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China's Economy: Findings of a Research Trip

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ABSTRACT

China's economic ascendancy has aroused great interest in the Congress. The report combines first-hand impressions of China's economy derived with an analysis of publicly available economic data and reporting on the challenges facing China. Based on a December 1997 research trip, the report is intended to be useful to future congressional delegations to China, as well as those who monitor China developments on a regular basis. See also CRS Issue Brief 98018, China-U.S. Relations, and Issue Brief 91121, China-U.S. Trade Issues. The report will not be updated.

China's Economy: Findings of A Research Trip

Summary

China's economic ascendency has aroused great interest in the Congress. This report combines first-hand impressions of China's economy and U.S.-China commercial relations with an analysis of publicly available data and reporting.

China's economy presents divergent and contradictory images. On the one hand, it is dynamic with considerable potential to become a world class power in many areas. On the other hand, visions of China as an economic power constantly collide with the stark reality of the country's poverty, uneven development, and glaring structural weaknesses. While Asia's financial crisis has elevated a sense of urgency among Chinese officials to push forward with fundamental reforms of the country's banking system and state-owned enterprises, a slowing economy will make the reforms more difficult to carry out.

In the Hong Kong Special Administrative Region (HKSAR), most officials appeared confident that Hong Kong's special role as China's main source of finance and services would continue to grow in the future. Their confidence was based on Hong Kong's successful transition to date, and on China's own obvious self-interest in maintaining the HKSAR as its "Golden Goose." At the same time, the challenge that Asia's financial crisis is posing for both Hong Kong and China, as well as Hong Kong's own growing internal problems, illustrated that the so-called "one country-two systems" arrangement remains delicate, subtle, and vulnerable to stress.

China's economic expansion was seen to be having a huge, albeit uncertain, impact, not only on the rest of the world, but on China itself. The effects, both positive and negative, encompass shifts in world trade, production, and employment, the environment, foreign relations, and China's Communist and authoritarian system of governance. The rapid expansion of China's economy has also coincided with an intensification of U.S.-China commercial ties. China's market holds tremendous allure for a growing number of U.S. companies, but it remains a very difficult one in which to do business. Although China's reforms and economic dynamism are gradually improving the business environment, its domestic market remains substantially regulated, and there are few short-cuts to commercial success.

The U.S. trade deficit with China is large, rapidly expanding, and increasingly sensitive politically. For many Americans, the deficit symbolizes an imbalanced trading relationship where Chinese firms have relatively more access to the U.S. market than American firms have to China's market. Chinese and U.S. officials proposed divergent solutions for curbing the deficit.

China's bid to join the World Trade Organization (WTO) is widely viewed as an enormously important, complicated, and risky undertaking. Depending on the terms of the accession agreement, China's entry could either weaken or strengthen its own economy, selected U.S. economic interests, as well as the world trading system. It is not clear what forces or events might push either side to reach a compromise or mutually acceptable agreement.

Contents

China's Economy: Findings of a Research Trip

Introduction

China's economic ascendency has aroused great interest in the Congress. This report combines first-hand impressions of China's economy and commercial relations with the United States with an analysis of publicly available economic data and reporting on the challenges facing China.

The impressions derive from a bipartisan congressional staff research trip to China and Hong Kong, from December 2, 1997, thru December 14, 1997. The trip was organized by the U.S.-Asia Institute based in Washington, D.C.— the 38th such delegation it has sent to China since 1978. The Chinese People's Institute of Foreign Affairs (CPIFA) hosted the group in China and the Better Hong Kong Foundation arranged the program in Hong Kong.

In addition to Hong Kong, the group met with officials and businessmen in Beijing, Shanghai, Suzhou (a "small" city of 5.7 million people), and Kunming (capital of Yunnan, a southern province located to the north of Vietnam). Opportunities to visit industrial and cultural sites were also provided.[1]

The purpose of the trip was educational -- to gain information and insights on a variety of issues confronting the China-U.S. relationship. This was done through meetings with Chinese and American officials and visits to the cities and countryside. While most topics affecting the China-U.S. relationship were raised at least in passing, discussions focused primarily on China's economy and U.S.-China commercial ties.

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[1]In Beijing, meetings were held with the Chinese People's Institute of Foreign Affairs (CPIFA), the U.S. Embassy, the China International Trust and Investment Corporation (CITIC), the American Chamber of Commerce, the Ministry of Foreign Affairs, Boeing and GM representatives in China, and the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). In Suzhou, meetings were held with the Suzhou-Singapore Development Agency and with local officials of the foreign affairs office. In Shanghai, meetings were held with the Municipal Foreign Affairs Office, the LuJai Zui Finance and Trade Zone Development, and the Nike Sports Company. In Kunming, meetings were held with the Yunnan Foreign Affairs Office and with representatives from a state-owned aluminum company and a village-based enterprise producing flowers. In Hong Kong, meetings were held with the U.S. Consulate, the Hong Kong Trade Development Council, Vision 2047 Foundation, the Provisional Legislative Council, the Hong Kong Monetary Authority, U.S. Republican and Democrat Groups Abroad, the Securities and Futures Commission, the Stock Exchange, and the Ministries of Trade and Industry, Finance, and Justice.

This report is intended to be useful to future congressional delegations to China, as well as those in Congress who monitor China developments on a regular basis. As China is in the process of rapid change, the report provides a current snap-shot of a variety of economic developments, as well as official Chinese views on these issues. For background and more comprehensive treatment of the issues covered, the reader is referred to the CRS reports cited below.

The opportunity to visit China and talk with a number of its officials provided heightened appreciation, as well as a more nuanced understanding, of current economic trends and developments. Visually and verbally, China's immensity and complexity became clear, as well as the dilemmas it faces in making a transition to a more open economy. Observing China's efforts to modernize its economy on a massive scale, the delegation was struck by numerous contradictions, challenges to U.S. economic interests, and unanswerable questions. Recognizing that China's success in addressing its economic problems and engaging positively with the international system may well be a key to a prosperous and stable 21st Century, the importance of narrowing differences on the full range of the issues that divide China and the United States became clear. These overarching themes and impressions are elaborated on below in sections on China's economy and U.S.-China commercial ties.

China's Economy

The following principal findings concerning China's economy were derived from the trip and supplementary research.

- China's economy presents divergent and contradictory images. On the one hand, China's economy is dynamic, with considerable potential to become a world class power in many areas. On the other hand, the majority of Chinese people are poor, and China's economy remains hobbled by a number of glaring structural weaknesses;

- Most Hong Kong officials and businessmen with whom we met expressed confidence that Hong Kong's importance to China as a source of finance and services will continue to grow. Grounds for a more guarded assessment, however, became apparent based on the challenge Asia's financial crisis was posing for Hong Kong and China, and on Hong Kong's own growing internal problems. Thus, it appeared that the Hong Kong-China or "one country-two systems" arrangement remains delicate, subtle, and potentially vulnerable to stress;

- China's economic dynamism is having a huge, albeit uncertain, impact not only on the rest of the world, but on China itself. The effects, both positive and negative, encompass shifts in world trade, production, and employment, the environment, foreign relations, and China's Communist and authoritarian form of governance.

Divergent Images

Dynamism and World Class Potential. In numerous meetings, Chinese officials proudly reiterated that China's economic growth rate has averaged 10% per year over the past two decades, making it the world's fastest growing economy. Fueled by massive inflows of foreign direct investment, rising exports, and one of the highest personal savings rates (around 40% of GNP) in the world, this exceptional economic performance has translated into a tripling of per capita incomes. A better material existence is apparent from the provision of food, clothing, and housing for the vast majority of China's 1.3 billion people to the widespread availability of basic consumer durables such as refrigerators, washing machines, and television sets for an increasingly large number of households.[2]

China's growing prosperity was evident by explosive construction throughout the country (Shanghai reportedly has 20% of the world's high-rise construction cranes currently in operation) and by a proliferation of services such as restaurants, fashionable boutiques, movies, and discos in the cities. For the growing and increasingly consumer-oriented middle class, shopping and dressing fashionably is definitely "in."

The country's economic dynamism was also manifested by its hardworking and friendly people. From the ubiquitous shops and stalls on the back-streets and alleys in the cities to the production line of a silk factory the group visited in Suzhou, the overwhelming impression gleaned was one of purposeful activity and vitality.

An underlying psychological component of this dynamism was demonstrated by a widespread confidence that the country's path of "opening and reform" is the right one for China. Viewed from the large number of individual entrepreneurs providing hair-cuts, shoe shines, and bicycle repairs on the streets of Beijing, along with the omnipresent open-air food stands, it was clear that substantial numbers of Chinese are taking advantage of new opportunities to earn money "off" a growing market economy. The bargaining skills of vendors ensconced at the Great Wall and Stone Forest in Yunnan Province, as well as Jake's Jazz Band at the Peace Hotel in Shanghai (which charges $6 per requested song), were other memorable examples of capitalism in action.

The staff delegation also had the opportunity to witness a form of Chinese-style capitalism flourishing in the countryside with a visit to a town and village enterprise (TVE) located in Chenggog County, Yunnan province. This TVE , which is locally owned and managed, has grown rapidly from concentrating on producing vegetables for local markets to growing flowers for export markets. While answers to questions concerning the specific form of ownership and division of the "profits" were unclear, the enterprise appeared to be producing high quality flowers, prospering, and employing much of the village. China-wide, TVE's now account for around 40

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[2]For an overview of China's economy, see Morrison, Wayne M. *China's Economic Development: An Overview,* CRS Report 97-932 E. October 10, 1997, 6p.

percent of total industrial output and employ over 100 million surplus farmers who otherwise may have been enticed to migrate to China's overcrowded cities.[3]

China's economic dynamism has led the International Monetary Fund to predict China will surpass the United States as the largest economy in the world by 2007 -- in less than ten years!.[4] While such predictions are subject to many assumptions and are often wildly inaccurate, visits to one part of the Pudong Economic Development Zone in Shanghai, the Suzhou Industrial Township (SIT), and the Shanghai National Museum made a speedy economic ascendency for China seem plausible.

Situated directly opposite the famous Bund area, across the Huangpu River in what was marshy farmland a decade ago, is the Pudong Economic Development Zone. The zone was designed eight years ago to jump-start Shanghai's development, with the goal of making Shanghai into a world class financial and industrial city in the 21st Century.

One of the special zones within Pudong, known as the Shanghai Lujiazui Finance and Trade Zone, symbolizes China's lofty aspirations and opening to the outside world. The master plan calls for several 100-story skyscrapers to be surrounded by nearly one hundred 40-story high rise buildings, a 100,000 square meter Central Garden, and 100-meter-wide central avenue. Based on completion in less than 6 years of more than 20 buildings in the zone, including a state-of- the- art stock exchange that we visited on its opening day, and a 94-story World financial center, it was not hard to envision the zone surpassing its billing as "East Manhattan On Rise" in 5-10 years. The breathtaking vista from the 64th floor of a tall tower prompted one participant to note that she would never define the words "big" or "immense" in the same way again.

The Suzhou Industrial Township (SIT), located 40 miles east of Shanghai, is a cooperative project of the governments of China and Singapore. The township is designed to provide the foreign investor, particularly higher tech companies, an exceptional, "one-stop" environment in which to do business in China. Backed by an estimated $20 billion in new highways, buildings, and utilities, the SIT eventually will be able to support a population of 600,000 and employ over 360,000 workers -- 100,000 of whom had previously been farmers on the land taken over for the construction of the industrial city.

While some Hong Kong officials expressed skepticism that this Singaporean-backed venture would be successful because it was not consistent with the "Chinese way" of doing business, the undertaking seemed to a number of the group participants capable of attracting substantial foreign investor interest. Obvious advantages included ready-built factories, preferential tax policies, modern infrastructure, an abundant and cheap labor force, attractive location, and efficient management of the industrial site.

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[3]Harding, James. "Chinese Collectives' Pace Checked," *Financial Times*, January 6, 1998, p. 4.

[4]International Monetary Fund, *World Economic Outlook*, Washington, D.C. 1997, p. 15.

A morning spent touring the new Shanghai National Museum served as a reminder that China, throughout much of its history, has been more advanced than the West in art, science, and writing. The display of some of China's magnificent national treasures (paintings, scrolls, and ceramics) underscored the differences between the sources of China's past greatness and its contemporary advancements.

Poverty and Structural Weaknesses. Visions of China as an economic superpower or giant, however, constantly collided with the stark reality of the country's poverty and fundamental structural weaknesses. Despite innumerable signs of economic dynamism and power, along with substantial success in providing food, clothing, and housing for most of its 1.3 billion people, a majority of Chinese people are poor. Among the 900 million Chinese living outside urban areas, substantial numbers are extremely poor by any measure, and lacking in significant opportunities for a better life. A recent World Bank analysis places the number of Chinese living a harsh, below subsistence existence (less than $1 per day) at 350 million.[5]

Signs of China as a developing country were everywhere. In the cities they included the dilapidated, tiny, and cramped living conditions for non-apartment dwellers, the ever present bicycle parades at street intersections, and the amount of goods (and people) that are still being hauled, carried, and lifted by human beings. On a country highway in Yunnan Province, scenes of farmers bent over tilling tiny vegetable plots or rice paddies with the same basic hoes that have been used for hundreds of years, crumbling mud brick huts, and chickens hanging from poles provided a few eclectic and timeless glimpses of rural China.

Combined with many visual images of China's developing country status, we were briefed by numerous Chinese government officials on many of the economy's fundamental "structural" weaknesses that make predictions of China's unrelenting economic rise problematic. Among the weaknesses discussed in our meetings, mostly in conjunction with generalized concerns about the impact of the Asian financial crisis on China, were a weak and overextended banking system, pervasive corruption, a glut of unsold goods (including real estate), and a bloated and difficult-to-reform state sector.

Of these four daunting and inter-related problems, we gained a direct impression of the inventory problem as it affects real estate and the difficulties involved in state enterprise reform. As noted above, skyscrapers rising all over China was one of the most striking visual images we encountered. "Build and they shall come" seems to be the philosophy behind this massive building spree. But with vacancy rates for commercial real estate on the rise in the cities - an estimated 40% in Beijing — the developers are either going to be proved visionaries or go bankrupt.[6] Inevitably rents are falling rapidly, causing one U.S. company based in Shanghai to relocate to a more attractive building with a 50% reduction in its monthly rent.

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[5]The World Bank, *World Development Indicators*, Washington, D.C., 1997, p. 50.

[6]Wong, Yu. "Builders Do Battle for Beijing's Heart," *The Asian Wall Street Journal*, December 5-6, 1997, p. 1.

Based on a visit to a major aluminum company, the group also gained a clear picture of some of the difficulties involved in state enterprise reform. An estimated 70% of more than 100,000 state-owned enterprises (SOE's) currently are losing money in China. Putting an end to the losses and drain on government resources means cutting back on redundant workers and their "cradle to death" benefits. It also means bringing in new managerial expertise and methods for the SOE's that are going to be restructured and reinvigorated.

Our tour of the aluminum company provided some understanding of the magnitude of the restructuring challenge. At the factory site, underutilized resources were strikingly evident by the preserve of a rail line along the property line absent rail cars to move the aluminum. After a less than informative briefing by a senior manager, we toured what was essentially a self-contained town complete with a hospital, school, recreation facility, housing, and retirement quarters. Staring what the Chinese call "the iron rice bowl" in the face, we thought that even the most profitable western company would be hard pressed to defray these social welfare and unemployment costs simultaneously.

But China is moving ahead with efforts to streamline and downsize its state sector, and according to press accounts, at considerable risk. Street protests have been reported to be occurring regularly across China as the state sector is cut back. Official projections are that future cut-backs could increase unemployment from the official figure of 9.6 million to 30 million in two years.[7] In this context, rapid economic growth to absorb redundant state sector workers, as well as to provide jobs for the millions entering the labor force every year, appears critical if the restructuring is to be accomplished with a minimum of domestic turmoil.

Asia's financial crisis has elevated for most Chinese officials a sense of urgency in pushing forward with reforms. A top-level official from one of China's largest and most successful state-owned enterprises maintained that the crisis was the "economic equivalent of the end of the Cold War." If the recently announced reforms of the banking system are any indication, the crisis so far does seem to be serving as "wake-up call" for China to address its structural weaknesses.[8] But the economic difficulties the crisis will cause for China's exports and foreign investment inflows are bound to slow China's growth rate, thereby making it more difficult to carry out the reforms.[9]

Hong Kong's Role in China's Development

Serving as a gateway to China and as the major source of finance, design, and marketing, Hong Kong historically has exercised tremendous influence over China's

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[7]Johnson, Ian, and Craig S. Smith, "China's Economic Strength Belies Simmering Problems, *The Asian Wall Street Journal,* December 16, 1997, p. 1.

[8]Mufson, Steven. "Asian Crisis Spurs China to Revamp Banking System," *Washington Post* , January 17, 1998, p. A 22.

[9]Sutter, Robert G. *China's Changing Conditions: Possible Outcomes and Implications for U.S. Interests*, CRS Issue Brief 97049 [updated regularly]

growth. Currently, Hong Kong companies operate 50,000 factories, mostly in southern China, that employ more than 5 million Chinese. Hong Kong handles half of China's trade with the world, generates about one-third of China's foreign exchange, and accounts for over 55% of all foreign direct investment in the mainland.[10]

Since reunification, many more mainland "redchip" companies have looked toward Hong Kong to list on the Hang Seng stock exchange, raise capital, and improve managerial expertise. A visit to the hectic floor of the Hong Kong Futures Exchange, combined with a meeting at the Securities and Futures Commission, demonstrated why Hong Kong's financial markets are considered among the most sophisticated and deep in all of Asia.

Most Hong Kong officials and businessmen argued that Hong Kong's role as the major source of finance and services for the mainland would continue to grow in the future. They pointed to the successful transition to date, which has maintained Hong Kong's vitality and confidence, and to China's own obvious self-interest in maintaining Hong Kong as its "Golden Goose." At the same time, a case for a more guarded assessment became apparent based on the challenge Asia's financial crisis was posing for Hong Kong and China, as well as on Hong Kong's own growing internal problems.

By all accounts, Hong Kong's transition from British to Chinese sovereignty in July 1997 has gone much more smoothly than the western press anticipated. The Beijing authorities have allowed the Hong Kong Special Administrative Region (HKSAR) a high degree of autonomy under the "one country, two systems" principle. A continuing lively political debate in the press and in the streets, a continuing free flow of information, and adherence to the rule of law were mentioned frequently.

Impact of the Asian Financial Crisis. The feasibility of two different economic systems operating in one country is being tested most directly by currency pressures stemming from the Asian financial crisis. In the case of Hong Kong, the challenge has been for its monetary authorities to defend its dollar against speculative attacks. Hong Kong officials viewed the strength and independence of the Hong Kong dollar as a visible expression of the "one country, two systems" concept. In the case of China, the challenge has been for the authorities to resist a devaluation of its currency, the yuan, to keep its exports competitive with those from all the countries in the region that have recently devalued. Given the heavy degree of interdependence of the two economic systems, an inability or unwillingness of authorities in either Hong Kong or Beijing to carry through on their exchange rate pledges could have very substantial negative consequences for the other.

For Hong Kong, the price of defending its $7.8 Hong Kong dollar link to the U.S. dollar is higher interest rates. Under its currency board, every Hong Kong dollar or bank note must be backed by the equivalent in U.S. dollars. Whenever Hong Kong dollars are sold for U.S. dollars, the monetary base shrinks and interest rates

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[10]For background and analysis on Hong Kong, see Dumbaugh, Kerry. *Hong Kong's Return to China: Implications for U.S. Interests*, CRS Issue Brief 95119, [updated regularly].

rise. As a result, adjustments come immediately through changes in asset markets, such as property and stock prices, as well as through the closure of overextended or heavily indebted companies.

Most Hong Kong officials to whom we spoke appeared confident that its adjustment would be swift, but painful. They also believed that lower property prices and the stock market correction would help to boost Hong Kong's competitiveness over time, thereby solidifying its role as China's premier service and financial center.

In defending the decision to maintain the link, Hong Kong authorities also emphasized that their underlying economic fundamentals, which are the strongest in East Asia, will help protect their economy from the financial turmoil. These include solid GDP growth, the third largest foreign exchange reserve position in the world (U.S. 91.8 billion dollars in October 1997), no government debt, a fiscal surplus in excess of 2% of GDP in 1997, a healthy balance of payments position, and no external debt. In addition, the authorities emphasized that Hong Kong had no large stocks of underutilized buildings or industries propped up with government subsidies with which to contend.

While Hong Kong so far has been able to withstand the speculative attacks, future attacks cannot be ruled out. In addition to generalized concerns that Hong Kong cannot maintain its high cost structure in the middle of a region that has undertaken large-scale devaluations, there could be growing pressures to sell Hong Kong dollars from residents that may be losing confidence in the government's ability to generate jobs, adequate housing, and education. The bankruptcy of Peregrine Investment Holdings (the largest investment bank in Asia outside of Japan), lay-offs by Cathay Pacific Airlines, and a big drop in tourism are further testing the confidence of Hong Kong residents.[11] The government's handling of the "bird flu" crisis has also reportedly undermined the public confidence and contributed to a rising level of public dissatisfaction.[12]

Future Considerations. At the same time, any move by Beijing authorities to devalue the yuan, to keep its exports competitive with the rest of Asia, could undermine efforts to stabilize regional economies by perhaps sparking another round of competitive devaluations. A devaluation could also damage confidence in the territory's new leaders, and lead to a massive sell-off of Hong Kong dollars.

On the basis of this one issue, the staff delegation obtained a glimpse of the degree that the Hong Kong - China or "one country, two systems" arrangement remains delicate, subtle, and vulnerable to stress. Loss of confidence in the leadership of either Beijing or Hong Kong on any number of issues could effectively torpedo or undermine the experiment severely.

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[11]Richburg Keith B. "Hong Kong Braces fro 2nd Wave of Woes," *Washington Post*, January 26, 1998, p. A 20.

[12]Richburg, Keith B. "Hong Kong Faulted On Handling of 'Bird Flu' Crisis" *Washington Post*, January 4, 1998, p. A 17.

Assuming that the transition continues along its present course, Hong Kong officials projected confidence that China by the year 2047 would become more like Hong Kong than vice versa. Their mind-set was reflected in the comment that "Hong Kong took over South China long before China took over Hong Kong," and they saw little reason why the takeover would not continue to move north.

In addition to the smooth transition to date, the optimism of most Hong Kong officials and businessmen that China would move increasingly towards Hong Kong's standards of free markets, a free press, freedom of choice, and the rule of law rested on the future generation of Chinese middle managers. These future leaders, many of whom have been educated abroad, have known nothing but "reform and opening" to the outside world as China's main policy orientation. According to one Hong Kong official, their mind-set is shaped by the American dream and a sense of optimism that their lives will be materially better than their parents -- not by any recollection of Mao Tse-Tung.

Effects of China's Rising Economy

As mentioned earlier, it is difficult to find words that can adequately describe the scale of China's economic revolution. Encompassing nearly one-quarter of the world's population, the movement since 1979 to energize a stagnating economy with market forces has been nothing short of massive and breathtaking. To date, these policies have transformed southern China's appearance and outlook in fundamental ways. The spread of this economic revolution to the rest of China is bound to have major impacts on the world, as well as on China itself.

Effects on the Region and World. China's immense productive capacity provides tremendous potential to compete with foreign production throughout Asia and the world economy. The government's still significant control of the economy allows it to create competitive advantages by attracting sophisticated technology transfers that can be combined with a low wage labor force and less enforceable environmental standards. Already China has made some steps from being primarily an exporter of labor-intensive products such as apparel, toys, and footwear to an exporter of increasingly higher-valued added products such as consumer electronics that are being produced by foreign joint ventures.

It is easy to see how China's growing industrial prowess can generate acute apprehensions that it can cause huge shifts in trade, production, and employment almost anywhere in the world. Recent accounts of huge gluts of unsold goods (in which China was described as the "mother of all inventory problems") add to concerns that many Chinese products can be easily "dumped" on world markets at prices that are below the cost of production, economically speaking. But with an estimated $361 billion in goods stockpiled at the end of 1996, press reports suggest that China has been tackling the problem by "liquidating stocks built up before 1995 and writing off losses against capital or profits."[13]

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[13]Smith, Craig S. "Asia's Glut of Unsold Goods Signals Deflationary Trend," *The Asian Wall Street Journal*, November 27, 1997, p. 1.

In a macro sense, Chinese officials demonstrated sensitivity toward the broad issue of the prospective destabilizing impact its exports could have on other countries by firmly reiterating the government's determination to resist a devaluation of the yuan. This decision was based substantially on the understanding that such an effort to increase China's export competitiveness could undercut regional stability. At the same time, some Chinese and Hong Kong officials appeared to show less sensitivity for the very real costs that specific export surges could impose on foreign workers and communities. A developing country mind-set -- how can a poor country possibly "injure" a rich country-- seemed to prevail.

China's rising economy also poses tremendous environmental challenges. In its drive towards industrialization, China has become one of the world's most polluted (both air and water) places in the world. Views of Beijing's skyline, for example, are measurably constrained by heavy smog, and pollutants in the air can make strenuous physical exercise unhealthy. Caused largely by the burning of mostly low-quality coal for heating buildings and running factories, a thin layer of black soot not uncommonly can be detected on one's clothes after a day of meetings.

China's reliance on coal (it has vast reserves) will have huge potential effects on global warming and depletion of the ozone layer. It also poses huge costs to China itself. The World Bank estimates these costs in terms of shortened life spans, and lost production to be equivalent to 8% of the country's total output each year.[14]

Chinese officials recognize that the industrialization of their huge country is placing incredible pressures on the environment, both domestically and globally. But they argue that they have put in place rigid environmental requirements (which allegedly are widely skirted through pay-offs to local officials) at an earlier stage of development than most other countries. Given severe budget constraints and the pressures to develop economically, they maintain that the government has few alternatives to heavy reliance on cheap coal as China's primary source of energy. Moreover, as Northern China possesses most the country's high quality coal, a large amount of coal must be shipped from the north to the south, putting a huge strain on an already overburdened transportation system.[15]

China's economic development imperative, on the other hand, was seen by the Chinese to be having a very favorable impact on its relations with the rest of the world. In order to focus priority attention on raising the living standards of its people and developing national power, Chinese officials clearly expressed a strong interest in building smooth and harmonious relationships with nearly all important countries. Themes of peace, friendship, and cooperation were constantly intertwined with discussions bearing on the economic development of China. In proudly pointing out their success in winning designation as the site for an International Horticultural Exposition to be held in 1999, officials from Kunming, for example, emphasized

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[14]Johnson, Ian. "China Fights to Contain Emergence of Megacities," *The Asian Wall Street Journal* , December 12-13, 1997, p. 1.

[15]Sentori, Jonathon E., David G. Fridley, and James Dorian. "China's Energy Future: The Role of Energy in Sustaining Growth," In U.S. Congress. Joint Economic Committee. *China's Economic Future: Challenges to Policy.* August 1996, p. 247.

that the event not only could provide their economy with a big boost, but could also help promote international friendship and cooperation.

A more friendly and open China, however, does not translate necessarily into a less nationalistic and sensitive China. While the Chinese officials with whom we met with reiterated the need to work pragmatically to establish smooth relationships with key countries, such as the United States, as a way of achieving economic modernization and national power, they did not refrain from expressing distress over U.S. criticism of China. A package of bills that passed the House of Representatives in November 1997, was a particular target of extreme sensitivity.[16] Maintaining that the legislation was "anti-Chinese," some Chinese officials warned that the legislation could ignite a nationalistic backlash against the United States. Explanations put forth by the delegation of some of the domestic political considerations and frustrations behind the legislation, including Chinese human rights violations and proliferation lapses, were not readily accepted or appreciated by the Chinese side.

Effects on China. Compared to possible external impacts, potential reverberations of China's economic revolution on itself appear as an even greater unknown. As elements of capitalism continue to spread throughout the economy, an overriding question bears on the future of the communist party.[17]

Chinese officials maintained that communism was still a long-term goal, and they emphasized that the party's decision to pursue a "socialist market economy" -- which can be defined as free market institutions with major economic policies and industries controlled by the state -- would bring China closer to that vision in some distant future. In particular, Deng Xiaoping's decision in 1992 to apply pragmatic and non-ideological tests to reform proposals (do they contribute to China's development and modernization?) was frequently cited by Chinese officials as a seminal event. One participant in our group likened this decision as equivalent to letting "innumerable economic-genies" out of the bottle.

The subsequent observed rise in individuality, consumerism, and the competition for getting rich all appear to be potent and irreversible forces. Dubbed by one participant "the dominoes of capitalism," a number of group participants wondered how these developments ever could be put back into a Communist bottle? And as China's middle class continues to grow, it seemed likely that there would be increased demands for more freedom, less corruption, and a cleaner environment.

At the same time, the vision of a fully individualistic and capitalist China raised its own set of questions. On the one hand, given its immense population and regional disparities, how could China stay together if it did not maintain a large dose of re-distributive socialism and the trappings of a welfare state? Given these challenges, could the frequently stated concerns of Chinese officials for stability be automatically

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[16]For background on the so-called "Cox legislation," see Dumbaugh, Kerry. *China: Pending Legislation in the 105th Congress,* CRS Report 97-933 F, updated January 22, 1998, 11p.

[17]For background on China's political conditions, see Sutter, Robert G. *China's Changing Conditions: Possible Outcomes and Implications for U.S. Interests,* CRS Issue Brief 97049, January 2, 1998, 15p.

dismissed as self-serving excuses for maintaining tight control over political dissent and for stonewalling on democratic reforms? On the other hand, could not the constant concerns of Chinese officials about stability be mostly an excuse for staying in power? And could China's deficiencies in the areas of democracy, human rights, and rule of law actually be key factors that are keeping the country economically backward?

While there were no easy answers to any of these questions, it seemed likely that as long as the economy continues to generate higher living standards for the vast majority of the people, the legitimacy of the Communist Party could remain substantially unchallenged. But in the event of a serious economic decline, it is much less clear what forces (beyond authoritarian rule) can hold the country together. Certainly, the marked absence of communist propaganda throughout the parts of the country we visited suggested that ideology may not serve as very strong glue.

Discussions with a number of U.S. company representatives put a somewhat different twist on this speculation. They noted that economic reforms have been accompanied by a considerable devolution of authority from Beijing and the central party organs to provincial and local authorities. While this process has made China a more free-wheeling business environment, it has also been accompanied by rising levels of corruption. In many cases, the greater difficulty of dealing with local authorities to obtain permits to do business has prompted them to bemoan the loss of predictability associated with a more centralized authority.

Commercial Relations with the United States

The rapid expansion of China's economy has coincided with an intensification of U.S.-China commercial ties. Since China launched its "opening and reform" policies, China has become a more significant trading partner and destination for U.S. foreign direct investment. Problems and tensions associated with the perceived allocation of the benefits derived from closer commercial ties has promoted intensified efforts to negotiate China's entry into the World Trade Organization (WTO).[18]

The main findings bearing on U.S.-China commercial relations that were derived from the research trip are as follows:

- China's market holds a tremendous allure for a growing number of U.S. companies, but it remains a difficult market in which to do business. Although China's reforms and economic dynamism are gradually improving the business environment, its domestic market remains substantially regulated, and there are few short-cuts to commercial success;

- The U.S. trade deficit with China is large, rapidly expanding, and politically sensitive. U.S. and Chinese officials proposed divergent solutions for curbing the deficit;

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[18]For background on U.S.-China commercial relations, see Morrison, Wayne M.. *China-U.S. Trade Issues,* CRS Issue Brief 91121, January 15, 1998, 16p.

- China's accession to the WTO is an enormously important, complicated, and risky undertaking. Depending on the terms of the accession agreement, China's entry could either weaken or strengthen the Chinese economy, selected U.S. economic interests, and the world trading system. It is not clear what forces or events might push both sides to conclude a compromise or mutually acceptable agreement.

China's Mixed Business Environment

Spurred by economic reforms and investment incentives introduced since the 1980s, China has become the world's second largest (the United States is the largest) recipient of foreign direct investment. While China's inflows of foreign direct investment grew on average by a few billion U.S. dollars in the 1980s, it began to surge in the early 1990s. In 1992, inward investment totaled $11 billion, only to rise nearly fourfold to $40 billion in 1996. Accounting for 13% of China's total investment in 1996, China's economy has become dependent on foreign capital infusions for a continuation of its rapid growth.[19]

Hong Kong and Taiwan accounted for over two-thirds of the $172 billion in cumulative foreign direct investment China received in the aggregate by 1996. U.S. companies are the third largest investors, accounting for about 8% of the total foreign direct investment.[20]

The American Chamber of Commerce in China, headquartered in Beijing, represents around 400 companies that are invested in China. They include most of the largest and well-known U.S. companies such as Boeing, Caterpillar, Citibank, General Motors, Kodak, Motorola, Nike, and Procter& Gamble, as well as a growing number of smaller and more specialized companies. The companies are producing and doing business in a wide spectrum of industries, ranging from footwear and apparel to cellular phones and computers.

The reasons why so many U.S. companies have invested in China are varied. For many, the most compelling reason is China's rapid growth and huge potential market for both consumer durables and capital goods. But blocked by a formidable array of trade barriers, many U.S. companies have found that producing in China is the only effective way of selling their goods to Chinese consumers or companies. China, as many other developing countries have done in the past, effectively encourages foreign investment through a range of performance requirements. Some of the most common ones stipulate that production technology be transferred to a joint venture partner or that a certain percentage of the company's production be

[19]Morrison, Wayne M. *China's Economic Development: An Overview,* p. 4.

[20]Ibid.

exported.[21] The fact that exports from foreign invested companies accounted for 47% of the total value of China's exports in 1997 attests to the policy effects.[22]

More specific motivations of American companies for investing in China vary greatly from sector to sector. For some producers of toys and clothing, for example, a primary attraction has been to utilize China's low-cost labor for assembly operations geared toward exporting. For some U.S. multinationals, such as General Motors, investment in China's automotive market is viewed as part of the company's global and regional competitiveness strategy, as well as to tap the rising demand in China for autos and auto parts. For a number of banks and insurance companies, the motivation is merely to develop a market foothold in anticipation of a more liberalized and less restrictive environment in the future.

In a luncheon meeting hosted by AMCHAM, representatives of U.S. companies expressed declining enthusiasm and increased frustration for doing business in China. A top concern was that only a few companies, such as Boeing, Procter &Gamble, Motorola, and Gillette, supposedly were making any money off their considerable investments. Frustrations were directed at a number of Chinese obstacles: excessive red-tape and restrictions on the scope of permissible business activities; weak and non-transparent laws, and inconsistent enforcement of rules and regulations.[23]

Company representatives shared different specific concerns. One complained that foreign companies operate on a completely different standard than Chinese companies on a whole range of issues including taxation and distribution. A second focused on the extensive efforts required to cultivate the right local and provincial officials, as China's legal framework for doing business remains undeveloped. A third complained about how difficult it was to get government officials to honor commitments without resorting to side payments, which are illegal under U.S. law.

Despite problems and disappointments, a number of U.S. companies see China's business environment improving incrementally as the process of economic reform deepens and as China's growth comes to depend increasingly on foreign capital. Citing a 30% decline in foreign investment commitments in 1997, several representatives opined that Beijing would soon move to restore a number of foreign investment incentives that were revoked or reduced in 1995.

Several company representatives stated that there are no short-cuts to operating successfully in China. A long-term time commitment and deep pockets were cited as necessary pre-requisites. According to one representative, many U.S. companies initially overestimated how big the relevant Chinese market was for their particular product and underestimated how much time and money it would require to develop the market.

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[21]Mastel, Greg. *The Rise of the Chinese Economy: The Middle Kingdom Emerges*, ME Sharpe, 1997, pp. 116-117.

[22]Chen, I-Chun. "China's 23% Exports Rise Pushed 11-Month Surplus Past $40 billion," *The Asian Wall Street Journal*, December 15, 1997, p. 13.

[23]These complaints are summarized in briefing papers prepared by AMCHAM, Beijing and available from CRS.

The importance of picking the right joint venture partner to facilitate dealings with the state-owned enterprises (SOE) was also emphasized. As one U.S. executive commented: "An SOE is behind everything. They are wired differently and you can't touch anything commercial without touching something government-oriented or owned." Knowing where the joint venture partner is connected in the Chinese system, and making sure that partner is not a front for someone else, was viewed as critical.

Finally, several U.S. executives pointed out the importance of "working" China's system. Disputes and misunderstandings with joint partners and local authorities can sometimes be resolved by making appropriate representations to the U.S. Embassy and Chinese authorities in Beijing. Given China's growing dependence on foreign capital for its economic growth, U.S. companies are not without leverage.

Growing U.S. Trade Deficit

The United States is experiencing a large and rapidly growing trade deficit with China. The deficit has jumped, according to U.S. Department of Commerce statistics, from $10 billion in 1990 to an estimated $50 billion in 1997. This has made China the second largest country source of the overall U.S. trade deficit. If current trends continue, China could easily replace Japan in 1998 as the largest deficit trading partner of the United States.

The growing trade imbalance is a politically sensitive issue. For many Americans, the deficit symbolizes an imbalanced trading relationship where Chinese firms have relatively more access to the U.S. market than American firms have to the Chinese market. As in the case of Japan, the trade deficit number rightly or wrongly is often used in the press and in government circles as a proxy for the state of the overall U.S.-China commercial relationship.

While a number of the Chinese officials we met disputed the size of the imbalance, most were acutely aware that it presented a political problem that both sides had to deal with.[24] Somewhat surprisingly, none of these officials argued that the deficit should be ignored or tried to defend the imbalance on the grounds of standard economic theorizing (i.e., that bilateral imbalances do not matter because trade is multilateral, or that trade balances are driven by macroeconomic forces and not by trade barriers).

Our discussions indicated, however, that the U.S. and Chinese sides have strong differences over why the United States is exporting much less to China than it is importing. U.S. embassy officials unequivocally pinpointed the closed nature of the Chinese market as the biggest cause of the U.S. trade deficit. One official argued that

[24]By Chinese data, which do not count Chinese goods that move through Hong Kong as exports, its trade surplus with the United States is only one-fourth of what U.S. data indicate. For discussion of the discrepancy, see Wessel, David. "Big Discrepancy Exists Between Data From the U.S. and China on Trade Deficit," *New York Times*, January 22, 1998, p. 2.

as China's economy grows at around 9% per year, its imports from the rest of the world would not be growing at only 1-2% if market forces were free to operate. Instead, the Chinese market was characterized as being "politically organized and manipulated." Many layers of overlapping tariff and non-tariff barriers were said to be denying U.S. exporters a level-playing field.

Chinese officials attributed the poor performance of U.S. exports to three factors. The first was the poor financial position of innumerable large SOE's -- a situation that has lowered their demand for imports, particularly raw materials.

The second related to the availability of U.S. concessionary export financing, as well as self-imposed restraints on U.S. exports. Chinese officials argued that Japanese and European exports were often favored because of the more attractive government-subsidized financing. They also argue that post-Tiananmen Square-imposed restrictions on export financing to China (Eximbank) and suspension of other export promotion and insurance activities sponsored by the Trade and Development Agency (TDA) and the Overseas Private Investment Corporation (OPIC) were hurting U.S. exports.. In addition, one official argued that U.S. export controls, particularly as they relate to dual-use items (civilian technologies with military applications), such as supercomputers and sale of U.S. nuclear power generating equipment, were curtailing U.S. exports.[25]

A third factor allegedly contributing to a weak U.S. export performance was uncertainty caused by the annual debate in Congress over China's MFN status. Under this view, which was echoed by several large U.S. company representatives, the annual debate was judged to have a chilling effect on the kind of business confidence that is necessary to conclude a number of mostly long-term sales agreements.

U.S. and Chinese solutions for curbing the imbalance diverged. The U.S. side argued that China needs to move aggressively to dismantle its formidable array of formal and informal trade barriers. The Chinese side maintained that U.S. export performance problems are primarily self-inflicted and could be solved by lifting restrictions on export financing, sales of high-tech goods, and by granting China unconditional, permanent MFN status.

Impasse Over WTO Accession

China has been negotiating for over ten years to join the General Agreement on Tariffs and Trade (GATT), and its successor body, the World Trade Organization (WTO). Chinese officials indicated that membership would provide it with greater assurances that its exports, which account for 20% of GDP, would gain greater and more assured access to world markets. They also indicated membership would

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[25]U.S. sources indicated that Tiananmen Square sanctions affecting Eximbank have not effectively restricted its program in China and that an easing of restrictions on U.S. nuclear power generating equipment is under consideration.

provide "reformers" with greater leverage in internal economic policy debates, as well as carry symbolic prestige for joining the world trade grouping.[26]

U.S. embassy and company representatives explained why China's accession "on commercially viable terms" is a top U.S. priority. The main reason cited was that China would have to eliminate or curb its trade, investment, and industrial policies that have the potential for disrupting global trade. Distortions caused by government-imposed trade barriers at the border, by investment performance requirements, by policies designed to build-up "pillar" industries, and by subsidies were flagged as overriding concerns. A more open Chinese market was judged to facilitate increases in U.S. exports as well as to strengthen U.S.-China relations.

While China's membership in the WTO promises to yield large-scale economic and political benefits for both sides, reaching a mutually acceptable accession agreement has been immensely complicated. Central to the impasse has been China's insistence on joining the WTO as a developing country. This would provide China very lenient treatment, primarily by allowing exemptions or flexibility to phase-in WTO responsibilities over a very long time period. A long time-frame for phasing in its obligations would obviously help China deal with the very real social adjustment costs and pain that liberalization will force on its people.

Although China's claim for developing country status appears reasonable based on its low per capita income level, its size and international competitiveness in selected industrial areas suggests that special protections or exemptions could prove quite disruptive to global trade, production, and employment patterns. For example, if China were exempted from WTO disciplines on subsidies or investment performance requirements, the trade and economic interests of many other countries could be put in harm's way. Similarly, if Chinese trade barriers and interventionist practices were not significantly altered, the source for much of U.S.-China trade friction would remain.

The task of negotiating an accession agreement that balances China's social and political needs against the requirements of the world trading system, as well as U.S. national economic interests, is formidable and complex. To meet the bottom-line objectives of both China and the United States, both Chinese and American officials appeared to recognize that compromise on both sides will be required.

However, none of the officials interviewed on either side conveyed the impression that WTO accession was a pressing priority. Chinese officials emphasized the long-term benefits, but they also indicated that accession could not be accomplished by sacrificing the country's development needs. U.S. officials recognized that even a "good" accession agreement would not level the playing field with China for decades to come. Given these different perspectives, it was not clear what forces or events might move the two sides toward concluding a compromise agreement.

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[26]For background and analysis, see Holliday, George and Robert G. Sutter, *China's Application to the World Trade Organization: Implications for U.S.-Chinese Relations,* CRS Report 97-348E, October 1, 1997, 18p.