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Chinese Agricultural Reform, the WTO and FTA Negotiations

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Abstract

China's early industrialization created distortions. This paper identifies major distortions in the Chinese economy in the pre-reform era and brings agricultural distortions into perspective. Comparison is made of the reform experiences in Chinese industry and agriculture. It suggests that with limited arable land, it is difficult to align Chinese agricultural production fully with its comparative advantage without also reforming China's grain policy. Reform has substantially freed up agricultural production but border distortions serve as one of a few remaining effective measures to ensure the grain self-sufficiency target. Unlike agricultural protections in rich countries, China's grain self-sufficiency policy has much weaker institutional underpinnings and is susceptible to the influence of interest groups. The patterns of Chinese agricultural trade explain its ambiguous positions in WTO agriculture negotiations. In terms of grain sectoral adjustment, a possible comprehensive China-Australia FTA is consistent with the multilateral process, while the China-ASEAN FTA is not. There is no evidence that the China-ASEAN FTA helps with the WTO agriculture negotiations, particularly when rice is excluded from the deal; but China-Australia FTA could generate competitive liberalization in grain trade, and thus help with the global agricultural liberalization.

Introduction

As a WTO member, China¹ has become part of the multilateral trade negotiations. At the regional level, China has also entered negotiations with the Association of Southeast Asian Nations (ASEAN), Australia, New Zealand and Chile for free trade agreements (FTA). Agriculture is a contentious issue in all those talks. As the largest developing member and a key trader in agricultural products, China's positions in and their implications for WTO agriculture negotiations and regional FTA talks have received much attention. To understand all those issues, one has to understand the role of Chinese agriculture in its national economic development, as well as economic and political factors that help shape Chinese agricultural trade policy. This paper first reviews Chinese industrialization process and identifies major distortions under central planning in Section 2. Section 3 compares Chinese agricultural and industrial reforms with a focus on agricultural trade. Section 4 discusses the political economy of Chinese agricultural trade policy and speculates about its future development. Section 5 explains Chinese negotiation positions on agricultural issues in the WTO and evaluates the China-ASEAN FTA. Section 6 concludes.

Distortions in the pre-reform Chinese economy

At the mid 20th century when People's Republic was founded, China was an agrarian economy with an under-developed industrial sector. Eager to catch up with the Western powers, like most developing countries at that time, China adopted a strategy that emphasized the development of industrial sectors². Agriculture was only in a position to serve this development strategy. Nationalization of the fledging industrial and commercial enterprises together with collectivization of the rural economy made it possible for the Government to effectively carry out this strategy, following the Soviet model of central planning in its management of the national economy. Except for the early 1950s when the country received aid from the former Soviet Union, China was isolated from rest of the world until 1979. As a result, China's early industrialization had to be internally financed. In addition to budget outlay bulk of which went to industrial investment, the Government set low wage for industrial workers, high price for industrial and low price for agricultural products as an implicit tax to divert agricultural revenues and private savings into industrial sectors. As such, agricultural sector was depressed.

¹ Throughout this paper, China refers to mainland China excluding Hong Kong and Macao, as a customs entity. Hong Kong, Macao and Taiwan, Province of China are identified as independent customs entities.

² For a thorough analysis of this "catch up" strategy, see Lin, Cai and Li (2003).

To develop industrial infrastructure at the expense of agriculture was a common practice in most post World War II developing countries. But in China, it was not just a matter of economic policy or development strategy. At play was also the way political status was granted to various social groups. According to Chinese Constitution, it is not peasants but workers in mostly state-owned industrial sector who are given the leading class status in the Chinese political establishment. It was customary for communist countries to regard proletariat workers as the vanguard of the regimes, because most revolutions took place in cities and the industrial workers formed the backbone of the communist military forces. Therefore, orthodox communist ideology commends proletariat workers. In China, however, it was peasants who supported the rural-based Chinese Communist Party in the Civil War against city-based Nationalists. In light of this, Chinese Constitution surprisingly put proletariat workers above peasants in Chinese political life. But it could be understood as a convenient way for the Government to lend its political support for the industrialization campaign and at the same time align itself with orthodox communist ideology.

Wages for Chinese workers were low by international standards but enviable in the eye of peasants. Workers in state-owned enterprises (SOEs) also enjoyed free housing, free health care and guaranteed job security. Later in the reform era when laid-off workers typically lose those perks, outcry pours in and the pace of SOEs reform has to be slowed down. In contrast, the under-represented Chinese peasants have never received the same treatment. Among examples of anecdotal evidence, in one incident, a rural housewife had to resort to the personal intervention of the Chinese Prime Minister through an accidental encounter to help her husband, a migrant worker at an urban construction site, to get back his (and million others') long overdue wage payment. The Chinese legal system itself should have been able to handle this case, but obviously it did not live up to the expectation of "justice for all", including the under-represented.

Biased resource allocation at the national level between agriculture and manufacturing was only one of many distortions pervasive in China's central planning system at that time. Within manufacturing sector, priority was given to heavy industries that produce investment goods, over light industries that produce consumer goods; within agricultural sector, grain production was emphasized to ensure adequate food supply for the country.

Normally, the catch-up strategy would also require an import substitution trade policy that effectively prevents a country from engaging in international trade to its fullest potential. In China's case, the US-led UN embargo against the new communist regime in the 1950s forced the country to make "self-reliance and self-sufficiency" the cornerstone of its foreign trade policy. In agriculture, policy-induced 1958-60 famine further reinforced the conviction of the Chinese

leadership that “grain self-sufficiency” should become the principle of utmost importance in agricultural trade policy making.

For the purpose of building up an industrial infrastructure in a short period of time, this development strategy had its own merit. However, for a country with scarce capital and land resource but abundant labor supply, the strategy was against its comparative advantage and only viable when foreign trade was restricted.

Emphasis on heavy industries and grain production did help boost productions, though apparently far below their potentials.³ However, intrinsic flaws of central planning also created severe problems, such as structural imbalance of the national economy and lack of incentives on the part of producers. By the end of the 1970s, the economy was such a shambles that it prompted the government to embark on reform that has profoundly transformed the Chinese economy forever.

Chinese reform and agricultural trade

Chinese reform has been a gradual process. At the beginning, the reform aimed to improve the efficiency of the system within the central planning framework, and market elements were introduced as supplements. Since early 1990s, market has been increasingly gaining legitimacy in the official reform blueprint and bold initiatives were introduced to correct various distortions. The reform has resulted in economic growth in both agricultural and industrial sectors.

Agricultural reform resembles industry reform in many aspects. Household responsibility system was first introduced in early 1980s to boost farmers’ incentives in agricultural production, and similar responsibility system was later applied to enterprises. As a *quasi* privatization measure, land tenure system was instituted to ensure farmers of the rights to keep the land for 20 years, while in enterprises reform, share-holding system gave workers stakes in firms’ production performance. Most commodity prices were freed up, subject only to market forces. Grain production was still the priority in agriculture. But instead of mandatory production quota sold to the government at lower than market price (the procurement practice during most of the reform years), price support program has been put in place to encourage grain production, though most of the time, market prices are higher than the minimal procurement prices. For Chinese peasants, this change in procurement policy helps transfer grain revenue from grain marketing bureaus to grain growers, and is a positive move as far as peasant’s income is concerned.

Liberalization has unleashed the potentials of labor-intensive production in both agriculture and industry. In agriculture, development of horticulture, poultry, dairy

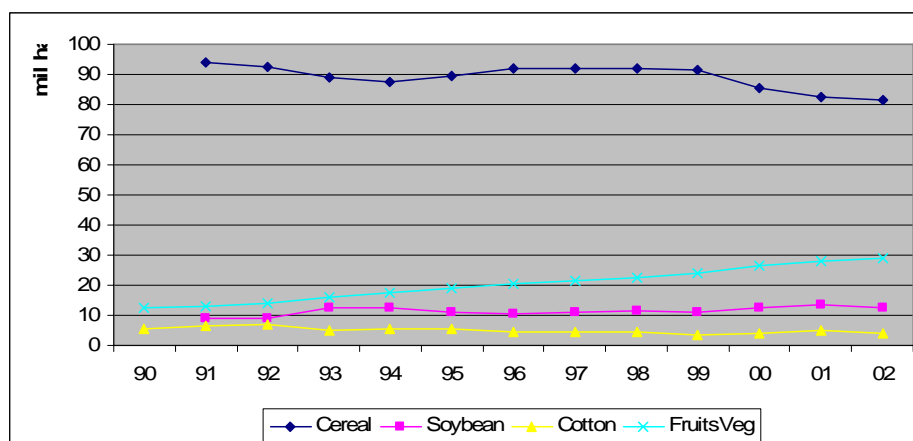
³ High growth rate under central planning was mainly due to more input use but often came with low productivity gain, a point that has been made popular by Krugman (1994).

and animal husbandry sectors has helped diversify the diet of the population, and also increased peasants' income. In industry, development of consumer goods sectors and integration with the international production chain through foreign trade, particularly under the processing trade regime, has changed the Chinese industrial make-up. As a result, within both agriculture and industry, distortions due to over-emphasis of grain production and heavy industry in pre-reform era have been substantially reduced, though more needs to be done to the factor markets.

However, despite of much liberalization of the Chinese economy throughout the reform era, the patterns that tax agriculture to subsidize industry did not change until as recently as this year (i.e. 2006). Despite overall economic growth, the rural-urban divide has further increased (the urban-rural per capita income ratio reached over 3:1 in 2005!). To correct this disparity, China's Eleventh Five-Year Plan has included "New Rural Development (NRD)" program into its platform, which aims to give rural development a higher priority. One immediate policy reform is to abolish all fees and taxes associated with agricultural production. This is a very significant move, because it is the first time in several thousand years' Chinese history that no tax and fees are imposed on peasants. This reflects the determination of the Chinese leadership to deal with the rural backwardness, which is a long overdue task. But it remains to be seen how far this campaign can go, as the NRD campaign comes as a top-down approach. It is not initiated, monitored or run by rural residents, the potential beneficiaries and therefore may deviate from its original objectives along the course of implementation. After all, NRD supporters have to compete for resources with other more politically powerful constituencies.

In China, arable land is scarce and so is capital. But unlike arable land, capital can be borrowed from abroad. This simple fact explains the different ways in which structural adjustment has been achieved in both agriculture and industry. In agriculture, with a slight increase in total sown area, additional land use for horticulture has been met mainly by a smaller sown area for grain (Figure 1), a reflection of China's changing policy on "grain self-sufficiency" (from 100% down to 95%). The declining grain acreage has been met by productivity gain at the same time. The Household Responsibility System gave a once for all boost for grain production in the early 1980s. Agricultural R&D investment, made mostly in grain sector and some in the pre-reform era, started to show its impact in the reform years. However, since the 1990s, grain yield has been mainly fueled by more inputs rather than by productivity improvement, a reflection of the grain sector fatigue.

Figure 1: Sown Area of Major Crops in China 1990 – 2002



Source: China Statistics Yearbook and FAO Database, various years

Correction of distortions within industry takes a different route. While many small SOEs have been privatized, medium and large SOEs are mostly intact and keep receiving generous state subsidies. Without substantial reform in SOEs, Chinese industrial make-up has been transformed by the emergence of a vibrant non-state sector that includes private, collective and foreign funded industrial enterprises. While the private and collective enterprises are struggling to raise money for their operations, foreign funded enterprises have brought in huge amounts of capital in the form of foreign direct investment (FDI). As of today, China is the top recipient of FDI in the world. Of course, release of rural surplus labor has also contributed to the development of labor-intensive industries. As a result, in 2005, SOEs contributed only 1/3 to the total industrial GDP in China. In contrast, because agricultural production solely relies on local factors (land and labor, etc), its structural make-up has not changed very much compared to industrial production. The share of grain and other land intensive crops (soy and cotton) still make up as much as 70% of Chinese sown areas in 2002.⁴

How far has the correctional process gone in Chinese agriculture? To answer this question, let's make some international comparison with Brazil, a country with

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