that they improved workplace management — many of the items are standard office equipment items. Western newspaper reports suggested the changes heralded a new, less generous approach towards foreign investment concessions by the Chinese government (FEER 26 Jan 1995: 53; AWSJ 12 Jan 1995), prescient given subsequent changes to the

[19] Citizens of the people's republic, especially Chinese students abroad, appear to be excepted. As an incentive to return to China, the government has extended privileges to students studying abroad, including permission to import certain goods duty free.

wider FIE investment import regime (although as already noted, the Chinese government continues to vacillate over cancellation of exemptions for investment projects committed before April 1996).

7 BARTER TRADE

Barter trade is of lesser-importance in the overall trading system when compared with some of the other categories detailed previously. Barter trade comprised 7.6 percent of China's total imports and export trade in 1990, amounting to approximately $6.5 billion (MOFTEC 1993: 60). Table 1 shows that in relative if not absolute value terms, barter trade has well-and-truly declined since then (to just 0.59 percent of total imports in 1996). However, barter trade is relatively more important for ferrous metal products, still comprising some 2 to 4 percent of China's total steel imports (Table 2), with possibly a larger proportion for steel imported from Russia, Ukraine, Kazakhstan, Eastern Europe and North Korea.

Barter trade involves direct exchange of goods instead of cash payment. At least until the end of the Eighth 5-Year Plan (but possibly cancelled subsequently), barter trade imports enjoyed tariff and licensing concessions. The concessions were only available to enterprises approved by MOFTEC to engage in barter operations, and expressly not available to FIEs.

Exports

No tariff concessions were provided for exports of goods made under barter trade deals. However, export licences were not required — except on shipments of grains (rice, soy beans, maize, wheat), oil (crude and refined) and tungsten ore. Unlike other Customs regimes, an export licensing exemption was extended for barter trade. But after all, as described below, barter trade is limited to markets of the socialist world, perhaps not the kind of countries likely to resort to American or EU-style anti-dumping measures or voluntary export restraints (although with transition away from socialist-style management of trade, some Eastern European countries may be becoming increasingly concerned at the prospect of "unfettered" inflows of Chinese goods). As explained previously, commercial diplomacy — the desire to avoid provoking sensitive export markets — nowadays forms one of the most important reasons why China resorts to export licenses and quotas. However, the continuing use of export licenses under barter trade for the specific cases of grains, petroleum and tungsten may reflect altogether different reasons — reasons now discarded by China for the majority of other commodities. In the case of grains and petroleum, China's main concern has been to ensure availability of scarce supplies for domestic users. In the case of tungsten, China restricts exports in an attempt to control world prices (on tungsten and rare earth export restrictions, also see Footnote 5).

Imports

Bartered imports resulting from two-way government-to-government transfers are generally subject to zero-tariffs. Imports made by enterprises approved to engage in barter trade operations, but doing so on their own initiative and not otherwise the result of specific inter-governmental deals, would experience a 50% reduction on the normal rate of tariffs. Barter trade imports were exempt from licensing, at least until the end of 1995. However, for steel imports, the import licensing system was abolished at the end of 1993, and "registration" instituted in its place by mid-1994 (Dickson 1996). Under the new system, bartered imports of steel must be "registered" before being allowed into the country (*YCHJ* Sep 1994: 4).

There are a number of important limitations on concessions enjoyed under barter deals. The tariff and NTB concessions described above are limited to imports originating from CIS countries (members of the former Soviet Union), Eastern European countries (Romania, the former Yugoslavia, Bulgaria, Albania, Poland, Hungary, the former Czechoslovakia) as well as Asian socialist (or formerly socialist) countries such as North Korea, Mongolia, Laos and Vietnam. Whilst FIEs in general did not qualify for barter trade concessions (regardless of whether the bartered imports were sourced from socialist countries or not), the same did not apply if the foreign partner hailed from one of the above listed countries, in which case the concessions were available under specific circumstances (Customs 1995: 152):

- Chinese participants in joint ventures *inside* socialist countries, purchasing (from income generated by the venture) local goods to import back into China.
- PCM ventures in which the Chinese processor is remunerated in kind using products imported from the socialist home country of the foreign client.
- A partner from a socialist country sells imported goods on China's domestic market in order to raise capital to fulfil investment commitments inside China.

Existence of such concessions may reflect currency convertibility issues, coupled with a desire to foster investment links between Eastern-bloc countries whilst recognising the straightened circumstances faced by potential partners in some of those countries (eg. North Korea). However, such concessions may also form a loophole for smuggling activities.

Barter trade was originally the method of choice for trade between socialist countries with non-convertible currencies, including between China and the Soviet Union in the 1950s era of good relations. Barter trade allowed for an extension of domestically-oriented material-balance planning systems, by affording opportunities to adjust surpluses or deficiencies of

domestically produced goods. In barter trade between China and the Soviet Union, the Rouble acted as the unit of account when valuing goods to be exchanged (until 1971). Early transactions between China and the Soviet Union tended to involve Chinese exports of agricultural products and raw materials in exchange for processed goods and capital equipment. In a reflection of changed bargaining strengths and priorities of the two partners, by agreement between China and the Soviet Union, as of 1971 the Swiss Franc replaced the Rouble as the unit of account (MOFTEC 1993: 59). In addition, by the mid-1980s, Chinese exports included an increasingly large proportion of manufactured goods and textiles, whilst raw resources such as lumber have become an important component of Russian exports to China. At the same time, pig iron and rolled steel have consistently occupied an important place in Russian barter exports to China (MOFTEC 1993: 58-59).

Whilst barter trade was the trade mechanism of choice between socialist countries, after the fall of the Iron Curtain, Chinese authorities continued to encourage the use of barter trade with the socialist-cum-transition economies (at least until conclusion of the Eighth 5-Year Plan). It was recognised that trading relations between Eastern Europe and China would eventually be placed on a more "normal" footing, but the rationale for continuing barter trade in the meantime was that barter trade served as a transitional mechanism, allowing trade relations to be maintained, perhaps even expanded, despite the difficult circumstances being experienced by some of the countries concerned (MOFTEC 1993: 60). The extension of barter trade concessions to aspects of the foreign investment regime as described previously also reflects a desire to maintain other forms of economic links (besides trade).

In addition to the limited range of countries, other important restrictions on availability of barter trade concessions concerns types of good. Concessions are not allowed on bartered imports of the following: bicycles, motorbikes, household electricals, cigarettes, alcohol, beverages, cosmetics, refined oil and finished steel (Customs 1995: 152). In fact, tariff concessions on bartered imports of steel were removed by State Council in 1994, when authorities became concerned at the high level of import competition faced by domestic iron and steel producers. State Council announced in 1994 that (*YCHJ* Sep 1994: 4):–

> For barter trade, border trade and donations imports of steel, commencing 11 September 1994, tariffs and VAT will be levied at normal regulated rates, and will no longer enjoy concessions or preferential treatment. For contracts signed prior to 10 September 1994, provided the imports arrive before 30 November, the original concessions still apply.

Given that tariff and VAT concessions for all new barter contracts for steel imports were cancelled in mid-September 1994 (along with imposition of "registration" requirements as already mentioned), how is it that according to Table 2, barter trade still accounted for 2-3

percent of steel imports in 1995 and 1996? Perhaps the answer lies in recalling that advantages of barter trade do not merely lie in possible tariff concessions but also in the fact that barter trade affords an alternative means of trade for cash-strapped trading partners (or where currency convertibility problems may exist). Nonetheless, it is clear that most of the impetus for importing steel through barter arrangements, prior to cancellation of the tariff and VAT concessions, was precisely in order to take advantage of those concessions.

The industry newspaper "Metal Bulletin" has provided some interesting evidence in this respect. An article published 28 July 1993 indicated Chinese steel importers, particularly those located within southern China, were engaging in illegal or unauthorised barter deals:

> While barter trade is supposed to take place between communist countries, those involved in this illegal business will make up their own certificates of origin and type in the correct countries to pass off their steel as barter cargo. [According to a Hong Kong steel trader]: "They have asked us for blank certificates of origin, and when we refused they made their own copies ... There were rumours that the Chinese government would drop barter trade or remove import duty preferential treatment with effect from July. Since no action was taken, now the rumours are saying that this will take place with effect from August."

In retrospect, it is clear that the Chinese government cancelled barter concessions for steel imports in neither July or August 1993, but waited until mid-1994 to announce the decision. In the meantime, barter trade probably continued to serve as a conduit for steel smuggled into China. "Metal Bulletin" has also noted that steel importers were able to avoid or reduce import duties by "shipping material through barter ports such as Fangcheng which do not impose import taxes" (MB 10 Jan 1994). Fangcheng, referred to here as a "barter port", is located in south western Guangdong province. Details such as these suggest why controls on imports into Guangdong in particular are "porous".

8 CONCLUSIONS

China runs a complicated trading system, with rules and regulations differing depending on the status and location of the importer, or the purpose to which imported goods will be applied. To some extent, China is not unique in these respects — there are circumstances in which all countries must make exceptions to the everyday application of trading rules and regulations. But in many western countries exceptions are trivial — in Asia, especially China, they are not. In China, the value of imports flowing into the country through duty exempt channels is enormous, leaving the observer wondering whether the ordinary tariffs and controls are not so "ordinary" after-all (accounting for just 30% of imports in 1996). Perhaps "normal" trade controls are better characterised as exceptions to the general rule!

The "bifurcation" [20] of China's import trade system through a myriad of different Customs regimes presents problems when trying to form conclusions about how "open" China is as a country. Decrees by China's State Council to implement new restrictions on steel imports, for instance, may not extend to steel brought into the country under processing provisions. An example is the implementation of a new "automatic registration" scheme for steel imports in 1994 (q.v. Dickson 1996) — there being no requirement to register steel imported under PCM or PPM regimes. Thus, many of China's trade regulations lack comprehensiveness, leading to obvious difficulties in assessing overall incidence of trade protection. There are many Customs regimes not detailed here, including border trade, outward processing, treatment of goods on lease, imports by "bonded enterprise groups" (for full list, see Section 2 above). Another major element leading to fragmentation of the trading system, but not touched upon in this paper is the use of "zones": special economic zones (SEZs), Economic and Technology Development Zones (ETDZs), High Technology Industrial Development Zones ("Science Parks"), open coastal cities, bonded tariff areas, "zones within zones" etcetera. Without doubt, China's trade system is complicated and fragmented, rendering attempts at overall assessment fraught with difficulty.

Whilst it is impossible to construct a scalar "incidence of protection" index for China (short of using a deceptively simple indicator such as trade-to-GNP), it seems reasonable to conclude that China is a more open country than its leaders actually intended it to be. The policy design is that imports enter the country with conditions attached; imports must either be used for self-investment purposes or otherwise re-exported, and may not *legally* be sold on the domestic market. The only "unconditional" imports occur through the "ordinary" trade regime, and here the government imposes strict controls. In this way, the government has sought to give reign to various forms of economic activity, whilst at the same time shielding domestic producers. The unintended result, however, has been systematic leakage (ie. smuggling) of materials from the "conditional" regimes onto the domestic market.

For example: China's ordinary trade controls are designed to protect the domestic steel sector (q.v. Dickson 1996). Translated excerpts in Appendix indicate that China's steel producers acknowledge that under normal levels of duty, imported steel products would be uncompetitive with domestically-produced substitutes. But these producers are worried that most steel imports appear to evade ordinary trade controls, instead entering the Chinese market via processing or FIE investment channels. With no duties paid, domestically produced steel becomes uncompetitive with the imported product (lack of competitiveness is most salient with regard to steel imported from CIS countries).

[20] Terminology used by Barry Naughton (1996).

Processing schemes are often utilised as the vehicle for smuggling goods into China — statistics show that in 1994, more than 60 percent of smuggling cases actually prosecuted by officials were connected with processing trade. It is instructive to realise that processing transactions generate a flow of information which should be sufficient for Customs authorities to police the trade. PPM and PCM deals must usually be completed within a one year time frame, and final verification must occur one month after the date of the last exports. Processing proposals must be notified to Customs, with subsequent imports and exports declared to Customs and recorded in registration booklets or carnets. Customs have well established systems of technical coefficients to match imports with the processed exports. So Customs should possess the informational capacity to detect infringements of regulations, at minimum because operating ventures fail to report back to Customs within specified deadlines. Therefore, the prevalence of smuggling via processing trades suggests either (1) that the information received by Customs may be misleading (eg. falsification of invoices or declared quantities), or else (2) Customs lacks the wherewithal — or perhaps the will — to follow-up on accurately reported information already in its possession.

In 1996, the central government introduced a new system of counter-accounts held at local Bank of China branches, in order to better ensure that export processing activities remain within the rules — an unofficial indictment of the failure of the Customs Administration to enforce the system. For one reason or another, Customs officials could not be relied upon.

During 1992-1994, barter trade also served as a conduit for steel smuggling, eventually prompting State Council's repudiation of barter trade concessions for steel products in September 1994. All considered, the present paper has shed only dim light on the mysterious world of Chinese smuggling — perhaps many of the facts are knowable only by practitioners. But it is hoped that some conclusions presented above will at least narrow the range of uncertainty, placing knowledge about the whys and wherefores of smuggling (especially where the export processing regime is involved) onto a slightly firmer footing.

Preferential treatment under processing and investment regimes is best viewed as extending *exemptions* rather than *concessions.* Chinese Customs authorities have limited latitude to determine the proportion of imports that will be subject to full tariffs, and by implication, the proportion which will be completely exempt — but they have absolutely no latitude to *vary* regulated tariff rates. If a choice is available to local Customs officials, it is generally between levying full tariffs or zero tariffs — the choice does not extend to selecting, at whim of the assessing officer, some intermediate level of tariff. This fact may qualify suggestions, sometimes encountered, that local Customs officials in China have

considerable discretionary capacity to adjust rates of duty — if the written rules as encountered by the present author are obeyed in practice, then there is no such latitude. However, this is not to deny a wider role for administrative discretion in other aspects of China's trade system.

APPENDIX: TRANSLATIONS FROM "WORLD METALS" NEWSPAPER

"Excessive amounts of steel imports assault domestic market" by Li Guoshun (6 Sep 1996):

… these steel imports for the most part enjoy concessions or exemptions on tariffs, so after importation, owing to the fact that import prices are very low, and because imports can easily flow onto the market, the impact on the domestic market and domestic steel producers is very large. FOB export prices for Russian and Ukrainian steel rods, the cheapest available on the international market, presently stand at around $235 per ton, to which may be added average transport-ation prices of $30, for a total of $265, or upon conversion, 2200 yuan; the tariff for wire rods is 10%, and VAT is 17%, on top of which must be added inspection, stevedoring, port construction and domestic transport fees, as well as bank commissions, so that ordinarily one ton of steel would sell for 3,000 yuan. In August, the average price for domestically produce wire rods per ton was 2,840 yuan per ton; so if the imports do not receive preferential treatment, the imports must lose money, and the potential losses will discourage all enterprises from engaging in the business. If Russian and Ukrainian wire rods are as such, then more expensive steel from other countries is even more likely to suffer losses. Thus, import tariffs must certainly be properly controlled, and must not be relaxed in a casual fashion, otherwise volumes of imported steel will become very difficult to control, and domestic steel market prices will be unlikely to experience a turn for the better …

"Metallurgical product exports experience overall declines — Large quantities of imported steel assault the domestic market" by Li Xin (13 September 1996):

… as to the excessive amounts of steel imports impacting upon the domestic market, relevant state ministries should strengthen control over steel imports during the last half of the year, and strengthen the work of collecting taxes and tariffs. According to Customs statistics for the first half of the year, 7.721 million tons of steel was imported, including 2.2 million tons through ordinary trade channels, comprising 28.5% — these imports are properly controlled by the state. In addition, processing, FIE investment imports, bonded warehouse imports and barter trade imports together comprised 5.329 million tons, or 69.1% of total steel imports, and this part of imports can very easily flow onto the domestic market, and enjoy positive profits. With regard to the cheap Russian and Ukrainian steel now on the international market, with the aid of calculations it is possible to show that if this type of steel attracts the full range of duties and other service fees after off-loading at port, then the import prices will exceed domestic market prices by around 160 yuan per ton. Therefore, during the last half of the year Customs tariff-collection management must be strengthened, so as to avoid giving speculative enterprises an opportunity to exploit, and if this is done, imports of steel in the second half of the year may well decline …

"The necessity of controlling momentum of iron & steel imports" by Xiao Lu (20 Sep 1996):

… to protect production in the domestic iron and steel industry, and to reduce the impact of imports on the domestic market, according to the spirit of the "Notice concerning improvement of management of iron and steel imports" announced by State Council, it is vital to strengthen import and export manage-ment. To this end, in the last 4 months of this year, it will be necessary to control the momentum of steel imports …

“Ministry of Metallurgical Industry makes suggestions on controlling excessive volumes of steel imports”, author unnamed (20 September 1996):

Recently, MMI’s production section and MMI’s import and export coordination committee combined to write a report, analysing the characteristics of steel imports during the first half of the year, with the aim of identifying reasons for the increase in steel imports, and furthermore, putting forward suggestions for controlling the excessive volume of steel imports. Since this year, owing to changes in the domestic and international market, our country’s steel import volumes again experienced an upwardly spiralling (*luo xuan*) trend, the main features of which were as follows. (1) Imports of plate material coincided with changes in domestic demand. Rod imports fell by 70,000 tons when compared with last year, but comprises a relatively large proportion of total imports. (2) FIE investment imports and imports in bonded warehouses experienced relatively large increases. (3) The main source countries for the increase in steel imports where in three countries of the CIS as well as China’s Taiwan province. (4) Guangdong remains the main destination for imports of steel, and Hainan and Shanghai also became new centres for increases in steel imports. The main reasons for increases in imports of steel are: (1) Patterns determined by the market. Since the fourth quarter of last year, the international steel market has remained weak, and domestic steel market prices remain stable, with some product types even experiencing price increases, factors which of necessity stimulate foreign steel to flow into the country. (2) Changes in state import policies. From 1 April this year, import tariffs declined, and import costs have fallen, causing import volumes to increase. (3) Russia’s policy of cancelling its steel export tax and simplifying steel export procedures has further stimulated steel exports to China, in addition to which Russian steel exports to South America have encountered restraints so have been diverted to the Asian market. For these purposes, MMI’s production section and the import and export coordination committee have put forward the following suggestions. (1) It is suggested that national supervising ministries take the lead, according to relevant regulations put forward by State Council to control steel imports, to conduct research into the condition of this year’s imports of steel, and especially, a serious investigation should be undertaken into the operations of bonded warehouses in Guangdong, Shanghai and Hainan as well as with regard to those operating units importing products over-supplied domestically, with proportionate and effective measures adopted in response. (2) Customs should strengthen control over imports of products in over-supply domestically, and especially should take a strong hand in controlling steel imports from the 3 main CIS countries. (3) All relevant ministries must strengthen coordination of domestic steel market prices, so as to maintain reasonable domestic steel prices, thus restraining imports from increasing any further.

“For six consecutive months, imports break the one million tons barrier — Exports suffer restraints, momentum has obviously declined” by Wang Guangping (11 October 1996):

… according to the above analysis, increases in steel imports are mainly due to FIE investment imports and to increases in ordinary trade imports. Whilst processing trade imports did not experience large increases, the proportion of total trade they comprises remains large, and in theory with ‘both ends of the deal outside’ (*liang tou zai wai*) there should be no influence on the domestic market. Imports of steel into bonded warehouses, because they do not directly enter the domestic market, but only form a kind of reserve stock, so long as there are no large and sudden changes, this should also not create any large influence on the domestic market. Barter trade, outward processing and border trade

only comprise 3% of total steel imports, and obviously do not possess the scale to influence the domestic market. But in reality, if present imports of steel are reckoned according to the stipulated tariffs and taxes, then after tariffs have been added on, import prices must exceed domestic steel market prices. In addition, domestic market demand for steel has still not recovered. These facts suggest that the conditions for large scale imports of steel should not exist. But from the above analysis, it is not difficult to discover, steel imports enjoying tariff concessions amounted to more than 5 million tons, comprising more than 50% of total imports. The tariff concessions provided by the state to FIE investment imports and to processing imports, as well as to other types of schemes are enjoyed on the basis of pre-conditions, such as own-use or for processing into products to be exported, so that according to regulations these may not enter the domestic market. However, at present, the steel imports imported into the country have had a large impact on domestic market prices, suggesting the probability that a large proportion of steel imports which enjoy preferential tariff treatment are entering the domestic market through irregular channels. In addition, in recent years, new development open ports in coastal areas have successively promoted "bonded tariff" (*bao shui*) policies in order to promote the development of outward oriented economic activity. At the same time, Russia and other CIS countries have been pushing large quantities of low priced medium-to-low quality steel for sale on the Chinese market, earning profits even at these low prices, causing import prices and costs to fall time and time again, and causing imports to continuously increase.

"Concerns about preferential policies for steel imports" by Ping Wang (25 October 1996):

… it is not difficult to see that export-processing forms the most important factor in the current growth of steel imports, comprising a large proportion of total steel imports. It is also evident that following the state's gradual adjustments to the tariff system, the excess amounts of steel imports have begun to zero-in on the remaining areas where preferential treatment still exists. This explains one problem: preferential tariff and tax policies attract investment, acting as a magnet for developing the economy, but at the same time they can have a serious impact (*chongji*) on the domestic market. Examining the relevant regulations, the state's formulation of preferential import policies has conditions attached, is focussed, the common condition for enjoying import tariff exemptions being that the materials will be used in processing for exports or will be used for one's own consumption, or will be placed into bonded storage, and it is not permitted for the materials to flow into common areas or to enter the market. Therefore, speaking from theory, these steel imports should not pose a serious threat to the domestic market. But according to understanding, at present in their import operations, in order to reduce import costs and to elbow their way into the domestic market, traders are always using all sort of methods to evade the normally regulated tariffs — importing "in bond" or "completing formalities" for processing trade; under-invoicing imports; using the pretext of processing to make imports, but reducing the volume of verified re-exports and then diverting to sale on the domestic market; or else, importing using the name of investment purposes, but actually diverting for sale on the market. Regardless of the method used, the intentions are abundantly clear — to use legal methods to win preferential import treatment, to enter the domestic market and to use unfairly low prices to participate in competition, the deleterious results of which go without saying. These intentions have already become the reality, and the impact is becoming ever more serious. From the above analysis, it is hard to avoid the following question: if imports of steel are as such, then import operations of other types of commodities may also be experiencing similar types of problem. To be sure, the phenomenon of all sorts of imports taking advantage of preferential policies in order to seek out exorbitant profits on

the domestic market is relatively common. The preferential policies are put forward in the basic interests of the nation, but if supervision is not appropriate, and unanticipated negative effects begin to appear, then this should attract the attention of government ministries. People remain reluctant to conclude that the preferential policies formulated by the government have turned into a mechanism for loss of control over imports, but at the same time, these anxieties are hard to dismiss.

"World Metals" editorial comment, dated 25 October 1996:

In recent years, our country's large imports of steel have attracted attention both here and abroad. Importing the types of steel which are hard to manufacture domestically is appropriate, but owing to blindness or to abnormal import channels, much of the large volumes of steel imported is for products where domestic demand and supply is already in balance (or supply exceeds demand), a situation which not only has severe impacts on the domestic market, but also gravely threatens the development of the domestic steel industry. As a result, rectifying the operation of steel importing work-units, rigorously carrying out examinations, approvals and verification procedures, as well as implementing an import licensing system for steel products, has already become a matter for which delays can no longer be tolerated. As understood from relevant departments, at present in Shanghai, Guangdong, Zhejiang and Shenzhen alone, the number of enterprises dealing in steel products has reached the tens of thousands, including some 5,000 in Guangdong province. These firms are infinitely resourceful, but their actions also carry a terrible blindness. To counter-act this situation, relevant departments of state should reduce the number of import operations; appropriately consolidate existing or new organisations to take over exclusive management of import operations; strengthen supervision and management; and strictly enforce examination and approval procedures. Especially with regard to non-ordinary forms of trade, controls must be strengthened, and steel import volumes, product types and structures strictly enforced. Even with regard to those types of imports that cannot be produced domestically, in principle these should *not* be imported; with regard to steel imports without an import license, without exception these must be prohibited; in coastal cities organisations for managing steel imports must be established to undertake supervision, and if problems are discovered, they must be dealt with in a timely manner.

"Steel import increases moderating, improvement in export product types evident", by Wang Guangping (31 October 1996):

… from the data alone, most of the increases in steel imports between January and September this year have been due to increases in ordinary trade and to FIE investment imports. But when examined from the degree of impact on the domestic market, especially in terms of impact on prices, ordinary trade imports of steel reckoned according to the stipulated tariff rates will usually experience prices higher than those prevailing on the domestic market, which in the current environment of depressed domestic steel prices would imply that imports no longer possess the capacity to influence domestic market prices. Therefore, ordinary trade imports may be the main cause of the increase in steel imports, but they are not the main factor causing the domestic market to slump. Analysis of the actual record of present imports shows that a very large proportion of imports enjoy preferential tariff rates, and at present this proportion of imports amounts to nearly 8 million tons, or 67% of the total. Even if we eliminate from consideration steel imports into bonded warehouses, as these do not enter the domestic market, and also do not consider the relatively minor outward processing and border trade imports of steel, and

only take into account inward processing and FIE investment imports, then this still amounts to a figure of some 5.9 million tons. Because this component enjoys the benefit of preferential tariffs, import costs are lower than for steel brought in under regular, ordinary trade channels, and therefore, from the aspect of prices, and the size of imports, this part of total steel imports alone has potential to impact upon the domestic steel market.

"China to strictly control imports, the target is the former Soviet Union", reprinted in "World Metals" from overseas news reports (8 November 1996):

According to a report in Japan's *Iron and Steel News*: Owing to cheap steel (from Russia, Ukraine and other countries of the former Soviet Union) flowing into the Chinese market, causing chaos in the Chinese market, it's predicted that the Chinese government will henceforth strengthen the management of steel imports. Sometime ago, because cheap steel was flowing into the Chinese market, and operating conditions for domestic iron and steel making enterprises were difficult, China's Ministry of Metallurgical Industry put forward a scheme for strengthening the management over imports of cheap steel from the former Soviet Union. After this, MOFTEC Vice Minister Liu Shan, at the time of a meeting with the vice head of Nippon Steel, indicated that steel is a crucial manufacturing material, and if steel markets become chaotic, economic development will suffer large and unwelcome impacts, and so from the present time onwards there will be a need to strengthen state guidance over import operations. In the first 8 months of the year, China accumulated 10.57 million tons of steel imports, an increase of 25% over the same period last year. If this is taken as the basis for extrapolating the annual outcome for 1996, then this year's imports will exceed by large margin the government's target, and will reach 16 million tons. In addition, China is certainly not increasing imports of Japanese steel, but rather has increased imports of steel from the former Soviet Union. Steel from the former Soviet Union is cheaper than Japanese steel by some $100 per ton. At present, the former Soviet Union has already replaced Japan as the largest supplier of steel to China. Large amounts of cheap steel flowing into the Chinese market has forced domestic steel making enterprises to lower sales prices, and the operating environment has become difficult, prompting the Ministry of Metallurgical Industry to put forward its plan to control imports from the former Soviet Union, as well as prompting MOFTEC to put forward its intentions to more tightly manage imports. Therefore, the Japanese side considers that the object of import controls will be steel from Russia, Ukraine and other former Soviet republics. Whilst Japanese exports of steel to China have also suffered from the impact of competitive exports from the former Soviet Union, due to the fact that Japan's exports to China are mainly the high quality product types produced in insufficient quantities by China's domestic industry, so that even if import controls are strengthened, Japanese steel exports to China will not suffer any further impact.

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