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## WASHINGTON'S AGONIZING DECISION: TO EXTEND OR REVOKE CHINA'S MOST-FAVORED-NATION TRADE STATUS

### INTRODUCTION

The calendar is bringing difficult new tests for Washington-Beijing relations. Perhaps the most challenging will be the need for George Bush to decide by June 3 whether to recommend that the People's Republic of China – or the PRC – continue to enjoy most-favored-nation (MFN) trading status. Such status gives a country the lowest available tariffs on its exports to the United States. Some 178 nations now enjoy MFN trading status with the U.S.

China has had its MFN status renewed every year since it was first granted in 1980. This year, the issue is certain to receive more scrutiny from American policy makers than ever before. The reason: Beijing's continuing political crackdown since last year's bloody suppression of pro-democracy demonstrations understandably upsets many in Washington.

**Failure to Respond.** Also upsetting has been the failure of Beijing to respond to America's well-crafted and patient overtures. Five months after George Bush dispatched a secret high-level delegation to Beijing, China's elderly leaders remain unrepentant and intransigent, determined only to bring their nation under heel. Indeed, while much of the world embraces democracy, mainland China heads in the opposite direction. Amnesty for last June's demonstrators is forgotten; dissident Fang Lizhi, still taking refuge in the American Embassy in Beijing, remains a constant target of Beijing's abuse; Hong Kong's freedom is newly threatened; and critics of Beijing's crackdown, particularly American congressmen, are denounced as "foreign

hostile forces.” One Administration official told The Heritage Foundation: “It’s difficult to apply any political muscle, much less strategic argument, on behalf of the relationship because the Chinese have not responded with any conciliatory or significant measures.”

It is in this environment that Bush must decide whether to renew China’s MFN trading status. If he were to oppose continued trade concessions for China, or if Congress were to disapprove his recommendation to renew China’s MFN status, it certainly would send an unmistakable message of condemnation to Beijing. Indeed, there may be no other measure in the American arsenal of possible China sanctions that is as harsh. Denying MFN to China hurts Beijing because it would:

◆ ◆ **Dramatically raise duties on Chinese exports to America**, making China’s goods more expensive for Americans and less competitive in the U.S. For example, tariffs on footwear will increase from 5.3 percent to 80 percent. The CIA estimates that overall China would lose at least \$3 billion a year in exports.<sup>1</sup>

◆ ◆ **Cost South China’s export industries up to two million jobs**. Over the past decade of economic reform, Southeast China’s Guangdong and Fujian Provinces have benefitted enormously from China’s so-called “open door” policies to the world. The area’s sudden decline of fortunes resulting from America’s denial of MFN, particularly the rise in unemployment, could create additional political problems for Beijing.

◆ ◆ **Reduce Beijing’s access to much needed hard currency**. China’s current international debt is estimated by the U.S. Commerce Department to be \$45 billion. If the U.S. denies China MFN status, it is unlikely that China will be able to boost its exports to service this international debt. This would add to China’s economic squeeze and, perhaps, the elderly leadership’s unpopularity. The loss of hard currency caused by denial of MFN status immediately will reduce China’s ability to import products from abroad.

◆ ◆ **Isolate China internationally** by cutting off Beijing from a major market for its goods. After Japan, the U.S. is China’s largest overseas trading partner.

If Bush seeks to punish China, then his decision on MFN is easy. What makes it hard is that the costs of denying MFN status to Beijing not only will be paid by China, but also by America.

What is left of the once balmy U.S.-China relations will be the first to suffer. Beijing clearly will be outraged if Washington opposes renewed trade concessions. Chinese Foreign Minister Qian Qichen warns that lifting MFN would cause a “major retrogression” in Chinese-U.S. relations. In retaliation, Beijing likely would impose further restrictions on U.S.-PRC academic and

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<sup>1</sup> Lena Sun, “China’s Trading Status with the U.S. Becomes Issue,” *The Washington Post*, April 18, 1990, p. A32.

cultural exchanges and may even step up harassment or expulsions of American diplomats and journalists. The Chinese leadership also may cut off American access to top-secret listening posts on Chinese soil which intercept Soviet communications.

To these must be added other costs that the U.S. would bear if it denies MFN to China. Among them:

◆◆ **Increased price and reduced availability of popular Chinese-made products to American consumers and importers.** For instance, toys and games, which account for over 10 percent of America's total imports from China, would incur tariff hikes of up to 70 percent. Other favorite U.S. imports, like sweaters, would see tariffs increase from 6 percent to 60 percent.<sup>2</sup> These increased tariffs inevitably would translate into price hikes and would hit hardest low-income Americans who buy inexpensive China-made clothing and toys.

◆◆ **Loss of Chinese markets for U.S. exporters.** Beijing not only could retaliate by closing its markets to American exporters but likely would favor other foreign partners over the U.S. Beijing may turn to Moscow for airframes and engines and look to Canada or Argentina for agricultural imports, particularly cereals, which in 1989 made up 21.4 percent of America's exports to China.

◆◆ **Sapping the economic vitality of China's most dynamic region, the southeast, by eliminating a key foreign market.** It is estimated that over 13,000 enterprises employing 1.3 million workers in Guangdong Province process and assemble products for export to overseas markets, including the U.S. It is this region that has been pushing economic reforms and decentralization fastest and furthest and that has been most resistant to Beijing's hard line of the past year. In a sense, ironically, the most reform-minded part of China will be punished most if MFN is ended.

◆◆ **Enormous new problems for Hong Kong at a time when the colony least can afford anything that undermines confidence in its future.** According to the Hong Kong Economic and Trade Affairs Office in Washington, over 80 percent of Guangdong Province's export-related enterprises are directly related to Hong Kong business interests.

◆◆ **Increased Beijing dependence on arms sales for cash.** There is evidence that Beijing continues to sell weapons to the Middle East. Cutting off American markets to Chinese goods could force a desperate Beijing to look to the international weapons market for hard currency.

◆◆ **Isolating moderate elements within the Chinese leadership.** Significant evidence indicates that powerful underlying forces for reform and

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<sup>2</sup> William Armbruster, "Shaky Ties with China may Cost U.S. Importers," *The Journal of Commerce*, April 17, 1990, p.1.

development continue to operate on the mainland. Denying China MFN could undercut those reformist trends.

**Ending Special Treatment.** One last option would be for the U.S. to renew China's MFN status but make clear to Beijing that Washington now intends to do business with China in a brutally honest way. Meaning: No more free hand-outs or special concessions. MFN for China will be renewed on its economic merits, but the days when Beijing was treated as something special – as the so-called “good communist” – are gone.

Specifically, for example, this could mean that while in the past, Washington bowed to Beijing's pressure to support its admission into the General Agreement on Tariffs and Trade (GATT) before Taipei was admitted, now, Washington explicitly could combine renewal of China's MFN status with support for Taipei's bid to join the GATT. Economic merits alone, Washington policy makers could argue, would determine America's relations with Greater China. Taipei plays a role in the global economy far greater than its size and population. It is the world's thirteenth largest trading nation. Its \$73.4 billion in foreign exchange reserves is the globe's largest. GATT's effectiveness as the principal multilateral agreement covering international trade has been impaired by its exclusion of Taipei.

## WHAT IS MFN

Although the expression “most-favored-nation” suggests that a country is accorded special trading privileges, the term in practice actually means something quite different. Specifically, a country that is granted MFN status by another country is entitled to all the trade benefits and concessions that the latter grants to any other country. Thus, MFN does not confer a special trading status; it simply treats all recipients of MFN equally. In fact, the term “nondiscriminatory” is often used as a synonym for MFN.<sup>3</sup> This is how MFN works: if the U.S. has a 5 percent tariff on coffee imports, then that 5 percent tariff would apply equally to all coffee-exporting countries who have MFN status with America.

While the principle of most-favored-trading status was broadly extended in 1947 at the inception of the Geneva-based General Agreement on Tariffs and Trade (GATT), the principal multilateral agreement on world trade, Washington for over a decade had tendered MFN status to all its trading partners. MFN, American policy makers correctly figured, encouraged reciprocity in trade and helped eliminate or reduce international tariff barriers.

In mid-1951, however, Washington broke with the policy of according MFN status to all trading partners. The reason: the need to counter the mounting communist threat. In that year, Harry Truman signed into law Section 5 of the

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3 Title IV of the Trade Act of 1974, United States Code, Section 2431.

Trade Agreements Extension Act, which suspended MFN status to any country dominated by a communist system. Although the 1951 law left open some possibility of “discretionary restoration” of MFN status for “non-market economies,” the Trade Expansion Act of 1962 subsequently made such “restoration” possible only by the enactment of specific congressional legislation. Even so, only a handful of countries are currently denied MFN by the U.S. Federal agencies do not even keep a list of nations that enjoy MFN. It is much easier to keep track of the sixteen nations that do not have MFN: Afghanistan, Albania, Bulgaria, Cambodia, Cuba, Czechoslovakia, Estonia, East Germany, Laos, Latvia, Lithuania, Mongolia, North Korea, Romania, the U.S.S.R., and Vietnam.

## THE JACKSON-VANIK AMENDMENT

The policy of denying MFN status to all communist countries was changed by the Trade Act of 1974. Specifically, Title 4 of the Act, known as the Jackson-Vanik Amendment, named after the late Senator Henry M. Jackson of Washington and former Representative Charles A. Vanik of Ohio, both Democrats, states that MFN status can be restored to “non-market economies” if their countries permit substantially free emigration of their citizens.

The mechanics of granting MFN to communist countries thus has been rather simple. First, if the President at mid-year and at the end of the year reports to Congress that a “non-market economy” country is not violating the Jackson-Vanik amendment’s “freedom-of-emigration” provision and if either House of Congress does not disapprove the President’s report by a resolution, then MFN status can be extended or restored.<sup>4</sup> To fulfill Jackson-Vanik emigration requirements a country must not:

- ◆ Deny its citizens the right or opportunity to emigrate;
- ◆ Impose more than a nominal tax on visas and other required documents;
- ◆ Impose more than a nominal fee for emigration.<sup>5</sup>

Second, MFN status must be based on a bilateral trade agreement with the country in question. This trade agreement remains in force for three years, and is renewed automatically for an additional three-year period if the President determines that there has been a satisfactory bilateral trade balance and reciprocation of trade concessions. While exceptions to the rules have been made, such as with the 1982 denial of MFN to Poland and the 1987 denial of MFN to Romania on human rights grounds, granting MFN status to a country under the Jackson-Vanik amendment nonetheless largely is automatic as

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4 If the President determines that the extension of the waiver authority will substantially promote emigration he may recommend to Congress that such authority be extended for twelve months.

5 19 United States Code, Section 2432 (a) 1,2 and 3.

long as both the President's freedom-of-emigration waiver and the bilateral trade agreement stay in effect.

**MFN Benefits.** Waiver of Jackson-Vanick immediately makes a country eligible for many U.S. credit and insurance programs such as those offered by the Export-Import Bank (Eximbank) and the Overseas Private Investment Corporation (OPIC). Moreover, reduced tariffs on exports to the U.S. enjoyed by nations with MFN translates into lower-priced and more competitive exports. MFN not only reduces the price of imports in the U.S. but usually increases mutual trade and results in increased economic cooperation. A U.S. International Trade Commission report released this January concludes that U.S. trade increased with China, Hungary, Poland, and Romania after MFN was granted. Notes the report:

... it is safe to conclude that trade turnover [exports plus imports] increases after the extension of MFN status. This is the result of both the improved commercial and political climate that led up to and followed the extension of MFN status and the trade increasing effects of lower tariffs.<sup>6</sup>

## THE U.S., CHINA, AND MFN

The U.S. first moved to grant the People's Republic of China MFN status in October 1979 when Jimmy Carter transmitted to Congress a bilateral Sino-American Trade Agreement and a waiver of Jackson-Vanick amendment considerations. Both were approved by the Congress on January 24, 1980, and entered into force on February 1, 1980.

This U.S. trade agreement with China has been extended three times since 1980, most recently on February 1, 1989; the Jackson-Vanick waiver for emigration from China has been extended annually. Indeed, only three days before last year's Tiananmen Square Massacre, George Bush transmitted to Congress his recommendation for the annual extension of the Jackson-Vanick freedom-of-emigration waiver regarding China.

**Measured Response.** Although Congress discussed the suspension or termination of China's MFN treatment in the wake of last June's carnage in Beijing, Washington policy makers nonetheless decided to delay consideration of it. The thinking then was that other economic sanctions on China, such as suspending the U.S. Agency for International Development's \$20 million Trade and Development Program (TDP), better could express American condemnation of Beijing's brutality. This kind of sanction hurts the Chinese

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6 "Survey Views on the Impact of Granting Most Favored Nation Status to the Soviet Union" Report to the Senate Committee on Finance, United States International Trade Commission, January 1990, Washington D.C., p. H-3.

leadership more than it does the average Chinese because TDP usually helps major Chinese government-sponsored projects. Moreover, if sanctions such as TDP suspension were imposed, the American businessman would not be caught in the two governments' crossfire.

Washington policy makers thus concluded that preserving the expanding Sino-American commercial relationship was important. Over the decade of economic reforms, China rapidly became an important U.S. trading partner. Even with the souring relations after last June, U.S. exports to China last year were valued at \$5.8 billion, while imports from China topped \$12 billion, a total trade increase of 30 percent over 1988 levels. Only two decades ago, grain and cotton were the major U.S. exports to China. Last year, however, in addition to American grain, China bought American power generating equipment, aircraft, chemicals, and machinery. The principal 1989 American imports from China: electronics, footwear, sporting goods, textiles, and toys.

This flourishing trade relationship benefits not only the U.S. and China, but the British Crown Colony of Hong Kong as well. Taking advantage of the colony's excellent packaging and shipping facilities, some two-thirds of China's exports to the U.S. are transported through Hong Kong. In addition, at least one-quarter of Hong Kong's re-export trade was produced by factories in China operated by Hong Kong-based companies.

## EFFECTS OF MFN TERMINATION

If MFN to China expires, the tariffs and duties on 90 percent of Chinese exports would increase, some to rates ten times their current level. For example, the rate on stuffed toys would jump from 5.5 percent to 70 percent; on women's knit sweaters from 5 percent to 45 percent; and on audio tape players from 3.7 percent to 35 percent.

The jumps in tariff rates naturally would increase the prices of many Chinese products in American stores. Indeed, some goods may be priced completely out of the market by these high tariffs, a result that could force U.S. companies to switch to other foreign producers, a time-consuming and costly process. Toy companies like Mattel Incorporated and Kenner Products Incorporated, clothiers like Levi Strauss and Company, and department stores like K-Mart Corporation and The Limited, will be especially hard hit.

**Prices Hikes and Shortages.** Harder hit will be the American consumer. Saddled with high-priced Chinese goods, America importers inevitably will pass the extra expense on to the American shopper. Meaning: If MFN is denied to China, Americans should expect both price hikes and shortages of a wide array of Chinese-made products.

This contrasts with U.S. trade with the Soviet Union, against which the U.S. for decades has brandished the MFN weapon — although the Soviets may be given MFN at this month's superpower summit in Washington. Total U.S.-Soviet trade last year was \$5.03 billion: \$4.3 billion of American exports to the U.S.S.R. and only \$703 million of Soviet exports to the U.S. In contrast to

## U.S. - CHINA TRADE

### TOP TEN PRODUCTS IMPORTED FROM CHINA IN 1989

| PRODUCT CATEGORY               | AMOUNT IMPORTED<br>IN \$ MILLIONS |
|--------------------------------|-----------------------------------|
| Apparel                        | 2,657.2                           |
| Toys, Games and Sporting Goods | 1,725.4                           |
| Electronics                    | 1,638.0                           |
| Footwear                       | 721.0                             |
| Travel Goods                   | 683.0                             |
| Crude Petroleum                | 504.1                             |
| Power generating machinery     | 330.9                             |
| Fish                           | 297.1                             |
| Plastics                       | 237.1                             |
| Iron and Steel                 | 225.2                             |
| <b>Total Imports</b>           | <b>11,938.5</b>                   |

Source: Department of Commerce.

Heritage InfoChart

### TOP TEN PRODUCTS EXPORTED TO CHINA IN 1989

| PRODUCT CATEGORY                        | AMOUNT EXPORTED<br>IN \$ MILLIONS |
|---|-----------------------------------|
| Power generating Machinery              | 1,844.5                           |
| Cereals                                 | 1,126.5                           |
| Aircraft                                | 536.2                             |
| Fertilizer                              | 487.4                             |
| Chemicals                               | 347.0                             |
| Cotton yarn and fabric                  | 280.4                             |
| Wood and wood pulp                      | 269.4                             |
| Professional and scientific instruments | 278.7                             |
| Iron and steel                          | 267.7                             |
| Electrical machinery                    | 243.9                             |
| <b>Total Exports</b>                    | <b>5,837.40</b>                   |

Source: Department of Commerce.

Heritage InfoChart



China, which sells the U.S. mainly inexpensive textile goods and toys, Soviet sales are heavily weighted toward luxury items like caviar, furs, and high-priced vodka. Thus, while denial of MFN to the Soviet Union makes luxury goods more expensive for wealthy Americans, denial of MFN to China will penalize mainly working class Americans.

American business in China also would be hurt by tariff increases. Says Herbert Ryan, vice-president for investor relations at Dresser Industries, which exports \$100 million worth of mining equipment annually to the Chinese: "They tend to do business with their friends. It would be a disaster to penalize China at this point."<sup>7</sup> Scorned in the American market, Chinese trade officials and plant managers not only may turn to other markets to sell their goods but also may give preferential domestic treatment to America's competitors in China, principally Japan and the European Community. Almost certainly, China will look elsewhere to make major government purchases, particularly for grain. Finally, the reduction in Chinese exports to the U.S. will reduce China's access to foreign exchange, and thus its ability to purchase imports, including American products.

**Hong Kong Uncertainty.** Washington policy makers should be acutely aware, moreover, that ending China's MFN status will affect significantly the 5.6 million citizens of Hong Kong. Says Peter Lo, Minister for Hong Kong's Washington Economic and Trade Affairs Office: "Virtually every sector of Hong Kong's commercial and financial community would be affected if China lost MFN."<sup>8</sup> For one thing, of the \$8.5 billion of Chinese goods exported to the U.S. in 1988, \$5.5 billion worth, or 65 percent, was sent to Hong Kong first, and then re-exported to America. In 1989, Chinese re-exports through Hong Kong jumped to \$8.5 billion, or 71 percent. For another thing, recent figures suggest that at least 25 percent of Hong Kong's re-export trade came from Hong Kong-based companies with production facilities in China's Guangdong province.<sup>9</sup>

As Hong Kong's largest foreign market and one of its principal investors, U.S. interests lay in a politically assured and economically healthy Hong Kong. Uncertain about their future, 50,000 Hong Kong citizens leave the territory each year. Denying China MFN status may well speed the exodus.

## CONCLUSION

George Bush and the Congress, by June 3, must wrestle with the complexities of whether to extend China's MFN status. A good case can be made for denying China this status; a good case can be made for extending it.

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7 Armbruster, *op. cit.*

8 *Ibid.*

9 Government Statistics from Hong Kong Economic and Trade Office, British Embassy, Washington, D.C., March 21, 1990.

Adding to the complexity of the decision is that it must be made in an highly charged political environment. Over the past year, virtually every unilateral American effort to prevent U.S.-China relations from getting worse has been answered by Beijing with recalcitrance and contempt. Conceded Assistant Secretary of State Richard Solomon in February at a hearing before the House Subcommittee on East Asian and Pacific Affairs: "The general mood within the Administration is that the process of trying to rebuild confidence — a base-of political support in both countries for this relationship — is going to be a tough and probably extended business. But it has to be reciprocal. One side cannot just rush ahead trying to say we want to improve relations without any response, without any action, on the part of the other side."

**Washington's Challenge.** Whether denying future trade concessions to Beijing will bring about a desired Chinese response is the issue at hand. Penalizing Beijing may be exactly what is needed to convince China's aged leaders that they had better relax repression.

Combining renewal of China's MFN status with American support for Taipei's membership in the GATT possibly could send the same message or even magnify the message by rewarding Taipei's steps towards democracy.

Such measures, however, may impair, even end, the wide array of U.S.-China contact that remains the best vehicle to encourage Beijing's cooperation. A senior Bush Administration official told The Heritage Foundation: "It may be too big a fly swatter for the size of the fly." Washington will be challenged to determine just this in the coming weeks.

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## PENDING LEGISLATION

- ◆ **HR 2611** (Gilman et al.)    **Introduced:** June 13, 1989  
**Committees:** Banking, Finance and Urban Affairs, Foreign Affairs, Ways and Means  
Denies MFN status for Chinese exports and prohibits the use of U.S. funds for the negotiation, conclusion, or implementation of any commercial agreement with China. Provides for lifting of sanctions under specified conditions.
  
- ◆ **HR 2613** (Lantos et al.)    **Introduced:** June 13, 1989  
**Committees:** Ways and Means, Foreign Affairs  
Denies MFN status to Chinese exports.
  
- ◆ **HJR 503** (Kostmayer)    **Introduced:** March 6, 1990  
**Committees:** Banking Finance and Urban Affairs, Foreign Affairs  
Instructs the President to suspend, within the Coordinating Committee (COCOM), any liberalization of exports to China, and to oppose loans, grants and other assistance to China by either the World Bank or the Asian Development Bank.
  
- ◆ **S 1151** (Helms)    **Introduced:** June 8, 1989  
**Committee:** Foreign Relations  
Denies MFN status for Chinese exports and prohibits the use of U.S. funds for the conclusion or support of any commercial agreement with China. Provides for lifting of sanctions under specified conditions.
  
- ◆ **S 1241** (Moynihan)    **Introduced:** June 22, 1989  
**Committee:** Finance  
Requires the President to withdraw any portion of any trade agreement relating to MFN status of China, denies MFN status to China and prohibits granting of MFN status to China under Jackson-Vanik.
  
- ◆ **S 1278** (DeConcini)    **Introduced:** June 23, 1989  
**Committee:** Finance  
Same as S 1241, above.
  
- ◆ **S 1242** (Cranston)    **Introduced:** June 22, 1989  
**Committee:** Finance  
Same as S 1241, above, but provides for restoration of MFN under specified circumstances.
  
- ◆ **HR 1594** (Bentsen)    **Introduced:** March 22, 1990  
**Committee:** Finance  
Contains provision to change congressional approval of Jackson-Vanik MFN status from a "concurrent resolution" to a "joint resolution," eliminating the possible unconstitutionality of current law, which has been interpreted as allowing a single branch of Congress to veto a presidential action.

**Source:** Vladimir N. Pregelj, *Most-Favored-Nation Status of the People's Republic of China*, Congressional Research Service, March 16, 1990, and from other sources.

**Comparison of MFN and Non-MFN Tariff Rates  
on Selected Chinese Exports to the U.S.**

| <b>Product</b>                | <b>MFN Rate (%)</b> | <b>Non-MFN Rate(%)</b> |
|-------------------------------|---------------------|------------------------|
| Apparel                       | 3.7                 | 90                     |
| Petroleum                     | 3                   | 45                     |
| Textiles and fabrics          | 14                  | 113.5                  |
| Footwear                      | 5.3                 | 80                     |
| Metal manufactures            | 7.8                 | 110                    |
| Vegetables and fruit          | 5                   | 50                     |
| Fish and crustaceans          | 14                  | 110                    |
| Iron and steel                | 4                   | 45                     |
| Industrial machinery          | 6.5                 | 67                     |
| Sound recording<br>equipment  | 2.4                 | 35                     |
| Furniture                     | 14.5                | 90                     |
| Electrical machinery          | 13                  | 77.5                   |
| Coffee, tea, cocoa,<br>spices | free                | 40                     |
| Luggage and handbags          | 8.4                 | 90                     |
| Office machines               | 4                   | 45                     |
| Road vehicles                 | 3.1                 | 45                     |
| Textile fibers                | 1.8                 | 93                     |
| Scientific instruments        | 17                  | 110                    |
| Leather                       | 8                   | 50                     |
| Power generating<br>machinery | 10                  | 90                     |
| Chemical materials            | 18                  | 114.5                  |
| Paper                         | 4.9                 | 60                     |
| Live feed animals             | free                | 20                     |
| Dairy products                | free                | 35                     |
| Animal feed                   | 3                   | 20                     |

Source: Hong Kong Government.

Note: Many of these categories contain a number subcategories, each with a different U.S. tariff rate. The above list contains a single rate from each category, which does not necessarily apply to all exports within that category.