

EXECUTIVE SUMMARY

CHINA'S SERVICES SECTOR HAS YET TO REACH ITS POTENTIAL

China's services sector is opening up, but further reform is needed. The services sector in China should account for a much greater proportion of the country's total output than it currently does given the country's level of per capita income. The services sector needs to grow and expand its share of the national economy to help strengthen the business sector, address unemployment pressures, accelerate trade and technological progress and increase overall economic efficiency.

China's services sector grew strongly in the 1990s as per capita income soared. However, an efficient and competitive 'services economy' has yet to emerge. The development of the services sector has been constrained by the country's development strategy, which has focused on manufactured exports, and by the substantial barriers to trade and investment in the services sector. While China's share of merchandise trade to GDP jumped from 45 per cent in 1993 to over 60 per cent in 2004, its share of commercial services trade to GDP only increased slightly from 5 per cent to 7 per cent of GDP over the same period.

However, China has started to address its neglect of the services sector. In its Tenth Five-Year Plan, 2001–05, the Government announced plans to develop the services sector and substantially expand its presence in the national economy. China committed to a dramatic opening of its services sector when it acceded to full membership of the World Trade Organization (WTO) in December 2001.

China's trade in services has increased significantly since its WTO accession. Foreign investors' interest in the services sector has been increasing. Transport, storage and telecommunications services recorded unprecedented growth in 2004. Education, health and social services are growing in importance reflecting the increasing value China and its people are placing on human capital investment – a critical ingredient for the emergence of competitive service industries.

LIBERALISATION OF CHINA'S SERVICES SECTOR

China's market opening commitments in services have been considered possibly the most comprehensive liberalisation ever negotiated in the WTO. These commitments were far-reaching, although there remain restrictions on ownership, business scope and geographical coverage.

China has made significant progress in implementing its liberalisation commitments in many services. But implementation is not yet complete and has not been without problems. At times China has shown difficulty in adhering to WTO rules. Its commitment to market access, for example, is being undermined by administrative measures. An opaque regulatory process and overly burdensome licensing and operating requirements continue to frustrate foreign providers of services.

China also has committed to broad legal reforms in the areas of transparency, uniform application of laws and judicial review. While there are episodes of increasing transparency, China's basic compliance with notice-and-comment commitments continues to be uneven. China has established an internal review mechanism to monitor non-uniform application of law, but problems persist.

Unlocking the enormous potential of services requires wide ranging and deeper reforms of the legal and enforcement system, the financial system, labour markets and state-owned enterprises. Complementary reform of the regulatory and legal enforcement system is necessary to give effect to China's commitments and ensure durability of liberalisation measures. Reform of the *hukou* system (China's household registration system, which places limits on the mobility of Chinese citizens) will be crucial in enhancing labour mobility and maximising the employment gains from the expansion of service industries.

Financial Services

Foreign banks now face no geographic restrictions in the conduct of foreign currency business. Since the end of 2004, China has allowed foreign banks to conduct local currency business in 18 cities. The insurance market is now also largely open to foreign competition although foreign insurers remain prohibited from statutory insurance business. Market access is constrained by high capital requirements and prudential requirements which are beyond international norms. Concerns about discriminatory treatment in branch approval processes also are being raised.

Transport, Logistics and Distribution Services

At the time of China's WTO accession, China had already introduced liberalisation measures along various points in its logistics chain. Today, China is benefiting from the partial opening of some distribution services, which has contributed to the development of modern organised food retailing and food service industries in the country. Some of the remaining restrictions on establishment, geographic scope and products are being removed in accordance with China's schedule of specific commitments. China has liberalised road and auxiliary services and issued regulations permitting wholly foreign-owned firms in storage, warehousing and in freight transport services. However, in practice substantial establishment and operational barriers remain, and at the provincial level, there is an additional layer of regulation.

Telecommunications

China took tentative first steps in 1994 to introduce competition in its telecommunication sector. More significant reforms were introduced from 1998 in anticipation of China's WTO accession. Since accession, China has relaxed foreign equity and geographic restrictions, although it has not committed to allowing more than 49 per cent foreign ownership in mobile telephony and fixed line services. China's restrictive interpretation of value-added services has also limited the opportunities for foreign firms to undertake innovation and development in value-added services. Overall, China's telecommunications sector remains highly restrictive with healthy competition being constrained by an unclear licensing system, compromised pricing regulations, inadequate regulations on interconnection and high capital requirements. Further reforms are needed to give effect to China's telecommunications services commitments.

Education Services

Foreign majority ownership is now permitted in joint ventures providing education services, but there is no guarantee that foreign educational institutions will receive national treatment. China still maintains a number of regulatory barriers restricting the delivery of education and training in relation to cross-border supply, commercial presence and the movement of educational professionals.

Professional Services

China eliminated geographic and quantitative limitations on legal services in 2002 but legal firms are not permitted to enter into joint ventures with local firms. Accounting, engineering and construction providers also face continuing restrictions. China has agreed to allow wholly foreign-owned subsidiaries to operate accounting, taxation, architecture and urban planning services by 2007, but some restrictions will remain, especially in legal and medical services.

Tourism and Travel-Related Services

Market access restrictions on foreign-invested travel service providers were lifted in 2004 much earlier than promised, but competition remains constrained by licensing requirements including extremely high turnover requirements and restrictions on business scope.

Intellectual Property Rights

China has amended its intellectual property rights regime to comply with the Agreement on Trade-Related Aspects of Intellectual Property Rights. However, enforcement remains problematic, with counterfeiting and piracy still at very high levels.

AUSTRALIAN BUSINESSES ACCESSING CHINA'S SERVICES MARKET

Australian companies are taking advantage of services liberalisation in China and are positioning themselves to gain access to China's rapidly expanding services markets. Despite the improved environment, Australian firms still face major challenges from entrenched domestic players, high capital requirements and a lack of transparency in a rapidly changing regulatory and administrative situation. China has to be viewed as a long-term market. Before entering the China market, businesses need to assess the risks along with the opportunities.

Financial sector revenues in the Asia-Pacific region are projected to grow from US\$390 billion in 2004 to US\$1.8 trillion by 2020. China will be the driving force of this growth. Australian banks have positioned themselves in anticipation of the potentially huge market and in light of China's commitment to fully liberalise the sector by 2006. The ANZ and the Commonwealth Bank have each taken equity stakes in local banks and the Macquarie Group is actively involved in property development, funds management and stock trading businesses. However, competition is constrained by the entrenched dominance of state-owned banks, high operating requirements and the constantly changing regulatory environment.

China is the world's largest consumer of international education. Australia has made significant gains in increasing its share of the market in recent years. Griffith University, the International Education Network (a consortium of Australian Universities) and TAFE NSW Global are just some of the many active providers of education services to Chinese students in Australia and in China. Regulatory barriers, including restrictions on recognition of overseas qualifications remain major challenges to foreign education providers.

China overtook the United States in 2002 to become the world's largest telecommunications market. This market still has huge potential for further growth given China's relatively low telecommunications penetration rate. Telstra is currently providing services as a consultant or facilitator to Chinese telecommunication companies looking to improve efficiency and service quality or to introduce new products and services. Telstra looks forward to greater regulatory liberalisation, including the enactment of a Telecoms law that would put in place a more transparent legal environment conducive to the development of competitive industry structures.

By 2020, China will become the world's largest tourist destination and the fourth largest source of tourists. Flight Centre, through a joint venture with an established agency, China Comfort, has gained a strategic opportunity to enter China's rapidly growing corporate travel market. Qantas has recommenced flights to Shanghai and will commence flights to Beijing in January 2006. While China has liberalised its travel agency market ahead of schedule, current licensing and business scope restrictions severely hamper foreign tour operators.

Many international firms have established sizeable professional practices in China to service the increasing needs of their clients. In 2004, seven Australian firms were among the 114 foreign law firms licensed to operate in China. One of the key issues for legal firms remains the restriction on entering into partnership with Chinese firms.

China will become the world's second largest trading entity by 2020, overtaking Germany and Japan. Linfox, one of Australia's largest transport and logistics management companies, has operated in China since 1984. Linfox's operations in China recently received a boost with the signing of a five-year contract with China's largest private construction material and department store chain, the Home World Group. While significant openings have occurred in the logistics and transport market, establishment remains hampered by regulations both at the national and provincial levels.

China is undergoing a boom in construction. Leighton, Australia's largest construction-oriented company has taken a cautious approach to its activities in China. It operates as a wholly foreign-owned project company focusing on build-operate-transfer (BOT) schemes in environmental and infrastructure projects, rail and tunnelling, contract mining and petrochemical and power industries. But changes to regulations were introduced in 2002 and in 2004 that are seen by many contractors as a step backwards, being less cost effective and less flexible.

AUSTRALIA – CHINA SERVICES TRADE AND INVESTMENT GROWING

Resources and rural exports are the core of Australia's exports to China, but the combination of rising real incomes and reform of the services sector are boosting significantly services trade and investment between the two countries. Bilateral trade in services has expanded from A\$1.47 billion in 2000 to A\$2.34 billion in 2004, with Australia recording a surplus over the past five years.

China was Australia's 6th largest services export market in 2004, up from 13th largest in 1995. Australia's services exports to China have almost quadrupled from A\$350 million in 1995 to A\$1.3 billion in 2004, representing 3.7 per cent of Australia's total services exports. China is now Australia's number one source of overseas students and fifth largest source of tourists.

China was Australia's 8th largest source of services imports in 2004, up from 12th largest in 1995. China exported services worth over A\$1.0 billion to Australia in 2004, representing around three per cent of Australia's total services imports. Transport and travel dominate China's exports to Australia. Over the past decade, the number of Australian short-term visitors to China has grown over twice as fast as the total number of Australian overseas tourists.

Bilateral foreign investment has remained fairly modest relative to overall growth in bilateral trade between Australia and China. But there has been a significant turnaround in Australian investors' sentiment during the past two years and in 2004, Australian investors signed over 700 agreements committing over US\$2 billion worth of foreign direct investment in China. Meanwhile, China's investment in Australia rose from A\$1.2 billion in June 1997 to over A\$3.4 billion in June 2000 but dropped to just under A\$2.0 billion in 2004. The reasons for this drop are not fully understood but it is not interpreted as a trend because of the very lumpy nature of Chinese investment and the sometimes lengthy period between investment approval and actual cross-border transaction. China's largest and high profile Australian investments are in the resources sector reflecting China's aim to secure upstream resources for its ongoing rapid industrialisation.

The free trade agreement currently being negotiated between China and Australia will enhance bilateral trade in services and investment. It will provide an opportunity to reduce barriers further, streamline and improve transparency of regulatory requirements and facilitate improved mutual recognition of professional qualifications further enhancing trade in professional services.