HUNTON & WILLIAMS

SPOTLIGHT

ON INTERNATIONAL BUSINESS OPPORTUNITIES

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A Note From the Publisher

When we published our first issue of *Spotlight* several years ago, we promised it would identify new opportunities in overseas markets for our clients and friends. The current issue is perhaps the most dramatic proof of our ability to keep that promise. Hunton & Williams established an office in Hong Kong to serve our growing Asian clientele in 1994. When the Asian economies nose-dived in the late 1990s, we held steady and even expanded our resources there. Now, with the world's largest potential market – China – poised to assume an even more prominent role in the global economy through membership in the World Trade Organization, it is an excellent time to provide the perspective of our people resident there. And, surprise, there are some misconceptions about the "new" China that all business people should heed. We have devoted this entire issue of *Spotlight* to a very thoughtful and provocative article by Hong Kong office head Ed Koehler and senior associate George Zhu. We think you'll enjoy it and welcome your comments.

Thurston Moore
Managing Partner

The WTO and the Chinese Market Correcting Five Common Misconceptions

After 14 years of negotiation, China is finally poised to enter the World Trade Organization ("WTO") after the signing by China and the United States of a bilateral agreement on trade ("WTO Accord") in November 1999. If the WTO Accord is approved by the U.S. Congress and China's bilateral negotiations with other WTO members continue to be successful, China will likely become a WTO member by the end of this year or early next year. China's entry into the WTO will have a positive impact on, among other things, the prospects for greater U.S. and foreign investment in China.

There are a number of common misconceptions about China's participation in the WTO and some of the developments that might follow. Five such misconceptions are discussed below:

Misconception No. 1: China's WTO accession will mark the first opening of the Chinese market.

China's entry into the WTO will not mark the beginning of the opening of the Chinese market, but rather will represent a significant further step in an ongoing process that has seen China gradually opening to foreign trade and investment over the past 20 years. As a non-WTO member, China is the largest economy and trading nation currently outside of the WTO. Since China opened its once-closed market to the outside world in 1979, it has experienced significant growth in both foreign investment and foreign trade. China's trading partners now include about 200 countries and regions. Over the past five years, China has been the world's second-largest recipient of foreign investment after the United States. China's membership in the WTO will commit it to further open some sectors of its economy that have been traditionally closed or restricted to foreign investment and foreign competition.

Misconception No. 2: China is finally ready to open its market completely.

China's entry into the WTO will not bring an immediate and complete opening of all sectors of the Chinese market. China has always intended to allow only a gradual increase in foreign participation in its key economic sectors. As a result, foreign companies that are eager to engage in business in China after China's accession may still face resistance in various markets that will not yet be fully open.

The WTO Accord will most likely create increased opportunity for foreign trade and investment in the following areas of China's economy:

- Agriculture. China has agreed to eliminate export subsidies, to permit agricultural trade outside of government-controlled channels, and to eliminate various tariffs. For example, agricultural tariffs will fall to an average of 17.5 percent by 2004, and China will grant import and distribution rights to foreign companies.
- Industry. In addition to reducing tariffs and quotas on industrial goods, China will also allow non-bank auto financing and begin eliminating tariffs on information technology products. As a result, average tariffs on industrial products (such as chemicals, electronics and wood and paper) will fall to 9.4 percent by 2005.
- Services. China has made commitments in all major service categories to eliminate most foreign-equity and geographic restrictions so that foreign companies can be well-positioned to compete in areas such as banking, insurance, securities, telecommunications and professional services. Specifically, China will end the ban on foreign investment in the telecommunications sector, allow 50 percent foreign ownership in value added (Internet) and paging services within two years after accession, and allow 49 percent foreign ownership in mobile telecommunications (domestic and international services) phased in over five to six years.
- Trade and Distribution Rights. China will gradually allow foreign companies to trade, distribute, and sell goods independently, as well as engage in auxiliary services such as leasing, air-freight, warehousing, advertising and packaging. China currently prohibits foreign companies from operating in these sectors.

However, the WTO Accord by no means represents an immediate and complete liberalization of all sectors of China's market. For one thing, the elimination of trade barriers and investment restrictions will occur over an extended period of time, and, indeed, may not be effectively achieved. As a result, U.S. companies will need to be able to operate in a dynamic, partially opened market for the time being. Also, in order to accommodate its WTO commitments, China will need to ratify a substantial body of new legislation in a limited time. Complicating the implementation of this new legislation are the uncertain economic and political impacts of the WTO requirements on (a) the sectors of China's economy that are currently heavily protected against foreign competition, and (b) the less efficient state-owned enterprises, the liberalization of which poses the

threat of massive unemployment and social instability. In short, both China and the United States have a long way to go in order to fully benefit from the WTO Accord.

Misconception 3: There is no rule of law in China.

The general perception is that the rule of law in China is weak, especially in light of the media's focus on China's human rights and corruption track records. However, to say that there is no rule of law in China is an exaggeration. In the Chinese judicial system, law is only one element in addition to other elements such as politics, status and personal relationships. However, the rule of law does function more powerfully than most people perceive, as the Chinese government has promulgated a significant number of laws and regulations affecting virtually all sectors of the economy. In many cases the problem has been not an absence of laws and regulations, but an overabundance of sometimes overlapping, at times contradictory, laws and a lack of transparency in the implementation of the law. WTO membership promises to improve the rule of law and the transparency of the legal system in China because the WTO is a rule-based international trading system. The WTO's dispute-settlement mechanisms provide credible and effective tools for the enforcement of the economic rights of China's trading partners, backed by the threat of WTO-authorized sanctions for non-compliance. Although integration of China into the global trading system is still at an early stage, the WTO's promotion of reliance upon international standards and systems should prompt China to meet international standards and adopt international systems. For example, WTO membership will commit China to implement and enforce international standards on the protection of intellectual property, an area of profound concern to foreign companies doing business in China.

Misconception No. 4: The Sino-foreign joint venture is the most popular way for foreign companies to invest in China.

After over 20 years of engaging in joint ventures with Chinese partners, many foreign investors have determined that the benefits of having complete control over a joint venture company (and, in certain areas, the ability to protect their technology) outweigh the benefits to be gained from their Chinese partners' local connections and know-how. Over the past few years, foreign investors have increasingly opted to invest in China independently. Based on figures compiled by a major international accounting firm, almost 45.5 percent of foreign-invested projects approved in 1997 were wholly foreign-owned enterprises ("WFOEs"), and 43 percent were equity joint ventures. This was the first time that WFOEs have outnumbered equity joint ventures in China. During the first half of 1999, WFOEs made up approximately 48 percent of total contracted foreign investment in China, as compared to 34 percent for equity joint ventures.

The new dominance of WFOEs is expected to continue after China's WTO accession, even though foreign participation will be restricted to joint ventures during the phase-in period for certain sectors, such as telecommunications. There are also concerns as to whether certain beneficial treatments available to

WFOEs will continue to be available after China's WTO accession. For example, WFOEs are usually given "export quotas" to fulfill and are able to obtain specific tax exemptions if they are classified as "exporting" enterprises. Since these tax exemptions can be considered as a form of export subsidy, it is not clear whether and for how long under the WTO Accord or during China's implementation of the WTO Accord they will continue after China's accession.

Misconception No. 5: China's WTO accession will further ease foreign investors' foreign exchange concerns when doing business in China.

As China's WTO accession will not require free convertibility of the Chinese currency, the Renminbi ("RMB"), foreign exchange will remain an important concern for foreign investors. Over the past six years, the foreign exchange system in China has evolved toward a more freely convertible RMB and, to a certain extent, toward greater flexibility. Presently, only current accounts (as opposed to capital accounts), such as payments for the purchase of foreign equipment, interest on foreign loans and the distribution of profits, are freely convertible. This means that there should be no impediment to accessing foreign exchange for a foreign investment company's needs provided that there are no foreign exchange shortages. Nevertheless, there might be other potential impediments to international business transactions because the RMB is still not freely convertible. Various government approvals are required for capital accounts conversion. Especially as a result of the recent financial crisis, China has tightened its control on all foreign exchange activities. In addition, Chinese regulations prohibit domestic transactions from being settled in foreign exchange, exposing foreign investors to the continuing risk of foreign exchange.

Also, China's WTO commitments may renew foreign investors' concern regarding the potential devaluation of the RMB. Despite numerous assurances by the Chinese government after the 1997 devaluation of several Asian currencies and the ensuing financial crisis, pressure for a RMB devaluation (which could reach 10 percent) will likely increase due to an enormous influx of cheaper imports as a result of the various tariff reductions and eliminations stipulated in the WTO Accord.

In conclusion, the WTO Accord commits China to further liberalization of its markets with respect to foreign products, investments and competition, and in turn provides foreign companies with significant business opportunities. However, the WTO Accord does not represent an immediate and complete liberalization of the Chinese market. It is only through a successful implementation of the WTO Accord, including, in particular, the strengthening of the rule of law and the proper management of the impact of the WTO Accord on the Chinese economy and society, that China and the United States will truly benefit from China's accession to the WTO.

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