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# The Status of China's Market Economy and Structural Reforms: The Issues Behind the U.S.–China Trade War\*

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## Abstract

This paper investigates the most essential issues behind the ongoing U.S.–China trade war. In addition to the apparent bilateral trade imbalance, China's status as a non-market economy (as labelled by the Trump administration) is one of the most fundamental reasons that the United States triggered the U.S.–China trade war. Accordingly, the United States' most pressing request is to urge China to implement further structural reform. This paper argues that the current Chinese economy is quickly becoming a modern market economy with a unique Chinese character: This is evident from ongoing structural reform to create a competitive environment between state-owned enterprises and private enterprises, and through a further opening-up of the market by guaranteeing a wider and deeper market access for inbound foreign direct investment.

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## 1. Introduction

The ongoing U.S.–China trade conflict involves two areas: trade imbalance and structural issues. The U.S. government is asking China to reduce the bilateral trade imbalance by reducing Chinese import tariffs and various nontariff barriers. More importantly, the United States is urging China to address possible related structural issues. For example, the United States is urging China to create a level field of competition for state-owned enterprises (SOEs) and private firms, to implement and enforce intellectual property rights in China, and to eliminate regulations on forced technology transfer, all of which will create a better environment for foreign direct investment (FDI).

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It is worth stressing that the U.S. request for structural reform is based on the investigation of China's status as a non-market economy, released by the U.S. Department of Commerce (USDOC 2017), after China's 15-year accession to the World Trade Organization (WTO). The USDOC concluded that China is a non-market economy for two reasons: the state's role in the Chinese economy and its nexus with markets, and the substantial distortions in the private sector. Along with this, in the current U.S.–China trade talks, the U.S. government insists that China implement structural reforms associated with its non-market economy.

Evidently, the U.S. request for structural reforms in China is based on its justification that China is a non-market economy. The USDOC report based China's status as a non-market economy on six related factors: (1) Whether or not China's currency (RMB) is convertible to other foreign currencies, and more importantly, whether the Chinese government is inclined to depreciate the RMB to generate competitive advantage; (2) The fact that blue-collar workers in China do not have sufficient bargaining power in wage determination; (3) The limited access of foreign firms because they are usually not permitted to hold wholly owned business plants in China; (4) The fact that the state still plays a fundamental role in the Chinese economy and private firms cannot compete fairly with SOEs; (5) The extent of the role of industrial policy in China; and (6) The influence of administrative law and the lack of regulatory transparency.

Admittedly, these observations appear to correctly identify, to some extent, the features of the Chinese economy. Nevertheless, it is important to stress that the report's conclusion regarding China being a non-market economy is based on a comparison with an extremely mature and perhaps highest standard market economy like the United States. If we carefully examine the current Chinese economy, even from the perspective of input factor markets that the U.S. government has focused upon, it would be fair to say that China is quickly approaching the standards of a mature market economy.

To shed light on this view and better understand the U.S.–China trade war and the associated structural reform requested by the United States, it is necessary to investigate the factors that have caused the United States to conclude that China is not yet a market economy. This is the task that the present paper picks up. We will not systematically explore all six factors mentioned herein, however, due to space limitations. Instead, we will focus on the two most important and substantial factors: the role of the state vis-à-vis SOEs and private firms; and the issue of market access of FDI investment in China.

The rest of the paper is organized as follows. Section 2 starts with a discussion about the U.S.–China trade conflict. Section 3 examines the trade liberalization in China, including both tariff reduction and nontariff-barrier eliminations. Section 4 discusses China's current FDI performance. Section 5 explores the level playing field between SOEs and private

firms. Section 6 provides further insights on China's status as a market economy. And Section 7 concludes.

## 2. U.S.–China trade dispute

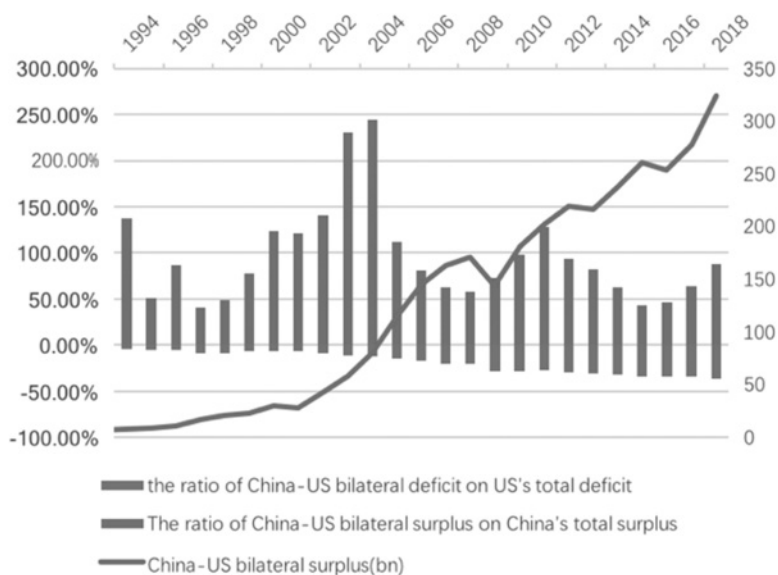
To fully capture the ongoing U.S.–China trade war, we need to understand the cause and consequence of the U.S.–China bilateral trade imbalance.

As interpreted by Liu and Woo (2018) and Yu and Zhang (2019), the Trump administration's position can be summarized by the following three key points: First, in U.S.–China bilateral trade, China has a trade surplus whereas the United States has trade deficit. Second, how should the bilateral trade imbalance be interpreted? The Trump administration believes that the trade imbalance exists because China has an export subsidy on its exporting goods and China imposes high tariffs against imports from the United States. Third, what is the solution to reducing the trade imbalance between the two countries? The Trump administration suggests that the only solution is for the United States to restrict China's imports by imposing high tariffs on China's export goods.

As argued by Guo et al. (2018), Amiti, Redding, and Weinstein (2019), and Yu and Zhang (2019), these points are inaccurate or misunderstand the essential tenets of U.S.–China bilateral trade. First, it is true that China keeps a huge trade surplus from the bilateral trade with the United States. As seen in Figure 1, the trade surplus emerges in the early 1990s and then increases to USD 330 billion in 2018. The U.S.–China bilateral trade surplus is the most important source of China's total trade surplus. In 2004, the bilateral trade surplus was around 2.4 times higher than China's total trade surplus. In other words, China had a trade deficit with many other trading partners. The U.S.–China trade surplus ratio to China's total trade surplus declines over time, but still maintains a high plateau of 88.1 percent. By contrast, the U.S.–China trade imbalance is also the most important source of the American trade deficit. The U.S.–China trade deficit ratio to the American total trade deficit increases over time and registered at 36.4 percent in 2018.

A trade surplus itself is not necessarily good for China, however, and a trade deficit itself is not necessarily bad for the United States, as also pointed out by Liu and Woo (2018). To better understand this point, we need to recognize that China uses most of its incremental current account surplus generated by the trade surplus with the United States to re-purchase American treasury bills, bonds, and assets. Indeed, China is the United States' largest creditor.

China's trade surplus is not necessarily good for the Chinese economy due to, in large part, the related import inflation induced by the trade surplus. China's central bank requires

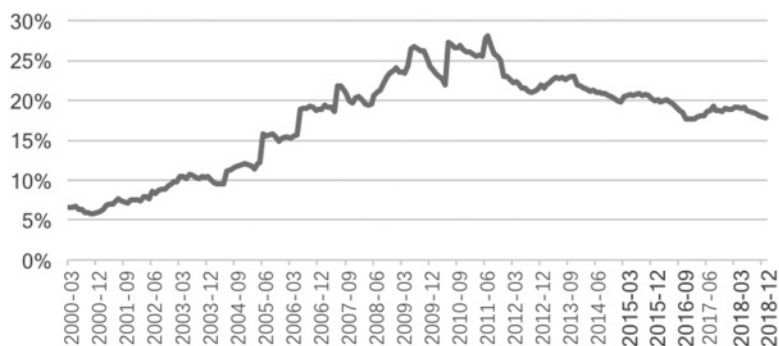
**Figure 1. China-U.S. bilateral trade, 1992–2018 (billion USD)**

Source: CEIC data set.

Chinese firms to sell its earned trade surplus to the central government.<sup>1</sup> In this way, more Chinese yuan (RMB) will flow into the market. The exact magnitude is enhanced due to the well-known monetary multipliers. For instance, if Chinese firms sell USD 150 billion to China's central bank, by assuming the exchange rate to be around 6.7 between RMB and USD, there will be a flow of around RMB 1,000 billion into the first commercial bank. If the required reserve ratio is 20 percent, the increased currency in the Chinese economy will be five times higher than the original amount, which means that the induced monetary injection will be RMB 5,000 billion. Given that China's broad money supply (i.e., M2) is roughly RMB 180 trillion, this will generate an inflationary pressure of about 3 percent. This gives the Chinese government a strong incentive to reduce the U.S.–China trade surplus.

Just as the trade surplus is not necessarily good for China, the American trade deficit is not necessarily bad for the United States. This is especially true due to the privilege of

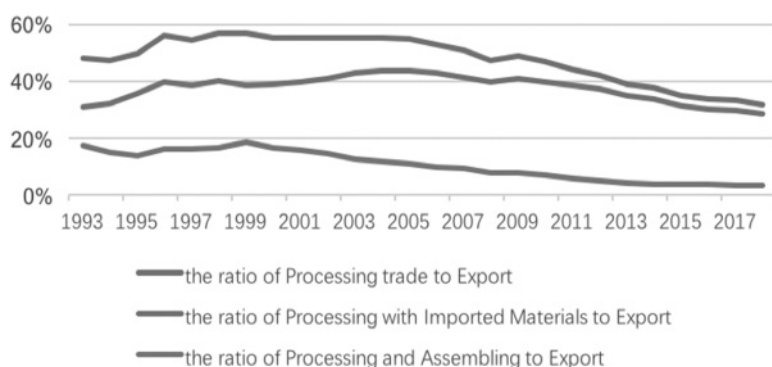
<sup>1</sup> This is especially true before 2006, when The People's Bank of China (PBoC) required all firms to exchange their U.S. dollar earnings obtained from international trade for RMB. During 2006–12 PBoC allowed large firms or experienced firms to retain U.S. dollar earnings but small firms are still required to sell their earned U.S. dollars to the state. After 2012, PBoC phased out such a regulation (see related announcement in State Administration of Foreign Reserve of China on 16 April 2012). But many Chinese firms still self-select to exchange earned U.S. dollars for RMB because of the expectation of RMB appreciation.

**Figure 2. China's investment in American treasury bonds**

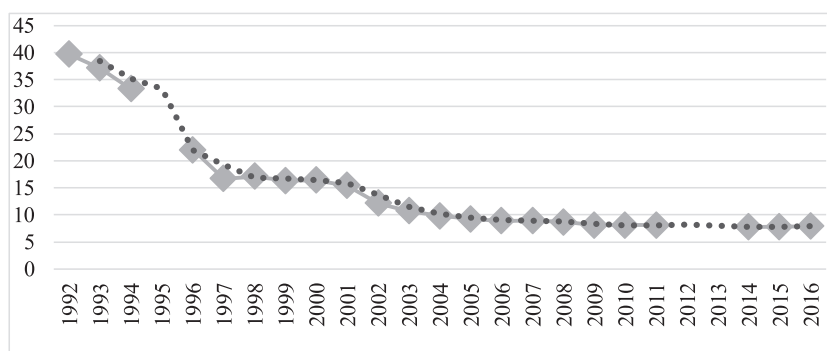
Source: CEIC data set.

the U.S. dollar's sovereignty tax. As a return of China's exportable goods, Chinese firms earn U.S. dollars back. Pursuant to Chinese regulations, Chinese firms are required to sell half of their foreign reserve to China's central bank—the People's Bank of China (PBoC). Once the Chinese government holds a huge amount of U.S. dollars, however, it seeks to invest it worldwide. Currently, it seems that the most attractive investment is still U.S. treasury bills, bonds, and securities. As seen in Figure 2, China is the largest holder of U.S. bonds. China's global share of U.S. securities increased from 6 percent in 2000 to around 20 percent in 2017 and reached a peak of more than 25 percent in 2010. China itself holds one-quarter of U.S. bonds, whereas the other three-quarters of China's total bond is held in 200 countries.

Second, the bilateral trade imbalance is essentially due to the comparative advantages of the two countries based on their respective factor endowments. China is a labor-abundant country and hence its labor cost is relatively cheap. Accordingly, China has a comparative advantage in labor-intensive industries such as garments and textiles. In contrast, China's trade surplus on capital-intensive industries is due to its engagement in the processing trade. This is consistent with the observation that most industries with a trade surplus are industries that engage intensively in the processing trade (see, e.g., Yu 2015 and Dai, Maitra, and Yu 2016). Processing trade is a popular and important mode of trade in China where it imports raw materials or intermediate inputs from other countries and then re-exports the final goods to other countries after local assembly (Tian and Yu 2015; Dai, Maitra, and Yu 2016). Processing trade accounted for around one-half of China's total exports before the 2008–09 global financial crisis and today still accounts for one-third of China's total export by registering around USD 700 billion, as seen from Figure 3. If we suppose that both China and the United States do not adopt any strategic trade policies, China will still have its trade surplus. The trade imbalance is a natural result of the economic structures and the respective factor endowments of both countries.

**Figure 3. China's processing trade as a share of export, 1993–2018 (%)**

Source: China's Customs and author's own calculations.

**Figure 4. China's import tariffs, 1992–2017 (Simple average %)**

Source: Yu and Zhang (2019).

### 3. Trade liberalization and nontariff barriers

In 1992, the simple average of China's tariffs was 39.7 percent. It fell to 7.5 percent in 2017 and could fall even further with the setup of regional and bilateral free trade areas (Figure 4).

Ing, Li, and Yu (2019) indicated that there are around 7,332 non-tariff measures (NTMs) in China. China has 29 regulatory agencies that are responsible for issuing and enforcing regulations related to NTMs. The top five agencies focus mainly on food safety, animal and human health, product safety and quality, and environmental protection. As shown in

**Table 1. China's nontariff measures**

Ranking	Issuing agencies	% of total number of NTMs	Number of NTMs
1	Standardization Administration of China (SAC)	48.69	3,565
2	General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ)	28.28	2,071
3	Ministry of Commerce	4.67	342
4	Ministry of Agriculture	4.66	341
5	General Administration of Customs	3.74	274
6	Others	9.96	739
	Number of total NTMs	100	7,332

*Source:* Ing, Li, and Yu (2019); author's own calculation.

*Note:* NTM = nontariff measure.

Table 1, the top agencies that issue and enforce NTMs are: Standardization Administration of PRC; General Administration of Quality Supervision, Inspection and Quarantine; Ministry of Commerce; Ministry of Agriculture; and General Administration of Customs.

Yu (2015) has shown that trade liberalization significantly boosts Chinese firm productivity. Particularly, aside from processing export, input trade liberalization has a stronger impact on fostering firm productivity than output trade liberalization. Similarly, China's nontariff barrier elimination has had a positive impact on promoting firm efficiency (Luo and Yu 2019).

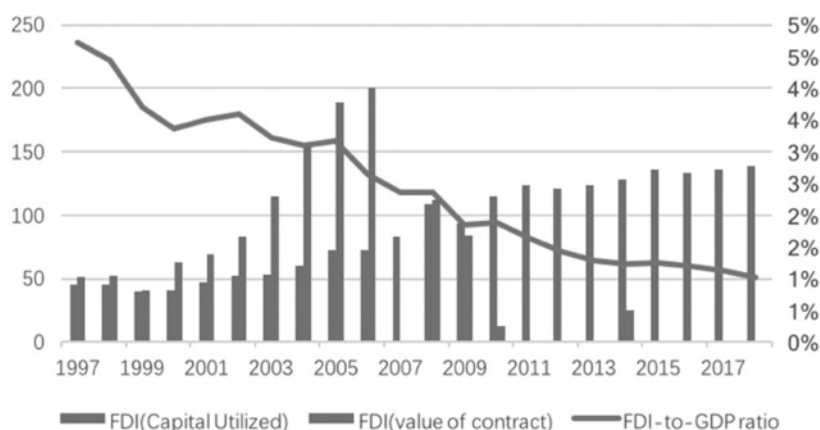
#### **4. China's inward FDI: Achievement, challenges, and recent reform**

##### **4.1 Achievement**

China is the second largest destination in the world for FDI. In 2018, China's inward FDI amounted to USD 135 billion and accounted for around 11.2 percent of the global inward FDI, as reported by Ministry of Commerce of China.<sup>2</sup> In 2018, China's FDI to GDP ratio was around 2 percent of China's GDP of USD 13.2 trillion (Figure 5). In the past four decades, China's inward FDI experienced a substantial increase. It is also important to distinguish between scheduled inward FDI and realized inward FDI. In fact, the realized inward FDI is smaller than the scheduled inward FDI due, in part, to the sudden financial challenge faced by foreign firms or potential adverse international conditions or changes in China's investment environment.

In the past 40 years, more than 960,000 foreign firms invested in China. China's accumulated realized inward FDI amounted to more than USD 2.1 trillion. Before China's move to establish the socialist market economy in 1992, the value of inward FDI was only around USD 4.37 billion. After more than one decade and just before China's entry into the WTO in 2000, China's realized FDI recorded a tenfold increase and stood at USD 40.7 billion. By

2 See <http://english.mofcom.gov.cn/article/statistic/>.

**Figure 5. China's inward FDI, 1997–2018**

Source: CEIC data set.

2012, China's inward FDI had reached a plateau of USD 120 billion. In 2014, the ratio of China's FDI to global FDI was 10.5 percent. It reached a new peak in 2018 with an amount of USD 135 billion.

## 4.2 Challenges

The declining trend of China's FDI to GDP ratio over the last two decades, especially after China's accession to the WTO in 2000, is a major challenge. One reason for this decline is that the growth rate of GDP is higher than that of inbound FDI. Another possible reason is the existence of hurdles to investing in China. In particular, the U.S. government blames China's inward FDI policy. The U.S. complaints focus on the following issues.

First, foreign investment in many industries face restrictions on equity share or the form of corporate joint venture or equity joint venture. Such sectors include agricultural sectors, telecommunication services, banks, insurance companies, and medical institutions. The Chinese government released a document called the "Foreign Investment Catalogue." The most recent version was revised in 2017. The catalogue includes three categories of foreign investment: encouraged, permitted, and restricted. The U.S. government complains that the 2017 amendment of the catalogue still has too many restrictions on foreign investment. For instance, 28 industries are still classified as restricted sectors, as shown in Table 2.

Second, foreign investment in China is plagued with bureaucratic, onerous, and time-consuming and complicated processes. FDI is often required to obtain the approval of



**Table 2. Restricted industries by foreign investment**

1. R&D, breeding and cultivation of rare and peculiar species, and production of relevant propagation materials including superior genes in crops, animal husbandry, and aquatic sectors in China	15. Radio stations, TV stations, radio and TV channels, and transmission networks at all levels on-demand radio and TV broadcasting and installation of ground receiving facilities of satellite TV broadcasting
2. Selection and breeding of transgenic crop, animal, and aquatic species as well as the production of their transgenic seeds	16. Development and application of technologies with respect to human stem cells, gene diagnosis, and treatment
3. Consultation on Chinese legal affairs	17. Surveying and mapping on geographic and geological information
4. Prospection and exploitation of tungsten, molybdenum, tin, antimony, and fluorite	18. Exploitation of wild animals and plants originating from China and protected by the state
5. Rare earth prospection, exploitation, and mineral processing	19. Compulsory education institutions
6. Radioactive minerals prospection, exploitation, and mineral processing	20. News agencies
7. Processing of Chinese medicines and production of traditional Chinese medicine patent drugs with secret formulas	21. Internet news information services, online publishing services, online audiovisual program services, venues to provide Internet access and Internet culture-related services
8. Smelting and processing of radioactive minerals as well as nuclear fuel production	22. Editing, production, and publication of audiovisual products and electronic publications
9. Arms and ammunition manufacturing	23. Fishing of aquatic products of sea areas and inland waters within China
10. Chinese art paper and ink ingot production	24. Production companies of radio and TV programs
11. Air traffic control	25. Film-making companies, film distribution, and marketing companies
12. Postal service companies and domestic courier business of delivering letters	26. Editing and publication of books, newspapers, and periodicals
13. Wholesale and retail of tobacco, cigarettes, leaf tobacco, and other tobacco products	27. Auction of cultural relics and cultural relic shops
14. Social research	28. Institutes of humanities and social science

*Source: China's Foreign Investment Catalogue (2017 Amendment).*

several different government authorities. A wholly foreign-owned investment, for example, is usually required to obtain dual approval from both the Ministry of Commerce (MOFCOM) and National Development and Reform Commission (NDRC). MOFCOM is interested in whether the investment fits with the development of China's national economy whereas NDRC focuses more on whether the potential investment has a substantial adverse impact on public interests. Some investments are now permitted to file solely with MOFCOM, but such investment still needs to seek approval from other Chinese government agencies.

Third, "forced technology transfer" is a longstanding concern of foreign investors in China. The U.S. Department of Commerce (USDOC) complains that some foreign investors are forced to transfer their advanced technology to Chinese partners. In practice this mainly happens in equity joint venture sectors such as electric vehicle and drug industries. As Chinese local governments may provide procurement preferences to technology localization, foreign investors consequently face a trade-off between losing a significant market share and forced technology transfer.

Nonetheless, the relatively poor performance of some foreign firms may not be because of the Chinese government's intervention, but because of a poor understanding of the Chinese market. For instance, U.S. companies like Amazon and eBay have performed relatively poorly because they are not able to understand the Chinese market as well as their domestic counterparts Alibaba or Tencent.

### 4.3 Recent FDI reform

In March 2019, China's national congress conference passed a new law on FDI that will be enforced in January 2020, as reported by China's State Council. It combines the three previous laws on FDI: The act of China and foreign equity joint venture; the act of China and foreign corporate joint venture; and the act of the foreign wholly owned firms. The new foreign investment law clearly defines how foreign investors are identified. First, a foreign investor is one who establishes a foreign-funded firm solely or jointly with any other investors. Second, a foreign investor is one who acquires property shares, equity, or stock share or any other similar ownership within China. Third, a foreign investor is one who solely or jointly with any other investors develop a "greenfield" new investment project. The new FDI act also clearly identifies that firms from Hong Kong, Macau, and Taiwan are classified as "foreign firms" and can enjoy all the rights mentioned in the new FDI law.

The most important features of China's new investment law are rules on market pre-entry national treatment and the Negative List. In particular, a foreign investor is guaranteed to have the same rights and access to the same beneficial policies that the Chinese government gives to Chinese firms in the same industry. The exceptions are clearly classified in the investment Negative List. For industries or business activities that are mentioned on the Negative List, the Chinese government is not required to give the same access or equal rights to foreign investors. In early discussions, the Chinese government also promised that it will reduce the content and the length of the Negative List.

The new FDI law also simplifies the procedure and entry threshold of foreign investment in China. Before this act, if a foreigner was interested in investing in China, they had to seek permits and approval from related Chinese government agencies. Particularly, a foreigner had to take three steps to establish a firm in China: (1) the investor had to submit all required documents to the government department. The designated department, which usually is the national development and research commission of the different tiers of China's government, will check whether the firm's contract and its business activities abide with the requirement. (2) The government will then verify and file the firm's exact investment areas. After that, the potential firm had to seek industrial permission to ensure that its investment project was not on the prohibited list. (3) If everything is satisfied, then the firm is allowed to register in the system and start its business operation. In contrast, under the new act the foreign investor only needs to ensure that their investment is not on the prohibited list.

Lastly, the new act strengthens the promotion, protection, and management of the new firm by establishing a complete FDI service system. The Chinese government is trying to establish a dispute settlement system for foreign firms. It also ensures that foreign firms have the same rights to participate in Chinese government procurement programs. Furthermore, foreign firms will have identical rights as Chinese domestic firms to engage in

the establishment of industry standards. Most importantly, the new act clearly emphasizes that foreign firms cannot be forced to transfer related technology.

## **5. Leveling the playing field between SOEs and private firms**

### **5.1 Development of SOE and private firms**

A hot debate is whether the Chinese economy today exhibits a phenomenon of “state strikes back and private retreats.” Scholars holding this view argue that SOEs today are much larger and more profitable than private firms (Lardy 2014, 2018) and employ more workers than private firms. Admittedly, this observation fits with the reality of the Chinese economy in recent years, especially after the global financial crisis. However, if a longer period is examined, a different picture of “state retreats and private advances” becomes evident. Particularly, SOEs accounted for two-thirds of the Chinese economy prior to China's WTO accession in 2001 but has shrunk to around less than 40 percent today. In 2018, private firms in China contributed one-half of China's total corporate tax, 60 percent of China's GDP, and accounted for 70 percent of China's technology innovation. Moreover, private firms also generated more than 80 percent of China's urban employment and they constituted 90 percent of China's total firms. Today there are around 34 million firms in China. Every day around 18,000 new firms register to start their business, as reported by the NDRC.

Meanwhile, SOEs are mostly concentrated in the upstream and service industries and still maintain an influential impact on the Chinese economy. Since 1998, China's government has adopted a strategy of “grasp the large and let the small go.” Large firms are maintained and consolidated into SOEs, but small firms are allowed to privatize. A new government agency called the State-owned Assets Supervision and Administration Commission (SASAC) was established to supervise the largest 102 central-controlled SOEs and their subsidiaries. According to USDOC, in 2017, the largest 115 Chinese firms on the Global Fortune 500 are state-owned, though the famous Huawei is an outstanding exception. Of these 115 giants, 48 are directly governed by central SASAC. SOEs are still the leading firms in several key areas such as aerospace, automotive, banking and finance, energy, and telecommunications, as reported by SASAC.

### **5.2 Reform for competitive neutrality**

In recent Chinese national congress conferences, the government has emphasized that China will forcefully enforce six related policies to guarantee a competitive neutrality between SOEs and private firms. As recently released by NDRC, such policies include:

- Reducing tax and phasing-out administrative fees by RMB 2 trillion (or equivalently, USD 300 billion);
- Encouraging direct investment from capital markets;

- Simplifying the administrative procedure;
- Easing the market access by using an investment Negative List; and
- Forcefully protecting property rights, especially for private firms.

First, China's environment for doing business in 2018 improved significantly. This can be seen from China's ranking in the doing business index. China ranked 93 in 2017 and moved up to 46 in 2019, as shown in the ease of doing business report of the World Bank (2019). Perhaps the essential way to improve the environment of doing business in China is to simplify the administrative procedures. China's government emphasizes separating government permits from business licenses nationwide. A number of government permits have to be abolished to reduce the time required to set up new businesses. Also, various types of industrial production permits were phased out by over one-third.

Second, China's National Congress emphasized wider and deeper market access for foreign firms in March 2019. China will not only allow external opening-up but also emphasize internal opening-up. Particularly, SOEs, private firms, and foreign firms will be treated equally on factor access, market entry permission, business operation, and even government procurement. The investment Negative List system will be implemented forcefully. And the government also aims to substantially shorten the length of the Negative List.

Third, regarding SOE reform, China is committed to actively and systematically pushing the reform of ownership. A mixture of both state-owned and private ownership will be highly encouraged. Accordingly, consumers can better share the related reform dividend. Moreover, some industries with natural monopoly features such as electricity, gas, and railway must open up their competitive business branches to allow private firms to enter.

Fourth, another key reform, emphasized in the official central government working report in March 2019 by Premier Li Keqiang, is that China will reduce the burden of the corporate value-added tax and social security payments by RMB 2 trillion (equivalent to USD 300 billion), which is much higher than the tax and payment reductions of RMB 1.3 trillion in 2018. The most important category of tax and fee reductions is of the value-added tax. Based on the previous round of tax and fees reductions in May 2018, the government dropped the value-added tax rate on manufacturing industries from 16 percent to 13 percent and dropped the rate on firms in the transportation and construction industries from 10 percent to 9 percent. Although the tax rates of both production and service industries still remain at 6 percent, China's government now allows tax reductions on more items in those industries. Table 3 lists such reform outcomes.

Fifth, regarding pension reform, the government is reducing the coverage of urban employee pensions required of employers (firms). Such proportions used to vary by province and ranged between 19 percent and 20 percent. After the reform, the coverage will be

**Table 3. Reform on cutting value-added tax rates and social security payments (%)**

	2018	2019
Manufacturing sectors	16	13
Transportation & construction sectors	10	9
Service sectors	6	6

*Source: Chinese Government Work Report (2019).*

reduced to 16 percent universally. This reform is particularly important and beneficial to firms in labor-intensive industries given that such firms only have a thin margin of profit due to increasing labor costs in China. Because private firms concentrate largely on labor-intensive industries, this new policy benefits private firms as well.

Sixth, this round of reform also emphasizes the incremental role of direct financing. Currently, indirect financing plays a more important role than direct financing. When firms are short of working capital, the conventional and most important financing channel is to borrow from commercial banks. Also, an interesting phenomenon is that private firms borrow from banks much less than SOEs do. In fact, the share of indirect financing by private firms is only around 30 percent. Moreover, private firms have to pay a higher interest rate than SOEs. The annual interest rate premium is around 9 to 13 percent (Chen, Tian, and Yu 2019). Therefore, an increase of the share of direct financing can significantly reduce the financing cost of private firms. This is achieved by several financing approaches such as issuing bonds by firms, equity financing, and transferring from bond to equality share. The government even encourages private firms to issue corporate bonds if such bonds are designed to finance firm innovation.

To further support China's innovation, China adopted a low corporate income tax rate of 15 percent for high-tech firms, which is 10 percent lower than for non-high-tech firms. China also encouraged big leading firms to set up research institutes and engage in innovation. Indeed, 28 out of the world's 500 largest leading firms are Chinese private firms.<sup>3</sup> Furthermore, it is important to note that 90 percent of artificial intelligence (AI) firms are private firms (see, e.g., McKinsey Global Institute 2017). Most of these AI innovations are driven by market demand. Indeed, AI-oriented private firms in China—such as Baidu, Tencent, Alibaba, and iFlytek—are closely tied to China's government plans to develop AI software and hardware systems to handle language processing autonomous driving.<sup>4</sup>

3 See, e.g., <https://www.scmp.com/business/companies/article/3019632/first-china-has-more-companies-fortune-global-500-list-us>. The complete list of Global 500 can be found from <https://fortune.com/global500/2019>.

4 See <https://www.marketwatch.com/story/china-is-overtaking-the-us-as-the-leader-in-artificial-intelligence-2019-02-27>.

**Table 4. Major reform for competitive neutrality**

Reform	Detailed policy arrangement
1 Market access	SOE and private firms are treated equivalently on factor access, market entry permission, business operation, and even government procurement
2 SOE reform	A mixture of both state-owned and private ownership will be highly encouraged
3 Tax and fee cut	Reduce firms' burden on corporate value-added tax and social security fee by RMB 2 trillion
4 Pension	Drop from 19% (20%) to 16%
5 Finance & loan	Increase share of direct financing. Encourage private firms to issue corporate bonds if such bonds are designed for firm innovation
6 Monetary policy	Drop deposit reserve ratio by 1 percent to increase long-term capital around RMB 800 billion
7 Debt & account Receivable	Requires central and local governments to clear half of the debt borrowed from private firms by the end of 2019

Source: China's State Council (2019).

Seventh, another helpful policy is that China has adopted an active monetary policy by dropping its required reserve ratio. In March 2019, the PBoC dropped the deposit reserve ratio by 1 percent, which will increase long-term capital by around RMB 800 billion. The required reserve ratio for private firms and small firms is even lower than that for all firms.

Eighth, another financial challenge faced by private firms is that they bear the burden of heavy accounts receivable. Such credits are owed by local government or SOEs. To address this challenge, the government now requires central and local governments to clear one-half of the debt borrowed from private firms by the end of 2019. The accounts receivable of private firms mainly focuses on construction projects. Indeed, until January 2019, both government departments and large SOEs have already cleared debt owed to private firms to the tune of more than RMB 160 billion.

Last but not least, the Chinese government work report (China's State Council 2019) also emphasizes issues in implementation. Although the central government encourages equal treatment and competitive neutrality between SOEs and private firms, in practice local governments do not implement such policies. To address this issue, the central government has stressed that government at all levels cannot purposely choose policies skewed toward their own interests. It is recognizing the importance of inspecting government inspectors as well. Table 4 lists the important reforms we have discussed here.

## 6. Further discussion on China's status on market economy

### 6.1 China is not a currency manipulating regime

Thus far, we have shown that China has implemented and enforced many policies to create a level playing field between private firms and SOEs, as well as to guarantee easy market access for FDIs. As mentioned previously, the USDOC report on China's status as a

non-market economy also complains that China inclines to manipulate its own currency by depreciating the RMB against the U.S. dollar. We now examine whether this is the case.

Admittedly, the Chinese yuan (RMB) is still not a free convertible currency in the sense that China's capital account is still not freely convertible. However, China's current account has already been convertible for around two decades. From 1994 China maintained a fixed exchange rate against the U.S. dollar for around a decade. One U.S. dollar was fixed as being equivalent to 8.27 RMB during the 1995–2005 period (Liu and Woo 2018). Since July 2005 China adopted a managed floating exchange rate regime. Up to August 2019, the RMB has already appreciated more than 15.5 percent, given that today one U.S. dollar converts to around 7 RMB.

The U.S. Department of Treasury (USDOT) has investigated three times (i.e., January 2017, October 2018, and May 2019) whether China has an intention to manipulate its currency against the U.S. dollar. According to the criteria set by USDOT itself, to label a country as a manipulating currency regime, the surplus country must satisfy the following three criteria. (1) The surplus country's current account surplus to GDP ratio must be always higher than 3 percent for several continuous years. (2) The surplus country has seriously intervened in foreign exchange rate markets for its own currency depreciation in the past 6 months. (3) The surplus country keeps a total trade surplus of more than USD 20 billion.

By carefully examining these three criteria, only the third criterion applies to China—given that China's total trade surplus is more than USD 20 billion. Nevertheless, some other countries, such as both Germany and Japan, also keep a trade surplus worth more than USD 20 billion. Such countries are not labeled as “currency manipulators.”

It is important to stress that the first two crucial indices do not apply to China. China's ratio of current account surplus to GDP was more than 3 percent only in 2015 (i.e., 3.1 percent). For all other years in the 21st century, China's ratio of current account surplus to GDP has varied between 1.6 percent to 1.8 percent over years, and this is much lower than the threshold of 3 percent.<sup>5</sup>

Moreover, there is no hard evidence showing that the Chinese government intervenes in the foreign market for RMB depreciation. By carefully reviewing RMB exchange rate variation and PBoC's response, one may conclude that the Chinese government does indeed take actions, if any, to support for RMB *appreciation*. For example, when the RMB depreciated to 1:6.97 in late September 2018, the PBoC advised markets to support RMB

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<sup>5</sup> The Trump administration lowered this criterion to 2 percent in early 2019. But even so, China's ratio of current account surplus to GDP is still lower than this threshold.



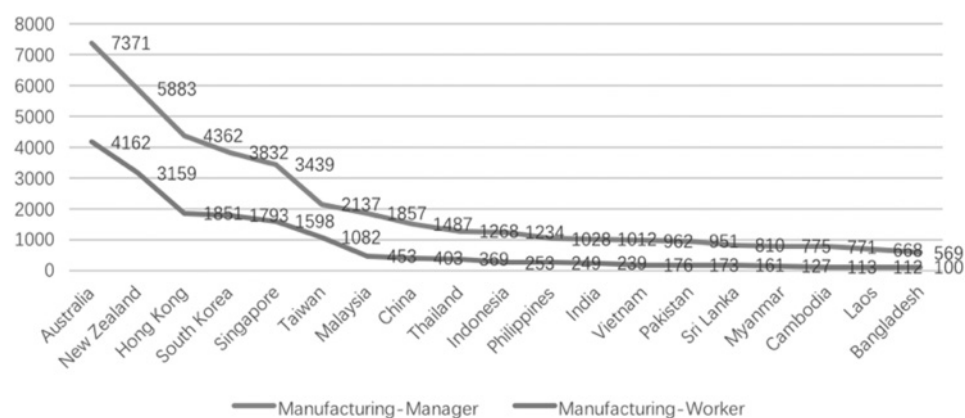
appreciation by asserting that China has no incentives for the RMB's further depreciation. Perhaps because of these observations, the USDOT concluded three times, correctly, that China is not a currency manipulating regime. Unfortunately, on 7 August 2019, the Trump administration mistakenly labeled China as a currency manipulating country without any further formal and necessary investigation.

It is also worthwhile to discuss whether China has an incentive to depreciate the RMB to give exports a competitive advantage. Those who advocate this view see a sudden RMB depreciation during the current U.S.–China trade war. In June 2018, just before the first round of the trade war, 1 USD was convertible to around 6.5 RMB. Only after four months, in mid-September 2018 when the second round of the trade war was launched, the RMB depreciated by more than 5 percent—1 dollar was converted to RMB 6.97. It is important to stress, however, that RMB depreciation was not engineered purposely by China. Instead, the sharp depreciation was mainly because the market did not foresee the U.S.–China trade war and the prevailing uncertainty. In its own interest, China has no incentive to depreciate the RMB even though it seems that a depreciation of the RMB can foster Chinese exports in the short run. Indeed, RMB depreciation is politically unfavorable as well, given that China is promoting the Belt and Road Initiative. RMB depreciation would harm the interest of ASEAN countries that have export structures similar to China. China is putting much effort in promoting the Regional Comprehensive Economic Partnership—the support from ASEAN countries is key to its success. From this perspective it is easy to understand why China has no incentive to depreciate its currency.

## 6.2 Discussion on wage bargaining

One last debate is whether blue-collar workers have wage bargaining power in the Chinese economy. People who are skeptical observe that labor unions seem not to play a key role in the wage bargaining process. In addition, workers seem not to have more bargaining power than management. If, however, we consider the Chinese economy against the background of globalization, it is easier to understand the role of labor unions in China. China is a labor-abundant country and it exports a labor-intensive product, which is consistent with the prediction of the Heckscher–Ohlin theorem. Accordingly, the price of labor-intensive products such as textiles and garments will increase due to trade globalization. Blue-collar workers, as the abundant factor, benefit from trade liberalization. This classical Stolper–Samuelson prediction finds its empirical verification in China. The cost of China's blue-collar labor has already risen to USD 750 per month, which is more than triple the rate from a decade ago. Compared with other labor abundant countries in east Asia, Chinese blue-collar labor costs have already risen four times higher than that in Bangladesh, whereas the Chinese white-collar wage rate is twice as high as that in Bangladesh, as seen in Figure 6. Admittedly, the rise of labor cost is also due to the relative shortage of labor in urban regions. Still, the strong labor demand is the most important driving force pushing up the wages of Chinese blue-collar workers (Chen, Yu, and Yu 2017). Given the sharp increase in



**Figure 6. International comparison of labor costs in manufacturing sectors (2014 USD)**

Source: CEIC database.

wages, it does not provide much incentive for labor unions to press management to further increase in their wages.

## 7. Conclusion

This paper investigates the essential issues behind the ongoing U.S.–China trade war. In addition to the apparent bilateral trade imbalance, the fundamental reasons that the United States triggered the trade war was based on the claim that China was not a market economy, as defined by the Trump administration. Therefore, the U.S. government has requested that China focus on the following structural reforms: further opening up its agricultural and service sectors, providing more market access for foreign investment, and creating a competitive environment where both SOEs and private firms can compete on an equal footing.

This paper argues that, in large part, the current Chinese economy is quickly approaching a modern market economy with some unique Chinese characteristics. The ongoing efforts include attempts to create a competitive neutrality between SOEs and private enterprises, and to push for a further opening-up of the Chinese economy by guaranteeing a wider and deeper market access of inbound FDI.

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