

The Prospects for US-China Services Trade and Investment

A Report by Oxford Economics

The China Business Forum



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Executive Summary

The dramatic expansion of trade and investment in services between China and United States has benefited both economies substantially and will continue to do so for the foreseeable future.

In China, the service sector already is growing, contributing to economic development and a rise in living standards by boosting the productivity of industrial enterprises. The expanding market for service-based jobs is vitally important to China's ability to absorb the large numbers of young workers and college graduates entering the job market each year. Historically, the growth of a service sector also is seen as a significant step in the evolution of a nation's economy.

For the United States, which is the world's largest service economy, trade and investment in services with China translates directly into high-wage US jobs and increased profits from investments in China that lead to further investment and job creation in the United States. The United States has a rapidly growing services trade surplus with China that slightly offsets the large manufacturing goods deficit. The more open the Chinese market for US service providers becomes, the more US services can be sold in China. These exports of services will continue to contribute positively to the US balance of payments.

From a broader perspective, the expansion of China's services infrastructure is essential to China's integration into the global economy and continued economic development. For example, China's establishment of a modern capital market will help China move toward a market-driven exchange rate. Market-based lending will help level the playing field between US and Chinese competitors. China's ability to provide pension and health care insurance to its citizens will enhance social stability and unlock capital resources tied up in precautionary savings. Improving the regulatory framework for services will help Chinese manufacturers and commercial firms to continue to move up the value chain, in all areas, from transportation, professional and financial services, and information technology, to retail, tourism, and hospitality, to name but a few.

These findings are the result of an extensive analysis of US-China services trade and investment conducted by Oxford Economics. The analysis demonstrates that China's initial implementation of its World Trade Organization (WTO) commitments in services already benefits both economies. But even full implementation of these WTO commitments will leave in place a range of impediments to the growth of China's service sector, as well as service trade and foreign investment. By removing these constraints, both the Chinese and US economies will realize the full

potential economic benefits of trade and investment in services detailed in this study.

Benefits for China

■ Chinese industry is growing rapidly in part because of strong imports of knowledge services, network services (transport, communication, and information technology) and financial services from developed economies.

■ Oxford Economics estimates that the increase in China's service sector imports after 2001 resulted in higher average labor productivity of 0.3 percent. This productivity increase equates to an increase in Chinese GDP of \$6.5 billion. Of that, around \$650 million is attributable to service sector imports from the United States.

■ Higher productivity in Chinese industry means higher standards of living for millions of Chinese citizens—the goal of China's economic development plan.

■ If the impediments to service sector growth in China are fully removed, the benefit would amount to an additional 2.5 percent of GDP (\$138 billion in 2006 prices) by 2015. This would make the average Chinese household better off by \$300 to \$400, or RMB 2,300 to RMB 3,100 per year. In comparison, average household income in China was around RMB 30,000 (around \$3,700) in 2005. Service sector trade and investment flows with the United States would generate one-tenth of the gains in household income by 2015 in this scenario.

■ The growth in service sector trade and investment by 2015 will add up to 7 million jobs in China in relatively high-paying, high-productivity service industries if the impediments to service sector growth in China are fully removed.

Benefits for the United States

■ The United States is already a net exporter of a broad range of services to China: the United States had a services trade surplus with China of \$2.6 billion in 2005. US service sector exports to China are growing rapidly—more rapidly than US service sector exports to any other economy. The United States is the world's largest exporter of services and is well positioned to benefit from China's rapidly growing demand for services.

■ US service companies provide high-skill services to customers, employees, and markets throughout China, largely in knowledge, network, and financial service industries

(including express delivery, banking, insurance, management consulting, and information technology services).

■ US service sector net exports and net income of service sector investments to China, worth \$3.1 billion in 2005, support some 37,000 jobs in high-productivity sectors of the US economy. This provides a permanent boost to US productivity—worth around \$460 million in 2005.

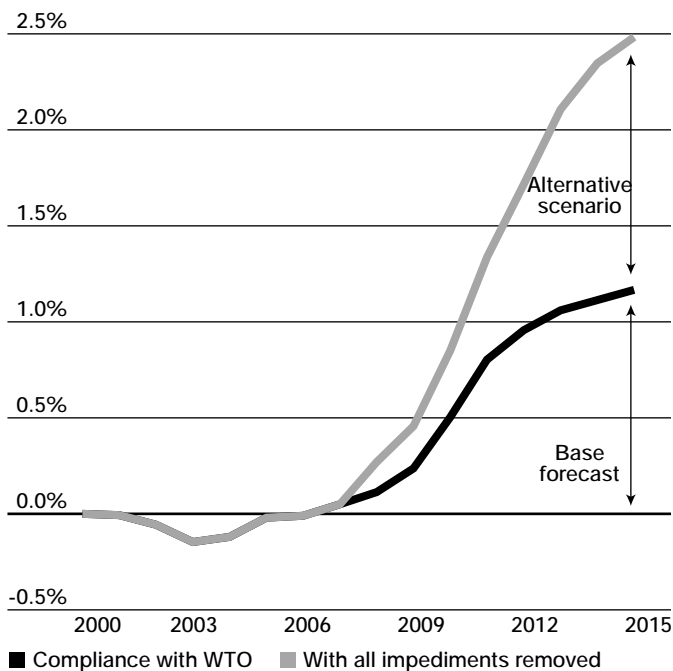
■ If the outstanding impediments to service sector growth in China are fully removed, the bilateral services trade surplus with China will increase to around \$60 billion by 2015, supplemented by extra income derived from US service-related investments in China worth \$7 billion. This would boost US GDP in the short term by about 0.3 percent.

■ The average US household would be better off by about \$500 per year in 2010 as a result of this growth in services trade with China.

■ The significant and growing US current account surplus in services with China (including repatriated profits from service sector foreign direct investment) is supporting the growth in service sector employment in the United States. The removal of all impediments to growth in services trade and investment with China would create up to 240,000 high-paying US service sector jobs by 2015.

Impact of removing all impediments to growth in China's service sector trade and investment

% impact on China's GDP



Source: Oxford Economics

■ In the long run, removing the remaining impediments to China's services market could boost US GDP by up to 0.2 percent, resulting in a permanent benefit for the entire US economy. By 2050, US service sector exports to China could reach between 1.5 percent and 3.5 percent of US GDP. The US surplus on service sector trade with China could be worth around 1 percent of US GDP, while inflows of profits from US service sector investments in China could contribute a further 0.5 percent of GDP to the US current account of the balance of payments.

Realizing these benefits

This study makes clear that the benefits of service sector trade and investment accrue to both economies. Implementing fully China's WTO commitments is an essential first step to maximizing the advantages for both economies of service sector links. Implementation is well under way, and both economies will reap the substantial benefits in the years to come.

But greater benefits will be realized in both China and the United States if PRC regulations, implementing rules, and license approvals are adjusted to increase the pace and scope of service sector reform.

In practice, this would entail:

■ Increasing the transparency of the regulatory environment for foreign service providers, through early publication of proposed regulations, consultation with foreign and domestic industry, participation in international service sector forums, and adoption of international standards and norms

■ Progressively deregulating markets for the provision of services, to encourage the growth of those services

■ Addressing current restrictions on market access and expansion (including foreign ownership, industry, and geographic limitations) so that foreign expertise in the service sector can become another tool to further China's Five-Year Plan objectives

■ Creating a level playing field, by reducing government support for domestic enterprises in the services markets

■ Continuing to gather and publicize sectoral data about the performance of the Chinese economy, to enable all participants in the economy to understand more clearly how quickly the various service sectors in China are growing, and what their future growth prospects might be

Adopting such measures would generate significant benefits for China and the United States, helping China to move more quickly and effectively to achieve its own economic development goals.

The Prospects for US-China Services Trade and Investment

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About the Authors

Erik Britton, project leader, is director of Economics at Oxford Economics, one of the world's leading providers of economic forecasting, analysis, modeling, and advisory services. Oxford Economics supplies a range of "off-the-shelf" products and services in addition to customized economic consultancy services.

Britton joined Oxford Economics in 2000. Since then he has assumed a wide range of macroeconomic forecasting responsibilities and undertaken consultancy projects for clients around the world, in both the public and private sectors. Britton joined Oxford Economics from the Bank of England, where he was responsible for running the UK macroeconomic forecasting model, then for coordinating the international forecast, and finally for managing a team of economists undertaking research into the economics of the corporate sector.

Britton graduated from Magdalen College, University of Oxford, in 1988, with a degree in Politics, Philosophy, and Economics. He holds an MSc in Economics from Birkbeck College, University of London.

Vanessa Rossi is director of International Economics at Oxford Economics. She has led Oxford Economics' work on a wide array of consultancy projects, specializing in international economics and model development for government departments and international organizations in Europe, the United States, and Asia. She also heads up Oxford Economics' analysis and forecasting work on the Chinese economy.

Rossi rejoined Oxford Economics in 1994 from Swiss Bank Corporation, London (now UBS), where she was a research director. Since her return, Rossi has helped to develop coverage of China and the emerging market economies, banking sector and financial market analysis, energy market models, and related analysis linked to consultancy projects and presentations. Rossi is co-author of a book on financial markets and has contributed to publications on the Chinese economy, the economic impacts of Kyoto and carbon trading, assessments of SARS and related health risks, and international bond market trends, among other articles on international economics and model analysis.

Rossi gained her first degree, with distinction, in Mathematics, Economics, and Statistics from Birmingham University in 1975 followed by a Masters degree from Warwick University (1976) in Mathematical Economics. She is currently an associate fellow of Chatham House.

About the China Business Forum

The China Business Forum, Inc. (www.chinabusinessforum.org) was established in 1987 by the US-China Business Council to promote broad-based policy discussion and greater understanding in both China and the United States of the economic systems and business methods of each country and of the role of commerce in the overall relationship between the United States and China.

The US-China Business Council (www.uschina.org) is the leading organization of US companies engaged in business with the People's Republic of China. Founded in 1973, the USCBC provides extensive China-focused information, advisory, and advocacy services, along with events, to nearly 250 US corporations operating within the United States and throughout Asia.

China is a rapidly industrializing economy. Manufacturing accounted for some 46 percent of Chinese GDP in 2004, and a similar proportion in 2005. The dominant role of manufacturing is accompanied by huge and rapidly growing exports of manufactured goods from China to other countries around the world, and also by shifts in the structure of the labor market in China as workers move from rural locations where they were mainly employed in agriculture, to the new centers of industry and commerce in and around the major cities.

China's economic development has many unique twists of its own, but the broad pattern of its development is similar to those of other economies. That pattern has two phases. The first is a shift from agriculture into manufacturing: industrialization, leaving only a small residual of agricultural production. The second is a shift from manufacturing into services: to a post-industrial economy, leaving a relatively small share of both manufacturing and agriculture. Both phases of development typically accompany pronounced increases in real standards of living for the average household.

In China today, several things are going on at once:

- Since 1991, employment has shifted out of agriculture into both manufacturing and services, with services now taking up most of the gains.
- The productivity of Chinese industry is increasing rapidly, as the manufacturing sector approaches the global technological frontier—the level of productivity achieved by the most technologically advanced companies in the world.
- As Chinese manufacturing moves towards that frontier, the industrial sector increasingly requires the range of knowledge, network, and financial services that are integrated into the most advanced manufacturing processes around the world.
- The manufacturing share of Chinese GDP probably has peaked already, and the service sector share will continue to increase.

Many countries, including the United States, are sources of the expertise that is transforming the productivity of the Chinese manufacturing industry: imports of knowledge (business) services, network (transport, information technology, and communication) services, and financial services are making valuable contributions to Chinese manufacturing productivity growth. Chinese firms' demand for this expertise creates a significant market

opportunity, now and for the next decade at least, for US-based providers of such services, supporting growth in these high-productivity sectors in the US economy.

In the decades to come, China's service sector will eclipse the manufacturing sector as the largest contributor to output and employment in the Chinese economy. The Chinese market for services across the board will provide a huge opportunity for all participants in the PRC economy, foreign and domestic alike.

This paper assesses the role of bilateral flows of trade in services between the United States and China on both economies. The rest of the paper is organized as follows:

Section 2 describes China's economic development path and the role of services in that development.

Section 3 sets out the trends and prospects for trade in services between the United States and China.

Section 4 assesses the benefits of services trade with the United States for the Chinese economy.

Section 5 assesses the benefits of services trade with China for the US economy.

Section 6 constructs scenarios that estimate the future growth of services trade between the United States and China.

Section 7 concludes by drawing out some implications for policy priorities in China.

Appendix 1 sets out a baseline forecast for the Chinese economy.

Appendix 2 summarizes China's commitments to the WTO and current state of compliance with those commitments.

Appendix 3 describes in detail impediments to growth in trade and investment between China and the United States in three service industries—financial services, including insurance; information technology services; and express delivery services—and the contributions of these three industries to the economic performance of China and the United States.

Appendix 4 details the measurement issues related to foreign direct investment flows from the United States to China.

China's economic development: the role of services

From farm to factory—and then to services

The dramatic growth of the Chinese economy is associated with equally dramatic changes in the country's industrial structure, as a largely rural, agricultural economy transforms into an economy increasingly dominated by industry. This transformation follows the same pattern already experienced by many other economies that are now further down the path of economic development, as shown in Table 1.

Historically, in all economies, the period of rapid industrialization generally is just the first phase of economic development. The next phase involves the shift out of manufacturing industries toward service industries. This second phase is already fairly advanced in most developed economies, is about to get under way in less-developed economies like South Korea, and may be still a decade or more into the future for emerging economies such as China. Figure 1 shows how the composition of employment in China has evolved over the last decade—viewed in terms of the shares of the agriculture, forestry, fishing, and mining industries (primary sector); the manufacturing and construction industries (secondary sector); and the service industry (tertiary sector) in total employment.

In spite of recent changes, Chinese employment remains heavily concentrated in primary industries, largely agriculture—a predictable pattern for countries at China's stage of industrialization. Because of the relatively low productivity of the primary sector, the primary share of employment in developing economies tends to be much larger than the primary share of GDP. Figure 2 illustrates the pattern of development over the longer term, in terms of the primary, secondary, and tertiary shares of GDP, as it has been experienced in three economies (South Korea, Japan, and the United States) since 1970.

Revision of China's national accounts

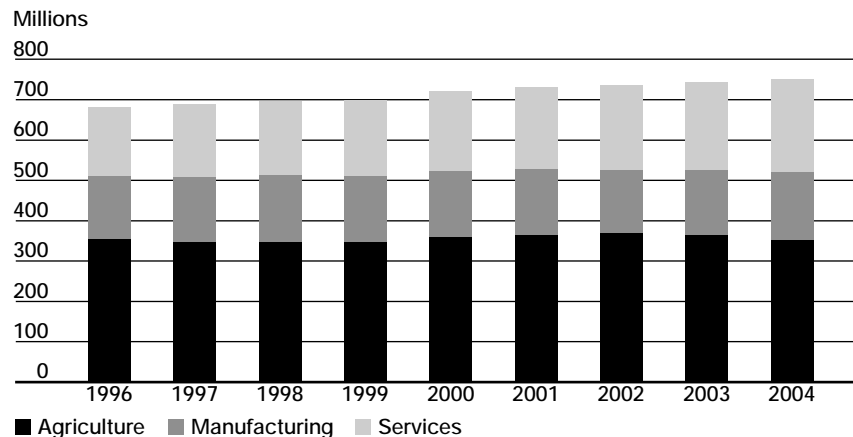
In China's case, manufacturing (secondary industry) accounts for almost half of economic output, and the service sector (tertiary industry) share has surpassed agriculture (primary industry). In December 2005, the PRC National Bureau of Statistics (NBS) revised the 2004 GDP estimate by 16.8 percent after preliminary input from the 2004 economic census (Figures 3, 4). NBS reported that RMB 2.3 trillion had

Table 1
Per capita GDP in US \$,
constant 2000 prices, at PPP exchange rates

| | 1980 | 1990 | 2000 | 2005 | Annual growth 1980–2005 |
|----------------------|---------------|---------------|---------------|---------------|----------------------------|
| United States | 22,393 | 28,091 | 34,306 | 37,046 | 2.0% |
| Japan | 16,677 | 23,244 | 25,955 | 27,226 | 2.0% |
| Germany | 18,184 | 22,446 | 26,506 | 27,224 | 1.6% |
| United Kingdom | 15,629 | 19,934 | 24,719 | 27,124 | 2.2% |
| France | 18,592 | 22,017 | 25,775 | 27,116 | 1.5% |
| South Korea | 8,780 | 12,977 | 15,275 | 18,594 | 3.0% |
| Hungary | 9,826 | 11,372 | 12,454 | 15,000 | 1.7% |
| Argentina | 11,649 | 8,914 | 11,906 | 12,281 | 0.2% |
| Poland | 7,670 | 7,056 | 9,934 | 11,476 | 1.6% |
| Thailand | 2,527 | 4,581 | 6,276 | 7,563 | 4.5% |
| Brazil | 6,805 | 6,458 | 7,206 | 7,542 | 0.4% |
| China | 680 | 1,429 | 2,842 | 3,709 | 7.0% |
| India | 1,157 | 1,652 | 2,369 | 2,936 | 3.8% |

Source: Oxford Economics

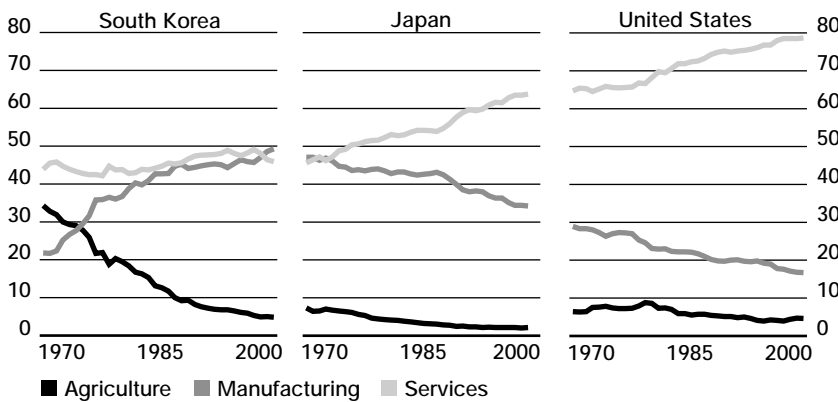
Figure 1
Employment in China by sector



Note: Agriculture=primary industry; manufacturing=secondary industry; services=tertiary industry

Source: PRC National Bureau of Statistics

Figure 2
Shares of private sector GDP
at different stages of development



Source: Oxford Economics

Figure 3
China GDP, 2004
(pre-revised)

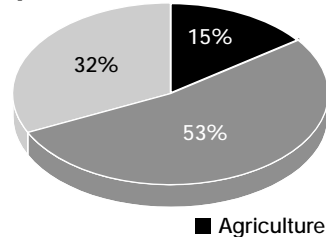
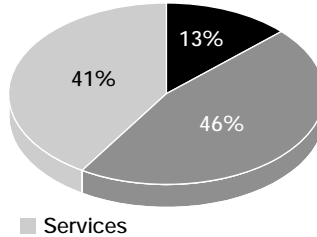
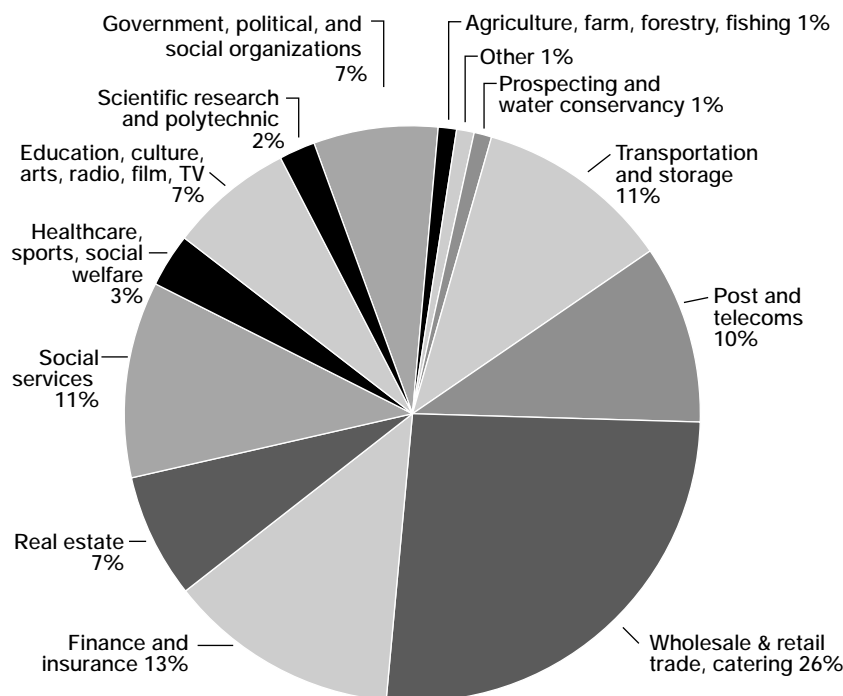


Figure 4
China GDP, 2004
(revised)



Source: PRC National Bureau of Statistics

Figure 5
Composition of China's service sector, 2004 (revised)



Source: Oxford Economics

been added to the 2004 GDP figures, bringing the total to RMB 15.99 trillion.¹ The first national economic census revealed many economic activities, mostly in the service sector, that had been previously underreported.

Revisions to service sector output accounted for more than 91 percent of the change—RMB 2.1 trillion out of the increase of RMB 2.3 trillion—implying that the composition of GDP had changed as well because of this revision. After the revision, the service sector's contribution to GDP increased to 40.7 percent from the previous estimate of 31.9 percent. There was a corresponding declining share for manufacturing: 46.2 percent of GDP versus 52.9 percent in the pre-revision estimate. The share of agriculture and related activities fell to 13.1 percent of GDP from 15.2 percent. Li Deshui, then-director of the National Bureau of Statistics, further stated that four sub-sectors of the service sector—transport and storage; post and communications; wholesale, retail, and catering trade; and real estate—together accounted for 70 percent of the increase in value added of the service sector.

This implies that within the service sector, the composition of output also has been revised. Assuming the relative importance of these three sub-sectors remains the same, and assuming the GDP share of each of the other services sub-sectors also remains the same, it is possible to construct a revised breakdown of the composition of the service sector.

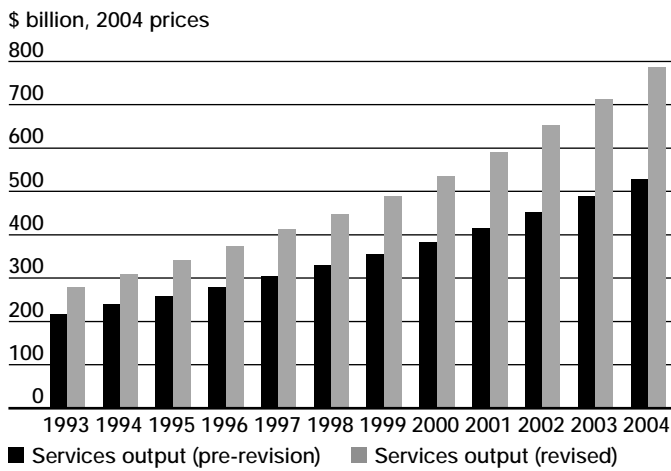
A larger role for services

Figure 5 shows the revised composition of the services (tertiary) industry, using Oxford Economics estimates for the shares of all the sub-sectors within services. In large part, the changes are due to activities in the rapidly developing sub-sectors that the economic census captured for the first time. In particular, the share of the transport and storage, and post and communications segments within the service sector has nearly quadrupled. The wholesale, retail, and catering trade sector now contributes 26 percent of services output, rather than the previous estimate of 7.6 percent. The contribution of real estate services also has more than tripled.

Using new findings of the first national economic census, NBS revised the level and composition of historical GDP data going back to 1993. Service sector output is both significantly larger and growing significantly faster than previously estimated (Figures 6, 7).

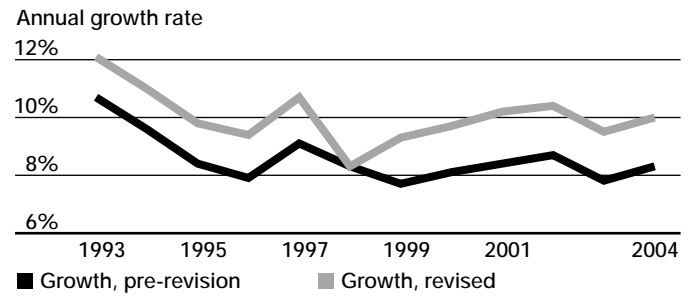
The Chinese service sector is growing far more rapidly than its counterpart in the United States (approximately 10 percent per year compared to 4 percent). But China's service sector remains but a fraction (about one-ninth) of the US service sector (Figures 8, 9).

Figure 6
Original vs. revised China services output, 1993-2004



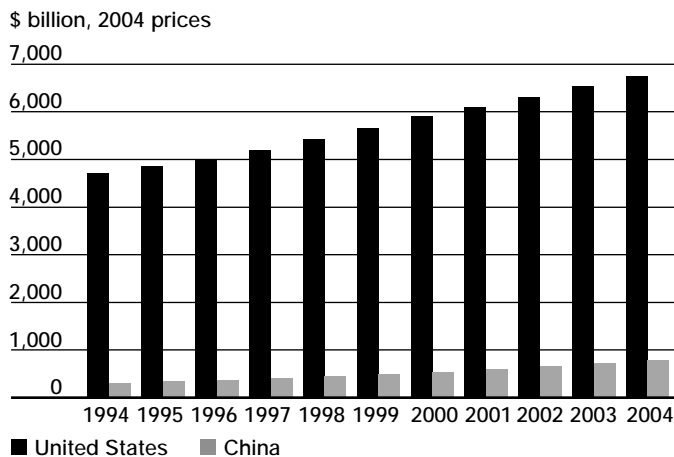
Source: PRC National Bureau of Statistics²

Figure 7
China service sector output growth rates, original and revised



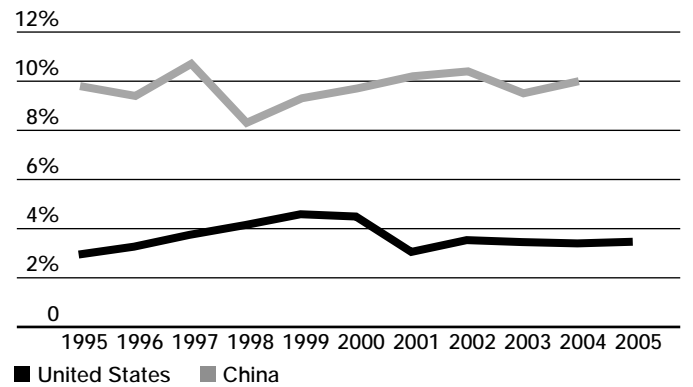
Source: PRC National Bureau of Statistics

Figure 8
Service sector output in the United States and China



Sources: PRC National Bureau of Statistics, US Bureau of Economic Analysis

Figure 9
Service sector output growth rates, United States and China



Sources: PRC National Bureau of Statistics, US Bureau of Economic Analysis

¹ "Press Conference by the State Council Information Office on the Economic Census," National Bureau of Statistics of China, December 19, 2005. http://www.stats.gov.cn/zgjpc/jryw/t20051220_402297087.htm, accessed on July 25, 2006.

² See footnote 1.

Trends and prospects for trade in services between the United States and China

Service sector international trade

The growth in service sector output in China has accompanied even more rapid growth in flows of services into and out of China via international trade (Figures 10, 11).

Both exports and imports of services have been growing at around 20 to 30 percent over the last few years in dollar terms, far outperforming the growth of service sector output (about 10 percent). Together, in 2004, service sector imports and exports were worth \$134 billion, or 17 percent of service sector output in China, up from 11 percent in 1993. These figures show the increasing importance of trade in China's service sector as well as growing opportunities for services exporters in the United States and other economies. US trade in services (to and from all other countries), like output, is growing much less rapidly than in China (Figures 12, 13).

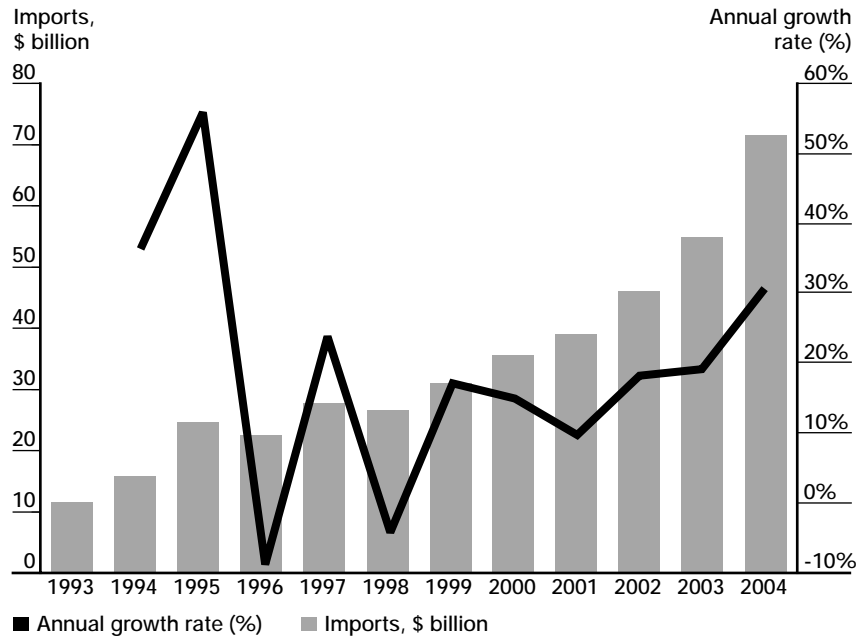
China-US services trade

China is running a substantial surplus on the current account of its balance of payments, including trade in both goods and services. But China is in deficit on its services trade account with all economies, to the tune of \$9.5 billion in 2004. China also had a \$2.6 billion deficit on its bilateral services trade account with the United States in 2005 (Table 2).

China's service sector exports to the United States are growing rapidly as the Chinese market opens up and the country becomes a more attractive destination for tourists and business visitors. The average annual growth rate is 14.5 percent in dollars at current prices. In 2005, Chinese service sector exports to the United States were \$6.5 billion, compared to \$1.5 billion in 1994. But Chinese service sector imports from the United States were \$9.1 billion in 2005, up from \$2.1 billion in 1994; an average annual growth rate once again of 14.5 percent over that period, and from a higher starting level than imports. China's bilateral service trade deficit with the United States has increased by almost \$2 billion over that period, and China's service sector imports from the United States were more than 14 percent of its total service sector imports in 2004.

Figure 10

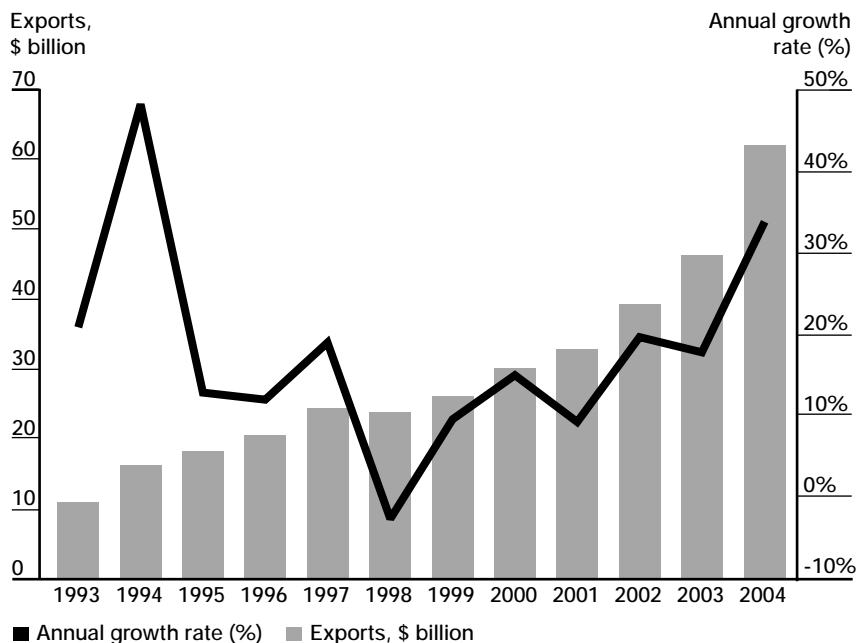
China imports of services—values and growth rates



Note: Figures for 2004 revised, all others pre-revised
Source: World Trade Organization

Figure 11

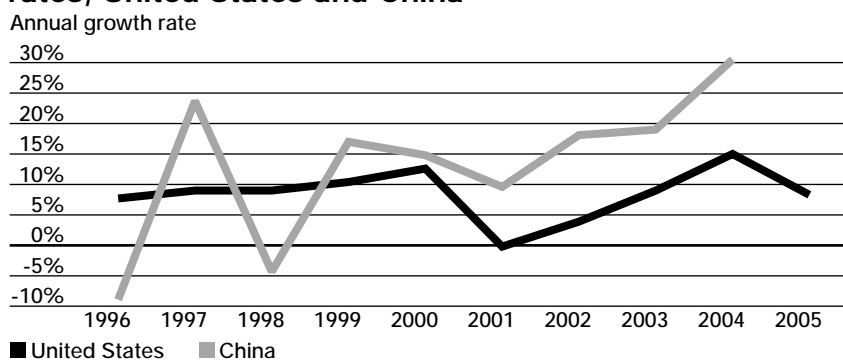
China exports of services—values and growth rates



Note: Figures for 2004 revised, all others pre-revised
Source: World Trade Organization

Figure 12

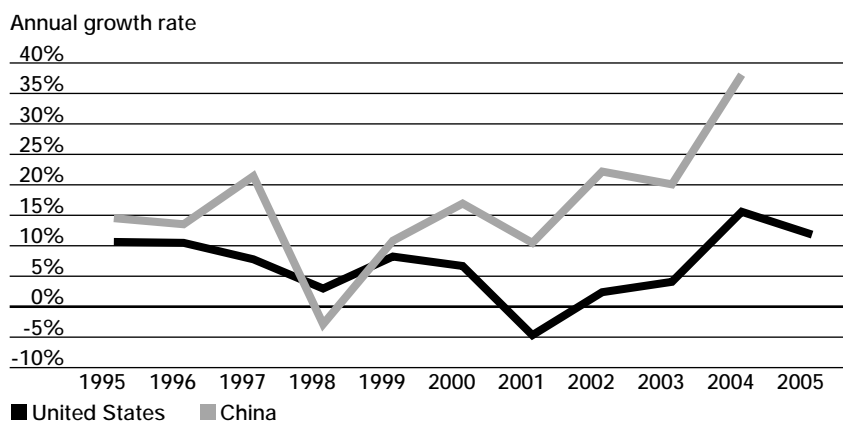
Service sector import growth rates, United States and China



Source: World Trade Organization

Figure 13

Service sector export growth rates, United States and China



Source: World Trade Organization

Table 2

China-US goods trade balance³ and services trade balance

| Year | Goods \$ million | | | Services \$ million | | |
|------|------------------|---------|---------|---------------------|---------|---------|
| | Balance | Imports | Exports | Balance | Imports | Exports |
| 1994 | 29,505 | 9,282 | 38,787 | -574 | 2,051 | 1,477 |
| 1995 | 33,790 | 11,754 | 45,543 | -829 | 2,512 | 1,683 |
| 1996 | 39,520 | 11,993 | 51,513 | -1,230 | 3,167 | 1,937 |
| 1997 | 49,695 | 12,862 | 62,558 | -1,387 | 3,612 | 2,225 |
| 1998 | 56,927 | 14,241 | 71,169 | -1,656 | 3,958 | 2,302 |
| 1999 | 68,677 | 13,111 | 81,788 | -1,346 | 4,029 | 2,683 |
| 2000 | 83,833 | 16,185 | 100,018 | -1,948 | 5,207 | 3,259 |
| 2001 | 83,096 | 19,182 | 102,278 | -1,996 | 5,639 | 3,643 |
| 2002 | 103,115 | 22,053 | 125,168 | -1,928 | 6,048 | 4,120 |
| 2003 | 124,068 | 28,368 | 152,436 | -2,070 | 6,010 | 3,940 |
| 2004 | 161,938 | 34,744 | 196,682 | -1,624 | 7,239 | 5,615 |
| 2005 | 201,673 | 41,799 | 243,472 | -2,568 | 9,105 | 6,537 |

Source: US Census Bureau, US Bureau of Economic Analysis

Composition of US-China service sector trade

Most Chinese service sector exports to the United States are in the travel and transportation sectors, with a small residual (5 percent) of other commercial services. In contrast, US service sector exports to China include a large component (43 percent) of other commercial services (Figures 14, 15).

Breaking down the “Other commercial services” category into its subcomponents reveals that the share of “Education” services was the largest, at 46 percent, followed by “Business, professional, and technical services,” with a share of 44 percent (Figures 16, 17). “Telecommunications,” “insurance,” and “financial” services accounted for the remaining 10 percent.

Another important commercial link: US investment to serve the Chinese market

The United States exports a broad range of services to China. US companies are also investing in China’s service sector. They are setting up operations in China to sell express delivery, financial, business, and other high-skill services directly to Chinese customers. The investments and sales of US operations in China are not reflected in bilateral trade figures, but they are an important element of the commercial relationship, as they are in US commercial relationships with other key trading partners.

The US Department of Commerce’s Bureau of Economic Analysis (BEA) produces data on US foreign direct investment (FDI) flows to China, broken down by sector (Figure 18, page 10). US FDI flows to China between 2001 and 2005 reached \$16.8 billion, of which \$3.2 billion, or 19 percent, was in service industries. Between 1996 and 2005, the service sector share of those investment flows has increased. In 2005, service sector FDI accounted for 54 percent of the total.

Note, however, that this picture of how US direct investment flows to China are distributed across the sectors refers only to the flows that go directly from the United States to China. It does not capture any flows that might be re-routed via Hong Kong or other countries. To include these re-routed funds would probably imply more than doubling the quantity of US direct investment into China (see Appendix 4).

US-owned affiliates in China

The earnings from the sale of US services in China directly benefit the US economy. In 2005, repatriated profits of all US affiliates in China (net of profits flowing in the other direction) were worth \$3.3 billion. Of that total, around 17 percent, or \$560 million, is attributable to US service sector affiliates in China.

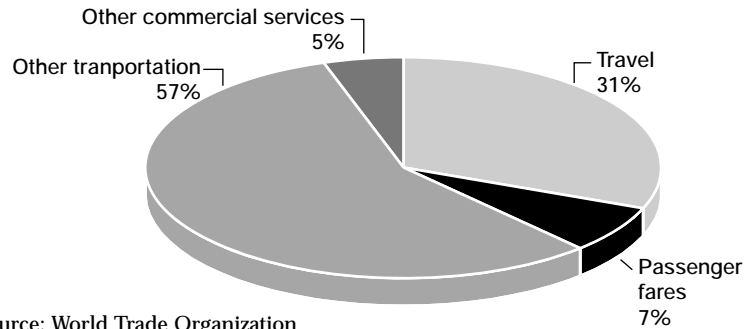
China also benefits from the sale of US services in China. In 2003 (the most recent year for which data are available), US majority-owned affiliates and direct branch operations contributed a gross domestic product (value added) of \$8.73 billion (0.6 percent of China's GDP in 2003), with sales reaching \$48.82 billion, and they employed 343,600 workers in China.⁴

In 2003, 17 percent (or \$1.5 billion) of the value-added contribution by US majority-owned affiliates to the Chinese economy was by affiliates in the service sector. This is the same proportion as the service sector share of US FDI outflows to China over the period 1996 to 2005. Wholesale trade took the lead with a 12 percent share; information services accounted for 2 percent; and professional, scientific, and technical services claimed 3 percent.

US majority-owned affiliates in service industries also contribute to employment in China, according to US BEA data. Out of the 343,600 people employed by the US majority-owned affiliates in China, about 33 percent were employed in the service sector. These employees of US companies sell their China-based customers a range of services, including banking services, insurance services and other financial products, information technology and consulting services, and express delivery services.

Figure 14

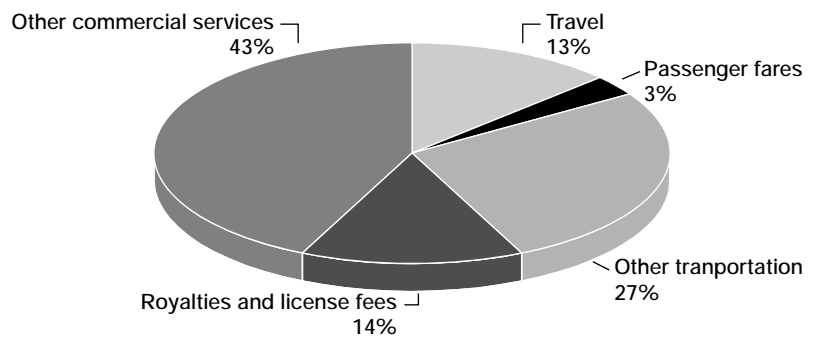
China service exports to the United States, 2004



Source: World Trade Organization

Figure 15

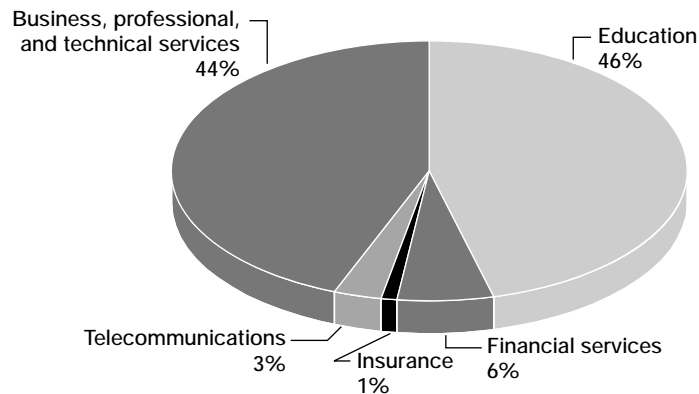
US service exports to China, 2004



Source: World Trade Organization

Figure 16

US "other commercial services" exports to China, 2004



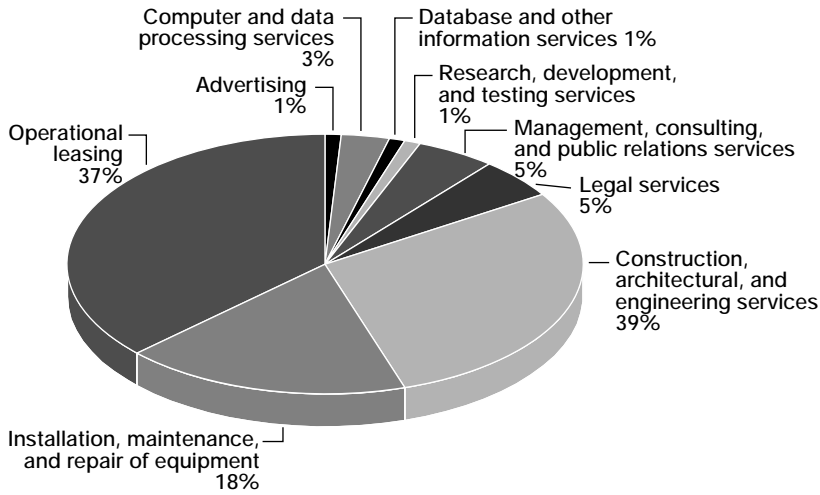
Source: World Trade Organization

³ Note that there is a serious discrepancy between official Chinese and official US data on the magnitude of bilateral goods trade flows between the United States and China—a point addressed in "The China Effect," Oxford Economics and the China Business Forum, January 2006.

⁴ "US Direct Investment Abroad: Financial and Operating Data for US Multinational Companies," US BEA.

Figure 17

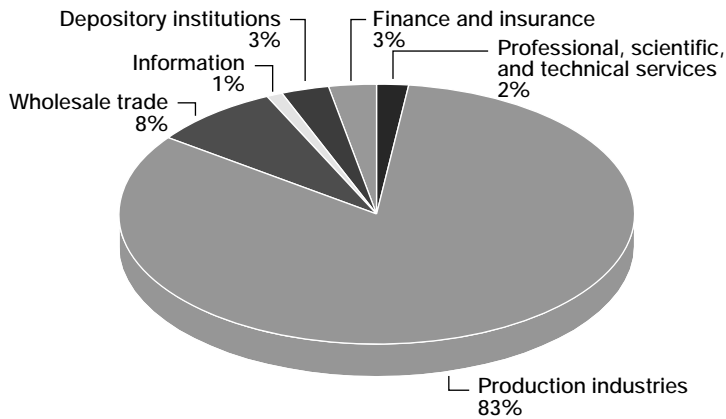
US "business, professional, and technical services" exports to China, 2004



Source: US Bureau of Economic Analysis

Figure 18

Sectoral distribution of FDI outflows from the United States to China, 1996-2005



Source: US Bureau of Economic Analysis

Impacts on China's economy

As illustrated in Figure 19, imports of services and inflows of investment in service industries play a number of important roles in China's economy:

- Imports of services allow China to exploit most fully the comparative advantages of foreign firms and foreign economies, thus making China's economy more efficient and more productive.
- Imports of and investment in global financial services can improve access to global capital markets and can contribute to the development of China's domestic capital markets. This greater access, in turn, can have a permanent impact on the investment and savings behavior of Chinese firms and households, and on the efficiency with which firms in other sectors can do business (See Appendix 3 case study on financial services).

- Imports of other services and inflows of service sector investment can contribute to permanent, supply-side improvements in the Chinese economy, via both investment and labor productivity (See Appendix 3).

- Trade in services has an impact on the current account of the balance of payments and therefore—temporarily—on GDP.

- Inflows of investment in service sectors contribute to the accumulation of fixed capital in China and therefore to the increases in both labor productivity and GDP.

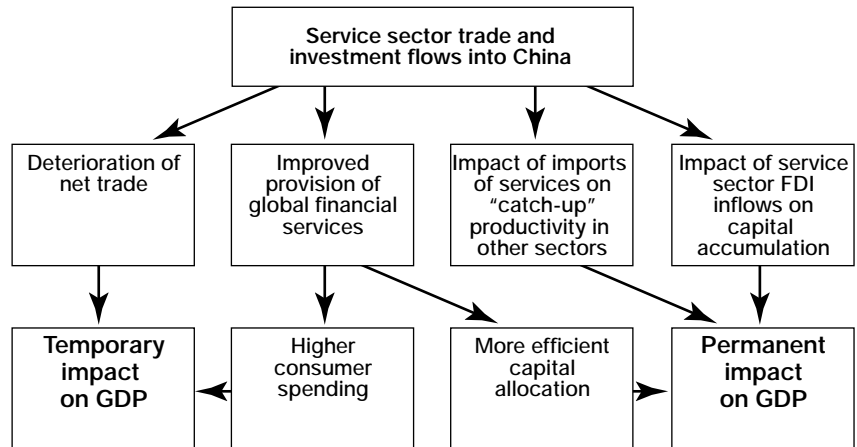
The effects of these channels on the Chinese economy are as follows:

- Inflows of service sector investment from the United States were worth around \$2.9 billion between 1996 and 2005. Assuming that between half and three-quarters of US FDI outflows to Hong Kong over that period ultimately were destined for China, then inflows from the United States would be around \$6.1 billion. This addition to the capital stock would contribute some \$1.6 billion, or 0.1 percent, to Chinese GDP in 2005, via higher productivity.

- Imports of banking, insurance, and financial services have a minimal effect on the average household saving ratio in China in the short term. But in the future, these effects will become more important to ensuring China's shift to a modern, consumption-based economy—assuming China opens up the financial services sector to foreign competition.

Figure 19

Channels of impact on the Chinese economy



Source: Oxford Economics

- Imports of services were worth \$72 billion in 2004, of which \$7.2 billion (or 10 percent) came from the United States. These imports contribute to the rate at which the overall economy develops. Oxford Economics estimates that, had China's service sector imports not increased after 2001, average labor productivity would have been some 0.3 percent lower than it was. As a result, Chinese GDP would have been \$6.5 billion lower in 2005. Of that, around \$650 million is attributable to service sector imports from the United States.

- China's service sector net trade deficit was worth \$9.5 billion overall, of which \$2.6 billion was attributable to trade in services with the United States.

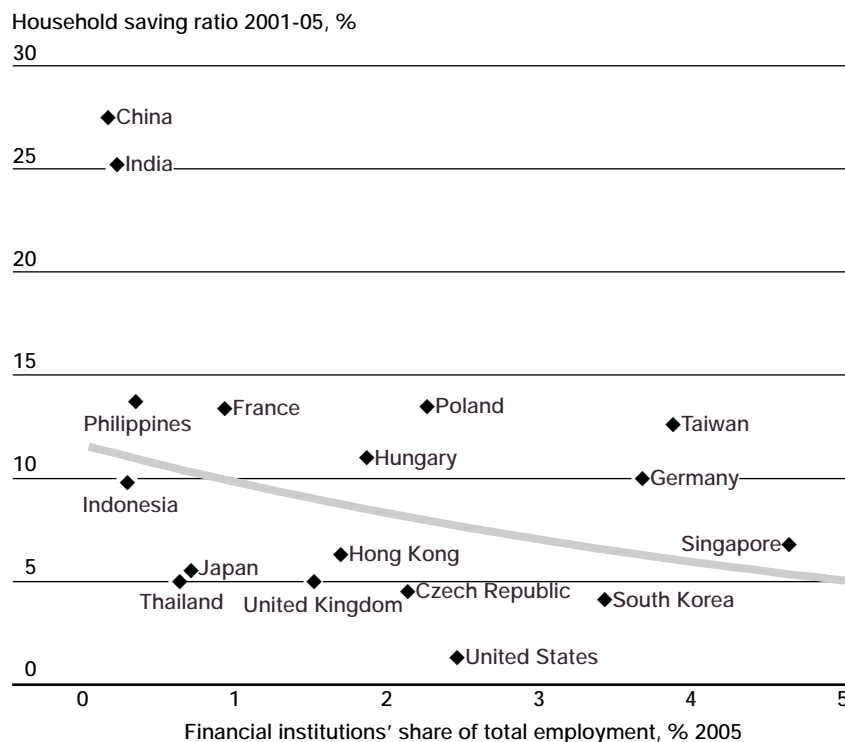
Taken together, the US investment inflows to, and service sector trade with, China in 2005 suggest the positive effects on productivity almost exactly offset the service trade deficit China runs with the United States. That balance is due to shift significantly in the years to come, as the temporary net trade effects fade while the permanent productivity effects increase, leading to a net increase in China's GDP. The degree to which China benefits from trade and investment in services will depend on how fully it opens its markets.

Table 3
Savings ratios in selected economies

| | Savings as a proportion of household income 2001–2005 | Total employment 2005 (thousands) | Financial sector employment share 2005 | Insurance sector employment share 2005 |
|----------------|---|-----------------------------------|--|--|
| China | 27.7 | 756,647 | 0.20% | 0.10% |
| India | 25.4 | 452,005 | 0.20% | 0.10% |
| Philippines | 13.9 | 32,313 | 0.60% | 0.30% |
| Poland | 13.7 | 12,846 | 3.70% | 0.40% |
| France | 13.7 | 25,030 | 1.50% | 0.40% |
| Taiwan | 12.8 | 9,942 | 4.70% | 0.00% |
| Hungary | 11.2 | 3,902 | 2.30% | 0.30% |
| Germany | 10.2 | 38,778 | 0.90% | 1.20% |
| Indonesia | 10.0 | 94,950 | 0.30% | 0.20% |
| Singapore | 7.0 | 2,272 | 1.70% | 0.70% |
| Hong Kong | 6.5 | 3,378 | 3.40% | 0.30% |
| Japan | 5.7 | 63,568 | 0.20% | 0.70% |
| Thailand | 5.2 | 35,257 | 3.90% | 0.10% |
| United Kingdom | 5.2 | 30,848 | 2.50% | 0.80% |
| Czech Republic | 4.7 | 4,764 | 1.90% | 0.40% |
| South Korea | 4.3 | 22,856 | 2.10% | 0.90% |
| United States | 1.5 | 141,719 | 0.70% | 1.50% |

Source: Oxford Economics

Figure 20
Relationship between provision of financial services and household savings



Source: Oxford Economics

Financial services, especially insurance, can reduce precautionary savings

Chinese households save a high proportion of their income. Developing and emerging economies generally have higher savings rates than developed economies, and China is at the top of the league in this respect. Part of the reason for the higher savings rates is poor provision of financial services, and particularly insurance services, in developing economies such as China.

Financial services provide ways to access capital markets, either to lend or to borrow. Lack of access to capital markets can prevent some households from borrowing in circumstances in which they would otherwise choose to do so. The result is an increase in the average savings ratio across all households. In economies that lack a broad, diversified financial services sector, total borrowing tends to be lower for any given level of income.

Households without access to insurance services tend to build up a buffer of precautionary savings against the risks that they face. Better provision of insurance services, by spreading risks, can help China to reach its economic development goals. By facilitating health care provision and retirement plans, and by insuring against untimely death or disability of an income earner, natural catastrophes, and adverse shocks to the agricultural sector, insurance services can contribute to a reduction in precautionary savings. Insurance services provide a means to achieve the same level of security as would be provided by precautionary savings, only much more efficiently, since the risks are shared across a larger population.

China has among the highest household savings ratios and one of the lowest financial and insurance shares of employment in the world, as shown in Table 3. The United States and other developed economies, in contrast, have among the highest financial and insurance shares of employment and the lowest household savings ratios.

There may be many reasons why the savings ratio in China is higher than elsewhere in the world. But, as Figures 20 and 21 illustrate, if the finance and insurance sectors in China were to double their shares of total employment, the increased provision of these services might reduce the Chinese savings ratio by up to 2 percentage points.

Even a 1 percentage point decline in the Chinese savings ratio would have pronounced effects on the Chinese economy, as well as on the global economy. This 1 percent decline in savings effectively would increase Chinese consumer spending by around 1.5 percent, and the Chinese cur-

rent account surplus would decline by around 0.4 percent of GDP. China's GDP would increase temporarily, with the impact of higher consumer spending being only partially offset by weaker net trade. But in the long run, the impact on GDP would fall to zero, since this is a shock to aggregate demand in China, and only shocks to supply can have any impact on the level of output in the long run.

However, imports of services and inflows of service sector investment can contribute to the supply side of the Chinese economy in several ways, and can therefore have positive impacts on GDP in the long run. These are examined in the next sections.

Service sector imports, foreign investment, and China's development

China, like all emerging economies, benefits from the fact that it can improve productivity relatively easily by adopting technologies and policies pioneered by more advanced economies. To some extent, the technological innovations made by those other economies can be readily adopted in China. The technologies already exist, and the lessons of how to apply them effectively have been learned. For China and other emerging economies, the fact that economic development was delayed for a long time means that it can occur much more quickly now that the development process is under way.

There are many mechanisms for transferring the experiences of advanced economies to China and to other emerging economies in a way that increases productivity. These include education and work experience, as Chinese students and workers in advanced economies or foreign operations in China learn highly productive skills that they can apply in China. Another method is the purchase or license by Chinese companies of the rights to technology that can improve the companies' productivity. Chinese companies can also partner with foreign investors in manufacturing and services, or undertake mergers with or acquisitions of highly productive foreign companies.

Chinese companies can import services from foreign knowledge, network, and financial service providers, or buy such services from foreign-invested service providers that have set up operations in China. Technically advanced manufacturing companies require advanced support from service industries,

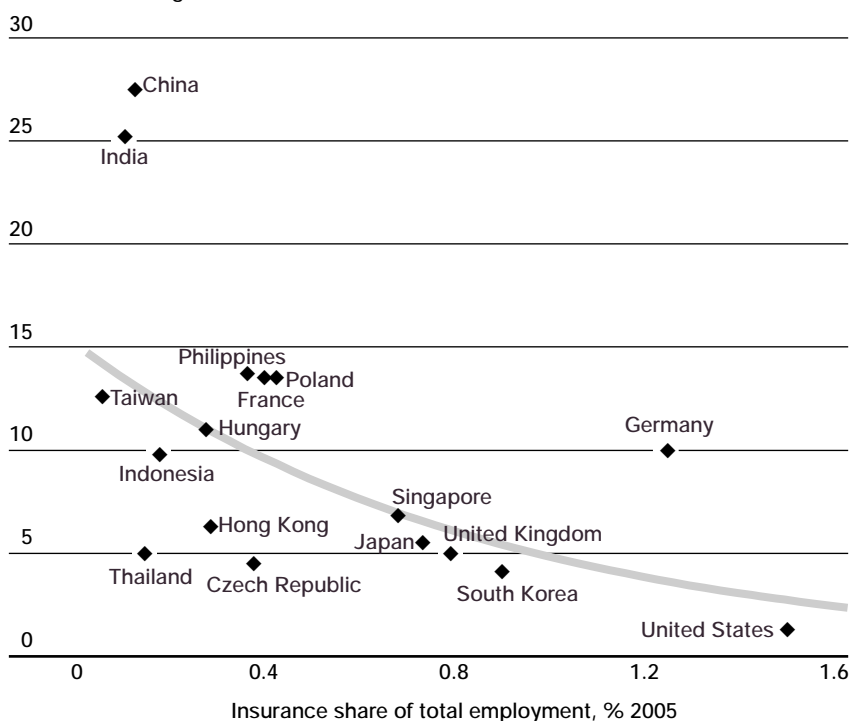
Table 4
US visits to China⁵

| | Leisure | | Business | |
|------|---------|---------------|----------|---------------|
| | Visits | Annual growth | Visits | Annual growth |
| 1995 | 308,172 | — | 206,678 | — |
| 1996 | 345,023 | 12.0% | 231,393 | 12.0% |
| 1997 | 368,979 | 6.9% | 247,459 | 6.9% |
| 1998 | 405,415 | 9.9% | 271,896 | 9.9% |
| 1999 | 440,776 | 8.7% | 295,610 | 8.7% |
| 2000 | 536,424 | 21.7% | 359,757 | 21.7% |
| 2001 | 531,746 | -0.9% | 417,415 | 16.0% |
| 2002 | 559,195 | 5.2% | 562,002 | 34.6% |
| 2003 | 481,132 | -14.0% | 341,379 | -39.3% |
| 2004 | 725,239 | 50.7% | 583,388 | 70.9% |
| 2005 | 867,552 | 19.6% | 697,865 | 19.6% |

Source: China National Tourism Administration

Figure 21
Relationship between provision of insurance services and household savings

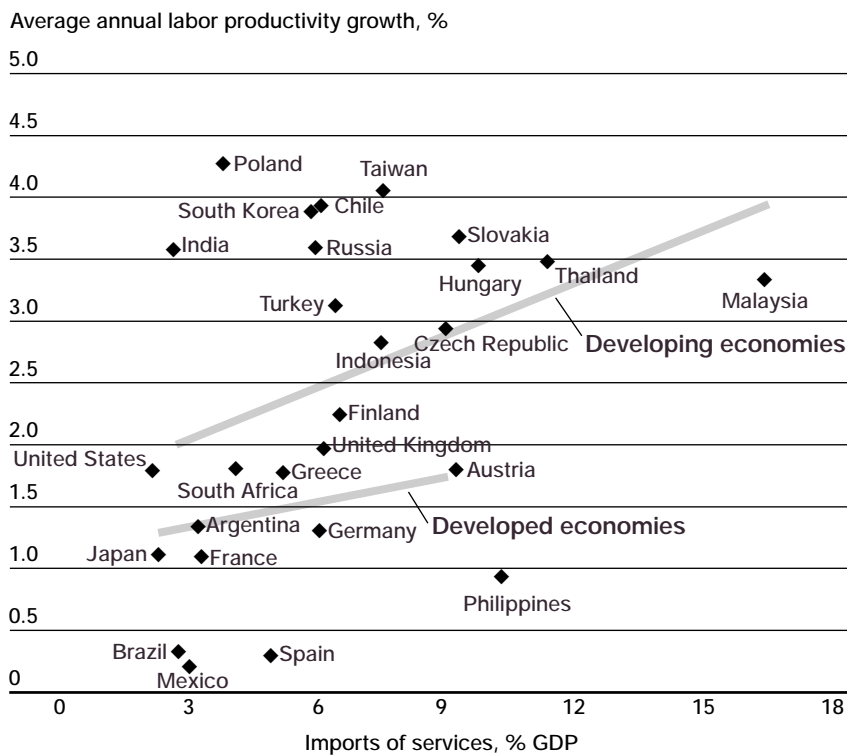
Household saving ratio 2001-05, %



Source: Oxford Economics

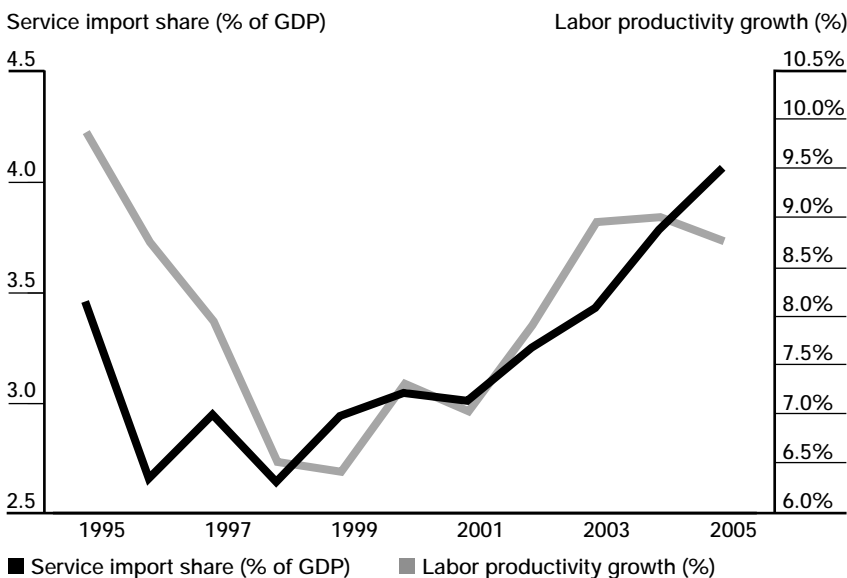
⁵ Prior to 2001, these data are based on growth rates in total visitor numbers, not differentiated between business and leisure visits.

Figure 22
Imports of services and labor productivity growth, 1990-2005*, selected economies



*1995-2005 for Eastern Europe
Source: Oxford Economics

Figure 23
Service sector import share and labor productivity growth in China



Source: Oxford Economics

including financial services to gain access to capital markets and advice on investment strategies; transport services to ensure their sourcing and their marketing can be efficient and global; information technology and communications services to manage complex processes as efficiently as possible; and consultancy services to design the most efficient structure and organization for their operations. These imports or purchases, too, increase average productivity in China.

Service sector net trade and GDP

China is running a deficit on services trade, worth \$9.5 billion or 0.4 percent of GDP in 2005. And China is also running a small deficit on services trade with the United States, worth \$2.6 billion or 0.1 percent of Chinese GDP in 2005. China's service sector exports to the United States largely consist of travel and tourism services.⁶ Both business and leisure travel from the United States to China have increased sharply in recent years, as shown in Table 4. US leisure visits have increased by 10.9 percent per year on average over the last decade, while business visits have grown even more strongly, at an average annual rate of 12.9 percent over the period.

This upward trend is projected to continue, providing a sharp increase in tourism revenues from US visitors in coming years, and boosting China's service sector exports to the United States. In spite of these anticipated increases, China's bilateral service trade account with the United States is likely to remain in deficit as US service sector exports to China also increase, implying a modest and temporary negative impact on China's GDP.⁷ But this temporary effect is far outweighed by the positive effects on the Chinese economy—both temporary and permanent—that arise from service sector imports and inflows of FDI. These imports and inflows of FDI improve the provision of much-needed, high-value services to the Chinese economy and Chinese households—services that Chinese suppliers cannot presently provide.

Assessing the effects on Chinese productivity

International trade boosts productivity for all economies that engage in it. Substantial empirical research exists to demonstrate the link between an economy's openness to international trade and growth in productivity. These findings are consistent with a widely accepted tenet of international macroeconomic theory stating that trade is a means of exploiting most fully the underlying

ing patterns of comparative advantage across economies, making all economies better off. This theory and these empirical findings apply to trade in services, just as they apply for trade in goods.

Figure 22 shows the relationship across a selection of developed and developing economies between imports of services as a proportion of GDP in each economy and the average annual growth rate of labor productivity in each economy. There is a clear positive relationship between these two concepts, as predicted by economic theory. The correlation holds within each group as well. Moreover, for developing economies the upward slope is more pronounced than that for developed economies, suggesting that developing economies benefit more from imports of services since they have a comparative disadvantage in the supply of these services.

China is an outlier (and therefore is not represented on this figure). It is an economy with an extremely large pool of rural labor with relatively low levels of productivity and a particularly rapid pace of industrialization. As a result, the rate of productivity growth is higher in China than in any other economy in the sample, although China's service sector imports are low by comparison with other economies (as a proportion of GDP). However, the cross-country relationship that is suggested in Figure 22 is borne out over the last decade within China, as Figure 23 demonstrates.

Service sector imports into China have increased as a share of GDP over the last decade; over the same period, Chinese average labor productivity also has increased sharply. Of course, productivity would be

expected to increase over time irrespective of what happens to imports of services. But it is striking to note that the average growth rate of labor productivity in China also has tracked the service sector share of Chinese imports over the last decade.

It is hard to be sure exactly how much of the recent acceleration of labor productivity growth in China is attributable to its increased imports of services. But the cross-country evidence for developing economies suggests that on average a 1 percentage-point increase in the share of service sector imports in GDP results in around a 0.1 percent increase in annual labor productivity growth. That would imply that about one-tenth of the acceleration in China's labor productivity growth could be attributed to higher imports of services. Other factors—including inflows of FDI, faster domestic capital accumulation,⁸ improving skill levels, and a rapid relocation of workers from rural areas to urban population centers—must account for the remaining nine-tenths.

The share of service sector imports in Chinese GDP stepped up again after China's WTO accession in 2001, from an average of 2.9 percent between 1994 and 2000, to an average of 3.5 percent between 2001 and 2005. And labor productivity growth also accelerated after 2001, from an average of 8.4 percent per year between 1994 and 2000, to an average of 8.7 percent between 2001 and 2005.

Section 6 outlines the scenario under which China's economy will benefit most from trade and investment in services. Section 5, meanwhile, takes a look at how the US economy benefits from service sector trade and investment with China.

⁶ When China exports or supplies tourist services to the United States and Chinese GDP benefits from that activity, US tourists consume that service in China, and vice versa.

⁷ GDP is, by definition, the sum of its expenditure components: private consumption, government consumption, total fixed investment, inventory accumulation, and net trade (exports minus imports). As China opens itself to service sector trade, its imports will increase, and its net trade position will deteriorate. If the other components of GDP do not change, the deterioration in net trade will imply weaker GDP. In the long run, the other components of GDP will change, since long-run GDP is determined by supply-side fundamentals (labor supply, productivity), not by demand. But an increase in imports is likely to have a temporary negative impact on GDP, since the other components of demand probably will not react immediately.

⁸ In fact, the data suggest that the rate of capital accumulation in China (including both domestic fixed investment and inflows of FDI) accounts for an acceleration in labor productivity growth of 0.4 percentage points per year between the two periods—twice as large an effect as Oxford Economics' analysis ascribes to increased imports of services.

Impacts on the US economy

Bilateral services trade surplus with China contributes directly to US GDP

Both trade and investment flows between the United States and China in service industries have an impact on the current account of the balance of payments and, as a result, on US GDP. In addition to the bilateral services trade surplus of \$2.6 billion in 2005, as mentioned earlier, repatriated profits of US affiliates in China (net of profits flowing in the other direction) were worth \$3.3 billion in that year. This is illustrated as “direct investment income” in Table 5. Of that, around 17 percent or \$560 million is attributable to service sector affiliates in China. Together, service exports to China, along with repatriated service sector profits from China, contributed a net \$3.1 billion to US GDP in 2005, reducing slightly the bilateral current account deficit with China. (As explained in section 6, US services exports to China have the potential to reduce the US current account deficit with China by an even larger amount in the future.)

Service sector exports to China are large, and growing fast

US service sector exports to China grew more than twice as fast as US total service sector exports between 1992 and 2005, at an average rate of 14.5 percent per year (current prices). That growth was faster than the growth of service sector exports to any other major economy over that period (including India, at 12.7 percent per year). As a result, US service sector exports to China, at \$9.1 billion in 2005, now account for 2.4 percent of US service sector exports, up from 1.0 percent in 1992. Figure 24 shows the average annual growth rates of US service sector exports to a selection of countries between 1992 and 2005.

By 2004, China was already one of the top ten destinations for US private service sector exports (Table 6).

US service sector exporters to China are highly productive

US net exports of services to China make a direct contribution to US GDP in the short term via the current account of the balance of payments. In the long run, the overall net trade position is determined by such factors

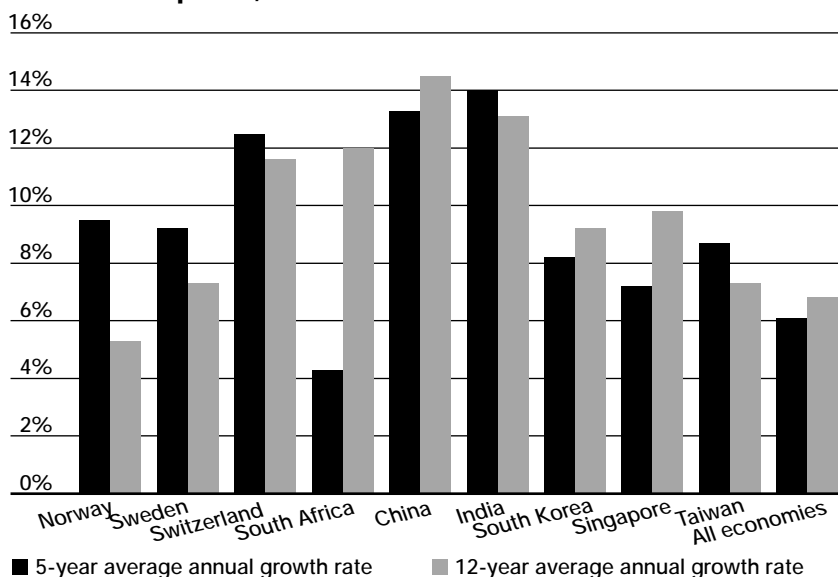
Table 5
US international transactions, by area—China, 2005 (\$ million)

| Current account | Credits | Debits | Balance |
|--|---------------|----------------|-----------------|
| Total goods and services and income | 55,107 | 273,256 | -218,149 |
| Goods and services | 50,904 | 250,009 | -199,105 |
| Goods, balance of payments basis | 41,799 | 243,472 | -201,673 |
| Services | 9,105 | 6,537 | 2,568 |
| Transfers under US military agency sales contracts | (*) | 4 | (*) |
| Travel | 1,181 | 2,104 | -923 |
| Passenger fares | 353 | 487 | -134 |
| Other transportation | 1,870 | 3,036 | -1,166 |
| Royalties and license fees | 1,118 | 63 | 1,055 |
| Other private services | 4,557 | 817 | 3,740 |
| Government miscellaneous services | 26 | 26 | 0 |
| Income | 4,203 | 23,247 | -19,044 |
| Income on foreign assets | 4,167 | 22,899 | -18,732 |
| Direct investment income | 3,333 | 11 | 3,322 |
| Other private income | 763 | 2,977 | -2,214 |
| Government income | 71 | 19,911 | -19,840 |
| Compensation of employees | 36 | 348 | -312 |

* Less than \$500,000(±)

Source: US Bureau of Economic Analysis

Figure 24
Average annual growth rate in the value of US private services exports, 1992-2004



Source: US Bureau of Economic Analysis

Table 6

US exports of services by type and country, 2004 (\$ million)

| | Total private services | Travel | Passenger fares | Other transportation | Royalties and license fees | Other private services |
|-----------------------------|------------------------|---------------|-----------------|----------------------|----------------------------|------------------------|
| All countries | 323,362 | 74,481 | 18,858 | 36,862 | 52,643 | 140,518 |
| 10 largest countries | 187,574 | 44,402 | 12,619 | 20,336 | 30,357 | 79,860 |
| United Kingdom | 40,096 | 9,576 | 3,079 | 2,999 | 4,519 | 19,923 |
| Japan | 35,197 | 10,051 | 3,043 | 3,693 | 7,670 | 10,740 |
| Canada | 29,698 | 7,930 | 2,506 | 2,744 | 3,575 | 12,943 |
| Germany | 18,943 | 3,636 | 1,051 | 2,643 | 3,485 | 8,128 |
| Mexico | 17,978 | 6,257 | 1,367 | 1,158 | 1,254 | 7,942 |
| France | 12,827 | 2,008 | 660 | 1,150 | 2,339 | 6,670 |
| South Korea | 9,113 | 2,218 | 64 | 2,412 | 1,657 | 2,762 |
| Switzerland | 8,746 | 670 | 240 | 666 | 3,415 | 3,755 |
| Netherlands | 7,737 | 1,162 | 388 | 1,067 | 1,515 | 3,605 |
| China | 7,239 | 894 | 221 | 1,804 | 928 | 3,392 |
| Other countries | 135,788 | 30,079 | 6,239 | 16,526 | 22,286 | 60,658 |

Source: US Bureau of Economic Analysis

Table 7

Productivity composition of US services trade with China

| | Net trade balance (\$ million, 2005) | Average productivity per employee (Value added per full-time-equivalent employee 2004, \$000s) | Ratio to average productivity | Average wage per employee (wages and salaries per full-time-equivalent employee, 2004, \$000s) |
|--------------------------|--------------------------------------|--|-------------------------------|--|
| Travel | -923 | \$34.7 ¹ | 40.3% | \$19.9 ¹ |
| Passenger fares | -134 | \$79.7 | 92.7% | 63.3 |
| Other transportation | -1,166 | \$76.5 | 89.0% | 40.7 |
| Other private services | 3,740 | \$96.7 ² | 112.4% | 50.3 |
| Royalties & license fees | 1,051 | \$86.7 ³ | 100.8% | 41.7 |
| Total goods and services | -199,105 | \$86.0 | — | 43.3 |

1 Average of accommodation and food services industries

2 Average of other private services, weighted by net exports to China in each category, Oxford Economics estimate

3 Average of private service-producing industries

Source: Oxford Economics

as the appetite for savings in the United States, compared to other countries, and its magnitude will not be affected by bilateral trade flows with any single country.

However, there is another way in which US service sector net exports to China make a permanent contribution to US GDP. Service sector net exports to China support employment in relatively high-productivity and high-wage sectors of the US economy. In fact, these exports are concentrated in knowledge and network services, which have among the highest levels of labor productivity and wages. Service sector net imports from China, by contrast, tend to be concentrated in sectors with relatively low levels of productivity, such as travel and tourism.

Table 7 shows net exports of services across a range of categories and average productivity per head in the United States in the sectors that correspond to those trade flows.

Average productivity in the other private services category (weighted according to the weights of US net exports to China within that sector) is some 12.4 percent higher than across the US economy as a whole, while productivity in travel and transportation is substantially lower than the whole economy average.

Net exports of other private services to China are supporting around 37,000 high-productivity jobs in the United States, according to Oxford Economics estimates for 2005. The productivity effect represented by these 37,000 jobs adds up to around \$460 million in 2005. (The *total* number of jobs supported by this category of exports to China in 2005 is 45,000; the net number of jobs is 37,000.)

Section 6 outlines the scenarios under which the US economy will benefit most from trade and investment in services with China.

Realizing the full potential benefits of trade between the United States and China

WTO membership: easing constraints on international trade

China's accession to the WTO in December 2001 committed the country to a process of removing and relaxing constraints on international trade in goods and services. This section assesses the impact of WTO membership on service trade in particular.

Upon its accession to the WTO, China committed to the substantial opening of a broad range of services through the elimination of many existing limitations on market access, particularly in sectors in which the United States is a global leader, including banking, insurance, telecommunications, and professional services.

In addition, China also made certain "horizontal" commitments, which applied to all sectors listed in its services schedule. The two most important were, first, a promise that the existing conditions of ownership, operation, and scope of activities will not in future be made more restrictive than they were on the date of China's accession to the WTO. Second, China also promised to commit to licensing procedures that were transparent and more predictable. In particular, China is committed to award new licenses to qualified foreign service companies based solely on prudential criteria, with no quantitative limits on the number of licenses or other restrictions such as an economic-needs test. The commitments made with respect to several sectors of particular importance to the United States and their respective compliance dates are summarized in Appendix 2.

Remaining impediments to service sector growth

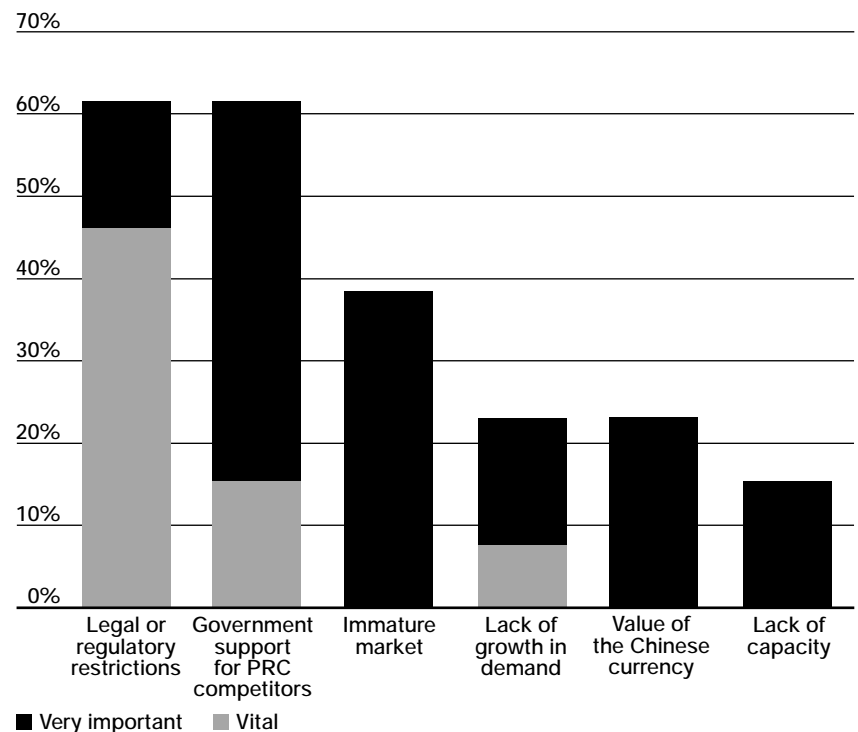
As part of this study, Oxford Economics undertook a detailed survey, including selected in-depth interviews, of US-China Business Council (USCBC) members involved in service sector trade with China. The firms participating in the survey represent a large proportion of all the service sector activity between the United States and China. Together, the respondents to the Oxford Economics service sector survey accounted for at least \$25 billion worth of

service sector business in China in 2005. And the results are consistent with those of the 2006 USCBC Member Priorities Survey as well as the results of surveys conducted by other US and foreign business and government groups.

Almost all of the respondents said that the Chinese market had either a "vital" or a "very important" role in influencing the prospects for their global business in the coming decade. But many respondents identified serious impediments to future growth in their exports to China (Figure 25). The most important factors they identified were government support for PRC competitors and legal or regulatory restrictions on access to the Chinese market, with 62 percent of respondents citing these factors as "vital" or "very important."

The US companies surveyed identified the most important legal or regulatory restrictions as licensing restrictions; restric-

Figure 25
Factors restricting the growth of US service sector exports to China, next five years



Source: Oxford Economics

tions on 100 percent ownership of subsidiaries or ownership share of joint ventures; restrictions on what kind of services can be provided, where, and to whom; and relatively high capitalization requirements for setting up businesses in China. Nearly 90 percent of respondents cited licensing restrictions as “vital” in holding back the growth of their service sector exports to China (Figure 26).

US service sector exports to China play a key role in supporting the growth of high-tech industry in the Chinese economy. The survey results indicate that most of the customers for US service sector exports to China are manufacturers of high-tech consumer or investment goods. More than 50 percent of the business customers for US service sector exports to China are wholly or partly foreign-owned businesses.

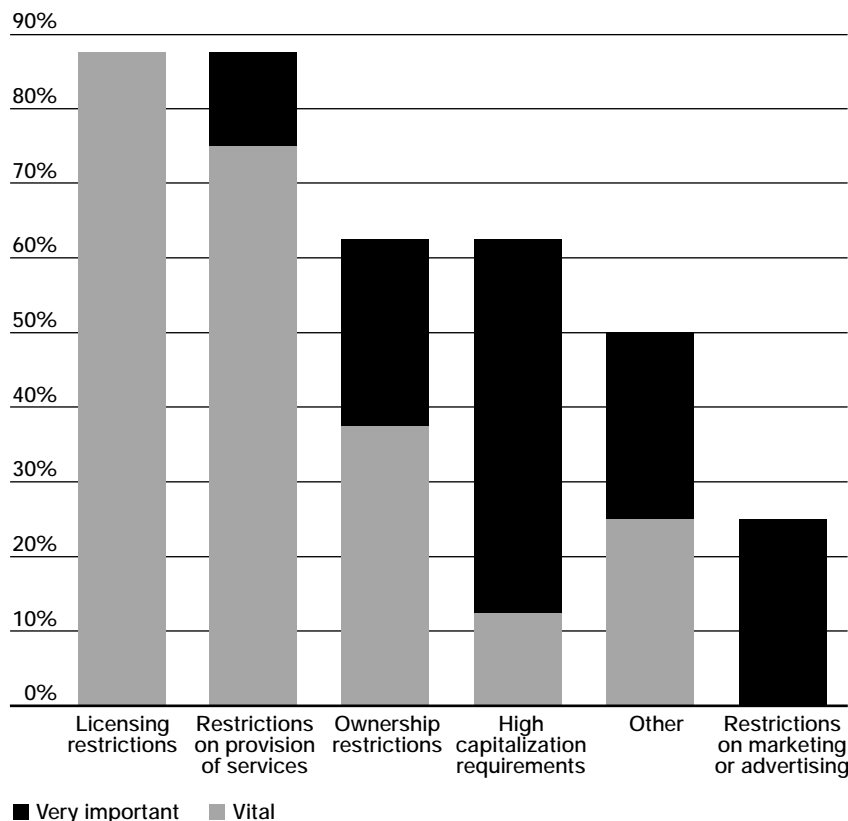
Service sector exports to China help support the growth of the sectors that contribute most to China’s rapid industrialization. Inflows of service sector investment help to improve the provision of services to China’s high-tech manufacturing sectors. More than 45 percent of respondents have invested in setting up or expanding a

wholly owned subsidiary in China over the last five years. Together with inflows of service sector exports from the United States, the profits that flow from these investments, in turn, support high-productivity and high-wage jobs in the United States.

The US service sector investors also recognized that there remain serious impediments to the future growth of these investment inflows. Again, legal or regulatory restrictions and government support for PRC competitors were cited as the most important factors restricting the growth of service sector investment in China in the coming five years, though a lack of transparency about the state of and prospects for the Chinese market are also deemed important. Similarly, USCBC Member Priorities Survey respondents ranked licensing and regulatory approvals as the number-two obstacle to doing business in China in 2005-2006, following human resources issues (hiring and retaining skilled employees).

Most respondents to the service sector survey said that the removal of all legal and regulatory restrictions on their service sector exports to or investment in China would have a significant positive impact on the growth of those exports/investments in the future. More than one-third said that the impact of removing these restrictions would be to more than double the value of exports to and investment in China over the next five years.

Figure 26
Specific legal or regulatory restrictions restricting US service sector exports to China, next five years



Source: Oxford Economics

Baseline forecast: implementation of WTO commitments

Oxford Economics’ base forecast⁹ estimates that the share of service sector imports in China’s GDP will increase from 4.1 percent in 2006 to 5.4 percent in 2015, as China gradually eases the constraints on international trade, and on service sector trade in particular. US service sector exports to China are slated to increase over the forecast period in proportion to Chinese service sector imports. Moreover, inflows of service sector FDI from the United States also increase over the forecast period, by an average of around 5 percent per year. This path for service sector imports and inflows of service sector FDI is consistent with the gradual relaxation and removal of constraints as per the schedule of WTO commitments outlined in Appendix 2.

China’s commitment to remove and relax these constraints will have a signifi-

⁹ See Appendix 1 for a detailed breakdown of Oxford Economics’ China forecast.

cant positive impact on China's GDP by the end of 2015. Figure 27 shows the magnitude of this impact.

If the share of China's service sector imports had remained at pre-2001 levels until 2015, there would be a substantial impact on whole-economy productivity: By 2015, Chinese GDP would be around 1.2 percent, or \$66 billion (2006 prices) lower than the figure projected in the Oxford Economics base forecast. Of that shortfall, around one-tenth, or \$6.6 billion, would be attributed to lower service sector imports and inflows of service sector FDI from the United States.

In the base forecast, US service sector exports to China increase to \$45 billion by 2015, while the US surplus on services trade with China will increase to \$15 billion, or 0.1 percent of US GDP. On top of that, inflows of net income from US service sector affiliates in China will increase to around \$1.5 billion by 2015. And the impacts on US productivity will also increase, as service sector trade and investment in China contribute a projected \$2.5 billion to US GDP in 2015.

Alternative scenario: removing all remaining service sector restrictions

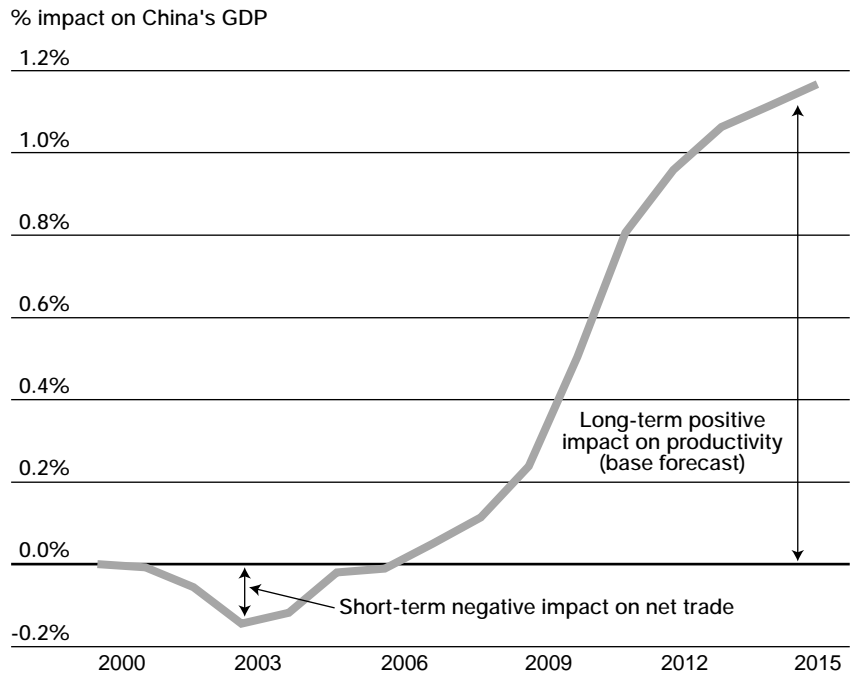
In the base forecast, the gradual removal of constraints on service sector imports and inflows of investment has a significant positive impact on productivity and GDP growth in China. But the evidence from the USCBC service sector survey and from other analyses suggests that these remaining constraints could be removed much more quickly than is envisioned in the base scenario. If this were to happen, the impacts on China's GDP and productivity growth would be even more substantial than in the base forecast.

Figure 28 compares the base forecast to an alternative scenario under which *all* the existing constraints on service sector imports and FDI inflows from all countries are removed by 2015.

In the alternative scenario, the benefits to China's GDP more than double by 2015, to reach almost 2.5 percent of GDP (\$138 billion in 2006 prices). Of this amount, one-tenth (\$14 billion) could be attributed to service sector imports and FDI inflows from the United States (the remainder is attributable to increased service sector trade and FDI flows from other economies).

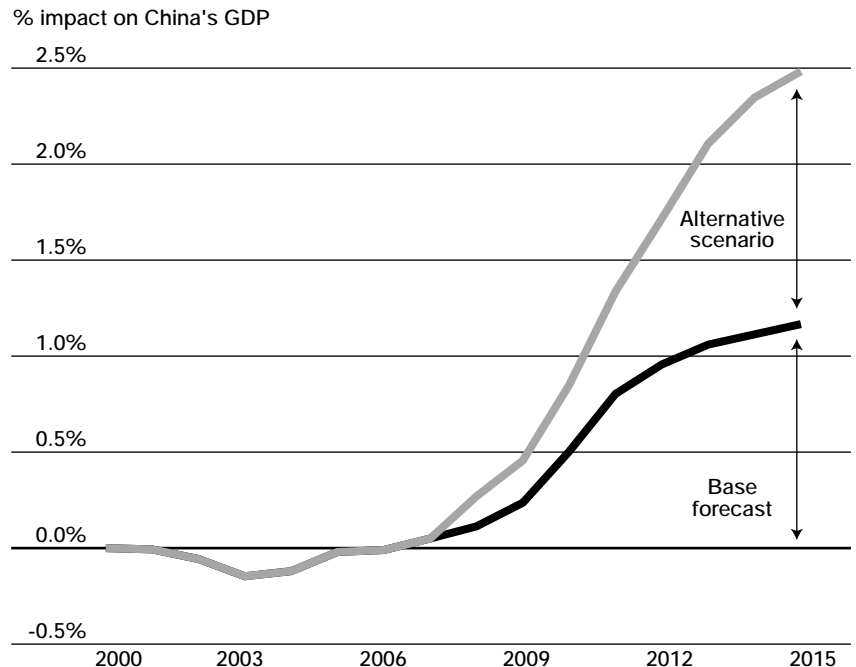
The benefits also extend to job creation. Of total employment in foreign majority-owned service sector affiliates of about 1.5 million, the US share was 8 percent, or

Figure 27
Impact of allowing Chinese service sector imports to increase after 2001



Source: Oxford Economics

Figure 28
Impact of removing all impediments to growth in China's service sector trade and investment



Source: Oxford Economics

111,550, in 2003, according to the BEA (*Survey of Current Business*, July 2005).

The Oxford Economics base forecast, which sees existing commitments to the WTO honored, projects employment in all foreign majority-owned service companies in China to increase to around 5 million by 2015 (of which around 400,000 jobs are in US majority-owned companies). In the alternative scenario that sees all impediments to service sector trade and investment removed, service sector employment in these companies would be nearly 7 million (550,000 in US majority-owned companies).

So the growth in service sector trade and investment by 2015 would create up to an extra 7 million jobs in China—jobs in relatively high-paying, high-productivity service industries. This figure is almost equivalent to the entire population of Xi'an, Shaanxi province.

The growth in service sector net trade with China and inflows of profits from service sector investments in China together support more rapid growth in service sector employment in the United States. In the Oxford Economics base forecast, these effects combine to create an additional 60,000 service sector jobs in the United States by 2015.

The increase in the US service sector surplus with China in the Oxford Economics alternative scenario leads to the creation of an additional 240,000 service sector jobs in the United States by 2015, accounting for 1.5 percent of the growth in service sector employment between 2005 and 2015.

However, the effects in 2015 do not capture the impact on the US economy in the long run. The Chinese market for services will have grown substantially by 2015, but the real focus of US service providers should be on a longer horizon, one that spans the decades to come. By 2050, US service sector exports to China could reach between 1.5 percent and 3.5 percent of US GDP. By then, of course, China's service sector exports also will have grown, but the US surplus on service sector trade with China still could be worth around 1 percent of US GDP, while inflows of profits from US service sector FDI in China could contribute a further 0.5 percent of GDP to the US current account of the balance of payments.

As detailed in Section 5, net services trade with China supports relatively high-productivity jobs in the United States, and the impact of this trade on the composition of US employment leads to higher average productivity and, therefore, higher GDP in the long run. The impact on US productivity via this channel could be worth 0.1 percent to 0.2 percent of US GDP in the long run: a substantial effect.

This scenario clearly projects long-run benefits for both the United States and China. For these benefits to develop fully, however, the market barriers in China's service sector must be dismantled completely. While China is well on its way to meeting its WTO obligations in services, a number of steps remain to be taken, as outlined in Section 7.

Conclusions and recommendations

China's economic performance over the last two decades has been extraordinarily strong—almost without global precedent. And in the short term at least, this remarkably strong performance is likely to continue, as the country's shift from a rural agricultural to an urban industrial population continues.

The Chinese service sector is set to grow rapidly, in tandem with a shift up the technological ladder as Chinese companies seek to incorporate the most advanced technologies in the world, and the growing wealth of Chinese consumers. Imports of high value-added services, along with investment inflows in these service sectors, will play a vital role in driving this next phase of growth—benefiting both China and the United States, as well as other economies that provide those services and supply the funds for investment.

Every economy gains from global trade: all economies benefit by exploiting fully the patterns of comparative advantage that exist across countries. Developed economies benefit from imports of competitively priced and high-quality products from China, which enjoys a comparative advantage in this area relative to developed economies. China, in turn, benefits from imports of and inflows of investment in high value-added services from developed economies (since developed economies enjoy a comparative advantage in these service industries relative to China).

China's entry to the WTO in 2001 marked a growing awareness on the part of the Chinese authorities of the substantial gains from trade that the Chinese economy stands to accrue. And, in the five-year period since WTO accession, service sector exports to China and inflows of service sector FDI into China have risen dramatically, contributing in part to the exceptional performance of the Chinese economy over that period.

But there remain serious impediments to the future growth in the provision of these services in China. These impediments, all of which threaten to undermine Chinese growth prospects in the longer term, include:

- Excessively opaque and inconsistent application of rules and regulations governing foreign exports of services to China, and foreign investment in the Chinese service sector.
- Excessive support for domestic state-owned service providers.
- Excessive bureaucratic burdens on foreign service providers.
- Overly rigid regulation of foreign service providers' entry (including capitalization, restricted corporate form, and ownership of investment) and expansion (including internal branch capitalization, licensing, and distribution) in China.
- Incomplete data on the service sector in China, which hinders the ability of policy makers and industry participants to measure trends and growth prospects.

If these impediments are removed, the impact on Chinese and US growth prospects will be positive and substantial. An aggressive strategy to remove these barriers would be consistent with the spirit of optimism and embrace of change that lay behind China's WTO entry, and would keep China on a fast path to long-term growth. Removing these barriers also would provide substantial benefits to US-based service providers, in the form of an increased share of one of the largest and most rapidly growing service sectors in the world.

Appendix 1:

China services and income: baseline data*

*This forecast represents the baseline projection of the changes to China's economy assuming no Chinese WTO entry or market openings. It is the underlying forecast from which the scenarios in Section 6 were modeled. For detailed forecasts of the two scenarios described in the report, please contact Oxford Economics (610-995-6600, postmaster@oef.com).

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| GDP and CONSUMPTION, \$ billion | | | | | | | | | |
| GDP in \$bn | 1931.6 | 2228.6 | 2664.6 | 3161.2 | 3750.2 | 4402.2 | 4995.6 | 5602.2 | 6281.1 |
| Of which: | | | | | | | | | |
| Consumption \$bn | 771.2 | 881.1 | 1033.5 | 1230.2 | 1475.6 | 1740.9 | 1994.8 | 2259.4 | 2560.2 |
| As share of GDP% | 40.6 | 40.2 | 39.5 | 39.6 | 40.0 | 40.2 | 40.5 | 40.9 | 41.4 |
| and | | | | | | | | | |
| Retail sales \$bn | 671.9 | 767.6 | 900.4 | 1071.7 | 1285.5 | 1516.6 | 1737.9 | 1968.4 | 2230.5 |
| As share of C% | 87.2 | 87.2 | 87.2 | 87.2 | 87.2 | 87.2 | 87.2 | 87.2 | 87.2 |
| SAVINGS rate as % of household incomes | | | | | | | | | |
| Out of all income | 28.2 | 28.2 | 27.7 | 26.6 | 24.9 | 23.9 | 23.2 | 22.3 | 21.4 |
| SECTORAL DATA | | | | | | | | | |
| Services total \$bn | 832.4 | 950.0 | 1147.2 | 1375.9 | 1667.4 | 2014.4 | 2326.7 | 2651.5 | 3012.1 |
| As share of GDP% | 43.2 | 42.8 | 43.2 | 43.6 | 44.5 | 45.8 | 46.6 | 47.4 | 48.0 |
| Primary sector \$ | 233.7 | 255.7 | 281.8 | 311.5 | 347.3 | 379.6 | 403.9 | 423.8 | 444.2 |
| As share of GDP% | 12.0 | 11.4 | 10.5 | 9.8 | 9.2 | 8.5 | 8.0 | 7.5 | 7.0 |
| Industry sector \$ | 865.5 | 1022.9 | 1235.7 | 1473.8 | 1735.6 | 2008.2 | 2265.0 | 2526.9 | 2824.8 |
| As share of GDP% | 44.8 | 45.9 | 46.4 | 46.6 | 46.3 | 45.7 | 45.4 | 45.1 | 45.0 |
| Of which: | | | | | | | | | |
| Construction tot \$bn | 159.0 | 193.7 | 236.2 | 308.3 | 403.9 | 495.4 | 592.8 | 698.9 | 821.8 |
| As share of GDP% | 8.3 | 8.8 | 9.0 | 9.8 | 10.9 | 11.4 | 12.0 | 12.6 | 13.2 |
| Priv res constr \$bn | 99.4 | 125.3 | 158.3 | 202.4 | 271.3 | 339.9 | 406.8 | 481.3 | 567.5 |
| As share of GDP% | 5.2 | 5.7 | 6.0 | 6.4 | 7.3 | 7.8 | 8.2 | 8.7 | 9.1 |
| TOTAL SERVICE SECTOR in US\$bn | | | | | | | | | |
| Services total | 832.4 | 950.0 | 1147.2 | 1375.9 | 1667.4 | 2014.4 | 2326.7 | 2651.5 | 3012.1 |
| Of which | | | | | | | | | |
| Wholesale/retail | 216.4 | 247.0 | 289.0 | 344.1 | 412.7 | 486.7 | 557.2 | 631.2 | 715.2 |
| Financial/insur | 108.2 | 123.5 | 145.8 | 173.4 | 207.4 | 247.8 | 290.0 | 335.7 | 388.2 |
| Transport/storage | 91.6 | 104.5 | 127.9 | 155.7 | 186.0 | 215.6 | 247.0 | 281.0 | 318.1 |
| Post/communications | 83.2 | 95.0 | 112.7 | 136.1 | 162.4 | 188.4 | 214.9 | 242.9 | 273.8 |
| Real estate | 58.3 | 66.5 | 79.3 | 98.1 | 122.3 | 149.9 | 179.4 | 211.7 | 249.5 |
| Education/culture | 58.3 | 66.5 | 77.8 | 92.3 | 110.2 | 129.8 | 148.5 | 167.9 | 189.8 |
| Science/research | 16.6 | 19.0 | 24.6 | 30.6 | 38.4 | 45.2 | 51.8 | 58.9 | 66.9 |
| and | | | | | | | | | |
| All other | 199.8 | 228.0 | 290.1 | 345.5 | 428.1 | 551.0 | 638.0 | 722.1 | 810.6 |
| SHARES in services % | | | | | | | | | |
| Wholesale/retail | 26.0 | 26.0 | 25.2 | 25.0 | 24.8 | 24.2 | 24.0 | 23.8 | 23.8 |
| Financial/insur | 13.0 | 13.0 | 12.8 | 12.7 | 12.5 | 12.4 | 12.6 | 12.8 | 13.0 |
| Transport/storage | 11.0 | 11.0 | 11.2 | 11.3 | 11.2 | 10.8 | 10.7 | 10.6 | 10.6 |

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---------------------|------|------|------|------|------|------|------|------|------|
| Post/communications | 10.0 | 10.0 | 9.8 | 9.9 | 9.7 | 9.4 | 9.2 | 9.2 | 9.1 |
| Real estate | 7.0 | 7.0 | 6.9 | 7.1 | 7.4 | 7.5 | 7.7 | 8.0 | 8.3 |
| Education/culture | 7.0 | 7.0 | 6.8 | 6.7 | 6.6 | 6.5 | 6.4 | 6.3 | 6.3 |
| Science/research | 2.0 | 2.0 | 2.2 | 2.2 | 2.3 | 2.3 | 2.2 | 2.2 | 2.2 |
| and | | | | | | | | | |
| All other | 24.0 | 24.0 | 25.2 | 25.0 | 25.4 | 27.1 | 27.2 | 26.9 | 26.6 |

SERVICES TRADE

BALANCE OF SERVICES TRADE

| | | | | | | | | | |
|---------------------|------|-------|-------|-------|-------|-------|-------|-------|-------|
| Services balance \$ | -9.7 | -10.1 | -11.2 | -12.8 | -13.0 | -14.8 | -17.0 | -19.6 | -22.5 |
|---------------------|------|-------|-------|-------|-------|-------|-------|-------|-------|

EXPORTS AND IMPORTS and comparison services and goods

| | | | | | | | | | |
|-----------------------|-------|-------|-------|--------|--------|--------|--------|--------|--------|
| SERV EXPORT total \$ | 62.4 | 79.1 | 95.9 | 118.9 | 154.6 | 184.4 | 213.8 | 247.2 | 285.0 |
| SERV IMPORT total \$ | 72.1 | 89.1 | 107.1 | 131.7 | 167.6 | 199.2 | 230.8 | 266.8 | 307.5 |
| versus | | | | | | | | | |
| GOODS EXPORT total \$ | 593.4 | 762.3 | 936.6 | 1119.9 | 1304.8 | 1517.1 | 1774.4 | 2057.3 | 2358.6 |
| GOODS IMPORT total \$ | 534.4 | 628.1 | 774.4 | 988.2 | 1199.3 | 1383.4 | 1622.7 | 1906.0 | 2208.6 |

BILATERAL SERVICES TRADE with United States

| | | | | | | | | | |
|--------------------|------|------|------|------|------|------|------|------|------|
| Exports to US | 5.6 | 7.1 | 8.6 | 10.7 | 14.0 | 16.7 | 19.4 | 22.5 | 25.9 |
| Imports from US | 7.2 | 8.9 | 10.7 | 13.2 | 16.8 | 19.9 | 23.1 | 26.8 | 30.9 |
| CHINA serv. bal US | -1.6 | -1.8 | -2.1 | -2.5 | -2.8 | -3.2 | -3.7 | -4.3 | -4.9 |

BILATERAL GOODS TRADE with United States

| | | | | | | | | | |
|----------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Exports to US | 179.3 | 229.6 | 281.8 | 336.8 | 392.3 | 456.2 | 533.6 | 618.4 | 708.9 |
| Imports from US | 43.9 | 55.9 | 74.3 | 98.6 | 120.1 | 139.2 | 164.6 | 195.3 | 228.5 |
| CHINA trade bal v US | 135.4 | 173.7 | 207.5 | 238.1 | 272.2 | 317.0 | 369.0 | 423.2 | 480.4 |

CHINA DETAILED SERVICES TRADE

SERVICES EXPORTS

| | | | | | | | | | |
|------------------------|------|------|------|-------|-------|-------|-------|-------|-------|
| SERV EXPORT total \$bn | 62.4 | 79.1 | 95.9 | 118.9 | 154.6 | 184.4 | 213.8 | 247.2 | 285.0 |
| As share of GDP % | 3.3 | 3.6 | 3.7 | 3.8 | 4.2 | 4.3 | 4.4 | 4.5 | 4.6 |
| as share of exports | 9.6 | 9.4 | 9.3 | 9.6 | 10.6 | 10.8 | 10.8 | 10.7 | 10.8 |

SERVICES DETAIL

| | | | | | | | | | |
|--------------------|------|------|------|------|------|------|------|-------|-------|
| Travel and tourism | 25.8 | 32.6 | 39.6 | 49.1 | 63.8 | 76.1 | 88.2 | 102.0 | 117.6 |
| Transport/storage | 12.5 | 15.8 | 19.2 | 23.8 | 30.9 | 36.9 | 42.8 | 49.4 | 57.0 |
| Other services | 24.2 | 30.6 | 37.2 | 46.1 | 59.9 | 71.4 | 82.8 | 95.8 | 110.4 |
| Of which | | | | | | | | | |
| Communications | 0.4 | 0.5 | 0.6 | 0.7 | 0.9 | 1.1 | 1.2 | 1.4 | 1.7 |
| Computer/infoserv | 1.6 | 2.0 | 2.4 | 3.0 | 3.9 | 4.6 | 5.4 | 6.2 | 7.2 |
| Constr. related | 1.5 | 1.8 | 2.2 | 2.8 | 3.6 | 4.3 | 5.0 | 5.7 | 6.6 |
| Insurance/finance | 0.4 | 0.5 | 0.6 | 0.7 | 0.9 | 1.1 | 1.2 | 1.4 | 1.7 |
| Other | 20.4 | 25.9 | 31.4 | 38.9 | 50.6 | 60.4 | 70.0 | 80.9 | 93.3 |

SERVICES IMPORTS

| | | | | | | | | | |
|------------------------|------|------|-------|-------|-------|-------|-------|-------|-------|
| SERV IMPORT total \$bn | 72.1 | 89.1 | 107.1 | 131.7 | 167.6 | 199.2 | 230.8 | 266.8 | 307.5 |
| as share of GDP % | 3.8 | 4.1 | 4.1 | 4.2 | 4.5 | 4.6 | 4.7 | 4.8 | 5.0 |
| as share of imports | 12.0 | 12.5 | 12.2 | 11.8 | 12.2 | 12.6 | 12.5 | 12.3 | 12.2 |

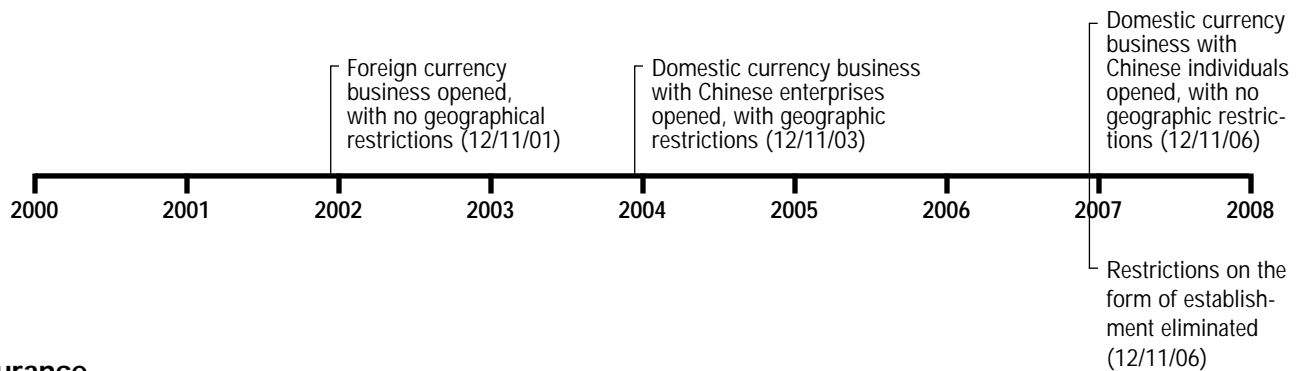
| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|--------------------|------|------|------|------|------|------|------|-------|-------|
| SERVICES DETAIL | | | | | | | | | |
| Travel and tourism | 19.5 | 24.1 | 28.9 | 35.6 | 45.2 | 53.8 | 62.3 | 72.0 | 83.0 |
| Transport/storage | 24.5 | 30.3 | 36.4 | 44.8 | 57.0 | 67.7 | 78.5 | 90.7 | 104.6 |
| Other services | 28.1 | 34.8 | 41.8 | 51.4 | 65.3 | 77.7 | 90.0 | 104.0 | 119.9 |
| Of which | | | | | | | | | |
| Communications | 0.5 | 0.6 | 0.7 | 0.9 | 1.1 | 1.4 | 1.6 | 1.8 | 2.1 |
| Computer/infoserv | 1.3 | 1.6 | 1.9 | 2.3 | 2.9 | 3.5 | 4.1 | 4.7 | 5.4 |
| Constr. related | 1.3 | 1.6 | 1.9 | 2.3 | 2.9 | 3.5 | 4.1 | 4.7 | 5.4 |
| Insurance/finance | 6.1 | 7.6 | 9.1 | 11.2 | 14.2 | 16.9 | 19.6 | 22.6 | 26.1 |
| Education/culture | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 | 0.4 | 0.5 | 0.6 | 0.6 |
| Royalties, fees | 4.5 | 5.6 | 7.0 | 9.1 | 11.5 | 13.7 | 16.2 | 19.0 | 22.0 |
| Other | 14.5 | 17.9 | 21.2 | 25.5 | 32.6 | 38.7 | 44.5 | 51.3 | 59.0 |

Appendix 2: China's WTO agreements and compliance

China's accession to the WTO in December 2001 committed the country to a process of removing or relaxing constraints on international trade in goods and services. In the service sector, China agreed to eliminate many existing restrictions on market access in banking, insurance, telecommunications, express delivery, and a range of professional services.

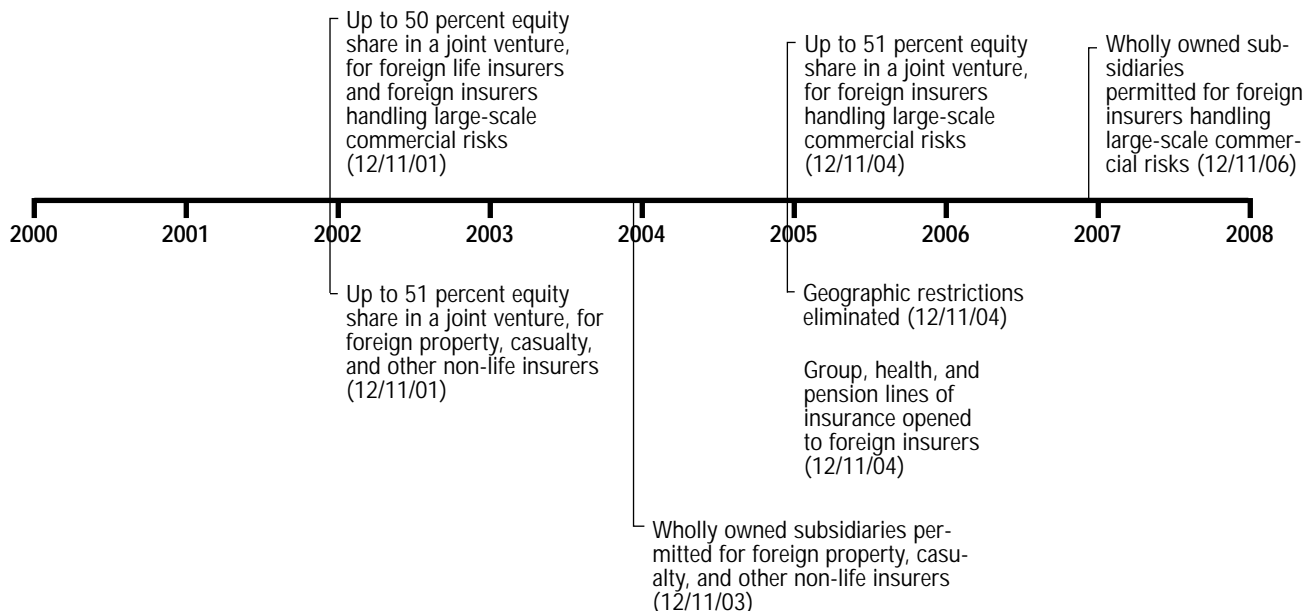
Banking

Over the past five years, a number of concrete steps have been taken to open up various segments of China's service sector. The Banking Compliance Agreement, for instance, outlines a specific timetable for gradually removing the barriers to foreign company participation in the banking arena. Most of these commitments have been met.



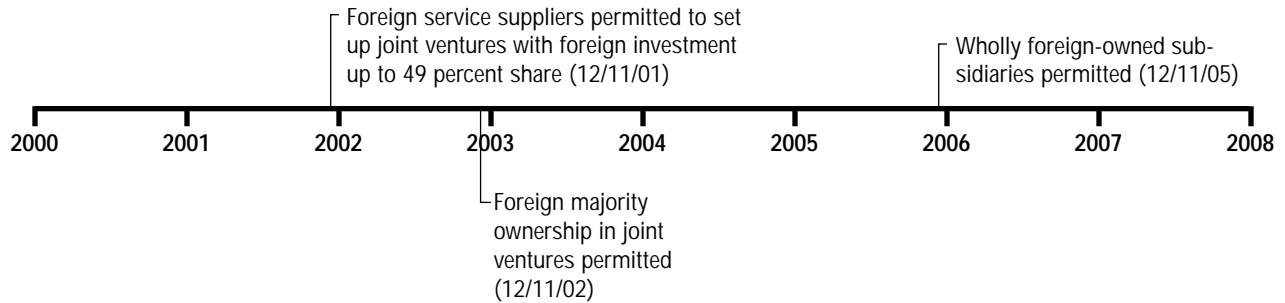
Insurance

In the insurance sector, there has been a similar schedule for China to open up to foreign insurance providers. In December 2006, for example, China committed to allow foreign insurers to offer group, health, and pension lines of insurance.



Express delivery services

China's WTO commitments apply to courier services, except those reserved by law to PRC postal authorities at the time of China's accession.



Telecommunications

The various levels of foreign equity share permitted and the respective compliance dates, for different types of services within the telecommunications industry, are shown in Figure A1. Also, China made specific promises regarding the elimination of existing geographic restrictions for foreign providers in the telecommunications industry, giving a target date of December 11, 2003 for foreign suppliers of value-added services; December 11, 2006 for foreign suppliers of mobile voices and data services; and December 11, 2007 for foreign suppliers of domestic and international wired services. China also promised to make its telecommunications regulator, the Ministry of Information Industry, more independent by separating its regulatory and operating functions and adopting pro-competitive regulatory principles.

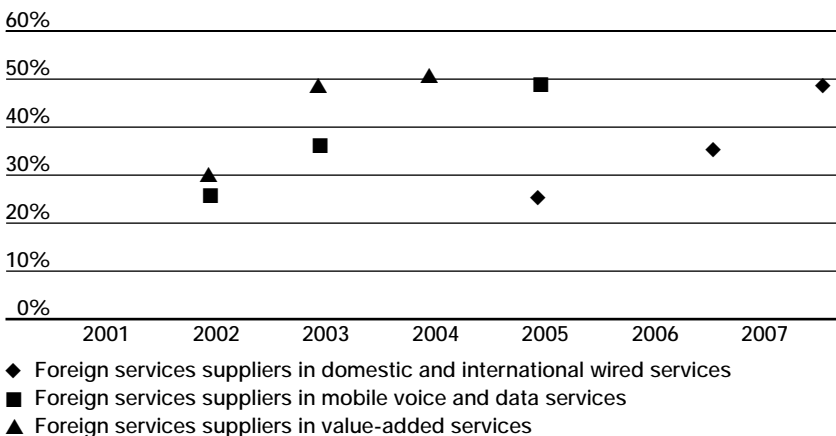
Other professional services:

- **Foreign law firms** On December 11, 2001, permitted to open up one profit-making representative office, with certain geographic restrictions and restrictions on the scope of activities; on December 11, 2002, all quantitative and geographic restrictions eliminated.
- **Foreign accounting firms** On December 11, 2001, permitted to affiliate with Chinese firms with restrictions on CPA certification by Chinese regulatory authorities.
- **Foreign architectural and engineering firms** On December 11, 2001, permitted to establish joint ventures with foreign majority equity share. On December 11, 2006, permitted to establish wholly foreign-owned enterprises.

Figure A1

Telecommunications Compliance Agreement

Foreign equity share permitted



Source: World Trade Organization

Compliance status of these commitments

According to an annual report on China's compliance with the WTO agreement, submitted by the US Trade Representative (USTR) to the US Congress, while China continued to keep pace nominally with the openings required by its WTO accession agreement in 2005 and 2006, it continued to maintain or erect terms of entry in some sectors that were so high or cumbersome as to prevent or discourage foreign suppliers from gaining market access.

For those American services firms with operations in China, the high barriers to entry and the lack of transparency in the Chinese regulatory system were among the most frequently cited impediments. The industry-specific concerns are summarized as follows:

Financial services

Banking

- Complex and confusing regulations and high capitalization requirements.
- Restrictions on foreign equity ownership for Chinese-foreign joint banks.
- Slow pace of approvals for new branch banks.
- Market access limitations on foreign electronic payment providers.

Insurance

- Inconsistent regulatory transparency, leaving ample room for bureaucratic discretion.
- Continued technical barriers to market access and expansion in the form of
 - a) high initial and subsequent internal branch capital requirements;
 - b) inconsistent and discriminatory business and branch licensing approval procedures; and
 - c) unnecessary focus on control of corporate form and percentage foreign ownership.

Motor vehicle financing

- Despite the delayed actual compliance, significant progress was made during 2004 and 2005.
- Reduced yet still relatively high capital requirements, which create barriers to entry for small and medium-sized enterprises.

Financial information services

- Lack of an independent regulator in the financial information services sector.
- Xinhua, the Chinese state news agency, is both a major market competitor of, and the regulator of, foreign financial information service providers in China.

Telecommunications

- High capitalization requirements.
- The industry regulator, Ministry of Information Industry (MII), has reclassified value-added services as basic services, exempting certain categories from the WTO agreement.
- MII maintains a lengthy license application process.

Express delivery services

- Potential restrictions on the types of packages express delivery operators are allowed to carry.
- Proposed new tax on express delivery operators.
- Lack of transparency concerning the restructuring of China Post, including the planned separation of business and regulatory functions.
- Potential changes that would make the licensing process more lengthy and burdensome.

Construction and related engineering services

- High capital requirements.
- Residency requirements for foreign staff (though the requirements have been temporarily relaxed).
- Requirements on type-specific engineering certification.

Legal services

- The imposition of economic needs tests for foreign law firms that want to establish offices in China.
- Unreasonable restrictions on the types of legal services that can be provided.
- Lengthy application process for new office openings.

As this list suggests, there are serious concerns and problems in certain industries, with regard to China's compliance with the WTO accession agreement. But there are also areas where China has kept its accession commitments and, in some cases, even gone beyond what had been promised.

Other services

USTR and US companies have confirmed that China appears to have met its WTO commitments to provide foreign service providers greater access in the following areas: tourism and travel-related services, educational services, environmental services, and certain types of other professional services.

Appendix 3: Case studies

Key points

■ Oxford Economics has examined in detail the contribution to both economies of US-China bilateral trade in three specific service industries: insurance and other financial services; IT and telecommunications services; and express deliveries.

■ Imports from the United States in each of these industries make an important contribution to the Chinese economy to the extent that they contribute to the productivity achieved in other sectors.

■ Provision of insurance and other financial services are a necessary condition for the growth of certain industries, and can improve the efficiency with which

resources are allocated across the Chinese economy. Access to these services can also contribute to a reduction in savings, boosting growth in Chinese demand and helping the global economy.

■ IT services and telecommunications services can help the Chinese manufacturing industry to improve its competitiveness and its connectivity.

■ Express delivery services can improve the efficiency of certain high-productivity sectors in China, and enhance global market access for their products.

■ US exports from each of these sectors to China support high-productivity employment in the US economy.

This section assesses in detail the economic impact of trade and investment flows between the United States and China in three specific industries: insurance and financial services; IT and telecom services; and express delivery services. Also discussed are the impediments to future growth in both trade and investment in these industries.

Insurance and other financial services

Figure A2 summarizes the recent history of trade in financial services between China and the United States. US financial services exports to China are growing very rapidly. In 2004, US financial services exports to China were worth \$188.3 million, compared to \$8 million in 1994. But China's exports to the United States in financial services were minimal; as a result, the United States has consistently posted a trade surplus with China in the financial services sector over the period 1994-2004. This surplus was valued at almost \$168 million in 2004, about 10 percent of the US service surplus with China in that year.

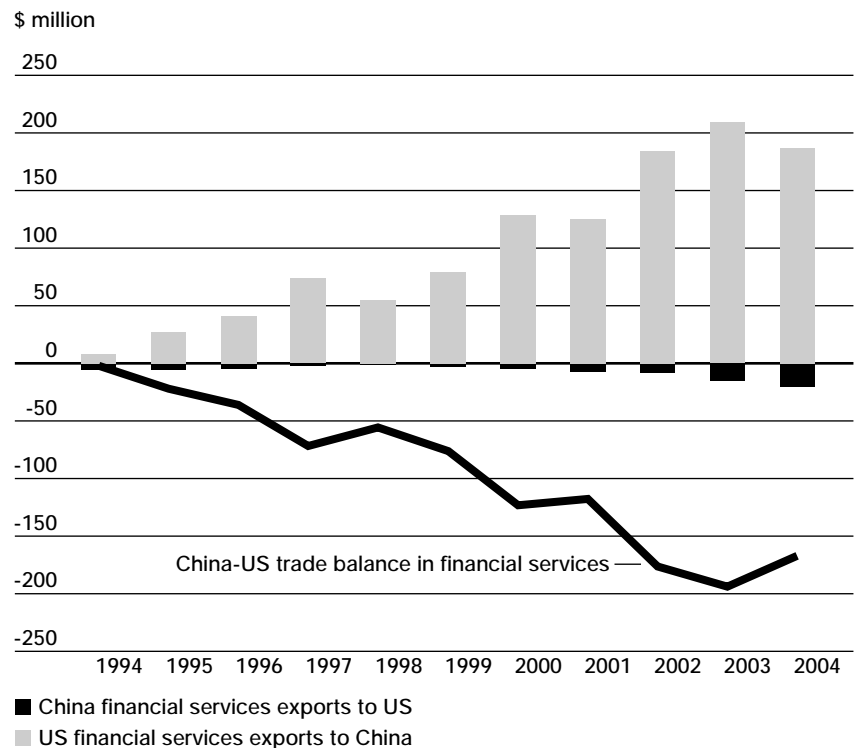
Since the financial services sector is one of the sectors that will benefit most from further market liberalization in China, it is likely that this trend will continue into the next decade.

Figure A3 shows US direct investment in China in the financial services sector during the same period. The data for 1995, 2002,

and 2003 were suppressed to avoid disclosure of the data of individual companies. US direct investment to China in financial services increased significantly in the mid-1990s, but the growth in investment has become

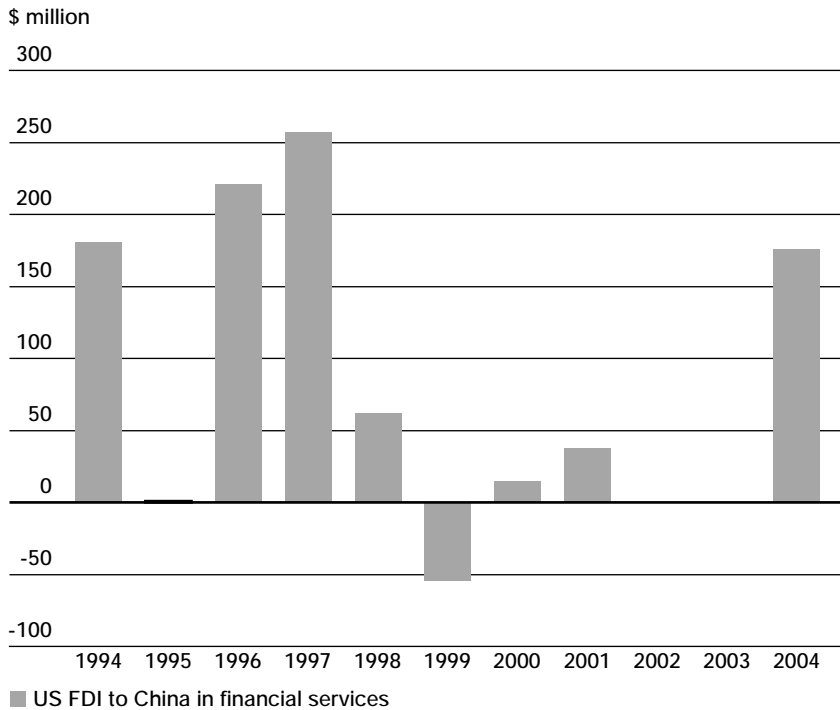
Figure A2

US-China financial services trade, 1994-2004



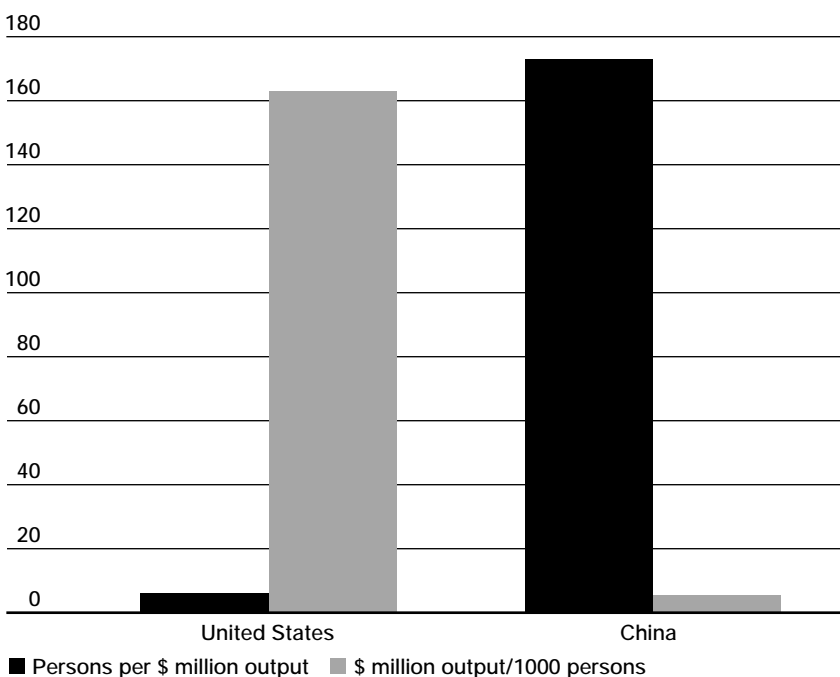
Source: US Bureau of Economic Analysis

Figure A3
US investment in China in financial services, 1994-2004



Note: The data in 2002 and 2003 have been suppressed to avoid disclosure of data of individual companies.
 Source: US Bureau of Economic Analysis

Figure A4
Labor productivities in US and PRC financial services industries, 2004



Source: Calculated based on US Bureau of Economic Analysis and *China Statistical Yearbook 2005* data

less stable in recent years, most likely due to regulatory changes in this sector. In 2004, US direct investment in the financial services sector in China was worth \$176 million.

Again, US investment in this sector of the Chinese economy is expected to grow rapidly in the next few years, as China fulfills those WTO accession commitments that are relevant to financial services industries, including insurance, banking, investment management, and securities. This presents enormous opportunities for US financial services firms, given the depth of their industry knowledge and management experience, and the higher levels of productivity that they achieve.

Figure A4 compares productivity in the financial services sector in the United States and in China. The financial services (including insurance) industry in the United States is almost 29 times more productive than its Chinese counterpart. As a result, US financial services firms are extremely well placed to benefit from and contribute to the growth of the Chinese market for financial services.

And the future growth in the provision of financial and insurance services will meet a shortfall that is currently having a negative impact on individuals and on other industrial sectors in China. Particularly for private enterprises—the most rapidly growing segment of the Chinese economy—the current low provision of international financial services means those firms lack access to much-needed funding to fuel even higher growth, and to the expertise in global capital markets that would help allocate that funding most efficiently (as detailed on page 12).

Insurance

Rapid economic growth has made China's insurance market one of the fastest-growing markets in the world, with premium value totaling \$52.2 billion in 2004, an increase of 11 percent over 2003. By 2014, China's insurance market is likely to become the fourth largest in the world—after the United States, Japan, and the United Kingdom.¹⁰

The provision of insurance services in China has increased significantly in recent years, partly as a result of the liberalization of the market, allowing imports and inflows of foreign investment into the sector. And the coming five years are likely to see an even more pronounced increase if China can relax current restrictions on foreign market access and provide equal competitive

¹⁰ Towersperrin, *Emphasis*, "China's Insurance Market—The Giant Awakens," 2-5.

conditions to foreign insurance companies. The 11th Five-Year Plan (2006-2010) states that by the end of 2010, 223 million Chinese will need old-age pension insurance, 300 million will need basic health insurance, 120 million unemployment insurance, and 140 million on-the-job-accident insurance—substantial increases relative to 2005 in all cases, as shown in Figure A5.

Increased provision of insurance services delivers important economic benefits, by

- Providing funds for increased capital investment, which increases the productive potential of the economy;
- Spurring improvements in productivity in the domestic insurance sector; and
- Allowing firms and consumers to reduce their savings.

In the case of China, lack of funds for investment does not represent a severe constraint on economic growth, though the economy would benefit from an increased share of FDI in fixed investment. Improved performance on the part of Chinese insurers would be beneficial, and appears to be under way. The most important effect is the impact on savings.

Although, as shown in Section 4, China's household saving rate is extremely high, this can be attributed to a lack of means to insure against income risks associated with illness, accidents, unemployment, and death.¹¹ Insuring against these risks would free up some of these savings for consumption without increasing the exposure of individuals and family units. This would, in turn, help China move toward its goal of a consumption-driven economy. It would also enable risks to be shared more efficiently across the economy.

A comparison of insurance density across countries confirms that insurance rates in China remain low. Despite rapid growth of the overall market, China's insurance density ranked 72nd globally in 2004 in terms of insurance premiums per capita.¹² Across the country as a whole, in August 2005, less than 4 percent of the population of 1.3 billion had insurance.¹³

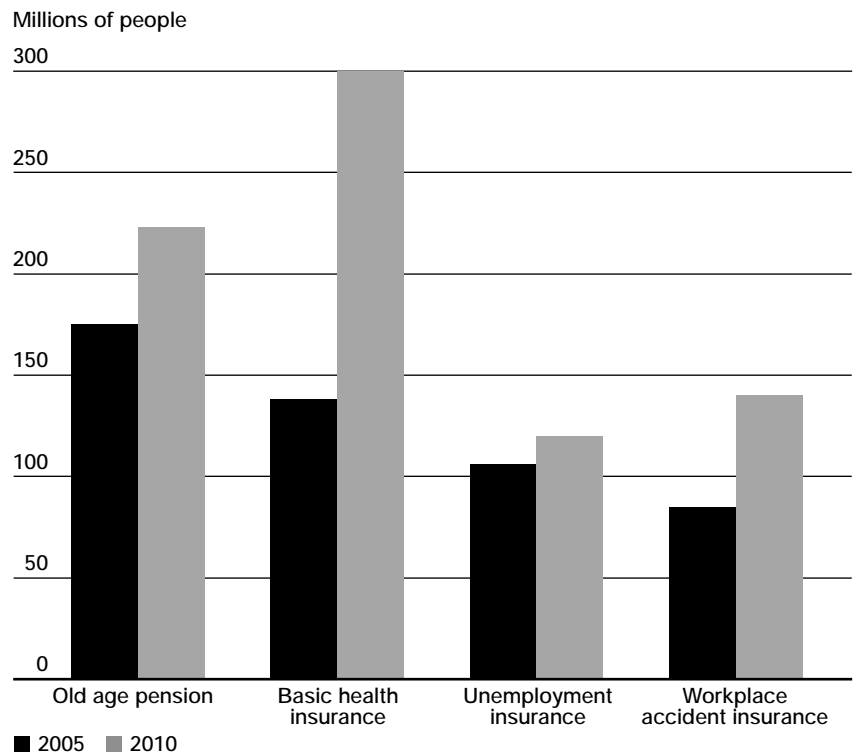
China's low insurance density and limited social safety net coverage, coupled with the unprecedented macroeconomic expansion and increase in average standards of living, underline the market's vast poten-

tial. A vibrant insurance industry can help provide Chinese citizens with health care insurance and long-term savings for retirement—an increasingly important issue for Chinese society as a whole, with a rapidly aging population and a pension system very much in need of an overhaul.

Since the late 1990s, foreign insurers have been invited to invest in China's insurance market; however, because of restrictions on foreign ownership and in-country expansion, the insurance market in China remained dominated by domestic insurance companies. Until 2004, the market share of all the foreign insurers in China was just above 2 percent. More than 90 percent of the market remained in the hands of three major domestic insurers—China Life Insurance, Ping An Insurance, and China Pacific Life Insurance.¹⁴

China gradually opened up this highly regulated market to foreign investors while

Figure A5
Growth in insurance provision in China



Source: PRC Eleventh Five-Year Plan

¹¹ Other factors contributing to the high saving rate in China include limited and deteriorating public pension and health care provision.

¹² Swiss Re, *Sigma* no.5 (2004).

¹³ Reuters, "AIG aims to maintain sole-ownership model in China," October 7, 2006.

¹⁴ *The McKinsey Quarterly*, "Selling Life Insurance in China," 2004 Special Edition: China Today.

attempting to fulfill its WTO commitments. As of October 2005, 44 foreign insurers had reportedly opened branch offices and were actively operating in mainland China. In the first four months of 2005, foreign insurers accounted for 13 percent of the Chinese life insurance market.¹⁵

The increase in the provision of insurance services indicates the contribution foreign insurers can make toward achieving China's 11th Five-Year Plan insurance-related goals. Foreign insurers are highly productive and offer world-class products, distribution methods, and customer service in China, as well as enhanced underwriting, risk management, and claims skills. Allowing greater participation by foreign insurers therefore will provide products, marketing methods, and technology to the marketplace and yield substantial benefits to Chinese consumers and to the overall Chinese economy. Consumers will be presented with a wider range of health care, life insurance, and pension products, and the Chinese economy as a whole will gain from the growth fueled by the reduced need for buffer savings, as a result of a more efficient and vibrant insurance industry.

Further participation of foreign insurers in the sector and the extent of their contribution to China's long-term objectives will depend on progress in the three critical areas of transparency, market access, and full national treatment to remove expansion restrictions.

US-China Business Council member companies surveyed have reported that there has been improvement in regulatory transparency in the insurance industry over the past 12 months. However, because transparency is so important to regulated industries such as insurance, continued efforts to improve the level and consistency of transparent dealings with industry would be ultimately to China's benefit. As the International Association of Insurance Supervisors (IAIS) notes, transparency fosters trust and thereby attracts sound investment, strengthening the marketplace. The IAIS has endorsed transparency, including a fully transparent legislative process that provides meaningful consultation with stakeholders, as a vital tool which

contributes to the regulator's legitimacy and credibility and to the creation of efficiency and stability in the marketplace.¹⁶

And transparency serves both regulator and regulated. IAIS Insurance Core Principle 3.2 provides that "independence, accountability, transparency, and integrity interact and reinforce one another" and describes transparency as the vehicle for "safeguarding independence, ensuring accountability, and establishing and safeguarding integrity."¹⁷ As for the regulated entities, given that many of the products insurers market are long-term obligations to the insured and their beneficiaries, transparency provides company management with the opportunity to plan ahead, and adequately design and price products and their distribution systems that meet both company objectives and government regulatory requirements.

Market access in China is somewhat impeded by high capitalization requirements. These requirements, combined with limitations on corporate form and on percentage equity ownership, usually instituted with the aim of protecting consumers and infant domestic industries, have a tendency to deter foreign investment and the healthy expansion of the industry that this provides. Therefore these well-intended measures can have the opposite effect, preventing the creation of a healthy competitive market and the weeding out of financially unsound companies.

National treatment restrictions affect access to and expansion in China's insurance market in the form of more favorable treatment to domestic insurers in the area of business and branch licensing. These restrictions act as obstacles to foreign insurers' geographic and product expansion and place them at a competitive disadvantage, such that they cannot fully contribute to the meeting of the important social goals set by China's 11th Five-Year Plan objectives.

Removing these impediments to the growth of foreign direct investment and foreign participation in the Chinese insurance sector will ensure that the Chinese economy benefits fully in the long term from widespread provision of insurance services to companies and households.

¹⁵ Ken J. G. Chen, *Hong Kong Securities*, "Counting Down to China's Long-Awaited Opening," February 2006.

¹⁶ *IAIS Insurance Core Principles*, Introduction 10, October 3, 2003.

¹⁷ *IAIS Insurance Core Principles*, ICP 3.2, October 3, 2003.

Information technology and telecommunications services

China's industries spent some \$63 billion on IT in 2004. This figure, driven by demand from the communications, financial services, and manufacturing industries, in particular, is expected to grow at a compound annual growth rate of 6.2 percent to \$85 billion in 2009.¹⁸ China's IT market has great potential with regard to its overall demand and growth prospects. George M. Scalise, president of the Semiconductor Industry Association, has stated "I don't think there are any other markets in the world that can even begin to compete with that kind of growth and demand overall."¹⁹ That potential applies to both the production and the consumption of IT hardware, as well as to the IT services that accompany hardware sales.

Figures A6 and A7 illustrate the rapid growth of trade and investment in IT services between China and the United States. In 2004, US computer and information services exports to China were valued at \$8.5 billion, compared to \$5.1 billion in 1997. China's exports to the United States in computer and information services have also been growing rapidly, but the United States has consistently posted a trade surplus with China in this sector over the period 1997-2004, reaching almost \$2.7 billion in 2004.

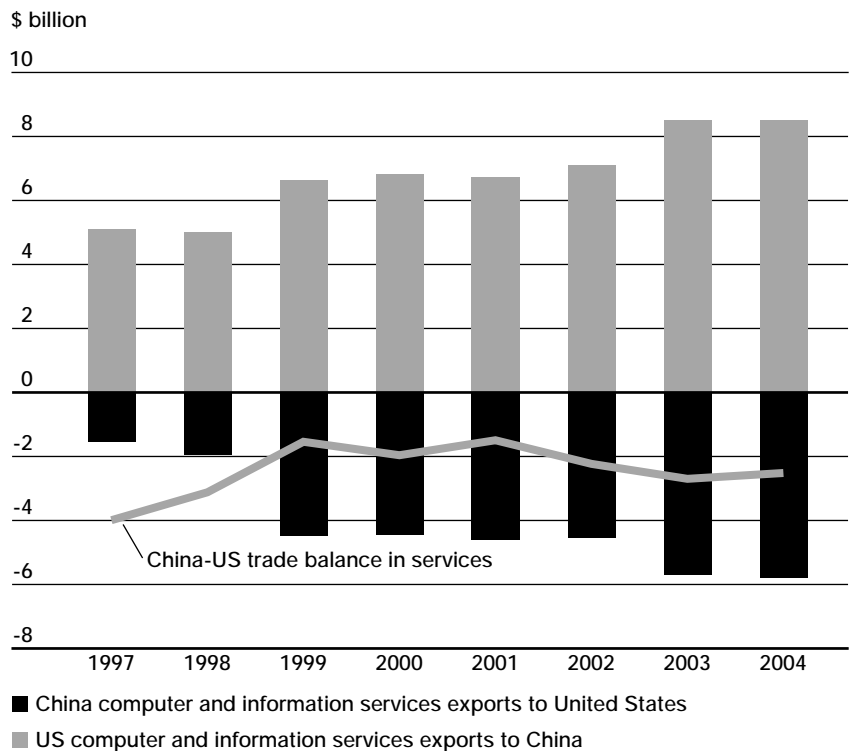
One important aspect of the Chinese market for IT services, along with the remarkable growth of the overall market size, is that the high-end (outsourcing/solution) market is still in its infancy. As a result, the services many foreign multinationals provide are still mostly tied to hardware products, namely system installation and maintenance services. Therefore, the full line of high-end services where US IT service providers would be most competitive cannot yet be absorbed by the market, because of its immaturity in the higher end of the spectrum. However, as the Chinese economy continues its march along the industrialization path, it is reasonable to expect that demand for outsourcing/solution services will pick up significantly, as organizations begin to require more sophisticated IT technology services.

Although the prospects are bright, there remain many challenges for foreign IT firms investing in China. One of these is strong local competition. In contrast to many other sectors, where foreign firms

¹⁸ Gartner, "Market Trends: Industry Analysis, China, 2004-2009," January 10, 2006.

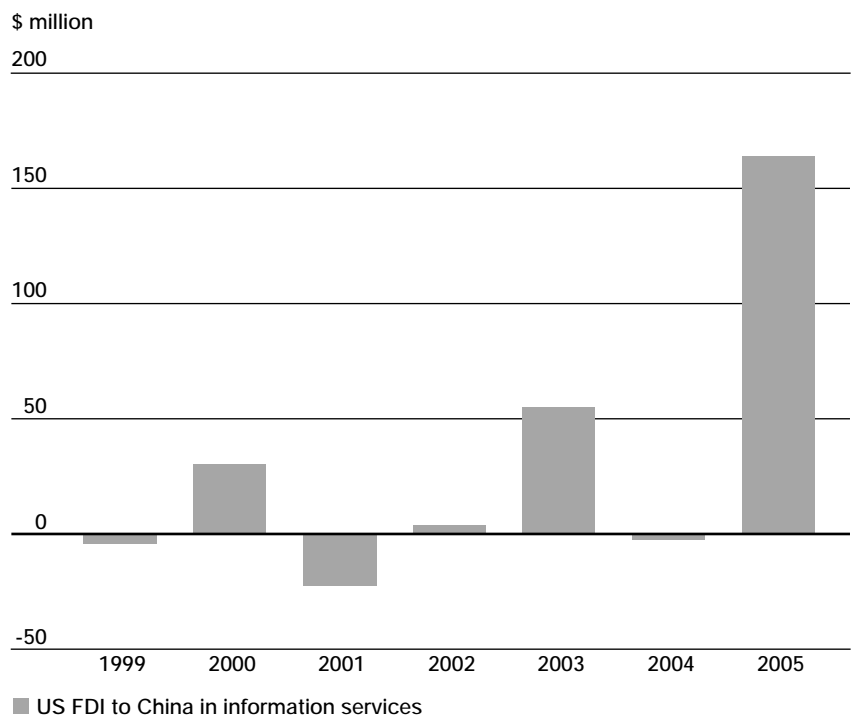
¹⁹ CNBC, "China's Growing Market Beckons Tech Firms," April 19, 2006.

Figure A6
US-China computer and information services trade, 1997-2004



Source: US Bureau of Economic Analysis

Figure A7
US investment in China in information services, 1999-2005



Source: US Bureau of Economic Analysis

usually possess certain skills and expertise that are beyond their local competitors' reach, foreign firms in the IT sector increasingly face a formidable challenge resulting from the emergence of strong local IT companies. Some of these local firms are themselves multinationals, competing with foreign companies not only in their own domestic market but also abroad. For example, according to a recent study by the Boston Consulting Group, which identified the top 100 multinationals from China, India, Brazil, Egypt, and other emerging economies with the most appeal to the top rank of global corporations, three IT firms from China made the top 15 list: Haier, Huawei Technologies, and Lenovo Group, all PRC firms, took the 8th, the 10th, and the 11th places, respectively.²⁰

Although lower cost is the major edge that these newly emerging contenders have over their established Western rivals, there is plenty of evidence that they are offering far more than just low-cost products and services. Many of these firms now boast enhanced global research and development networks, higher customer satisfaction, and improved management agility. For example, Huawei has ten R&D centers globally, and claims that about 48 percent of its 44,000 employees are dedicated to research and development activities. Also, Huawei maintains a service network of 300 local centers in China, and was voted the best in customer satisfaction in the IT industry in a poll conducted by Gallup for the years 2000-2004.²¹

The improvement in the products and services provided by Chinese IT firms in recent years is a clear example of how the Chinese economy has benefited from trade and foreign investment. Such activities gave Chinese firms and employees access to the most advanced IT products and services, creating both a knowledge diffusion effect and competitive pressure on domestic firms in the sector, which have resulted in higher productivity, not only in the IT sector itself, but also in the industries that they serve.

The strong local competition that has resulted from these improvements is mainly in the field of IT hardware and low-end services, as the market for high-end IT services in China is still immature. In future, that market will grow, as Chinese manufacturing firms become more advanced and need to make increasing use of high-end IT

services. That will provide an opportunity for US-based IT services companies to contribute even further to the performance of the Chinese economy.

As part of this study, Oxford Economics interviewed a major global supplier of IT services, whose views are summarized in the next paragraphs.

Although most US IT firms investing in China have gone through a "localization" process—utilizing local resources, hiring local talent, and serving the Chinese domestic market—such operations in China still provide substantial benefits to the US economy. In addition to the IT service-related export revenues and investment returns accruing to US shareholders, the goals of establishing brand awareness in one of the fastest-growing markets, while building infrastructure to reap the enormous benefits from the potentially remarkable growth in the coming decade, are crucial strategic goals for any major global IT company.

In order for the potential benefits of imports of and inflows of investment in IT services to be realized, barriers to trade and investment in the IT sector must be addressed. For example, the classification by the regulatory body, the Ministry of Information Industry, of certain IT services as "value-added telecoms" requires formation of a joint venture with a 50 percent limit on foreign investment.²² The joint-venture requirement, in turn, often gives rise to issues to do with effective management, which can reduce the value provided to clients and lead to poor levels of customer satisfaction, potentially cutting into revenues. This could cause foreign service providers to hesitate in making further investments in China, and hinder the development of a service economy.

China's government has released plans aimed at replicating India's success in developing the IT service sector. One strategy that has helped India in this regard is that in the late 1990s it dropped foreign equity limits. But it appears that China so far has been reluctant to follow suit.

The different viewpoints and agendas of the various ministries within the Chinese government also contribute to this uncertainty, by creating conflicting goals when it comes to industry regulation. And some foreign firms believe that government backing of local competitors is also an issue. This

²⁰ *Businessweek*, "Emerging Giant," July 31, 2006.

²¹ <http://www.huawei.com/about/inworld.do?id=141>, accessed August 10, 2006.

²² United States Trade Representative, "2005 Report to Congress on China's WTO Compliance," December 11, 2005.

usually takes the form of setting and adopting domestic procurement policies or standards that are to the local firms' advantage.

China has made much progress since acceding to the WTO, particularly in view of tariff reductions and in becoming more open and transparent, although more could be done. The Oxford Economics survey reveals that if these regulatory impediments to trade and investment in the IT services sector in China were removed, both exports to and investment in China would increase significantly, further increasing the benefits for both economies. In the event of such a relaxation of regulatory constraints, the IT services industry might run into capacity constraints in terms of a shortage of suitably skilled staff. But this problem could be addressed by the Chinese government providing a broader technical education to students about to enter the workforce.

Telecommunications

The telecommunications sector provides another example of an industry where the potential future growth of the Chinese market is enormous; where the benefits of that growth both for the Chinese economy and for US-based service providers would also be substantial; where the market is currently under-supplied; and where serious impediments to future growth in the provision of services remain in place.

As part of this study, Oxford Economics interviewed a major global supplier of telecommunications services, whose views are summarized in this section.

In order for China to progress as rapidly as it hopes along the path to industrialization, it will in future need world-class standards of connectivity—only in that way will it succeed in attracting and retaining the investment of multinationals with globally distributed enterprises. Business-grade standards of customer care and security go hand-in-hand with the connectivity needs. At present, providers of telecommunications services in China are not well placed to provide these services, though the demand for these services is likely to grow in the years to come.

The companies best equipped to provide these services are foreign firms, including US-based service providers. Their activities are hampered by multi-layered barriers to entry into the Chinese market. These barriers include a range of restrictions on inflows of FDI:

- Any joint venture must be majority-owned by a Chinese company, often a direct competitor with the company supplying the funds for that FDI.
- Joint ventures can only be set up with state-owned telecoms suppliers.
- High capitalization requirements driving up the required rate of return to very high levels: joint ventures require \$250 million capitalization.
- Opaque licensing procedures, involving far too many steps.
- Unclear dual role of the industry regulator, which supports state-owned enterprises and regulates the sector as a whole.

If China were to make progress in these areas, inflows of investment in the telecommunications sector would increase dramatically. In general, if there is any realistic opportunity to increase telecommunications investment in China, this will happen simply because the market potential there is so great.

But the constraints on FDI and on exports of telecommunications services to China are more onerous than in other comparable emerging economies. It appears that there is less urgency in China than elsewhere about exploiting marginal investment opportunities. The Chinese approach to a managed process of industrialization is laudable, and has achieved a great deal, but this ultimately does not ensure a best-in-class, vibrant service sector. That is something that only comes when all parties compete for market share, without state protection or support. As long as the rules protect domestic service providers, the Chinese service sector will under-perform relative to its potential, and the negative impact of that under-performance on the rest of the economy will grow.

Express delivery services

Since China began to integrate itself into the international trade network more than two decades ago, air cargo to and from China has grown at an amazing pace. In 2003, air cargo volumes from China were 10 times greater than a decade earlier. More than \$60 billion worth of goods were shipped by air from China in 2003.²³ Earlier studies have predicted that this figure will increase dramatically over the next 10 years as China further integrates into the global trade network. Traditionally, air cargo volumes grow at about twice the rate of overall trade growth and most observers expect this trend to hold true for China's air cargo trade.

All four major global express delivery companies have operations in China. These firms initiated service in China at the beginning of the process of reform and opening up and have gradually set up domestic networks in China that are linked to their global networks. The express delivery services industry in China will continue to make major investments.

For example, following the landmark US-China Air Services Agreement in 2004, both FedEx and UPS announced plans to establish cargo hubs in China—FedEx at Baiyun Airport in Guangzhou, and UPS at Pudong Airport in Shanghai. And with the additional opportunities available under the 2004 agreement, both FedEx and UPS have dramatically increased the number of flights they operate to and from China. FedEx's US-China weekly flight rights have increased from 11 to 30, and UPS's have increased from 6 to 21.

Global express delivery giants like FedEx and UPS, along with other foreign express delivery firms, now carry approximately 75 percent of China's inbound and outbound express delivery volume.²⁴ This impressive success is mainly due to these firms' global networks, enhanced logistics management, and high efficiency.

As part of this study, Oxford Economics interviewed a major global supplier of express delivery services, whose views are summarized in the paragraphs that follow.

The growth in express delivery services in China over the past two decades has con-

tributed to further growth in China's trade with the rest of the world. Efficient, reliable, and fast international transportation services offered through far-reaching delivery networks have opened markets that would otherwise have remained closed due to time and distance constraints. In the future, as the Chinese economy moves to supplying higher-value goods, a highly efficient logistics network becomes ever more crucial.

The success of US express delivery companies in China also brings in significant benefits for the US economy. First, the Chinese market is lucrative for US express delivery companies such as FedEx and UPS, and the market has great potential. Second, as further economic liberalization in China brings Chinese consumers unprecedented higher living standards and as the country further improves its production technologies, Chinese businesses and consumers will demand more high-end products and services. Companies such as FedEx and UPS will facilitate to an even greater extent China's domestic and international trade.

However, significant barriers against further trade and investment remain in place. These include:

- The lack of transparent, independent regulation. Regulation of the industry is split among numerous agencies—the General Administration of Civil Aviation of China (CAAC), the State Postal Bureau, the Ministry of Commerce, and the Ministry of Communications—with no one agency responsible for promoting an efficient, competitive market for express delivery services. Regulators have been more interested in protecting their bureaucratic "turf" and business interests than in creating an industry that will bring maximum benefits to the overall economy.

- A refusal to deregulate freight forwarding and courier services in line with China's WTO commitments, despite having kept many of the promises made to gain WTO entry. This limits foreign express delivery companies' ability to expand their services within the country, and bring the resulting benefits of a competitive, thriving express delivery service industry to shippers in China.

²³ Speech by Michael L. Ducker, FedEx Express, "China-US Relations: Past, Present and Future," November 6, 2003. <http://www.fedex.com/us/about/news/speeches/chinaeconomy.html?link=4>

²⁴ See footnote 23.

■ A proposed new tax on express delivery operators, designed to fund China's universal postal service under the revised postal law.

■ A proposal to prohibit foreign-invested companies from gaining access to the domestic express delivery market.

■ In a related issue, even after being fully licensed by the central government by going through an arduous process, a foreign service provider needs to go through another process at least 70 percent as exacting to open a branch in any other Chinese city.

These regulatory barriers impose great inefficiencies on the operations of the foreign express delivery companies in China and impose a hidden tax on China's logistics system as a whole. Such inefficiencies contribute to uneven investment allocations, leading to wasted materials, high inventory levels, and higher costs for consumers and businesses. For example, according to a study by the American Chamber of Commerce in Shanghai, logistics accounts for at least 16 percent of the overall cost of a product manufactured in China, compared with 4 percent in developed economies.²⁵ If the inefficiencies resulting from regulatory barriers and the lack of transparency of the regulatory environment were removed from the Chinese economy, both the United States and China would benefit enormously.

Another major global supplier of express delivery services cited three examples of how the provision of these services can contribute to improved performance on the part of US and Chinese companies:

■ **Jesse and Frichtel** is a US-based dental lab providing high-quality, cost-effective products to the dental community. By using express delivery services, the lab was able to link up with a lab partner in Shenzhen, China, reducing costs and shortening the time-in-transit for dental products significantly—benefiting US customers and improving the business prospects for both the US and Chinese partners. International express deliveries made such an alliance far more effective.

■ **Tomer** is a fashion designer. The process of creating original designs is long and complex. Before the clothing arrives on the hangers of select stores, fabric, buttons, designs, and samples have to be shipped back and forth many times between Italy, New York, and China. But express delivery services have helped streamline this process to such an extent that Tomer is able to complete each step on time, in spite of the often unexpected challenges involved in the fashion industry. The express delivery industry has made it possible for the manufacturers and designers of different components to collaborate without compromising the timeliness of the production process, generating opportunities in both the United States and China that could otherwise never have been realized.

■ **Jetboil** is a manufacturer of award-winning outdoor products. It has set up a second manufacturing site with a partner in Shenzhen, China, to provide cleverly designed, high-quality, and cost-effective products. Jetboil uses express delivery services to ship designs to manufacturers in China, samples back to the United States for testing, and final products from China to retailers worldwide. Express delivery services also help to keep Jetboil's costs under control, which is essential to its success. Without such an efficient logistics system, the Chinese manufacturers would not have been able to supply a US-based company and meet worldwide demand.

The provision of express delivery services has made possible faster growth across a wide range of industries in China, as the previous examples illustrate. Constraints on the future provision of those services are therefore also constraints on future growth in the Chinese economy as a whole. If those constraints are removed, both the US and Chinese economies would benefit significantly.

That general insight is applicable right across the service sectors in China: impediments to the future growth in inflows of FDI or imports in that sector are strongly negative for the long-term prospects for China's economy as a whole.

²⁵ Frederick W. Smith, FedEx Corporation, "Guangzhou University Speech," July 13, 2005.

Recent developments in the regulatory environment in China²⁶

Recent changes within the regulatory environment in China for foreign investors have the potential to impose new hurdles for foreign investors, ranging from increased scrutiny of foreign-backed mergers and acquisitions, to proposed restrictions in areas from retailing to manufacturing.

Examples of such attempts within the services sector include:

- A proposed rule restricting the expansion of large-scale chain outlets. This rule, if passed, is likely to put foreign companies such as Wal-Mart Stores Inc. and Carrefour SA at a disadvantage.
- Another set of rules issued in July 2006 could make it more difficult for foreign companies to operate Internet businesses.
- A new set of regulations concerning mergers and acquisitions by foreign-invested enterprises, which took effect September 8, 2006, calls for the PRC

Ministry of Commerce to review and approve deals in key industries or that would involve the transfer of control over famous Chinese brands, as a way to protect China's "national economic security."

- Xinhua, China's government news agency, issued rules in September 2006 imposing new restrictions on foreign providers of financial information services (though the rules have yet to be implemented).

Oxford Economics research suggests that any moves to erect new barriers to foreign investment in China's service sector would be very costly, not only for US-based service sector firms seeking to export to and invest in China, but also for the Chinese economy as a whole in the longer term. China's growth prospects would be undermined by the under-provision of the high value-added services that will play a key role in the next phase of Chinese industrialization.

²⁶ Summarized from *Wall Street Journal* article, "In Strategic Shift, China Hits Foreign Investors with New Hurdles," August 30, 2006, and US-China Business Council analyses.

Appendix 4:

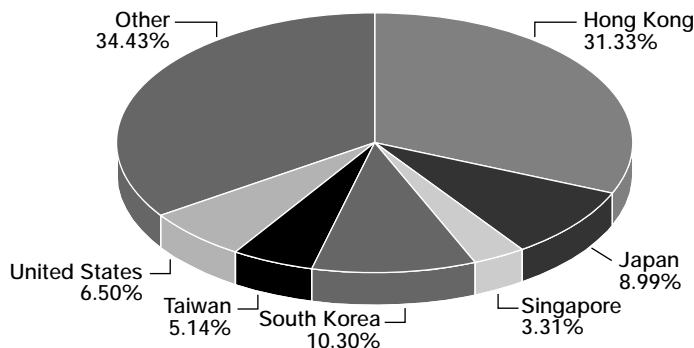
Foreign direct investment inflows to China

The magnitude of US direct investments in China is difficult to assess. There are two major issues related to the publicly reported China foreign direct investment (FDI) figures across all sectors of the economy:

- The total amount of FDI into China usually is *overstated*. This is a result of what is known as “round tripping,”²⁷ whereby capital that originates from mainland China goes through another country, before re-entering China as “foreign” investment. Hong Kong is the most popular stop for such round-trip outflows, followed by the British Virgin Islands, Cayman Islands, and Bermuda—which together accounted for 15 percent of all FDI inflows to China in 2004, more than twice the US share.

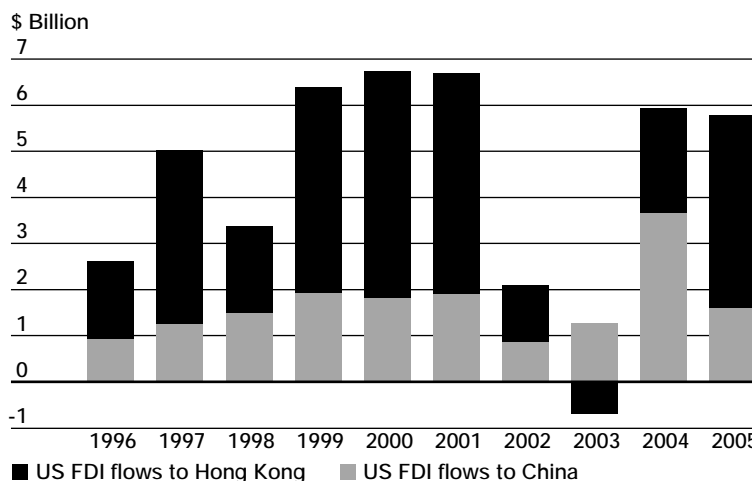
- The amount of FDI to China originating from the United States (and other developed economies), is usually *understated*. Such investments will often be “re-routed” via Hong Kong. So a large proportion of the FDI nominally from Hong Kong in reality comes from the United States and other developed economies.²⁸ On average, flows into Hong Kong are around 70 percent larger than flows into China. Given the nature of the two economies, this strongly suggests that there is a great deal of “re-routing” going on. Conservatively, it is reasonable to assume that between half and three-quarters of the FDI into Hong Kong actually has China as its final destination.

FDI flows to China, by source, 2004



Source: *China Statistical Yearbook*, 2005

US FDI flows to China and Hong Kong



Source: US Bureau of Economic Analysis

²⁷ “China’s FDI Merry-go-round,” April 2, 2003, http://www.fdimagazine.com/news/fullstory.php/aid/215/China_percent92s_FDI_merry-go-round.html.

²⁸ “Foreign Direct Investment in China: Effects on Growth and Economic Performance,” Edward M. Graham and Erika Wada, Oxford University Press, 2001.

The China Business Forum

1818 N Street, NW, Suite 200
Washington, DC 20036-2470 USA
Tel: 202-429-0340 Fax: 202-775-2476
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